Measuring a Fair Share
by Allison Christians

It is perhaps advisable not to think too deeply about political slogans, especially during election campaigns, but it so happens that campaign rhetoric often taps into some fundamental questions about the individual’s obligations to the state, and this year’s offerings are no exception. President Obama’s call for everyone to “pay a fair share” (along with getting a fair shot and playing by the same rules) is — at least in part — a swipe at his opponent, for whom speculation continues regarding his tax planning, on- and offshore. Republican nominee Mitt Romney’s defense, “I’ve paid all the taxes required by law,” invokes another version of what a fair share is, and one that is complicated by his intimations that 47 percent of Americans pay no share at all. Those statements by would-be leaders evoke a litany of familiar arguments about what fairness requires in tax policy. To be sure, fairness is a topic of great importance in any debate about tax policy, and one that undoubtedly deserves thorough reconsideration from any society on an ongoing basis. Yet it is also worth considering what that word “share” means.

The concept of a share is important because it implies that some representative whole exists that can be measured and meted out in some principled way. Asking what is fair necessarily requires first identifying that which is to be distributed. But this task is often overlooked in the rush to debate what fairness means. Inevitably, failing to consider what we mean by the “whole” allows vastly different and often inconsistent assumptions to creep undetected into the debate about fairness. Stepping back in order to have a discussion about what is to be shared reveals that some of the most fundamental questions involved in exercising the nation-state’s right to tax have yet to be resolved.

Share of What?

Consider two possible definitions of this theoretical “whole” to be meted out in some principled way. One might define that representative whole as the total amount the nation expects to collect from all taxpayers based on its tax laws on the books at any given time. Or one might define the representative whole as the total pool of resources available to all the taxpayers and therefore in some measure to their government.

Those are two distinct yet interrelated definitions, and they provide two very different perspectives on how we appraise the tax system. Each presidential candidate has implicitly invoked one or both of those definitions, with no critical examination, in order to construct a narrative about taxes and the relationship between people and their government. Taken together, those two perspectives might come close to defining a conceptual whole around which a tax policy system can measure everyone paying a fair share. But it might be surprising just how incomplete our thinking is on either definition and how this incompleteness leaves any discussion about fairness in tax policy bereft of resolution.

Measure by Expected Revenue

The first definition is often articulated in the concept of a “tax gap”: the idea that there is a measurable amount of revenue that should have been collected, but was not, because taxpayers are not compliant with the tax law. This idea animates much of the speculation over whether Romney’s undisclosed tax returns contain tax planning strategies like the conversion of ordinary income into capital gains, the assignment of little or no value to shares contributed to tax-free savings accounts,
or the stashing of cash overseas. It is a compelling idea because it suggests that there is a correct revenue figure that can be extrapolated from a mechanical application of the tax law, so that a person who pays that mechanically derived number can be said to have paid his fair share, while a person who does not do so has shirked his responsibility. This is the definition implied by Romney’s defense of his effective personal income tax rate. But, as compelling as the idea is, this is not a straightforward measure.

The Problem With Projections

From a pragmatic perspective, the measure is difficult because it requires accurately predicting expected revenues in a given period. It should be abundantly clear that such a thing is not easily accomplished. We might get close to a number with sophisticated projections, but taxation is a complex system that interacts in inherently unpredictable ways with socioeconomic reality. Natural and man-made disasters (hurricanes, wars, and market crashes, to name but a few) are traumatic examples of events that affect the unpredictability of a future revenue stream in the aggregate, but there are myriad more mundane reasons why revenues cannot be predicted with great accuracy even for an individual taxpayer.

For example, it is difficult to predict how much a given tax credit might cost in terms of revenue expectations, since taxpayers may make more or less use of the credit than expected. This can happen as a result of market conditions that make it more or less likely that taxpayers will engage in the behaviors targeted by the credit, but it can also happen because taxpayers don’t make use of the credit out of ignorance or failure to plan, or even because other tax mechanisms, such as alternative minimum tax rules or even the progressive tax rate structure, end up affecting the availability of the credit in ways the taxpayer or the government could not have anticipated.

Even if those obstacles could be overcome, however, a more analytically fundamental problem with defining the whole by reference to potential collections arises if we try to use compliance as a measuring tool. Tax laws, like any other laws, are written down in statutes, regulations, agency guidance, and judicial interpretation, but all of this law must be interpreted through practice — and in practice, things are complicated. Interpretation involves differing views on what the language of the law technically requires as well as whether the taxpayer must abide not only by the letter but also the “spirit” of the law, whatever that may mean. Among the taxpayer, the IRS, and the courts, there is plenty of room for disagreement about what constitutes legal tax avoidance and where an imaginary line is crossed into noncompliance. A second and related problem is that taxpayers have far more information than the IRS does when it comes to measuring what could be collected in a world of full compliance.

The Problem With Compliance

A look at official measures of the tax gap reveal how the compliance problem affects our use of expected revenues as a metric for measuring a representative whole. In the United States, the IRS defines the tax gap by reference to three categories of noncompliance: “nonfiling,” “underreporting,” and “underpayment.” The picture that emerges is both incomplete and under-theorized. Nonfiling is a particularly intriguing category, as it attempts to estimate that which by definition does not exist. In 2006 the IRS estimated that $28 billion in revenues went missing because of nonfiling, but the category includes only personal income taxes and estate taxes; it provides no estimate regarding what is missing from nonfiling of corporate income tax, employment tax, and excise tax returns.

In light of events like the UBS whistleblowing case and the increasingly extreme attempts of the IRS to extract more information about nonfiling through regimes such as the Foreign Account Tax Compliance Act and foreign bank account reports, this $28 billion figure alone seems susceptible to significant upward revision. But the underreporting and underpayment categories are no more comforting. They involve both incomplete information as well as interpretive judgment calls on the part of the IRS and could similarly be off by significant amounts. The estimates rely generally on prior-year IRS audits, but there is no way to estimate how information asymmetry between taxpayers and the Service and the future outcomes of disputes between taxpayers and the Service influence the overall picture.

Perhaps the best explanation of the tax gap then is that it purports to measure the revenues that would be raised if the IRS had complete information about everyone, the IRS processed everyone’s tax return according to its own interpretation of the law, the IRS never made a mistake, no one ever countered with a different view, and everyone paid on time. It is difficult to imagine that this describes anyone’s definition of compliance, yet this is a narrative told in the story of the tax gap. This fails to construct a convincing representative whole that can then be divided into shares, and the failure occurs long before we ever get to the question of what would make those shares fair.

Measure by Economic Resources

That brings us to the second option: that the representative whole must be some measure that involves not a macro-estimate involving the amount the nation’s revenue collection system will produce by reference to

the tax laws, but rather an aggregate of all the economic resources available to anyone that the government can call a taxpayer. It is this unstated and unexamined view that drives much of the discussion about who pays taxes in America and who does not. Thus, when a claim is made that 47 percent of Americans pay no income tax (regardless of the factual accuracy thereof), the implication is that they are taxpayers and that they have resources that for some reason are not being sufficiently extracted by the government. It seems unlikely that the assumed reason is widespread noncompliance (even though that might describe a large part of that number). Instead, the assumption is much more likely that the tax system is simply failing to do what it could and should do, by design.

This involves a very different and more difficult measurement of a representative whole for the purpose of determining fair shares. It involves first identifying whom a government can and should tax, and then identifying what resources of those persons a government can and should claim. This definition means that deciding what is fair can only be undertaken after identifying first a pool of taxpayers and then the pool of resources available to them.

**Who and What Can We Claim?**

It is surprising how seldom it seems to be acknowledged that even the first task, defining the pool of taxpayers, is fundamental to defining what fairness requires, yet this issue remains almost wholly unresolved by any government in the world. At first glance, the question may seem easily answered: When we are thinking about a fair share, we mean relative to our fellow citizens. But this is too simplistic. Nations don’t impose tax on the basis of citizenship. Rather, nations tax more broadly by reference to their territory — anyone who is permitted access to the territory in some fashion comes under the nation’s jurisdiction for tax purposes. This is by no means restricted to those with citizenship. Moreover, it is by no means restricted to those located in a physical, geographic space, so we cannot simply switch our assumption from citizens to residents.

Instead, the concept encompasses anyone who accesses the market, that ethereal and ever-shifting plane of global economic and financial integration. All nations make efforts to claim resources from this ethereal plane, and so the taxpayer is not only the easily recognized resident, physically located within the boundary lines, but anyone, anywhere, who can be said to interact economically with or within the nation. That means that we cannot even begin to decide what a fair share is unless we come to some understanding about what a nation can and should claim for itself from the whole world of individuals and resources. Perhaps it will come as no surprise that in practice, nations resolve this problem every day by resorting to a mix of innumerable forms of uneasy consensus based in historical practice and hazy principles, and there is little doubt they get it wrong as often as they get it right.

This might seem like an abstract meandering into academic questions of sovereignty and citizenship, but in fact it highlights an enduring issue for taxation. Once we realize that measuring a fair share requires first identifying everyone in the world that can be said to be a taxpayer, we confront the same problem we saw in the idea of measuring compliance: the information-constrained state. It is practically impossible for any one government to identify all the people who are jurisdictionally available to it by virtue of their economic and financial ties to the national economy, assess all of the economic resources available to each individual, and then determine what claim the nation can make over those resources. Since obtaining that information is unfeasible, it follows that it is not being accomplished.

One answer is that governments do the best they can with the information they have, and constantly seek to extract more information through cooperative and sometimes coercive methods. We can see this in the various information-sharing efforts being reassessed in countries around the world, the FATCA regime being one particularly controversial example. But it is equally possible that governments do not do the best they can; rather, they act selectively and according to the political and personal motivations of their elected and appointed officials, and those institutional and policy frameworks that involve economic, social, and geopolitical history support an ongoing international consensus that satisfies itself with obtaining less than what is needed in order to accurately assess any whole from which shares could be allocated in a principled way. This is the story of transfer pricing, intermediary chains of ownership, deferral of foreign profits, and myriad other internationally accepted regimes that allow the shifting of resources through legally sanctioned (or ignored) arrangements.

**Partial Measure Is No Measure at All**

Herein lies the basic problem of measuring a fair share. If the measure begins with identifying a pool of available taxpayers and their resources, the task is defeated as soon as individuals can omit themselves or their resources from view. This is true whether taxpayers are shirking legal obligations with questionable strategies and structures (noncompliance), or whether tax systems allow that omission by design. If nations cannot or will not identify a complete pool of taxpayers and available resources, it will be impossible for anyone to measure a representative whole.

This explains the persistence of offshore tax avoidance and evasion despite exploding media coverage and public activism against it, but it also explains the basic and enduring frustration with Romney’s undisclosed tax returns, along with the periodic frustration that arises whenever the media cover the exploits of
another fabulously wealthy individual or another fabulously profitable corporate enterprise alongside his or its fabulously low tax payments. It also explains why it is sometimes politically expedient to raise the nonpayment of taxes by some percentage of the population as a self-evident violation of an unstated assumption about what is fair. In each case, the public has information that suggests a pool of resources available to people that are easily recognized as fellow taxpayers but has little or no information about why the government cannot or will not extract some greater claim over those resources.

The result is that when politicians talk about paying a fair share, we are faced with a bewildering framework of assumptions, few of which are discussed, much less resolved, in public discourse. If nothing else, this discussion should demonstrate that before we ever get to measuring what is fair, we need to define what we mean by a share. No doubt, that conversation will never be had in the context of a political contest over national leadership. But we may at least be comforted by the fact that the question of what is fair continues to arise in the political discussion, giving us a chance to once again consider how taxation reflects a constant working out of ideas about the individual, society, and the nation-state.