THE ETHICS OF TAX POLICY

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Abstract. Tax policy must address three fundamental questions: what is taxed, who is taxed, and how tax burdens are allocated among taxpayers. This chapter examines the ethical dimensions of these questions, including the merits of income taxation, consumption taxation and Pigouvian taxes, the tax treatment of families and of corporations, the justification of progressive taxation, and tax competition. It considers theories of tax fairness grounded in taxpayers’ ability to pay and in the benefits taxpayers receive from government as well as the perspectives of utilitarians, egalitarians, and public choice theorists.

Nobody likes paying taxes, but almost everybody prefers to live in a society with taxation than in one without. Agreement about tax policy usually goes no further. This is not surprising since tax policy implicates fundamental and hotly contested questions of distributive justice. Given that developed nations typically collect at least a quarter of their GDP in taxes, the stakes are very high (OECD, 2016). Moreover, taxation is used for such a wide range of purposes that almost every area of public policy has at least some connection with taxation. Tax policy raises extremely complex ethical questions, including both large-scale questions of distributive justice, such as the extent to which the tax
system should be used to redistribute income, and narrower questions, such as how tax rates should be set for different types of households.

This chapter provides an overview of some of the many debates in tax policy that have significant ethical dimensions, with a particular accent on the relationship between taxation and democratic government. It begins by outlining the function of taxation and the ways in which it interacts with ethical concerns. The bulk of the chapter is devoted to ethical questions raised by tax policy, including what should be taxed, how we should individuate taxpayers, and how we should allocate tax obligations between taxpayers. It examines theories of tax fairness based on ability to pay and on the benefits received from government spending. The latter part of the chapter discusses the tax base, the taxation of families, and the taxation of multinational corporations and concludes by exploring a few of the implications of this analysis for taxation in democratic theory.

I. The purpose of taxation

Taxation is the life blood of the modern fiscal system. The most basic function of taxation is to provide revenue for the state. The decision to devote a given fraction of income to tax puts the choice of how to use it in the hands of the government rather than private parties. In a democratic society, this means making consumption choices collectively, usually through elected representatives. Tax rates therefore establish the balance between private and public choices regarding consumption. Less obviously, tax policy may be used to influence choices about consumption and investment made by the private sector by making some options more expensive than others. Second, taxation is
often used to pursue distributive aims. This is most obviously true of inheritance taxes, progressive tax rates, and the exemption of necessities from consumption taxes. A third important function of taxation is as a form of regulation that encourages or discourages certain activities. Taxes on pollution, for example, can force polluters to pay the social cost of their activities without outright prohibition. Taxation is thus a potential alternative to prescriptive regulation that allows the state to influence rather than prescribe individual choices.

Although the substance of tax policy is a source of perennial conflict, taxation itself is an important form of social cooperation. Any group of people that cannot muster resources for collective projects will not be able to act efficaciously as a group and any state that cannot successfully raise revenue will not long survive. Taxation might be viewed as a stress test for state efficacy. A state unable to collect taxes is probably feeble regardless of its formal powers, and a state that does not need to levy taxes (e.g., one that receives a great deal of money from state-owned natural resources) is in danger of atrophy since its rulers have less need to be concerned with the quality of public administration.

Tax collection is extremely expensive without some degree of willing cooperation between government officials and citizens. In pre-modern times, collection of direct taxes on income or wealth was administratively challenging and states often made do with other forms of public finance, such as feudal dues, tariffs, or state monopolies. States in the developed world now collect what is, from a historical perspective, a remarkable amount of revenue remarkably harmoniously. Public cooperation with the tax authorities, sometimes called “tax morale”, depends in part on public perceptions of the legitimacy of the
state and the fairness of the tax system (Kirchler 2007). Tax morale also depends on expectations about the behaviour of others. People often are willing to make sacrifices for the public good only if they think others will as well (Bicchieri 2006). High tax morale can thus lead to a virtuous cycle of high tax collection and high tax compliance, whereas low tax morale may lead to a vicious cycle in which most people attempt to evade taxes when possible, anticipating that most of their fellow citizens do the same. The importance of tax morale is a reason to avoid policies that are opaque or diverge too greatly from common moral intuitions even if they are desirable on other grounds. It is also a potential source of advantage for democratic government since citizens may be more likely to cooperate with tax authorities if they feel that they have influence over fiscal policy (Casal et al. 2016).

**II. The allocation of tax burdens**

Any system of taxation must address three questions: what is taxed, who is a taxpayer, and how tax burdens are allocated among taxpayers. The third of these questions raises the most fundamental normative questions. Traditional approaches to tax fairness include ‘ability to pay’ theories that apportion tax burdens on the basis of taxpayers’ resources and ‘benefits’ theories that apportion taxes in proportion to benefits received from the state. Whereas ability-to-pay principles consider taxation apart from the rest of fiscal policy, benefits theories explicitly link taxes with spending by considering the fairness of tax burdens in light of the benefits received by the taxpayer from the state. As ability-to-pay theories are somewhat more straightforward, it makes sense to consider them first.
II.A ‘Ability to pay’ theories of tax fairness

‘Ability to pay’ theories evaluate the fairness of tax burdens in light of a taxpayer’s income, wealth, or some other measure of ability to bear tax burdens. The underlying idea is that fair tax schemes allocate burdens between taxpayers impartially. John Stuart Mill (1848: 348) argued that ‘equality of taxation . . . means equality of sacrifice’, which means that every taxpayer should feel ‘no more and no less inconvenience from his payments than every other person experiences from his’. It is quite difficult to specify what constitutes equality of sacrifice. Ability-to-pay theories therefore encompass a wide range of possibilities, including proportional taxation schemes in which all taxpayers pay the same tax rate for every increment of income and progressive schemes in which the marginal tax rate is higher for those with more income or wealth. Proponents of both views might agree on a more basic principle, horizontal equity. This is the principle that taxpayers with equal incomes should pay equal amounts of income tax (Musgrave 1959). Although horizontal equity sounds straightforward, applying it proves to be difficult. Much seems to depend on how income is defined. Two taxpayers might have equal incomes under one definition and quite different incomes under another. Although economic analysis might put some constraints on plausible definitions of income, there are numerous cases in which it is unclear whether a given item reflects true ability to pay. Many deductions from taxable income might seem fair on the grounds that they capture something important about the taxpayer’s ability to pay, regardless of whether the deduction tracks income in a purely economic sense. For example, allowing taxpayers to deduct health care expenses might seem fair in that money spent on health care
reduces disposable income without putting the taxpayer in a better position than healthy taxpayers with equivalent income. Horizontal equity might therefore be thought to merely shift the question of what taxes are fair to the question of what should count as taxable income. Even if horizontal equity is responsive to the requirement that the state treat citizens as equals, there are such a large number of candidates for what might constitute equal treatment that it is difficult to see how one can be selected without resort to some further theory of distributive justice.

This problem also infects the debate between proponents of proportionate and progressive income taxation, with each appealing to different conceptions of equality. The notion that taxes should be proportionate to income can be traced back at least to Adam Smith (1776). John Stuart Mill defended this principle as best approximating ‘equal sacrifice’ from every taxpayer (Mill 1848: 350-56). The grounds of the view are, however, a bit mysterious on closer inspection (Fried 1999). It is not clear that a rich person who pays £100,000 in tax on a £1,000,000 annual income is making an equal sacrifice to that of a poor person who pays £1,000 out of a £10,000 annual income. The former may go about life no differently as a result of the tax and merely be left with a smaller bank account at the end of the year, whereas £1,000 may make a sizable difference to the quality of life of a poor person. Extreme results of this sort can be mitigated by exempting income sufficient to cover the necessities of life from income tax and imposing a flat rate of tax upon the rest. But the objection does not depend on a poor person’s ability to afford adequate food or shelter. The ability to go away on a relaxing vacation might make a real difference in the life of a taxpayer.
just above the tax exemption threshold. Alternatively, proportionate taxation might alternatively be defended in terms of the equal treatment of taxpayers. It seems quite plausible that every taxpayer should face the same tax rate at the given level of income. But why equal marginal tax rates at different levels of income should be required as a matter of treating citizens equally is rather mysterious. Perhaps the best defence of proportionate taxation is that it provides a simple, clear, and impartial rule for allocating tax burdens that diminishes the extent to which one group of citizens may unfairly shift the tax burden onto another. If proportionate taxation is not the best policy, at least it prevents worse. This is roughly the conclusion that Henry Sidgwick (1887) came to despite his acknowledgement that progressive rates of taxation could, in theory, have salutatory distributive effects.

In any case, proponents of progressive taxation have had their way in most developed countries since the early twentieth century. They advance a range of arguments for progressive taxation. First, one might argue that progressive taxation is required by some egalitarian theory of distributive justice. A second argument is that because marginal utility of income diminishes with income, progressive marginal tax rates maximise aggregate welfare. In other words, a 1 per cent tax will diminish the welfare of a poor taxpayer more than the welfare of a wealthy taxpayer. For this reason, one might think that ability to pay in the normatively relevant sense increases more with income for the wealthy than for middle-income taxpayers. Third, progressive taxation serves as insurance against bad outcomes for citizens who are uncertain about their future prospects. It may be worthwhile to accept the prospect of higher taxes in the case of economic good fortune in exchange for
lower taxes in the case of ill-fortune. One need not be a utilitarian to see risk spreading as an important function of the social welfare state (Heath 2006). A final consideration is that material inequality may diminish social solidarity and make it more difficult to devise policies that serve the needs of both rich and poor. Designing effective public policy is easier when most citizens have income levels near the mean, since they are likely to have similar interests to each other. By contrast, the very rich and very poor have little in common with each other or with the middle class. Furthermore, inequality may tend to undercut loyalty to the nation or willingness to sacrifice for it if people perceive that the benefits from collective efforts accrue to only a few at the very top of society. And greatly unequal societies may find it difficult to prevent the ultra-wealthy from corrupting the political process or undermining democratic control of government altogether.

Opponents of progressive taxation, such as Mill and Sidgwick, worry that allowing higher rates for a small minority of taxpayers will encourage confiscatory tax rates or wasteful spending since only the very wealthy will bear this burden. Once progressivity is introduced to the tax code, it is difficult to find a principled limit. One might suspect, therefore, that there is a tendency for tax rates to rise to dysfunctional, confiscatory levels. Lower- and middle-income voters might readily vote for higher taxes on the wealthy without much regard for whether the revenue is well spent. Subsequent history should provide some reassurance on this point. Although marginal tax rates on the wealthy reached extremely high levels in the US and various western European counties during the mid-twentieth century, these rates have fallen very substantially since then. At the same time, the tax burden on middle- and
lower-income citizens in many counties has increased substantially. It does not appear, therefore, that progressive taxation inevitably creates a one-way ratchet effect in countries with universal suffrage (Scheve & Stasavage 2016).

Opponents of progressive taxation also worry that excessively high tax rates discourage work by highly skilled workers, savings and investment by the affluent, or both. High marginal tax rates also encourage higher earners to devote their energies to tax avoidance rather than to socially productive activity. There is a vast economics literature on the incentive effects of high taxes on the rich. Many studies suggest that top tax rates in most developed countries are not enough to be seriously deleterious (Diamond & Saez 2010). This is not, however, a universal view and there is heated disagreement among experts (Feldstein 1995). As will be discussed presently, there are ways to mitigate the incentive effects of progressive taxation, although these strategies may also have undesirable distributive consequences.

II.B ‘Benefits’ theories of tax fairness

‘Benefits’ theories of tax fairness are a rival to both proportionate and progressive ability to pay theories. Benefits theories evaluate the fairness of tax burdens in light of benefits received from the state. The underlying idea is that of reciprocity: a tax is fair if benefits received from the state at least roughly compensate for the burdens of taxation. If one assumes, as Adam Smith (1776) did, that benefits received by the state vary in proportion to income, the normative upshot of the benefits theory might not differ greatly from ability-to-pay approaches. There is no reason, however, to believe that this is always the case. In any case,
the normative foundations of the two approaches are very different. An important objection to benefits theories is that it is extremely difficult to value the benefit that each person receives from public goods such as national defence, a well-functioning legal system, environmental protection, or a high-quality system of education (Mill 1848). What is needed is some way to measure the benefits received by individual taxpayers. One strategy is to require unanimous consent for the imposition of new taxes (Wicksell 1958). Since taxpayers will not consent to a tax that does not produce sufficient benefits to leave them better off, all taxes under such a scheme should benefit every taxpayer. The unanimity rule thus forces taxpayers to reveal their private valuation of public spending. Furthermore, citizens that value a prospective spending project especially highly should be willing to assume the costs even if other citizens decline to raise their own taxes. In practice, of course, the problems of opportunistic holdouts and of irrationality make it prudent to relax the unanimity requirement to a large supermajority (Buchanan 1975). In principle, constitutional mechanisms could be designed to approximate a scheme of taxation based on the relative benefits enjoyed by different taxpayers. Such a system might turn out to have troubling distributive consequences, but its possibility shows that benefits theory proponents have more resources at their disposal than was recognised in Mill’s time.

A second way to determine how different taxpayers value various government services is ‘Tieboutian’ competition, which involves citizens sorting themselves into groups for purchasing local public goods (Tiebout 1956). Decentralising some aspects of fiscal policy so that local governments can pursue different policies gives prospective
residents a choice between different packages of taxes and government services offered in different jurisdictions. For example, parks and libraries might be funded out of local property taxes. Some citizens might select jurisdictions with higher taxes and more expensive services, while others might opt for the reverse, thus satisfying the mutually inconsistent preferences of both groups. The benefits of public goods are also more closely linked to the burdens of taxation since the value of high-quality public services tends to be capitalised into real estate prices. However, Tieboutian competition relies on a relatively high geographical mobility combined with fiscal decentralisation and so may have somewhat limited application outside of countries with a suitable tradition of local government. Local residents may be best positioned to monitor the quality of local public goods, but this matters only if political authorities are sensitive to local sentiments. Tieboutian competition also threatens to exacerbate inequalities if wealthier citizens are able to cluster together to purchase local public goods while withdrawing support for public goods at the national level.

A third strategy is to rely on special purpose taxes that raise funds for particular purposes from those who benefit. For example, funding road repairs from petrol taxes and tolls has the effect of collecting revenue from people in very rough proportion to the extent to which they benefit from their use. Creating an explicit link between taxation and spending that benefits the taxpayer may be useful in building political support. This seems to be the case for state pension and social insurance programs. Although there is no principled reason why they should not be funded out of general tax revenue, it is often the case that pension and disability insurance programs are supported by special payroll taxes, as
in the US, the UK, France, Germany, and many other nations. Workers may be more likely to accept this tax as fair because social insurance payments during retirement are conditioned on prior tax contributions. This advantage must be weighed against the inefficiency of maintaining separate systems of payroll and income taxation.

Benefits theories have traditionally been associated with classical liberalism since they seem to provide a principled way to limit the potential obligations of taxpayers, especially wealthier ones. As a historical matter, however, benefits theories were often used to argue in favour of more rather than less progressive taxation. Until at least the nineteenth century, income and property taxation was not the primary source of government revenue. Tariff revenue and various consumption taxes likely were regressive compared to proportionate income taxation since the wealthy, who need not consume all of their income, would bear a relatively small proportion of the tax. Adam Smith’s appeal for proportionate income taxation likely would have represented an increase in the progressivity of the tax system of his time. Likewise, Knut Wicksell (1958) saw his unanimity rule as a way to prevent the wealthy and powerful from shifting the tax burden to the poor and powerless.

Whether the benefits principle is inconsistent with progressive taxation depends on how one measures benefits. If benefits are measured in terms of cost to the state, the benefits theories will tend to suggest that taxes on the wealthy must be rather modest. But if benefits are measured, as contemplated by Wicksell, in terms of willingness to pay, the benefits received by wealthy taxpayers might be quite sizable since willingness to pay tends to increase with income for most good and services. This interpretation of the benefits principle provides a rule that
limits oppressive taxation while being neutral between tax policies that benefit all taxpayers. A progressive interpretation of the benefits principle would suggest that wealthier taxpayers should pay higher tax rates because they derive the greatest benefit from the existing political order. Low-wage workers derive less benefit from the persistence of the present government because they have little property to protect and could continue to earn subsistence wages under a different political regime. The principle that taxpayers should not be forced to pay more in taxes than the benefits they receive in return therefore seems consistent with funding national defence, the legal system, and other public goods that protect property rights entirely out of taxes on the better off.

II.C Egalitarianism and utilitarianism

In contrast to the tax-specific principles of fairness considered thus far, one might instead analyse tax policy in light of some egalitarian theory of distributive justice, such as Rawls’s difference principle. Such principles of distributive justice are used to evaluate government policy as a whole rather than applying to tax policy in isolation. Taxes are simply a tool, albeit a very important tool, to be used alongside transfer payments and other government spending programs to achieve just distributive results. Liam Murphy and Thomas Nagel (2002) argue that since just post-tax distributions are all that matters, taxes should not be evaluated by comparison with pre-tax income or with the benefits received from public spending. Tax-specific principles of fairness that take the existing distribution of property rights and pre-tax income as a normative baseline are confused because the normative status of property rights depends on the resulting distribution of post-tax income.
and thus cannot provide any independent basis for evaluating the fairness of tax burdens. In other words, the property entitlements that produce taxable income are just only insofar as the entire system of property rights, tax obligations, transfer payments, and government spending is just. Measuring ability to pay in light of an unjust distribution of property rights will not yield a fair scheme of taxation. Nor will evaluating taxes in relation to the benefits of an unjust fiscal system.

Much of the reception of Murphy and Nagel’s argument focused on the question of whether people have any pre-institutional claim to income from property or labour. If they do, then Murphy and Nagel’s attack on principles of tax fairness that compare tax obligations to pre-tax income fails. Both this debate and the debate over the correct principles of distributive justice are far beyond the scope of what can be considered in this chapter. In any case, there are reasons to be sceptical of Murphy and Nagel’s approach even if one sets aside objections grounded in natural rights. Although one might reasonably argue that people with special talents, wealthy parents, or good luck do not intrinsically deserve higher incomes than others, it does not follow that the state should be free to redistribute revenue from such assets as it sees fit. Whatever the theoretical virtues of Nagel and Murphy's approach, it has the disadvantage of seeming to reduce questions of tax policy to the most controversial questions of distributive justice. If the fairness of tax rules depends largely on broad questions about the fairness of the existing distribution of property rights, it is hard to see how one can achieve agreement between members of the public with differing ideological commitments. In a polity with deep disagreements about
distributive justice, taxing power unconstrained by pre-institutional entitlements may seem less attractive. In the interest of minimising negative-sum political conflict, it may be reasonable to treat existing property entitlements as having some normative weight and patterns of pre-tax income as providing some constraints on the permissible degree of redistribution (Lindsay 2016). Ability to pay and benefits theories of taxation have the virtue of approaching questions of tax fairness in a way that may allow people with different views on broader distributive questions to find common ground.

Utilitarians may agree with Nagel and Murphy that there are no tax-specific principles of justice and argue that just tax policies are those that maximise aggregate utility (Kaplow 2008). In general, a utilitarian approach to tax policy will be concerned both to allocate the tax burden to those able to pay with the least loss in welfare and to impose taxes in a manner that distorts the behaviour of taxpayers as little as possible. However, these considerations are often at cross-purposes. Taxes that minimise economic distortions, such as lump-sum taxes that collect a fixed sum from every taxpayer regardless of income, tend to be regressive. Taxes that minimise the welfare loss of the taxpayer, however, tend to be progressive to the extent that the marginal utility of income declines as taxpayers become richer (Edgeworth 1897). Utilitarians more concerned with the first consideration will tend to favour relatively less progressive tax policies, while those concerned with the second consideration will tend to favour relatively more progressive tax policies. Agreement on ethical principles does not, therefore, assure agreement on tax policy, especially for those, such as utilitarians, who are committed to highly abstract ethical principles.
Utilitarian analysis of taxation sometimes reaches conclusions that seem peculiar from the perspective of competing theories and fly in the face of popular sentiment. On plausible assumptions about the effect of tax rates on work, marginal tax rates should decline over a certain level of income (Mirrlees 1971). The reason for this is that taxpayers with high earning capacity may be tempted to use their high income to cut back on labour effort and are especially likely to do so if facing a high marginal tax rate. This policy has the counter-intuitive result that extremely high earners actually pay lower marginal tax rates on their last dollar of income than those with much lower incomes. Similarly, it might be better to avoid direct taxes on labour entirely and instead tax some fixed attribute that is a proxy for capacity to earn so as to avoid disincentives for earning income.

Consumption taxation provides another illustration of the tension between economic efficiency and distributive concerns. As Frank Ramsey (1927) argued, consumption taxes are more efficient when applied to items for which demand is relatively inelastic — in other words for which consumers are unlikely to change their behaviour in response to higher taxes. This has the implication that sales tax rates should be set differently on different items, potentially with higher taxes on staples that are relatively price-insensitive.

That utilitarian reasoning sometimes yields results at odds with common intuitions about tax fairness should not be surprising. Hardline utilitarians will not find it disconcerting. Yet there is reason for utilitarians as well as for egalitarians such as Nagel and Murphy to be attentive to popular sentiments when designing tax policy. If, as was argued earlier, public perceptions of tax fairness are important in
securing voluntary compliance with the tax system as well as political support, divergence between philosophical theories and “folk theories” of tax fairness may diminish cooperation with the tax authorities even if one believes that the folk are mistaken.

III. What to tax

Establishing principles for the allocation of tax burdens among taxpayers is only one task faced by policy-makers. Two other questions are perhaps even more fundamental: the question of what is to be taxed and the question of how to individuate taxpayers. The first of these questions concerns the nature of the tax base. Candidates include income, consumption, property, socially undesirable activities (e.g., pollution, smoking, drinking), and foreign trade. The choice of a tax base is of fundamental importance because it shapes the options available to every citizen. In addition, governments often exempt certain goods from taxation, which has the effect of making decisions about what constitutes taxable economic activity an important expression of public values and a significant component of social welfare policy. Caution must be exercised when approaching this issue because the person who pays a tax does not necessarily bear its economic cost. It is sometimes very different to determine tax incidence. For example, the incidence of sales tax depends on the responses of sellers and buyers to the imposition of the tax. Depending on these responses, the burden of the tax might fall predominantly on either party.

One long-running debate concerns the relative merits of income and consumption taxes. The main difference is that an income tax applies to income regardless of whether it is saved or consumed, whereas a
consumption tax applies only to what is consumed. Thus, in a consumption tax system, a person who saves her income may postpone her tax liability until she chooses to consume her savings. One common argument for consumption taxes is that it is unfair to tax a person once when he earns income and then a second time on income from what he saves when a person who chooses to spend all of his earnings immediately is taxed only once (Mill 1848). Taxation of income likewise seems a socially undesirable disincentive to save and invest. Many experts favour a consumption tax on these grounds. Like income taxes, consumption taxes may be made progressive by imposing higher rates of taxation on those who spend more. Alternatively, a flat consumption tax, such as a value added tax, might be combined with an income tax that applies only to those with high incomes. The logic of this position is quite strong with respect to taxpayers with modest incomes and, in fact, many income tax systems provide ways to shield some amount of savings from taxation – for example, through pension plans or retirement accounts. On the other hand, a pure consumption tax system may allow great stocks of wealth to escape taxation altogether since taxation can be postponed indefinitely. This seems quite inequitable in the case of inherited wealth. In theory a vigorous inheritance tax regime should prevent wealthy heirs from escaping taxation, but in practice it is difficult for estate taxes to encompass all intergenerational wealth transmissions. A poorly designed inheritance tax system may serve as a trap for the unwary while allowing those with the benefit of the best advisors to avoid much of the tax. For these reasons, a progressive income or wealth tax may provide a useful backstop even in tax systems built primarily around consumption taxes.
An even more extreme proposal motivated by efficiency considerations is the so-called endowment tax, which taxes capacity to earn rather than actual income. By taxing people based on their potential earnings rather than the actual earnings, one could avoid the deleterious effect of discouraging highly compensated work and encouraging leisure. Income taxes are also arguably unfair to high earners who prefer consuming material goods to consuming leisure since those who prefer leisure enjoy their preferred good tax-free. Earning ability is not directly observable, so one would need to tax some proxy for it. Despite the economic case for such an approach, it is often felt that endowment taxes would be oppressive because they could force people to work at their highest paid occupation on pain of accepting a very low standard of living. For example, a talented investor who owes taxes based on the highest wage that she could receive in the market might have such a high tax liability that she could not afford not to work in finance. Opponents of endowment taxation bear the burden of explaining why this effect is less objectionable than income taxation compelling taxpayers to work longer to achieve a given post-tax income (Olson 2010).

An alternative to general taxes on income, earning ability, consumption, or wealth is to levy taxes on socially undesirable activities. So-called Pigouvian taxes seek to discourage externalities, such as pollution, by imposing a tax that is equal to the social harm caused by the externality. For example, one might impose a tax on carbon emissions designed to reflect the social harm of their contribution to global climate change. This has the fortuitous consequence of raising revenue by discouraging something socially
undesirable, such as pollution, rather than something socially desirable, such as working or investing. Extensive use of Pigouvian taxes, however, risks imposing inequitable tax burdens since tax incidence will depend on factors only loosely related to ability to pay or the benefits received from public spending. It is better, therefore, to regard Pigouvian taxes as being primarily justified as a form of regulation rather than as a way to raise revenue.

IV. How to define the taxpayer

In order to apportion tax burdens between taxpayers, one must first decide who counts as a taxpayer. Taxes may be assessed at the level of households or individuals. For example, some countries encourage spouses to file joint tax returns, whereas others tax each adult as an individual regardless of his or her marital status. Under a system of progressive taxation, these choices can have quite significant implications because married people with different incomes will face different tax rates depending on whether they are taxed individually or jointly. If, as in the US, a couple is taxed jointly under progressive tax rates, lower-earning spouses may face a much higher marginal income tax rate than they would as single persons. This is a substantial incentive for those with a high-earning spouse to drop out of the labour force. By contrast, there is no such incentive where, as in the UK, each adult is taxed separately. However, under the UK system, two households with the same income may owe very different amounts of income tax and single-income households may face a high marginal tax rates at a relatively modest household income. The US approach has the virtue of respecting horizontal equity between households and might be more
supportive of middle-income families with children. The UK system avoids providing an incentive for second earners to drop out of the labour force or cut back on hours worked. Under progressive tax rates the trade-off between equal tax obligations for households with equal incomes and equal marginal tax rates for workers with equal incomes is unavoidable: one cannot have both at the same time.

The tax treatment of households with children likewise raises thorny questions. Income tax systems differ greatly in their treatment of children. Some countries, such as France, tax families in proportion to the number of members, thus substantially lowering the effective tax rate for families with children, especially for those with many children (Loutzenhiser 2016). At the other extreme, the UK does not consider family structure at all in taxation of income from labour and instead offers a “child benefit” outside of the tax code that is phased out at higher levels of income (Loutzenhiser 2016). Tax benefits for lower-income families with children might be justified as an anti-poverty measure. Tax policy regarding middle-class families with children depends crucially on whether it is fair for the state (and implicitly childless taxpayers) to defray the costs of raising children or whether costs should fall on parents. If the decision to have children is treated like a private consumption decision and does not trigger tax benefits, then child-rearing expenses will consume a large portion of the post-tax income of middle-income households with children. If, on the other hand, households with children are given extra tax exemptions, parents will owe substantially lower taxes than non-parents with equivalent income. This question is less urgent in societies where the majority of taxpayers will fall in each category over the course of their lifetimes. In
places where a large fraction of taxpayers never have children, the stakes are much higher.

A final question is how to tax business enterprises. Most countries impose income taxes on large corporations directly. In part this is done for administrative convenience since it may be easier to collect taxes from one corporate entity than from its thousands of investors. To the extent that corporate taxes are not counted against the tax liability of investors, the justification for taxing corporations is unclear. Economists are uncertain whether the burden of taxes on corporate income falls on investors, employees, or consumers (Shaviro 2009). The answer may be different in different contexts. If it is consumers or employees rather than investors who ultimately pay, corporate taxes do not necessarily contribute much to the progressivity of an income tax system. The only clear justification for corporate taxation is that it prevents wealthy individuals from using corporate entities to shelter their income from tax.

In any case, increasing international capital mobility and the growth of cross-border transactions are undermining the ability of national governments to tax multinational corporations and capital income more generally (Kleinbard 2011). Multinational corporations increasingly organise transactions so as to realise income in low-tax jurisdictions even when mainly doing business in higher-tax jurisdictions. In one notorious case, the US coffee chain Starbucks managed to operate a large, fast-growing, and apparently profitable chain of coffee shops in the UK while recognising virtually no income for tax purposes in the UK by, for example, making payments to a Dutch subsidiary for use of Starbucks’s “intellectual property”, including its brand and its business
plan (Kleinbard 2013). Shifting income to low-tax jurisdictions is even easier for multinationals that are genuinely dependent on ownership of intellectual property, such as Google or Apple (Kleinbard 2011). This tax avoidance behaviour is often openly abetted by countries that seek to attract investment by offering the promise of little taxation and no transparency to foreign tax authorities. Tax treaties have traditionally aimed to alleviate double taxation of income in which the same revenue is taxed concurrently in two jurisdictions. Today, the OECD and the G20 are grappling with how to avoid double non-taxation of income through the Base Erosion and Profit Shifting (BEPS) project. International cooperation on this front will require agreement on how to allocate income between jurisdictions. In light of these developments, tax theory cannot focus exclusively on the nation-state, but must consider the international dimensions of distributive questions. What is good policy from the perspective of citizens of one state may have adverse effects on foreign nationals.

Tax competition between nations is part of the reason for the recent trend away from reliance on taxation of capital and towards higher payroll and consumption taxes. Whatever the policy merits of this trend (itself a hotly contested question), one might worry that democratic governments, especially in smaller economies, have less policy flexibility and are therefore less responsive to the views of their own citizens. In this case, democratic control might require international agreements that carve out a space for tax policy on the national level that is protected from tax competition.
V. Taxation and democracy

The relationship between tax fairness and democracy is complex. Benefits theories of tax fairness might be thought to be in tension with democratic considerations because they tend to represent taxation as an exchange with the state and taxpayers as consumers of government services rather than regarding the taxpayer as one of many citizens who govern collectively (Mill 1848). Ability-to-pay theories, by contrast, regard taxation as a collective obligation shared by citizens. Mill’s equal sacrifice principle establishes a link between tax fairness and the obligation of a state to treat citizens as equals that seems especially apt for democracies. This leaves much scope for disagreement about what equality requires. It may be argued that equality requires that tax policy mitigate economic inequalities between taxpayers or that equality requires only that that all make reasonable contributions to public goods in light of their means. Alternatively, Elizabeth Anderson’s (1999) theory of democratic equality suggests that our focus should be on policies that allow all citizens to be able to relate to each other as equals. This might counsel in favour of income and inheritance taxes to dissipate fortunes that threaten to undermine social equality but allow for some degree of economic inequality so long as higher- and lower-income citizens are able to interact as equals. Anderson’s theory might also imply that tax and transfer policies should be arranged such that low-income citizens pay at least a nominal amount of tax so that all citizens are seen as contributors to the public fisc.

Although ability-to-pay theories may appear more democratic in spirit, setting taxes according to benefits received may have advantages for polities deeply divided on questions of fiscal policy. Doing so allows
governments to simultaneously satisfy the preferences of citizens who prefer high taxes and lavish public services and those of citizens who prefer low taxes and stingy public services. This might be accomplished by fiscal decentralisation that allows citizens to select jurisdictions that match their preferred levels of taxation and public spending or by funding services out of taxes that are targeted at users, such as fuel taxes that are earmarked to fund road repairs. Agreeing to disagree is one possible result of democratic deliberation. An alternative approach is to require universal consent to new taxation and government spending. This might both appeal to ideals of collective self-government and safeguard citizens against oppressive levels of taxation.

The best policy-making will combine rigorous thinking about the ethical aims of tax policy with nuanced understanding of the economic effects of tax policy and the psychology of tax compliance. It is not necessary, or perhaps even desirable, that all taxes be justified in the same way. A single fiscal system might combine forms of taxation justified on different grounds. For example, public goods that are inherently national in scope might be funded by income or consumption taxes assessed in light of ability to pay and adjusted to pursue distributive aims at the national level. Other taxes might follow the logic of the benefits principle or be derived from Pigouvian taxes.
References


