What is the Appropriate Role for Economic Efficiency in Formulating Tax Policy?

James R. Repetti*

Abstract

Traditionally, the great democracies of the western world assigned equal weight to distributive justice and economic efficiency in designing a tax system. In the past few decades, however, economic efficiency has dominated the debate about the best design of a tax system in politics and analysis by legal academics. For example, many advocate low tax rates on capital gains to reduce the efficiency effects of taxing capital income despite the fact that a capital gains preference reduces progressivity and significantly complicates our tax system. Similarly, discussions of progressive tax rates often focus on the adverse efficiency effects of high rates while ignoring benefits arising from a progressive rate structure's reduced burden on lower income individuals. In addition, many have proposed replacing the income tax with a consumption tax in order to eliminate the tax burden on investment income even though a consumption tax, regardless of its design, would increase the tax burden for many lower income taxpayers.

This article argues that the emphasis on efficiency is misguided. The ascendancy of efficiency over distributive justice has occurred in part because predictions of gains from increased efficiency seem more certain than benefits from equity. Efficiency gains appear quantifiable and certain. In contrast, gains from distributive justice appear uncertain because they are rooted in intangible notions about human behavior and what we consider to be important in our lives.

This article suggests, however, that efficiency gains should not be given priority over equity because efficiency gains, themselves, are highly speculative. Gains from achieving efficiency are based on predictions about taxpayer behavior, which to date cannot be predicted as a matter of theory. Current tax theory usually posits two opposing responses to most taxes and cannot predict which response will dominate. Thus, the issue how taxpayers respond to tax changes is an empirical question. But empirical analyses of the effects of taxation on human behavior are almost always contradictory.

This article illustrates the uncertainty of the impact of taxation on taxpayer behavior by considering some very basic efficiency issues that have dominated tax policy considerations for decades. It explains that the prevailing belief that efficiency gains would arise from broadening the tax base and lowering rates is not certain in theory or empirically. Moreover, the notion that high tax rates encourage tax evasion and discourage work is also not predicted in theory and results of empirical examinations are contradictory. Similarly, current arguments that taxing investment income discourages savings are not corroborated in theory and the empirical evidence is ambiguous. Lastly, the argument that a consumption tax is more efficient than an income tax is not clear in theory or in reality because of transition effects and behavioral responses.

---

* William J. Kenealy, S.J. Professor of Law and Associate Dean of Academic Affairs, Boston College Law School.

Having shown the weaknesses of applying efficiency analysis to some basic areas of tax policy, the article suggests, paradoxically, that efficiency analysis is also deficient because it has been applied too narrowly. Advocates of tax reform that have used economic arguments to support reduced tax burdens on investment income have ignored the economic benefits that arise from a progressive tax system that redistributes wealth. Significant uncontradicted empirical studies show that achieving equality in society contributes long-term efficiency gains. Thus, the article concludes that tax policy analysis cannot ignore equity concerns in forming tax policy.