

The Golden Rule of Taxation

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Source: *Proceedings. Annual Conference on Taxation and Minutes of the Annual Meeting of the National Tax Association*, 2018, Vol. 111 (2018), pp. 1-14

Published by: National Tax Association

Stable URL: <https://www.jstor.org/stable/10.2307/26939544>

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The Golden Rule of Taxation

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November, 2018

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Introduction: A Welfarist Role for Nonwelfarist Rules

- We (optimal tax theorists) are making a big mistake when assuming that we can fully trace a policy's effects on welfare
 - ▶ This assumption is key to Kaplow & Shavell (2001): "Any nonwelfarist method of policy assessment violates Pareto efficiency"
 - ▶ Without full information, we will routinely get policy very wrong
- *Nonwelfarist* principles may act as informational proxies
 - ▶ A welfarist role for nonwelfarist rules into policy analysis (WRNR)
 - ▶ Very controversial, and rightly so
- Two ways to see this argument:
 - ▶ Extension of logic for rule utilitarianism from individual ethics
 - ▶ Specific version of a general argument to use society's wisdom

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Contribution in this paper

- In this paper, I propose a specific example of such a nonwelfarist rule, what I call the Golden Rule of Taxation
 - ▶ The rule is Adam Smith's first maxim of taxation: what Musgrave (1959) called Classical Benefit-Based Taxation (CBBT)
 - ▶ I will explain why CBBT is the Golden Rule of Taxation by drawing an analogy to the familiar Golden Rule of Ethics
- Embracing the Golden Rule of Taxation will, I believe, increase the impact of optimal tax theory
 - ▶ To matter, theory should resonate with how people think about taxes
 - ▶ In other words, tax theory is not physics, it's political economy

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The Golden Rule of Ethics: a paradox

- "Do unto others as you would have others do unto you"
- A core element of modern common morality
 - ▶ Often said to be a tenet of many (most?) religious traditions
 - ▶ Related to *impartiality* idea common to many ethical systems
- Paradoxically, largely dismissed by philosophers as an ethical guide
 - ▶ Key problem: GR is *subjective*; judgments depend on one's views
 - ▶ GR is silent on the fundamental determinants of right and wrong

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Resolving the Golden Rule of Ethics paradox

- R.M. Hare's (1975) "two levels of moral thinking":
 - ▶ Level 2 thinking is done by an "archangel [with] superhuman knowledge of the facts"
 - ▶ Level 1 thinking is done by real people, using "learnt principles, which, in order to be learnt, have to be fairly general and simple"
- Big debate: is Level 1 useful instrumentally (Level 2 better if possible) or fundamentally (Level 2 impossible)
 - ▶ Hayek, for example, believed the latter (I tend to agree)
 - ▶ If Level 2 thinking is impossible, we need Level 1 rules
 - ▶ *Level 1 rules carry information we can't get otherwise*
- The Golden Rule of Ethics is clearly Level 1 thinking
 - ▶ General, simple, widely learned (and taught)
 - ▶ Not used by those who practice Level 2 thinking (philosophers)

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Three strengths of the Golden Rule as a Level 1 rule

- 1 It relies on decentralized and localized ethical judgments, eliminating the need to know all effects of actions
- 2 It covers the essence of the ethical dilemma by including both sides, the actor and the acted upon, through an elegant "flip"
- 3 Its vagueness protects us from grave errors vs. more specific principles: "it is better to be approximately correct than precisely wrong"

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Seeking a Golden Rule of Taxation

- I believe Level 2 thinking is just as unlikely in tax theory as in ethics
 - ▶ We cannot know all the effects of a tax policy—our knowledge is limited
 - ▶ We are kidding ourselves if we think we can build models yielding tax policies that will effectively further a Utilitarian objective
- Therefore, we need a Level 1 rule that can act as a Golden Rule of Taxation

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A candidate for the Golden Rule of Taxation

- Consider Smith's first maxim of taxation
 - ▶ "The subjects of every state ought to contribute toward the support of the government, as near as possible, in proportion to their respective abilities; that is in proportion to the revenue which they respectively enjoy under the protection of the state."
 - ▶ Musgrave (1959) called this "Classical Benefit-Based Taxation"
- In Benefit-Based Taxation, people pay taxes based on the benefit they obtain from the activities of the state
 - ▶ CBBT specifies how to calculate benefit; i.e., through the magnification of innate ability
 - ▶ So, people should pay taxes based on the income they can earn due to the activities of the state
- I explore CBBT in two recent papers
 - ▶ One formally links Smith's idea (seamlessly) with Mirrleesian theory
 - ▶ A second shows widespread popular support for CBBT as a tax principle

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The Golden Rule of Taxation paradox

- Like the Golden Rule of Ethics, the Golden Rule of Taxation is:
- A commonly cited perspective on tax
 - ▶ O.W. Holmes: "I like to pay taxes. With them I buy civilization."
 - ▶ IRS: Publication "Why do I have to pay taxes?" starts with the answer: "Taxes Benefit Everyone"
 - ▶ Jack Lew: arguing against inversions to "avoid paying taxes here, notwithstanding the benefits they gain from being located in the United States."
 - ▶ All of local (property) tax in the United States
- Denigrated by experts (tax theorists)
 - ▶ Absent from 5 definitive texts (and BBT criticized if mentioned): Mirrlees Review (IFS, 2010), Atkinson and Stiglitz (1980), Kaplow's (2008), Salanié (2011), Boadway (2012)

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CBBT shares the three strengths of the Golden Rule

- 1 It relies on decentralized and localized judgments, eliminating the need to know all effects of actions
- 2 It covers the essence of the tax problem by linking revenue to its uses
- 3 Its vagueness protects us from grave errors

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#1: It relies on decentralized and localized judgments

- Taxes are justified based on the individual's direct benefit from government, not as a way to achieve broader social objectives
 - ▶ If set fairly, therefore, taxes are justifiable at individual level
- Benefit-based taxes' great appeal, in fact, is based on this local logic (see Lindahl, Moulin, Brennan, Hines)
 - ▶ [A new paper with Robert Scherf tries to compare/contrast these models simply]

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#2: It covers the essence of the tax problem

- Mirrleesian theory focuses on efficiency vs. equality
 - ▶ Important, but the *fundamental* tax problem is to fund a capacious state in a legitimate way
- Related, modern theory separates taxation from expenditure
 - ▶ This is fine if people judge tax and spending policy independently
 - ▶ But, if people judge based on CBBT, this assumption is faulty
 - ★ If wages depend on state activities, connection is automatic
 - ▶ *I believe this may be the single most problematic assumption in modern optimal tax theory*
- CBBT (uniquely) links the revenue and spending side of tax policy

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#3: Its vagueness protects us from grave errors

- Our theory's results are notoriously fragile
 - ▶ Worse, results can be way off with most people knowing
- Instead, CBBT is self-regulating
 - ▶ If benefits do not align with taxes, people will *know it*
 - ▶ Moreover, ways of producing benefit will evolve and adjust

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Implications and Conclusion

- Just as the Golden Rule remains central to actual ethical reasoning, CBBT should guide our discussions of and thinking about tax policy.
- President Obama understood this:
 - ▶ "As a country that values fairness, wealthier individuals have traditionally borne a greater share of this [tax] burden than the middle class or those less fortunate. Everybody pays, but the wealthier have borne a little more. This is not because we begrudge those who've done well — we rightly celebrate their success. Instead, it's a basic reflection of our belief that those who've benefited most from our way of life can afford to give back a little bit more."
- Formally incorporating CBBT into optimal tax theory is not difficult, but many empirical and theoretical challenges remain.
 - ▶ I believe the payoff from meeting these challenges, in terms of the impact of optimal tax theory, would be large!

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