C. INTRODUCTION TO TAX POLICY

Revenue is the primary goal of taxation. If the government needs a trillion dollars to carry out its functions, then it must raise that money somewhere. The government can borrow money, and the United States does, but borrowed amounts need to be paid back eventually. Taxation is a uniquely effective way for the government to raise the prodigious sums that it uses. If the government spent less, then it could also tax less, and there is a fundamental link between the taxing and spending functions of government that can not be ignored in formulating tax policy. However, once the government determines that it will collect a certain amount, the central tax policy question arises: who should pay?

Tax policy analysts use two primary considerations in determining who should pay: efficiency and fairness. It is impossible to evaluate the
desirability of any tax system, or even any individual tax provision, without understanding a bit of economics and defining fairness in taxation.

1. EFFICIENCY

a. Neutrality

In deciding whether a tax is efficient, tax policy analysts focus on whether the tax affects people’s behavior. The more a tax changes behavior, the less efficient it is. If the tax has no effect on behavior, it is said to be neutral. For example, if the government were to impose a tax on oranges and people curtailed their consumption of oranges in favor of apples, the tax would be non-neutral because it would discourage the consumption of oranges. On the other hand, a head tax (also called a lump-sum tax by economists) would be neutral because it could not easily affect taxpayer behavior; it is levied simply on account of existing as a human being, and most people would agree that the consequences of avoiding the tax are probably not worth the cost. Both income taxes and consumption taxes affect behavior: they encourage people to engage in leisure activities that do not cost money and therefore escape tax that would be levied on either earning (income tax) or spending (consumption tax).

Just because a tax makes certain choices more expensive than others does not necessarily mean that people will alter their choices. Whether a person actually responds to a tax by changing her behavior depends upon the elasticity of her response. If her response to the tax is highly elastic, then a small tax would lead to a large change in behavior. If her response is highly inelastic, then even a large tax might not affect her decision to engage in that behavior. For example, an addict’s demand for heroin is highly inelastic, and therefore, an addict would buy heroin even if a tax on heroin made it very expensive. While a tax on inelastic goods is an efficient tax because it does not change taxpayer behavior, demand is most inelastic for goods, like life-saving medicines, that we might not want to tax for reasons other than efficiency.

A tax on income might encourage a person to work less than she otherwise would, in order to avoid the tax. If people substitute non-taxed leisure for work, then they can pay less tax by earning less. On the other hand, an income tax might encourage people to work more than they would have if there had been no tax, the income effect, in order to have the same amount of money left after tax that they would have had if there had been no tax. The income effect and the substitution effect of a tax on wages therefore counteract each other in affecting an individual’s decision to earn income. Whether an income tax encourages or discourages work overall depends upon whether the income effect or the substitution effect predominates.

b. Incidence

Because the central tax policy question is who should pay tax, it is crucial that we know who really bears the burden of a tax, not just who
writes the check. The real incidence of a tax falls on the person who bears the burden; while the nominal incidence falls on the one who pays the bill. For many taxes, the government has a choice to collect it from the person who bears the burden or from someone else who is in a position to impose the burden on another. For example, the government could levy a consumption tax directly on the individuals who consume by requiring them to keep track of all their purchases and write a check at year-end based on how much they spent. Alternatively, the government could levy the tax on the retailers, who would raise their prices by the amount of the tax and charge their customers accordingly. Even though the retailers nominally pay the tax in the second scheme, the real incidence of the tax rests on the consumers in both examples. They are the ones who bear the burden of the tax because they must forego other goods, services, or accumulation on account of the tax.

Sometimes, it is easy to determine who bears the real burden of the tax. For example, if a tax on a certain good is imposed and the price of that good rises by the amount of the tax, then it is apparent that the consumer bears the burden of the tax, and the merchant, the nominal taxpayer, has shifted the burden to the consumer. However, if the price fails to rise by the full amount of the tax, then the consumer does not bear the entire burden of the tax. Often, it is difficult to determine on whom the real incidence of a tax falls. The classic example of a tax with an indeterminate incidence is the corporate income tax. While it is clear that only humans can feel the pain of the burden of a tax, corporations nominally pay tax on their income, and economists disagree about which humans actually suffer for it: the corporation’s shareholders, employees, or consumers. There is some evidence that all investors share the burden, even those with no direct connection to the corporation at all. While there might be political advantages in adopting a tax whose incidence is unknown, it is impossible to analyze the fairness of the tax burden’s distribution if we cannot tell on whom that burden really rests.

c. Capitalization

The market affects who really bears the burden of a tax. The market can shift the burden of a tax by affecting an item’s price. For example, if an annual real property tax is introduced (or increased), the current owner of real property may bear the burden of all the real property tax that will be paid by subsequent purchasers of the property in addition to the real property tax that she will pay herself. This is because the value of the property might fall on account of the tax. If the value falls by the present value of all future tax liability, then the tax will have been fully capitalized into the price of the property, and the current owner will bear the entire burden of all the tax that will be paid on account of the property, even after she disposes of it.

Tax capitalization is the mechanism by which the market responds to differing tax treatments of economically identical transactions. For example, the market will bid up the price of a bond if the interest on the bond is tax-free so that the after-tax returns are equal on otherwise
economically equivalent taxable and tax-free bonds, even if the pre-tax return differs. If taxable and tax-free bonds with the same terms and the same risk of default are both paying 10% interest, the price of the tax-free bond will rise in the market so that the rate of return on the bond goes down. In a 40% tax world, full capitalization would mean that the price of the tax-free bond would rise until the return on the tax-free bond is 6%, the same as the after-tax return on the taxable bond paying 10% interest.

Once a tax preference is fully capitalized into the price of an asset, no economic advantage exists in owning the tax-preferred asset—the after-tax return to the asset is the same as the after-tax return to other assets. For this reason, the extent to which the market has capitalized a tax benefit is important in determining whether some taxpayers are enjoying advantages not available to others. If the market has erased any advantage in owning the tax-favored asset, then Congressional repeal of the tax provision providing an apparent benefit would not operate to equalize taxpayers. Repealing tax preferences that have been capitalized away in the market penalizes those taxpayers who purchased assets at prices dependent on their favorable tax treatment. For example, if Congress repeals the home mortgage interest deduction, the value of owner-occupied housing would likely plummet because the market for housing has adjusted for the fact that mortgage interest is tax-favored.

d. Deadweight Loss

Taxation represents the transfer of resources from private hands into public coffers, reducing individual consumption and increasing public spending. As long as a dollar of tax produces a dollar of public goods, the decision to tax turns on whether the dollar is better spent by individuals or government. Unfortunately, a tax often reduces individual welfare more than it increases public welfare—even if the government spends the money wisely.

A hidden cost of any tax includes the loss in welfare caused by the changes in behavior of people who avoid the tax. Recall the tax on oranges. Some people like oranges enough to keep eating them even if the price rises. If people purchase oranges at a higher price due to a tax, then they bear the burden of the tax. The taxed amount is transferred from the orange eaters to the government for use on government programs. The orange eaters are worse off for having to pay the tax, but presumably they (or other people) are better off by the government’s provision of goods and services using the tax revenue. However, there are undoubtedly going to be some people who decide not to eat oranges because the tax wedge makes oranges cost more than they are willing to pay for them. The people who choose not to buy oranges bear a burden also, even though they do not pay any tax. The loss to would-be orange eaters is in foregoing the sweet and juicy fruit that they would have enjoyed but for the tax. Because their loss does not translate into tax paid, the government gets no revenue, so it is an overall loss, rather than a transfer from one pocket to another. This is known as deadweight loss.
or excess burden. Individuals are worse off, but the public is no better off as a result of it.

An efficient tax system must minimize deadweight loss. As a tax becomes more onerous, it can produce deadweight loss at the expense of revenue. In an extreme case, an inefficiently designed tax might produce only deadweight loss and no revenue by encouraging everyone to substitute something nontaxable for the taxable good, service, or activity. As long as revenue remains the primary goal of taxation, policymakers must consider whether the deadweight loss produced by a particular tax is worth the revenue collected. At the same time, the government might choose to tax an undesirable activity heavily with the express purpose of making the activity prohibitively expensive, subordinating revenue considerations to other goals.

e. Simplicity

Simplicity is related to efficiency. Complexity is unacceptable if (1) a tax system's enforcement costs are greater than the revenues collected through enforcement; (2) taxpayers cannot understand the law and comply even if they want to; (3) lots of smart attorneys and accountants spend time figuring out the law and finding loopholes. We can simplify our tax system by getting rid of deductions and exclusions and by refusing to make distinctions between different kinds of taxpayers and different kinds of income. But the price of simplicity is often reduced fairness.

2. FAIRNESS

The prior discussion of efficiency should make it clear that efficiency and fairness are related: we cannot decide whether the tax burden is fairly distributed until we determine who actually bears the burden of the tax. At the same time, there are situations in which the dictates of efficiency and fairness seem to conflict so that an efficient tax may not be a particularly desirable one.

a. Theories of Distributive Justice

While most people agree that any tax system should be fair, people have vastly different ideas of what fairness is. Some people believe that a fair tax should be based on an individual's ability to pay so that all people with equivalent abilities to pay should pay the same amount of tax. A fairness ideal based on ability to pay underlies the income tax. Others believe that a fair tax should be based on an individual's standard of living so that people with equivalent spending should pay the same amount of tax. A fairness ideal based on standard of living underlies consumption taxes.

Even among those who agree on a single ideal—either ability to pay or standard of living—there is room for much disagreement on how to measure one's ability to pay or standard of living. If we are to choose a tax based on ability to pay, how do we compare the relative abilities of
people in different situations? What is relevant in determining one’s ability to pay? John Stuart Mill, in discussing Adam Smith’s tenets of good taxation, suggested that a fair tax should require equal sacrifice from all those subject to it. Equal sacrifice is one way to interpret ability to pay, but we must still decide what constitutes equal sacrifice for people with different incomes, wealth, personal needs and prospects. Should we base equal sacrifice purely on money or should we try to extract equal sacrifices based on welfare so that reductions in well-being on account of tax are uniform among individuals?

For a long time (and many would argue still today) utilitarianism served as the dominant theory underlying discussions of tax policy. Utilitarianism focuses on maximizing utility, variously described as well-being, happiness, and preference satisfaction, and whether rules and actions will produce desirable consequences. Utilitarians argue that the goal of the state should be to provide the “greatest good for the greatest number,” with each person’s utility counting equally in determining society’s overall level of utility.

In matters of taxation, the utilitarian principle of declining marginal utility of income—that people derive less utility from each dollar as they have more dollars—provides the theoretical justification for progressivity. A progressive tax is one in which taxpayers pay a greater proportion in tax as the tax base (such as income, consumption or wealth) increases. A proportionate tax is one in which the percentage of the base paid in tax stays constant even as the base varies, and a regressive tax is one in which the percentage of the base that is paid in tax decreases as the base increases. The system of graduated rates contained in § 1 of the Code, in which the rate of tax increases as income increases, constitutes one mechanism for achieving progressivity, but it is not the only one. For example, progressivity can be achieved with the combination of a single rate of tax, a flat tax, and either an exemption or a uniform payment from the government, known as a demogrant.

Utilitarians can reasonably disagree about which tax base is most consistent with utilitarianism, and whether progressive, proportionate, or regressive systems of taxation will produce the greatest societal utility. But a greater challenge for utilitarian-based justifications comes from the rejection of utilitarianism. Some critics of utilitarianism reject utility maximization as a legitimate societal goal. Others question utilitarianism’s attempt to reduce all social values into a single metric or doubt that there really is declining marginal utility of income. Even people sympathetic to utilitarianism may wonder whether utility can readily be translated into money, or whether there are generalizations about utility curves that can be made for the population as a whole, both of which would be necessary to transform utilitarianism into practical guidance for taxation.

There are other theories about what constitutes a fair society that do not depend on utilitarian assumptions and aspirations. Thus, people
who subscribe to the ideals of fairness espoused by these other political theories are likely to have different criteria than utilitarians do for determining what makes a tax system fair. For example, some people, in keeping with John Rawls' *A Theory of Justice*, believe that economic justice requires improving the situation of the least well-off group in society. They might favor a tax system that significantly redistributes resources from the rich to the poor, even if that redistribution produces a loss in overall societal utility and reduces the well-being of the rich compared to no redistribution. Conversely, some people believe that economic justice is about rights and obligations, rather than consequences or welfare. Robert Nozick's *Anarchy, State and Utopia* defines distributive justice by focusing on historical entitlement and free choice for individuals in the market. Libertarians, such as Nozick, reject redistribution on fairness grounds.

For students of taxation, there is an important lesson to be learned from the various theories of distributive justice. Many competing conceptions of fairness may underlie a system of taxation. These competing conceptions often explain why people favor different tax systems. Logical arguments cannot persuade everyone to believe in the same theory of distributive justice—one notable tax economist has explained his preferences by stating "that's what my mother taught me." Therefore, our tax system may need to contain compromises reflecting a variety of fundamental attitudes about the state's role in distributing economic resources. If we all agreed on a theory of distributive justice, then the tax writers' task would be merely to implement it, but unfortunately, the job is made much more difficult by the need to accommodate conflicting goals.

b. *Horizontal and Vertical Equity*

Traditional tax policy literature often discusses fairness in terms of horizontal and vertical equity. Vertical equity is about the differences in tax burdens on people in different economic situations. The above discussion of theories of distributive justice illustrates how one might think about questions of vertical equity: whether the rich should be required to pay for redistribution to the poor depends on a theory of justice in taxation, for which there is no simple answer or general consensus. Vertical equity depends on a belief about what justifies greater or lesser taxation of individuals.

Horizontal equity can be understood as a subset of vertical equity. Once we determine the criteria allowing the state to extract a greater tax from some rather than others, then it follows that people who are the same, according to those criteria, will pay the same amount of tax. For this reason, some have argued that horizontal equity has no independent meaning apart from vertical equity. Nevertheless, horizontal equity serves as a useful tool for policymakers in drawing lines between taxpayers and defining legislative categories. Horizontal equity demands that we consider whether two taxpayers are the same in some relevant respect and should therefore be taxed the same. Even if we are unable to
agree about the questions of distributive justice that would allow us to achieve vertical equity, we can still use the goal of horizontal equity as a more limited way to approach fairness in taxation. At the very least, we can try to identify the reasons why two people are similarly or distinctly situated, according to whatever criteria of distributive justice that has been chosen. For example, if, based on some broader vision of societal fairness, we decide to tax based on standard of living so that people with equal levels of consumption pay the same tax, then we must determine what constitutes consumption for that purpose, and apply it consistently to all taxpayers. Horizontal equity simply requires evenhandedness in application of the law, and can therefore be seen as a subset of fairness, one that law students should be familiar with from their other subjects.