



PRINCIPLES OF TAXATION



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Annotation. *Given the necessity of taxes, it is the economist's task to provide some guidance in designing a tax system that minimizes the undesired side-effects of collecting them (efficiency) and apportions the burden in some way that addresses the equity concerns raised in this article*

Key words: *Ability to pay, Benefit principle, Consumer surplus, Laffer curve, Poll tax*

Every type of tax has positive and negative attributes. Some are more stable than others, or create fewer distortions in household and business decisions. Some are more costly to collect than others. Some are hidden, others highly visible. Some have broad bases, others narrower bases. Certain kinds of taxes are useful for correcting externalities while others may lend themselves to a more equitable distribution of tax liabilities.

Ideally, economists and policy-makers would think systemically about taxes, rather than focusing on a particular tax. Public policy should be concerned with the fairness and the revenue yield of the system as a whole, rather than a particular tax. But in order to see what a particular tax might contribute to the revenue system, it's usually easier to take them one at a time.

This article concentrates on the two most important qualities of a tax and a tax or revenue system. One is efficiency. The other is equity. Efficiency means many things. It may mean minimizing the (negative) impact on household decisions about where to shop, where to live, how hard to work, whether to save and invest. It may mean encouraging (or discouraging) business location in the country or state or county, or encouraging investment and job creation in general. Sometimes a tax is intended to distort consumer or business decisions, such as CO₂ emissions or smoking, so its efficiency would be measured by how much it discouraged that undesirable activity. Efficiency may also mean minimizing the cost of collection and compliance, or annoyance to taxpayers. Jean Baptiste Colbert, Minister of Finance to the French king Louis XIV, is famous for observing that "The art of taxation consists in so plucking the goose as to get the most feathers with the least hissing."

Equity means fairness in distribution of the tax burden among households, and firms, including households and firms located outside the taxing jurisdiction. Efficiency lends itself to objective measurement, but equity is subjective. There is some general agreement among economists that the tax system should be at least proportional, so that it takes about the same share of everyone's income. There is less consensus about the idea





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that it should perhaps be even moderately progressive, taking a larger share of the income of wealthier households.

These two criteria are so important that this entire chapter is addressed to analyzing the efficiency and equity implications of taxes. Other criteria include adequacy, visibility, cost of collection and compliance, and stability. A tax is said to be efficient if it does not change any of the economic decisions that firms and households would have made in the absence of the tax. There are very few taxes that can meet that high standard of efficiency.

A **poll tax**, which is a flat charge per person or per household, is one of the few taxes that do not distort economic decisions. The burden of a poll tax does not change with changes in location, work effort, consumption spending, wealth, or any of the other factors that can affect one's tax liability for income, sales, property, excise, and estate taxes. The poll tax is rarely used in modern industrial nations (it was briefly introduced in Great Britain during the 1980s and then repealed) because it is extremely regressive it takes a much higher percentage of income from the poor than the rich. But the poll tax does provide a useful standard of non-distortion against which the effects of other taxes can be measured.

An analytical tool that is useful in evaluating the distorting effect of taxes and their impact on consumer welfare is the concept of consumer surplus. This concept may be familiar to you from an earlier course. Recall that each point on the demand curve measures the amount consumers are willing to pay for a particular quantity of a good. But in most cases, all consumers pay the same price, the market price, even though for many consumers (or many units purchased) the price they would have been willing to pay is higher. A tax on any kind of spending has two effects: it raises the price and reduces the quantity. In raising the price, the tax will increase revenue, but in reducing the quantity, or eroding the tax base, it will reduce revenue. The same kind of effects can be observed in the case of taxes on income or on assets. Is there some point at which the second effect, or base erosion, dominates the first, so that an increase in the tax rate will reduce tax revenue rather than increase it? This is the question to which economist Arthur Laffer sketched out an answer on a napkin in the form of his famous diagram, the **Laffer curve**.

Laffer expressed this concern very simply. At a zero tax rate, there is no tax revenue. At a 100 percent tax rate, taxable economic activity is pointless, so there will be no tax base and there will again be no revenue. Between those extremes, the tax system will generate revenue, but there are tradeoffs between the revenue-increasing and revenue-decreasing effects of higher rates. Not all these effects are capturable in a simple algebraic or graphic model. If tax rates get high enough, people will resort to barter or tax evasion; they will go underground, reduce their work effort, leave the country, buy abroad.





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