# 17

# INTRODUCTION TO TAXATION

**FOCUS QUESTIONS**

1. What are the five key attributes that a good tax system should have?
2. What are the various ways in which tax systems affect economic efficiency?
3. What are the difficulties in determining what is a "fair" tax system?

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Unlike most transfers of money from one individual to another, which are entered into voluntarily, taxation is compulsory. Chapter 5 showed that contributions to support public services need to be compulsory because of the free rider problem: unless support for public goods is made compulsory, no one will have an incentive to contribute. The discussion showed how all individuals may be made better off by being compelled to contribute to the support of public goods.

Government's ability to compel individuals' support of public goods, however, may also enable it to compel individuals' support of special interest groups: it can force one group to give up its resources to another group. Such forced transfers have been likened to theft, with one major difference: transfers through the government wear the mantle of legality and respectability conferred upon them by the political process. When the political process in a country becomes detached from the citizenry and is used to transfer resources to the groups in power, the distinction between taxation and theft becomes blurred at best.

These issues were of critical concern to the founders of the United States. The rebellion that became the Revolutionary War is often dated to imports / when imports

the Boston Tea Party, which was motivated by the conviction that unjust taxes were being levied on the colonies. The slogan "Taxation without representation is tyranny" provided one of the central motifs of the revolution. Distinguishing between the legitimate and illegitimate uses of the power of taxation is a matter of continual contention.

## BACKGROUND

Taxation is as old as organized government. The Bible says that a tithe (one-tenth) of the crops should be set aside for purposes of redistribution and for the support of the priesthood. It is not clear what the enforcement mechanism was then, and the Bible does not report on the extent of tax evasion. Chinese emperors dating back to 300 BC generated a significant share of their revenues by taxing salt. In the Middle Ages, individuals provided services directly to their feudal lords; these were effectively taxes but they were not monetized. The fact that vassals were forced to provide these services meant that they were, to some extent, slaves. Some have argued that the fact that modern taxes are **monetized**—individuals are compelled to provide not services (except in the special case of the military draft), but money—should not obscure the underlying relationships. An individual who must give the government, say, one-fourth of his or her earnings is effectively working for the government one-fourth of the time.

There are, however, two critical distinctions between feudal levies and modern taxes. In the former case, individuals were not allowed to leave their manor without the permission of their lord; today individuals can choose where they wish to live, and therefore the jurisdiction that will impose taxes on them. Second, whereas under the manorial system individuals were compelled to work, in modern taxation individuals are compelled only to share with the government what they receive from working (or what they receive from investing, or what they spend). They can choose to pay less if they are willing to work less and receive less for themselves.

In the United States, concern about the possible abuse of the power to tax led to certain constitutional restrictions on the kinds of taxes that could be imposed. For instance, because the agricultural South—then the major exporting region of the country—was afraid that the more populous North would impose export levies, forcing southerners to bear a disproportionate share of the costs of government, such levies were explicitly barred by the Constitution. Other provisions of the Constitution attempted to ensure that taxes would not be imposed in a discriminatory manner.



For example, the uniformity clause says that taxes must be imposed in a uniform way, and the apportionment clause says that direct taxes must be apportioned among the states on the basis of population. Such constitutional restrictions were interpreted to imply that the government could not impose an income tax, and it was not until a constitutional amendment was passed in 1913 that the federal government could impose such a tax.

The restrictions on taxation reflected the experiences of the American colonies with discriminatory taxes levied by the British government. The writers of the Constitution did not anticipate—and probably could not have anticipated—all of the forms of discriminatory taxation. Thus, despite the safeguards that the founders of the republic attempted to provide through the Constitution, issues of taxation have been among the most divisive facing the country. For instance, in the early nineteenth century there was considerable controversy over tariffs.[1] Although they raised revenues, tariffs on industrial goods also served to protect the industrial North, and the South suffered by having to pay higher prices for the protected goods.

## FORMS OF TAXATION

The variety of taxes governments have levied has been huge. At various times, there have been taxes on windows, luxury boats, sales of securities, dividends, capital gains, and many more items. Taxes can be divided into two broad categories: *direct taxes* on individuals and corporations; and *indirect taxes* on a variety of goods and services.

In the United States, the three principal direct taxes at the federal level are: the individual income tax; the payroll tax, a fixed percentage of wages up to some limit, used to finance Social Security; and the corporation income tax, a tax on the net income of corporations. Another important direct tax is the estate and gift tax, which is primarily a tax on bequests from one generation to the next. Because the individual income tax is levied both on wages and on capital income, it affects decisions about labor supply, retirement, education, and so forth, as well as decisions about savings and investment. At the state and local level, there is one other important direct tax, on property.

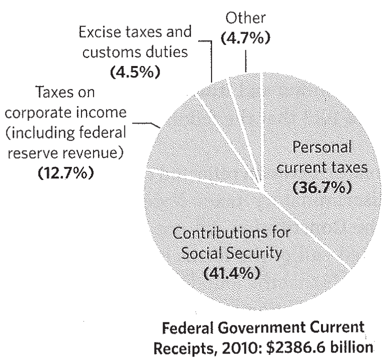
The principal indirect taxes at the federal level are customs duties, levied on imports of goods from abroad; and excise taxes, on goods such as

[1] Tariffs are taxes imposed on imported goods. By raising the prices of the imported goods, they enable domestic producers of similar goods to raise their prices as well. In this way, tariffs "protect" domestic producers.

FIGURE 17.1

**SOURCES OF FEDERAL REVENUE, 2010**

The individual income tax and payroll taxes for social insurance account for the lion's share of federal revenues.




SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*, Table 3.2.

telephone service, air travel, and luxuries. Many states and local jurisdictions also impose a sales tax, a flat percentage tax on all retail sales of a broad category of goods. Some states exempt food from their sales tax, whereas others have a broader range of exemptions. Many foreign governments, rather than imposing a sales tax at the retail level, impose a value-added tax: at each stage of production, the value added is the difference between the value of the sales and the value of purchased (non-labor) inputs.

Figures 17.1 and 17.2 show the sources of revenues at the federal, state, and local levels in 2010. At the federal level, Social Security taxes and individual income taxes together comprise almost four-fifths of revenues (78.1 percent), and the corporate income tax accounts for 12.7 percent. All other taxes are small by comparison. However, at the state and local level, individual income and payroll taxes together make up just over one-seventh of revenues (14.8 percent); transfers from the federal government contribute a quarter of revenues, whereas property and sales taxes each account for another fifth.

## CHANGING PATTERNS OF TAXATION IN THE UNITED STATES

The establishment of the income tax with the passage of the Sixteenth Amendment in 1913 marked a turning point in the structure of taxation



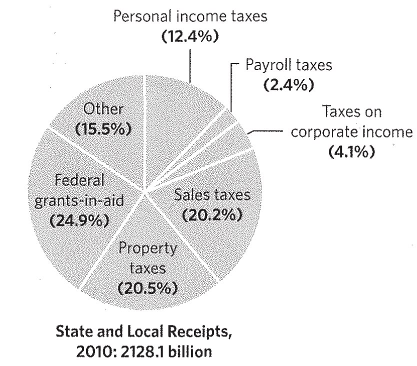



FIGURE 17.2

**SOURCES OF STATE AND LOCAL REVENUES, 2010**

Sales taxes, property taxes, and federal grants contribute about equal amounts to state and local revenues. Income taxes are less important.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*, Table 3.3.

in the United States. Prior to that, the principal sources of federal revenues were excise taxes and customs duties. During the twentieth century, these have dwindled in importance.

Figure 17.3 shows the changes in the relative importance of various taxes during the past century. In particular, we see (a) a marked increase in the relative importance of taxes imposed directly on individuals and a steep drop in the importance of indirect taxes, and (b) within direct taxes, a sharp decrease since 1950 in the role of the corporate income tax and a marked increase in the role of payroll taxes.

There have also been marked trends at the state and local level, reflected in Figure 17.4: an increased reliance on personal income taxes and federal grants, and a decreased reliance on property taxes.

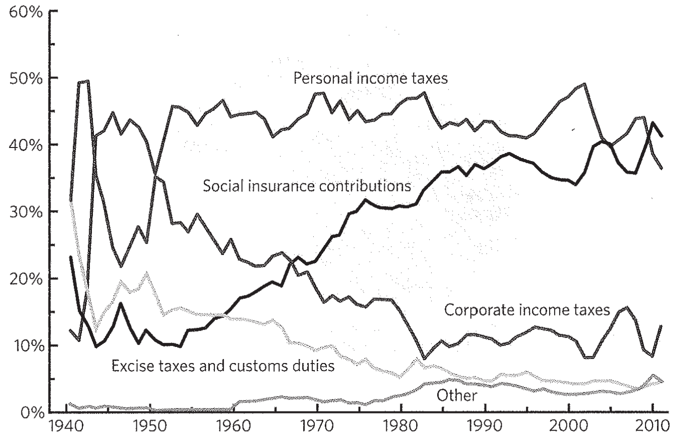
## COMPARISONS WITH OTHER COUNTRIES

During recent decades, most countries have switched to an increased reliance on value-added taxes. As is evident in Figure 17.5, the United States and other Anglophone countries rely much more heavily on the individual income tax than do most other nations, whereas middle-income countries such as Chile, Mexico, and Turkey are particularly dependent on the value-added tax.

FIGURE 17.3

**SOURCES OF FEDERAL REVENUE, 1940–2010**

Customs and excise taxes, and the corporate income tax, have diminished in importance over time, whereas the dependence on payroll taxes for social insurance has grown.

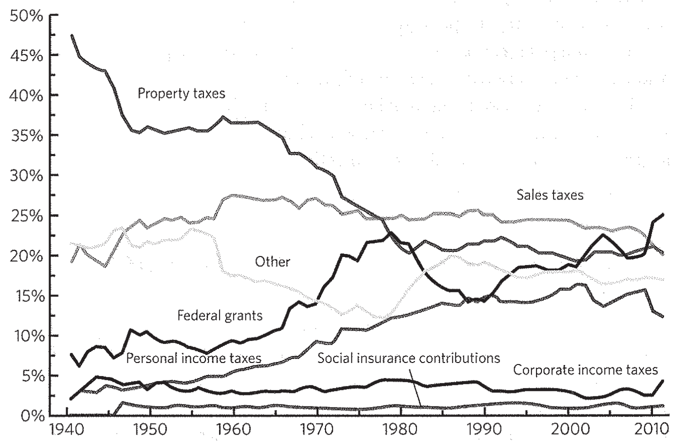



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*, Table 3.2.

FIGURE 17.4

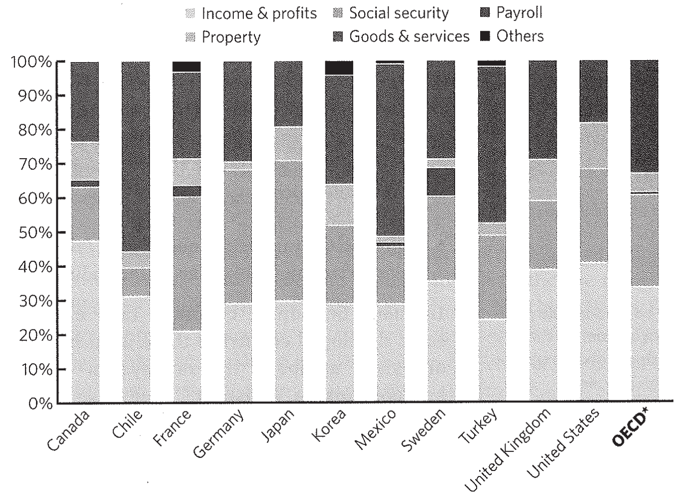
**SOURCES OF STATE AND LOCAL REVENUES, 1940–2010**

The contribution of property taxes to state and local revenues has fallen substantially over the past seventy years, whereas the importance of all other sources (particularly personal income taxes and federal grants) has grown.




SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts*, Table 3.3.






*unweighted average

FIGURE 17.5

**SOURCES OF REVENUE FOR SELECTED COUNTRIES, 2009**

Taxes on income and profits are more important in the United States than in most other countries, where taxes on goods and services account for a larger share of total revenue.

SOURCE: Organization for Economic Cooperation and Development, Centre for Tax Policy and Administration, *Revenue Statistics 1965–2010* (Paris: OECD, 2011), Table 6.

# THE FIVE DESIRABLE CHARACTERISTICS OF ANY TAX SYSTEM

Taxes are inevitably painful. Not surprisingly, designing tax systems has always been a subject of considerable controversy. To put it most simply, most people would like to see their own taxes reduced. Quite ingenious arguments can be devised for why others should pay more.

Governments, in deciding how best to raise the revenue they require, have looked for general principles. There are five accepted properties of a "good" tax system:

1. *Economic efficiency*: the tax system should not interfere with the efficient allocation of resources.

2. *Administrative simplicity*: the tax system ought to be easy and relatively inexpensive to administer. Good tax systems rely on self-compliance, so the system should be designed to make compliance easy and voluntary.