Chapter Summaries

Chapter 13: The Pursuit of Equity in Taxation

Chapter 13 begins with a number of short introductory sections on taxation and taxes that make the following points:

1. The main normative issue of taxation is the effect of taxes on social welfare, that is, on the public interest in efficiency and equity.
2. The two main positive issues of taxation are the effect of taxes on consumption (saving), investment, and labor supply, and the incidence or burden of individual taxes.
3. Public choice adds a concern for how best to limit the legislature's power to tax.
4. A broad-based tax is a tax levied on many products or factors of production and paid by many individuals or firms. The six broad-based taxes that governments use are: the personal income tax, the payroll tax, the corporation income tax, the property tax, the general sales tax, and the value added tax. Economists are also interested in the personal expenditures tax, a variation of the personal income tax that deducts saving from the tax base.
5. The five goals of tax policy are: ease of collection (from the point of view of Departments of Revenue); ease of compliance (from the point of view of the taxpayers); flexibility (a macroeconomic goal that refers to the ability to change tax liabilities quickly and that the changed tax liabilities then have a rapid and substantial effect on the economy); efficiency (since taxes generate inefficiencies, the goal is to collect a given amount of tax revenue with the least amount of inefficiency); and end-results equity.

The chapter then notes that the previous chapters on public expenditure theory have already described quite a number of different taxes as part of the expenditure theory, including: the lump-sum taxes (and transfers) to satisfy the interpersonal equity condition for a social welfare maximum; Pigovian taxes to correct for externalities; marginal cost prices for decreasing cost services; and Lindahl prices (taxes) for non-exclusive goods. The following points are stressed.

6. These taxes can only promote social welfare, either by promoting end-results equity (the lump-sum taxes (transfers)) or efficiency (the last three taxes).
7. If lump-sum taxes were feasible, there would be no normative theory of taxation separate from public expenditure theory. Either the specific taxes mentioned above are used to promote efficiency or tax revenue is raised lump-sum, in which case it is tied in with the interpersonal equity condition. Broad-based taxes are, unfortunately, not lump-sum, so they have their own set of efficiency and equity issues.

The chapter then focuses on the pursuit of equity through taxation, beginning with a review of what has been said in the previous chapters.

8. The mainstream view is that equity and efficiency have to be considered together. Atkinson's three assumptions about the social welfare function – equal social marginal welfare weights for people in the same economic circumstances; identical tastes; and diminishing marginal utility of income – by themselves imply perfect equality, with everyone having the mean level of income. Inequality has to be justified and it is by the three inefficiencies of taxes symbolized by Okun's leaking bucket – administrative costs, compliance costs, and deadweight efficiency loss in markets. The goal for taxation is to achieve the best balance between efficiency and equity.
9. The only other equity principle mentioned is the benefits-received principle of taxation, which has standing as an equity principle among the general population but not in the mainstream public sector theory. Its only use is as an efficiency principle. Adam Smith and John Stuart Mill wrote at a time when the only equity principle of taxation was the benefits-received principle. They proposed a new equity principle, the ability-to-pay principle, which views taxation as a necessary sacrifice for the social good.
10. Smith and Mill argued that people should sacrifice through the payment of taxes in accordance with their ability to pay. In addition, taxes should honor the two subprinciples of horizontal equity and vertical equity.
11. The quest for horizontal equity is the search for the ideal tax base, since two people with the same amount of the tax base would pay the same amount of tax.
12. The quest for vertical equity is the search for the ideal tax structure, which consists of the tax rate(s) applied to the tax base and any allowable deductions and exclusions from the tax base.

The quest for horizontal equity:

13. Robert Haig and Herbert Simons, writing in the 1920s and 1930s developed the following three principles for determining the ideal tax base:
    a. People ultimately bear the burden of taxation;
    b. People sacrifice utility when they pay taxes. This led to Martin Feldstein's proposals for horizontal and vertical equity:
        i. Horizontal equity: Two people with equal utility before tax should have equal utility after tax.
        ii. Vertical equity: No reversals in utility. If person #1 has higher utility than person #2 before tax, then person #1 should have higher utility after tax.
    c. The ideal tax base is the best surrogate measure of utility.
14. Haig and Simons argued that income was the best surrogate measure of utility, defined as the increase in purchasing power during the year. In the parlance of the national income accounts, Haig–Simons income (Y_{HS}) equals personal income plus capital gains. $Y_{HS} = PI + CG$. Two people with the same Y_{HS} should pay the same tax. Y_{HS} is commonly referred to as the comprehensive tax base (CTB).
15. The various sources and uses of income should not matter in determining a person's tax liability, but in fact do matter under the U.S. personal income tax.
    a. Sources of income: whether income is in the form of personal income or capital gains; whether income is earned or unearned; and the sources of earned income, including whether income is cash or in kind.
    b. Uses of income: whether income is consumed or saved; what goods and services a taxpayer buys; and whether capital gains are accrued or realized.
16. The only legitimate deduction from Y_{HS} in computing taxes is business expenses.
17. The tax base should be indexed for inflation so that Y_{HS} reflects purchasing power that is invariant to the inflation rate.
18. All other taxes besides a personal income tax that uses Y_{HS} as the tax base are inappropriate, because they lead to the possibility that two people with the same Y_{HS} would pay different taxes.

The chapter then shows, using the labor–leisure model, that Y_{HS} can be a poor surrogate measure of utility.

19. If people have the same tastes for labor and leisure and the same opportunities (same wages), then Y_{HS} is a perfect surrogate measure for utility, but so is anything else that is commonly consumed or supplied by identical people. If tastes and/or opportunities differ, however, then Y_{HS} can be a misleading measure of utility. The problem is that income captures only part of what generates utility; it misses the value of leisure. Many mainstream economists believe that consumption is the better tax base, by the following arguments:

20. Utility should be measured over a person's lifetime, not annually as it is in arriving at Y_{HS} as the ideal tax base. Two people with equal utility over their lifetimes before tax should have equal utility over their lifetimes after tax (discounted to present value, which is described in Chapter 20).
21. The act of consumption generates utility. Therefore, two people with equal lifetime consumption before tax should have equal lifetime consumption after tax. Regarding this principle:
    a. If taxes were levied on a lifetime basis, either income or consumption could serve as the tax base since lifetime consumption equals lifetime income (with bequests counted as either the final act of consumption or the first receipt of income).
    b. Since taxes are levied annually, only a consumption tax satisfies the principle.
    c. An annual income tax does not satisfy the principle because it doubles taxes saving.
    d. The principle can be satisfied under an income tax either by:
        i. Deducting saving from the income tax base, in which case it is an expenditures (consumption) tax.
        ii. Excluding income from capital (the returns to saving) from the income tax base.
22. Richard Musgrave argued that consumption and income are equally good tax bases. All horizontal equity should mean in taxation is that tax liabilities do not depend, inappropriately, on personal characteristics of taxpayers such as religion, gender, race, or creed. The important issue for equity is vertical equity, the tax structure.

The chapter concludes with a brief discussion of vertical equity, in particular, the standard judgment of taxes based on whether they are progressive, proportional, or regressive.

23. Under the Haig–Simons standard, compute the ratio of the annual tax burden (T) to Y_{HS} for any tax. If
    a. T/Y_{HS} increases as Y_{HS} increases, the tax is progressive;
    b. T/Y_{HS} remains constant as Y_{HS} increases, the tax is proportional;
    c. T/Y_{HS} decreases as Y_{HS} increases, the tax is regressive.
24. Under the consumption standard, T should measure the lifetime burden of a tax, and the denominator of the ratio should be lifetime Y_{HS} or lifetime consumption.