

Taxing Ourselves

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The Theory of Optimal Taxation

- Placed the evaluation of taxation on a rigorous basis.
- Generated two unintuitive prescriptions:
 1. Regardless of other distortions, preserve production efficiency: goods should be produced in a social-cost-minimizing way.
 2. All taxed goods should be taxed differentially, i.e., uniform taxation is optimal only under very strong assumptions about utility functions.

Key Aspects: Set #1

- Focus on benevolent government.
- People understand and react rationally to the tax system. Thus the government has no reason to manipulate citizens' perceptions.
- A consequentialist and welfarist orientation.

Key Aspects: Set #2

- Asymmetric information between the government and private citizens plays a central role.
- A sharp distinction between what is measurable without cost and what is not measurable at any cost; e.g., ability cannot be measured, but income can.
- No meaningful role for firms.

Set #1 Has Been Under Attack

- The public choice economists argue that people in government (i.e., bureaucrats and politicians) are self-motivated and rational—or at least as rational as everyone else—and therefore do not automatically make decisions in the public interest.
- Behavioral economists have questioned the core assumption about rational decision-making that underlies not only public economics, but all of economics.

Set #2 is My Focus Today

- What I see as inadequate in tax theory.
- Some recent attempts to rebuild the empirical and theoretical analysis of *tax systems*.
- What are the outstanding unanswered questions.

Correspondence Principles

- Theory should apply to developed and developing countries.
- Theory should apply to sophisticated taxpayers (e.g., high-income individuals and MNCs) as well as everyone else (e.g., employees subject to withholding).
- Conforming theory should inform practical issues addressed by lawyers and accountants.

A *Tax System* Establishes:

- 1) what events or states of the world trigger tax liability, and the magnitude of that liability: *tax bases and rates*.
- 2) who or what entity must remit that tax liability, and when: *remittance rules*.
- 3) what procedures ensure compliance with the remittance rules, including information reporting requirements and penalties for noncompliance: *administrative and enforcement rules*.

The standard theory presumes that tax liability can be ascertained and collected costlessly, in which case 2) is irrelevant and 3) is unnecessary.

A Theory of Tax Systems Addresses:

- What fraction of (and which) returns to audit
- Penalties for noncompliance
- Remittance regime (e.g., withholding)
- Information reporting regime
- Compromises to textbook-ideal tax bases, e.g. realization-based taxation of capital gains and schedule-based depreciation

The Behavioral Response to Taxes

- All behavioral responses to tax rates are symptoms of inefficiency.
- Although traditionally economists focused on labor supply responses, the same logic applies to avoidance and evasion responses.
- These are particularly important for sophisticated taxpayers: high-income individuals and multinational corporations.

The Tax Base Elasticity (TBE)

- For an income tax, all the responses are summarized by the *elasticity of taxable income*, or ETI. More generally, they are summarized by the *tax base elasticity*.
- This includes avoidance and evasion responses and, e.g., substitution toward tax-deductible expenditures.
- Much recent effort has gone into estimating the ETI. It seems to be bigger than the labor supply elasticity, and relatively big among high-income people.

Caveat: The Endogeneity of TBEs

The TBE depends on:

- Enforcement choices made by the home government. This implies there is an “optimal” TBE.
- Avoidance opportunities facilitated by other governments (e.g., tax havens).
- Taxpayers’ investments in greater elasticity.

Caveat: Theoretical and Empirical Challenges Abound

- The appropriate TBE for welfare purposes must consider tax shifting across tax bases and across time periods.
- Identification issues severely plague existing methods; note that the marginal tax rate is a function of taxable income!
- See Saez, Slemrod, and Giertz (forthcoming in the *Journal of Economic Literature*) for a critical review .

Tax Havens

- Are they a good thing, providing small open economies a way to effectively reduce distorting taxes on capital that cannot be explicitly enacted?
- Or are they a bad thing, leading to the wasteful expenditure of resources by both firms and by governments?
- In Slemrod and Wilson (*JPubEc*, 2009), either full or partial elimination of havens improves welfare for the residents of non-haven countries.
- Why is Elvis on Burkina Faso postage stamps?

Bringing Firms into Tax Theory

- Firms are largely absent from optimal tax theory. This is a problem because tax systems rely on firms to collect taxes.
- Public finance textbooks assert a remittance irrelevance proposition: it doesn't matter which side of a taxed transaction must remit. This is wrong, though.
- Examples: predominance of firm remittance, VAT vs. RST, employer withholding, small business exemptions.

Why Exempt Small Businesses?

- It violates the optimal tax theory injunction against production inefficiency.
- But it economizes on collection costs.
- This tradeoff has not been closely addressed by the optimal tax literature.
- One reason is that heterogeneous firms are absent from the modern theory of taxation.

Taxes and the Missing Middle

- Dharmapala, Slemrod, and Wilson (*JPubEc*, forthcoming) identifies conditions under which it is optimal to exempt small firms from taxation.
- These inefficiencies occur because 1) small firms are tax-favored and 2) some firms get (inefficiently) smaller to obtain the tax exemption, creating a “missing middle” in the firm size distribution.
- This production inefficiency is balanced against the cost savings from collecting revenue from, on average, larger firms.

Line Drawing

- Much real-world scuffling about taxation involves drawing and interpreting lines, yet analysis of this topic is almost completely absent from economic analysis. Why?
- The theory allows an unlimited number of commodity tax rates and a general non-linear income tax function.
- But both are impractical or infeasible.

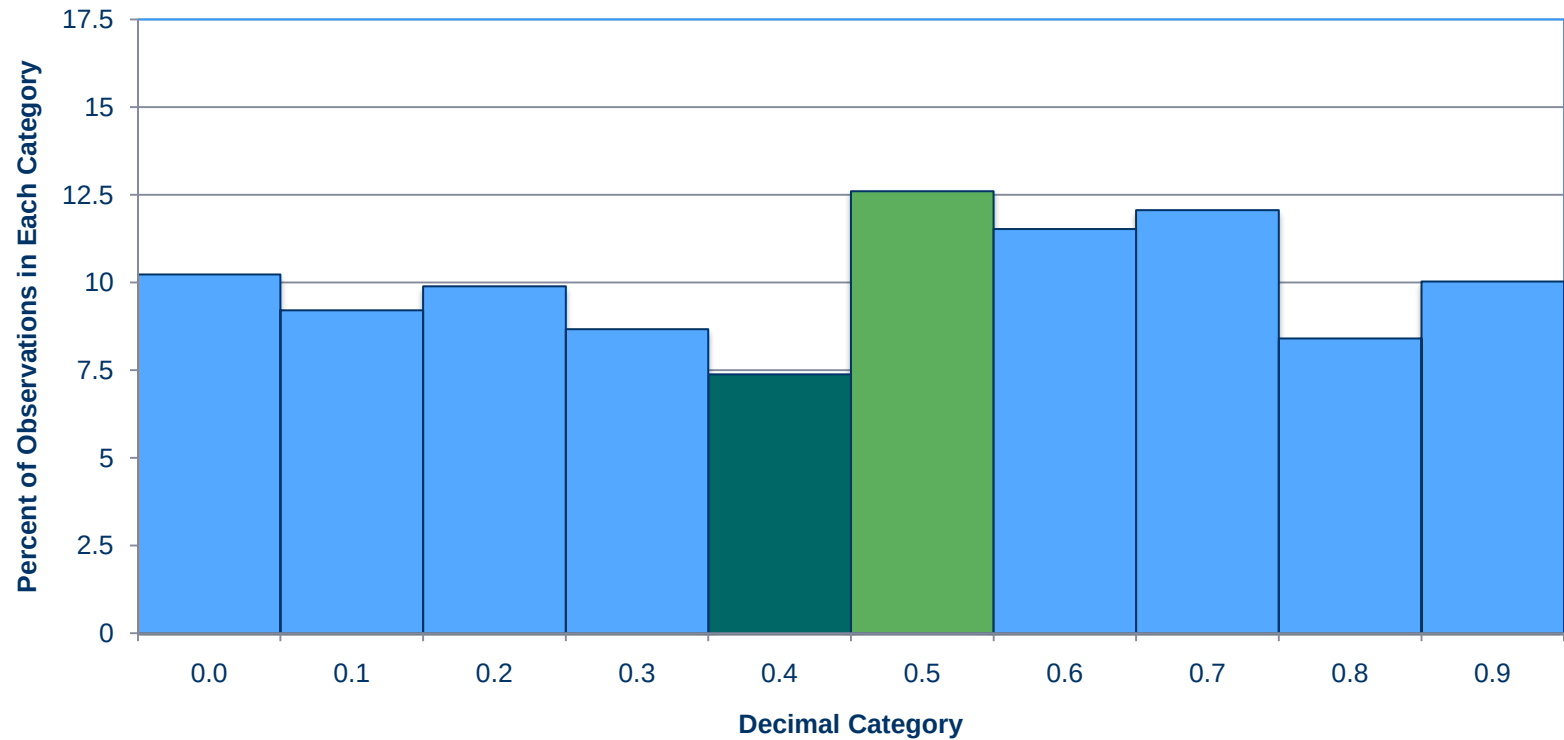
Tax-Driven Product Innovation

- Drawing lines create "notches" in choice sets--a small change in some aspects of the taxed good creates a large change in tax liability.
- This causes *tax-driven product innovation*, goods just slightly on the low-tax side of the line.
- An example: car-like motorcycles in Indonesia and car-like panel trucks in Chile.
- A bigger example: equity-like finance that qualifies for (debt-like) interest deductibility.

Notches

- Many tax schedules create discontinuous budget sets-- they have *notches* (not kinks).
- This causes bunching and excessive distortion that presumably is justified by some cost of a levying a continuous tax.
- Example: The Gas Guzzler Tax, which changes discretely at 0.5 decimals of MPG.

Gas Guzzler Tax Notches



Summing Up

- The British economist Frank Hahn once wrote that “optimal tax formulas are either guides to action or nothing at all.”
- As of now, these formulas refer to a stylized world that is far from the muddy tax trenches of withholding, information reports, audits, tax havens and evasion, line drawing and notches.
- But we can do better...

How to Do Better

- Model heterogeneous firms.
- Model information value and acquisition.
- Model revenue-rapacious governments.
- Take seriously behavioral models of:
 - Salience (cognitive capacity of taxpayers and policy makers)
 - Noncompliance (deterrence versus duty)