

# INEQUALITY: WHY EQUITY AND FAIRNESS SHOULD BE PART OF TAX POLICY AND GOVERNANCE

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## Abstract

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The theoretical literature on inequality and tax policy contains compelling and competing arguments for and against the inclusion of inequality measures and metrics into tax policy. Some tax policy arguments reflect equity-efficiency tradeoffs. Other tax policy arguments reflect attempts at achieving greater equity (fairness) through further inclusion of inequality over efficiency. The third school of thought seeks a middle ground, with arguments for achieving both lower income inequality and higher economic growth. Thus, the research question analyzed in this article and present in all three aforementioned policy views is whether inequality should be included in tax policy and design. This article implements an interpretivist methodological approach relating to tax policy, augmenting and complementing the relevant research and seminal scholarship of Saez and Zucman (2019), Mirrlees (1971) and Akerlof (1978), among others. This article argues that in balancing the current research literature and evidence, inequality measures incorporating equity and fairness should be part of tax policy and governance.

**Keywords:** Inequality, Tax Policy, Equity, Fairness, Gini Coefficient

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## 1. INTRODUCTION

Certain policymakers view the reduction of 'inequality' as a function of 'fairness' and 'equity,' which is arguably and implicitly a function of tax design and its stated objectives. The term 'inequality' in itself is subject to interpretation and can mean inequality in income, wealth, and opportunity, among other metrics. What do these terms mean, individually, and specifically in terms of tax policy? And how do these varying interpretations of inequality work in conjunction with one another - should they each be weighed equally or not, and why? Moreover, would a given interpretation of inequality be measured over a certain short time series (e.g., per quarter, semi-annually, annually), over a lifecycle, or over more than one lifecycle (e.g., intergenerationally)? Should such tax policies related to inequality be targeted to the average, median, bottom quintile, or

another subset of the population? Even if income inequality is the main substrate of inequality, what formula should determine income inequality - the often-cited Gini coefficient, Lorenz curve, Kuznets curve, or another metric? Finally, is the choice between equity and efficiency a false or real bifurcated dichotomy of a 'tradeoff' that imputes a zero-sum game, sweeping assumption? Or can equity and efficiency be 'complementary' that imputes the possibility of a positive-sum game assumption? As is clear, many factors shape policies aimed at tax policy based on perceptual interpretations of fairness, equity, and distributive justice.

Several reasons exist to argue for the inclusion of 'inequality,' which this article will generally interpret to mean 'income inequality.' One argument within the literature for including (income) inequality as a tax goal is that certain equity-enhancing policies (such as a progressive tax

on high income earners) can increase economic growth, which in turn, will raise tax revenues (Saez & Zucman, 2019). Since raising tax revenues is a relatively undisputed tax objective, including inequality issues such as equity, are inextricably linked to achieving tax revenue generation.

Equity distribution, however, may lead to fewer individuals falling below the poverty line, which may save on transfer payments and related redistributive policies (Carter, 2012). Intergenerational equity effects also play a role, based on the literature, such as an International Monetary Fund (IMF) study whereby individuals below the poverty line had a continued cyclical effect on future generations (IMF, 1999). Similar continued lifecycles of poverty could also presumably exist for pension schemes, whereby current payments may be at a tradeoff for the socio-economic well-being of future taxpayers.

A perception of less inequality, in the form of non-discrimination among groups, could also arguably relate to income effects. Such income effects could act as an incentive scheme for more economic actors and groups to participate (or participate more optimally) in the economy, by seeking gainful employment. This effect, in turn, could generate greater personal and corporate income taxation revenue (Fjærli & Aaberge, 2000; Stiglitz, 1987). As McGregor, Smith, and Wills (2019) acknowledge such a challenge, 'measuring inequality is not straightforward, as it requires decisions to be made on the variable, population, and distributional characteristics of interest' (p. 368). As such, this article delves into the central question of whether inequality should be incorporated into tax policy and design.

The structure of this paper is as follows: Section 2 reviews the relevant literature relating to tax policy and inequality; Section 3 provides the paper's research methodology; Section 4 observes the relevant findings; Section 5 presents the paper's discussion; and Section 6 concludes the article.

## 2. LITERATURE REVIEW

Within the literature, a working model assumption exists that the optimal tax theory is the policy standard by which to determine tax objectives (and as such, whether inequality should be a function of tax policy. Optimal tax theory, in short, addresses tax design from the rubric of maximizing 'social welfare,' which is arguably a function of 'distributive justice' and 'empirical evidence,' such as behavioral and rational decision-making effects to incentives (and disincentives) (Mirrlees, 1971; Ramsey, 1927; Stiglitz, 1987). The optimal tax theory literature seeks to provide a more objective and systematic framework in evaluating the 'tradeoff' between equity and (economic) efficiency<sup>1</sup> (Akerlof, 1978; Saez, 2001).

The optimal tax theory is predicated on maximizing social welfare, which in turn, is

a derivative form of utilitarian-based social welfare<sup>2</sup>, that is, a function of the sum of all utility (economic surplus) functions. However, utilitarianism defined more broadly can also be viewed as the sum of overall utility, expressed in units of happiness as well-being, rather than a more linear interpretation (Ramsey, 1927; Bakija, 2013). Even assuming that maximizing utility (i.e., expanding the pie) is a tax policy objective, should it include some, little, or no regard for distribution (i.e., who gets what slices of the pie), and why? What if a large majority of maximized utility goes to a few concentrated players, should this matter, and why?

Economist James Mirrlees did pioneering work in this field, ultimately leading to a Nobel Prize for his seminal scholarship (Mirrlees, 1971; Diamond & Mirrlees, 1971). More recently, Emmanuel Saez of UC Berkeley has furthered the discipline by adding another overlapping Venn diagram of empirical measurements to incentives combined with ethical considerations derived from philosophy and other fields (Saez, 2001; Saez & Zucman, 2019; Piketty & Saez, 2003; Bakija, 2013).

Tax policy, from a reductionist purview of optimal tax theory, has among others, two overarching goals<sup>3</sup>:

- tax efficiency;
- tax fairness (equity).

Tax efficiency, in which the doctrine of economic efficiency and Pareto optimality was imported into tax research literature, can be achieved by, among others, minimizing direct and indirect costs to the economy (i.e., efficiency costs). Can such efficiency be measured? Generally, yes, efficiency can be measured based on Pareto optimality, but is predicated on certain underlying assumptions, and is mainly concerned about *effective* incidence. A tax and public policy perspective arguably includes other criteria, including not only efficiency and fairness, but also robustness to avoidance, and administrative efficiency (Stiglitz, 1987; Slemrod, 1990).

Tax policy can adversely impact efficiency through distortions, such as distortions of incentives and deadweight costs (Loutzenhiser, 2019; Mirrlees, 1971). An example of deadweight loss is where a certain income tax design reduces incentives for work and/or savings. To minimize deadweight losses, imposed taxes ought to be applied to those individuals and/or firms that have the most inelasticity to such imposed taxes. Tax efficiency may also be affected through administrative costs. This is because public resources are needed to pay and collect tax revenues (Ramsey, 1927; Mirrlees, 1971).

<sup>1</sup> As a juxtaposition of tax and economics, the optimal tax theorists factor in the 'efficient markets hypothesis' espoused by the likes of Eugene Fama at the University of Chicago, who imputed a dataset of stock prices from 1926 to 1960 to argue that prices reflected 'all available information,' and as such, were stable and self-correcting (Fama, 1970; Fama, 2019b). What was not so explicitly questioned in the literature, however, was whether all parties at all times acted fully 'rationally,' with every economic actor consistently bearing and incorporating 'all available information' into market prices.

<sup>2</sup> Utilitarianism (also referred to as 'consequentialism') within the field of philosophy both coexists and competes with other school of thoughts within the same discipline, including deontological ethics that focuses on duty and maxims (espoused by Jeremy Bentham, Immanuel Kant, and Peter Singer), virtue ethics that focuses on the virtues of an individual's mind and character (espoused by Socrates, Aristotle, Plato, and Stoics), and practical ethics focused on scientific inquiry (espoused by John Dewey) (Russell 1967; Rawls 1971). Such philosophical inquiry frequently overlaps with tax policy and inequality issues concerning critical policy questions, such as what constitutes a 'fair' amount of tax, is paying tax a moral duty, should the rich pay more tax, and what is the duty and role of the state and taxpayers concerning tax revenue generation and redistribution? (Russell, 1967; Sandel, 2010; Gribnau & Dijkstra, 2019).

<sup>3</sup> Taxes can also remove or reduce market failures, as well as to improve economic efficiency. A classic example is a Pigouvian tax, such as a tax on pollution, and other kinds of tax design to offset, in whole or in part, negative externalities.

Determining the most economically efficient tax design would be one factor in minimizing tax-related distortionary effects and deadweight costs. Fama recently opined on the benefits of a 'simpler tax scheme' as it relates to economic efficiency (Fama, 2019a). This would inhibit optional economic output. Another means of lowering distortions would be simplifying the tax code, which therefore lowers administrative costs, and in turn, may decrease tax avoidance and related tax planning schema. Less distortion through greater administrative efficiency may also be furthered by continued information-sharing, as proffered by the OECD (Carter, 2012), along with greater IT computational capabilities, such as better software, machine learning and algorithms, that can help track, measure, and predict tax-related events. Moreover, such policies should ensure that negative externalities, such as environmental harm, can be mitigated to the extent possible.

### 3. RESEARCH METHODOLOGY

This article is largely, but not exclusively, conceptual and interpretive in methodology. As such, the majority of this research is primarily prescriptive and tax policy-based in approach and methodology. Primary and secondary sources are drawn across data sources from various public- and private-sector institutions relating to this article's main research question: whether inequality should be a tax policy goal.

Some of the related literature incorporated quantitative and/or qualitative analyses, charting relevant data including market capitalization, tax policy efforts and impacts, among others. Operationalizing the understanding and analysis of such research is a notable methodological challenge of this study. Primary and secondary sources from various public (and non-public) sources were therefore required to complete the analysis.

A limitation of this paper is 1) the lack of available primary and secondary sources relating to inequality and tax policy issues; and 2) access to surveys/data collection, as applicable. However, the first limitation is inherent in many areas in which scarcity of literature exists, which signals a need for this niche area to be further augmented. The second limitation was remedied by augmenting the research to non-survey data regarding similarly-situated tax policy design schemes and objectives.

The next section takes an interpretivist research methodological approach, from a tax policy and design perspective, to provide the article's results relating to inequality as a potential tax policy goal.

## 4. RESULTS

### 4.1. Tax fairness: What does fairness mean?

A common tax objective, in addition to economic efficiency, is tax fairness. But what does 'fairness' mean exactly? From whose perspective? And what ought to be done when one person's fairness is different than another person's perception of fairness?

Tax fairness, often linked to tax equity concerns, is a means to redistribute a state's tax

burden in a 'fair' manner. Tax equity is generally more concerned about formal (rather than effective) tax incidence.

Among the research literature, two dominant theories emerge:

- benefits principle;
- ability-to-pay principle.

The benefits principle states that those who benefit from public spending should bear the tax burden that pays for such public spending<sup>4</sup> (Sugin, 2004). The ability-to-pay (ATP) principle holds that those with a greater ability to pay taxes should pay more taxes, as espoused by Kendrick in a seminal *American Economic Review* article (Kendrick, 1939). Thus, a positive correlation should exist. The unsubtle implication underlying the ability-to-pay principle is that the rich should pay more than the poor, *ceteris paribus*. In practice, however, the correlation is not proportionate to income, but can be a higher percentage of income, thus becoming progressive.

Murphy and Nagel (2002) of New York University argue that taxation 'can put into practice a conception of economic justice'. They posit, among other things, that public policy, political, as well as law and economics disciplines have taken a misguided approach. Specifically, the emphasis on the distribution of a tax burden relative to pretax income is a non sequitur. Because property rights are a function of laws and rules that are primarily possible due to a functioning tax system, tax fairness cannot be evaluated by their impact on preexisting entitlements. Moreover, concepts of 'justice' in a tax framework should not be applied to tax distribution but to the end-effects of the entire systematic framework of economic institutions. In short, as advocated by Murphy and Nagel (2002), tax policy debates focus on the wrong issues because of a lack of a moral foundation.

Certain academic perspectives, such as those proffered by John Stuart Mills (who viewed maximizing utility as maximizing 'pleasure and freedom from pain') and more recently by Robert Frank may differ, specifically in arguing that the state 'may not legitimately constrain any citizen's freedom of action except to prevent harm to others' (Mills, 1863; Frank, 2008, p. 1777). Mills, moreover, argued that, pursuant to his 'greatest happiness principle,' moral behavior is one that promotes utility, and immoral behavior is one that subtracts from utility (Mills, 1863). This then raises the question of whether inequality can constitute 'harm to others' under the Mills framework. Yet another view of tax justice by Rixen (2011) provides that 'the minimum requirement of justice is to devise global rules that ensure that national tax systems remain capable of implementing distributive justice as they see fit' (p. 447). This also begs the question of who exactly constitutes 'they' - policymakers, taxpayers, the general public, or perhaps other actors? (Rixen, 2011).

Fairness and equity can also be perceived through the lens of the 'equality of opportunity' versus the 'equality of outcome.' If economic

<sup>4</sup> Although arguably elegant in theory, actually applying the benefits principle in practice can be less elegant. Moreover, efforts of applying the benefits principle can, in certain circumstances, ironically lead to inequitable circumstances, involving among others, the free rider problem (e.g., of public goods) and preference revelation problem (incentivizing under-reporting of benefits).

outcomes are inequitable, it can be argued that the equality of opportunity is insufficient, or in a more extreme version, has outright failed. It can also be argued that inequality of outcomes creates, and as such is highly correlated with, inequality of opportunity due to factors such as access to credit, financial literacy, education, and access to health.<sup>5</sup>

The next section continues an analysis of tax fairness and equity considerations into other inequality metrics, including aspects related to measuring and interpreting such related methodologies.

#### 4.2. Common inequality metrics

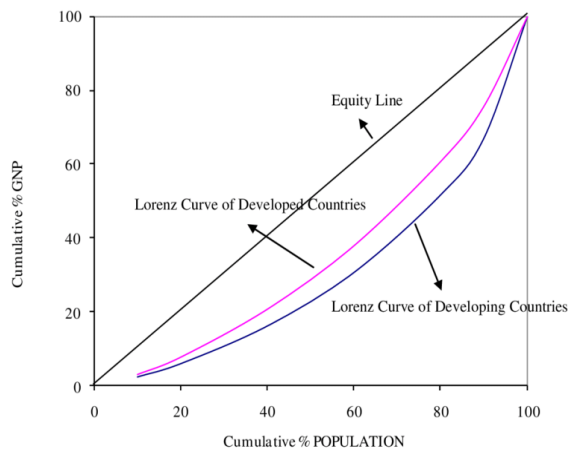
What are accurate and generally-accepted means and metrics to measure inequality?<sup>6</sup> How many are in the bottom quintile of income? How much the top one percent own of total wealth? Framed broadly, what ought to be the methodology towards measuring and interpreting inequality?

Various attempts to measure inequality are, among others, the Gini coefficient, Lorenz curve and Kuznets curve (United Nations, 2015). Although their methodologies differ, their objective of measuring inequality is generally the same for all of them.

The Gini coefficient is an often-cited measure of inequality. When the Gini coefficient = 0, the income is distributed perfectly equally across all income groups. When Gini coefficient = 1, then the highest income growth receives all the income.

The Lorenz curve measures inequality by revealing the percentage of income owned by  $x$  percent of the population. On the horizontal axis is the cumulative number of income recipients ranked from the poorest to the richest individual or household. The vertical axis displays the cumulative percentage of total income.

Figure 1. Lorenz curve

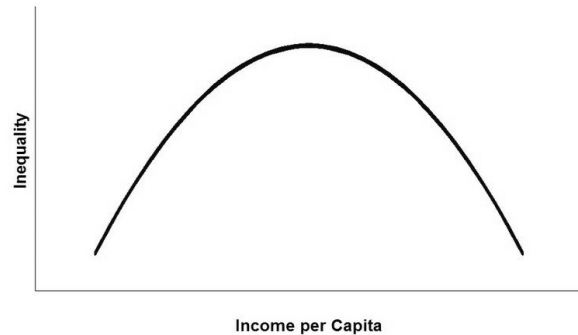


<sup>5</sup> These factors, can also be viewed within the lens of a proverbial 'life lottery,' meaning that where one is born, such as the hemisphere (northern hemisphere GDP is greater), country (developed versus developing), region of a country (rich or poor region) and postal code (city/province) are all determinants of outcomes and opportunity, although one has no choice in these matters.

<sup>6</sup> Recent research on inequality from an interdisciplinary perspective, such as recent findings from Payne, a behavioral scientist, offer a dynamic and disturbing perspective into the profound implications beyond mere income inequality, specifically, '[r]egardless of their average incomes, countries or states with greater levels of income inequality have much higher rates of all the social maladies we associate with poverty, including lower than average life expectancies, serious health problems, mental illness, and crime' (Payne, 2018).

The Kuznets curve hypothesis contends that as market forces take hold in an economy, inequality worsens, then improves over a longer time horizon (Kuznets, 1955).

Figure 2. Kuznets curve



Another metric for estimating inequality is the distribution of income, which is linked to tax fairness (Atkinson & Bourguignon, 2015). Factors of distribution of income, related to inequality, include the following:

- distribution of assets;
- education and human capital;
- bargaining positions in collective bargaining;
- monopoly/market concentration/financialization;
- international trade issues;
- technology and technological change;
- highly unregulated laissez-faire market dynamics.

Separately, an unequal distribution of income can be argued as due to unequal distribution of assets, particularly capital. Piketty's research demonstrates that income inequality has become even more exacerbated since the wealthy generally have greater access to assets, particularly capital (Piketty, 2014; Piketty & Saez, 2003). Given that  $R > L$ , whereby returns to capital ( $R$ ) are greater than returns to labor income ( $L$ ), the wealth gap widens over time. The distribution of income relates to the distribution of assets, namely land, labor and capital. However, some critique Piketty's empirically-based research by arguing that the differentials are notably due to gaps *within labor wages*, not between capital and labor (DeLong, 2015).

Education and human capital also relate to the distribution of income. Given the increasing rising costs of education, particularly at the university level, access to education is increasingly becoming the province of the privileged. Empirical research suggests that 'a higher level of educational attainment of the labor force has an equalizing effect on income distribution' (Park, 1996, p. 51). From a tax efficiency purview, this phenomenon can lead to suboptimal outcomes since overall wealth will not be maximized. In economic parlance, the production possibility frontier curve (PPF curve) will not be fully maximized with nonoptimal access to education, which in turn, diminishes an economy's human capital. This factor also has intergenerational effects over a long-term time horizon. This is because wealthier individuals will more likely to attain even more levels of education, while poorer individuals attain lower levels of education (Park, 1996).

The level of symmetry versus asymmetry in bargaining positions between workers and firms in the collective bargaining context also plays a notable role in the distribution of income. If labor unions increase in strength, this will lead to a relatively greater bargaining position (negotiation power), which in turn, will generally lead to relatively higher levels of wages (Ahlquist, 2017). An argument can be made that unions artificially inflate bargained-for wage levels above market wage levels, while a counterargument exists that unions are needed to minimize the possibility of wages being reduced to levels that undermine workforce morale and market value.<sup>7</sup> It can also be argued that many workers without adequate union representation, when paired with a lack of political lobbying power on their behalf, also exacerbates asymmetry in wages between certain historically-represented professional fields, such as for attorneys and doctors, compared to, for example, blue-collar workers.<sup>8</sup>

The degree of monopoly power arguably also plays a pervasive role in the distribution of income. The argument can be made that the greater the market concentration by dominant firms, the lower the profit and wage levels for smaller firms (due to market concentration and monopolistic/oligopolistic/monopsony-like behavior). Such patterns arguably exacerbate the levels of income inequality, as espoused by Boushey (2019), head of a Washington D.C. think tank, who argues that such forces have led to stagnant wages and deteriorating labor conditions. A counterargument, as put forth by the likes of Milton Friedman, is that free market forces can drive prices down, but in exchange for less (or lower-quality) services.

International trade and inequality are often highly correlated, in both developed and developing economies (Leamer, 1996; Meschi & Vivarelli, 2009). International trade issues, related to Ricardo's theory of comparative advantage, allows states to increase productive output relative to a counterfactual scenario in which no international trading exists. Furthermore, increased trade levels lead to increased levels in demand for abundant factors pursuant along Heckscher-Ohlin (H-O) lines (Deardorff, 1982). Conversely, in instances of protracted international trade such as in the ongoing trade war between the U.S. and China – the world's top two global economies – suboptimal outcomes can result, not too dissimilar to a prisoner's dilemma (PD) where two parties must strategically choose between cooperation or competition (betrayal)<sup>9</sup> (Axelrod, 1984; Schelling, 1981). As Dagan (2017) has argued, utilizing a PD framework, two parties seek to cooperate or compete based on PD-related payout matrix relating to

decision-making, including whether to join multilateral and bilateral tax treaty regimes, and whether a dominant strategy (DS) within a PD framework exists (Dagan, 2017; Walker, 1980; Axelrod, 1984). However, the PD framework generally assumes rational behavior, which behavioralists, have found debatable based on recent evidence, such as 'nudging' effects (Thaler & Sunstein, 2009). In terms of financial funds flow, some research suggests an 'overall strong correlation between several financialisation indicators and income inequality', which is based on a comparative perspective among 20 OECD economies over 13 years (1995-2007) (Kus, 2012, p. 477).

Technology and technological change also affect the distribution of income. Demand for factors is a function of technological change. Thus, those firms and individuals with greater resources are more competitively positioned to incorporate (or outright purchase via acquisition) technology, which less wealthy parties are less capable of emulating, thus leading to a further wealth gap (Krugman, 1979; Greenwood, 1997; Guceri & Liu, 2019).

Finally, highly unregulated and liberalized laissez-faire economic policies (colloquially, 'winner-takes-all' market dynamics) arguably can play a role, in which market economies are increasingly unregulated and left unfettered, as seen in the 2000s until the 2007-09 subprime crisis, and unrestrained by regulation/re-regulation (Gridharadas, 2019). Such a hyper-liberalized version of the free market system can arguably lead to an economic and tax environment with grossly unequal outcomes and greater market concentration by dominant firms, in exchange for greater overall economic output, as seen in the post-2008 era (Saez & Zucman, 2019; Raworth, 2018).

An applied case of the above exists in the US experience between 1972 to 2002. Income distribution in the United States has become increasingly unequal in recent decades based on available data sets, whereby former Federal Reserve Chairperson Janet Yellen acknowledged in public remarks that 'distribution of income and wealth in the United States has been widening more or less steadily for several decades' (Yellen, 2014). Between 1972 and 2002, higher-income family tax groups grew at a faster rate than lower-income family tax groups, whereby average income in the lowest quintile rose by only 5.8 percent, compared to the highest quintile that rose nearly eightfold at 45.7 percent (Weinberg, 1996).<sup>10</sup>

The next section provides an analysis and discussion of the competing arguments related to tax fairness and distribution, which is often viewed as a trade-off within a bounded optimality framework.

## 5. DISCUSSION

Several arguments supporting the case for redistribution exist to further fairness and equity concerns. Equity, in turn, links to the concept of

<sup>7</sup> In contrast, the Keynesian wage efficiency theory posits that paying above-market wage levels increases workforce morale and firm loyalty, thus leading to less workforce disruptions, which in turn, reduces the firm's notable associated costs of workforce retraining for newly hired workers.

<sup>8</sup> Based on the U.S. Bureau of Labor Statistics (BLS), 'the median annual wage was \$37,690 for all occupations in 2017. By comparison, the median wage was \$103,820 for doctoral- and professional-level occupations – the highest of any education level – and \$68,090 for master's-level occupations' (Torpey, 2018).

<sup>9</sup> Should tax design be predicated on a 'broad base – low rate' tax policy, which appears to be the convergent global trade? Such dynamics appear to correlate with the ongoing global race to a tax regulatory and rate bottom. But this raises important threshold questions: Is this a net good or bad, and based on what metrics – fairness or utility maximization (arguably a proxy for achieving a utilitarian, output-driven approach towards achieving the greatest good for the greatest number of actors)?

<sup>10</sup> Why did such phenomenon occur? One thesis can be that it was due to factors, such as the differential between skilled and unskilled labor wage levels as a result of technological changes, and to a lesser extent, international trade patterns. Moreover, the falling of wage shares, along with the increase in executive-level salaries and tax cuts (which represents an exception to U.S.'s progressive tax policy) for the wealthy may have also played notable roles in such outcomes.

distributive justice (Sugin, 2004; Loutzenhiser, 2019). Another argument for redistribution includes achieving more optimal levels in efficiency. From a public policy purview, low levels of income at the bottom income distribution levels (e.g., bottom quintile, poverty-line income levels) may also lead to bad health outcomes, poor attendance and access to quality educational opportunities, and less access to capital and other lines of credit for spending and/or investment).<sup>11</sup>

The more conventional category of argument relates to citing the tradeoff between efficiency and equity (Akerlof, 1978; Saez, 2001). Thus, in an economists' bounded optimality framework, a macro-economy cannot have it all. It must choose and trade efficiency for equity, or vice versa. But it cannot have both economic efficiency and equity. Thus, an argument exists that taxing the rich will reduce incentives to work, and take market risks (linked to seeking investments and entrepreneurial ventures), as linked to optional tax theory (Albanesi, 2006). Another scholarship has noted the role of shared entrepreneurial risk-sharing with the government as a factor in tax effects (Cullen & Gordon, 2002), while others have noted the 'positive and significant impact of tax credits for R&D, implying a user-cost elasticity estimate of around -1.6' (Guceri & Liu, 2019, p.266). Such a phenomenon, as a result, can arguably lead to deadweight costs<sup>12</sup> (Stiglitz, 1987; Diamond & Mirrlees, 1971).

Some have advocated for a blended tax design approach. An IMF 2014 report noted that tax policies must balance 'distributional and efficiency objectives' with an 'appropriate mix of instruments' that depend on administrative capacity, societal preferences for redistribution, and political economy considerations (IMF, 2014). Moreover, in advanced economies, applying means-testing to gradually phase out benefits as incomes rise, implementing progressive personal income tax rate structures, and reducing regressive tax exemptions were supported. For developing economies, expanding conditional cash transfer programs (as administrative capacity improves), and expanding coverage of the personal income tax, among others, were suggested by IMF policymakers (IMF, 2014).

The second line of argumentation against redistribution relates to philosophical concerns. Specifically, the argument relates to the proper role of the state. Under this view, the state should not, generally speaking, over-reach for fear of transforming a democracy to a monarchy. In the U.S. case, for instance, its constitution specifically sets forth so-called enumerated powers, whereby only an explicitly defined province of duties are delegated to the federal government, whereas all other powers generally then default to the state and local level (as a check and balance between federal and local level regulations).<sup>13</sup> Thus, under this purview, the federal government's role should be limited, not expansive,

to maintaining the rule of law, providing basic public goods and services, and controlling externalities. Anything above and beyond these clearly defined boundaries can therefore arguably be viewed as over-reaching, and perhaps arguably even unconstitutional on its merits (Isaacs, 1977).

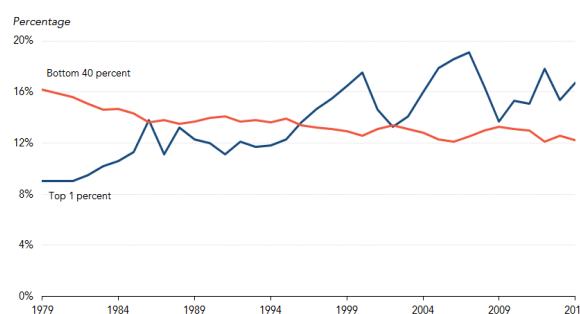
One view, under the median voter theory, is that what policies are adopted is not the province of philosophical debate, but something more realpolitik: specifically, what do the voters want? However, this answer raises many more interesting questions (Rowley, 1984). After all, voters are not a monolith. Each voter has different interests, tastes, and preferences, which may be expressed differently. So, whose should ultimately prevail, and why? Linking this more directly to the median voter theory, actual applied public policy will generally (but not always) reflect the preferences of the median voter. A clear implication is that competing political parties act rationally - in vying for voters - as rational actors trying to maximize their utility (political influence) in a game theory model.<sup>14</sup>

### 5.1. Inequality and extreme wealth

The top one percent income earners have received their fair share of academic and journalistic criticism relating to inequality and tax design. But is the negative narrative supported by data? And should extreme wealth influence inequality and tax policy?

According to the U.S. Congressional Budget Office (n.d.), the income of the top 1 percent from 1979 and 2014 was fairly flat but began increasing in the 1980s.<sup>15</sup> This increasing trajectory, in the U.S. case, was only interrupted in 2001 (after the dot-com bubble) and 2007-08 (after the global subprime crisis). Moreover, the post-2008 crisis rebound in global equity markets has also positively correlated with income shares for the top 1 percent increasing yet again (Congressional Budget Office, n.d.).

**Figure 3.** Share of before-tax income for top 1 and bottom 40 percent income groups (1979-2014)



Source: Congressional Budget Office (n.d.).

<sup>11</sup> Such factors, individually and collectively, may also lead to higher crime levels for such population groups, thus, leading to higher incarceration rates, which represents a deadweight and social cost to the public and macroeconomy.

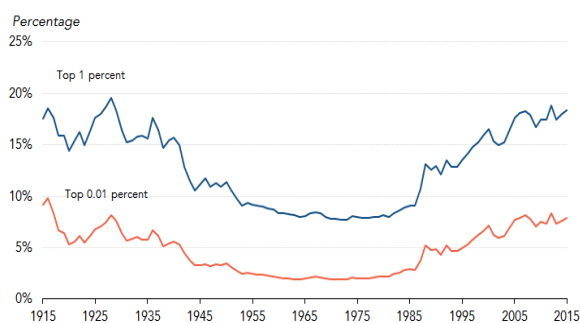
<sup>12</sup> Deadweight costs are generally to be avoided in an economist's conventional view of the world since they are indicators that a tax policy is not Pareto optimal.

<sup>13</sup> This raises the question: which side of the case should be applied as public tax policy.

<sup>14</sup> However, the elegance of the theory often does not match with equal elegance in practice, since parties' positions have not always obeyed the median voter theory, due to many factors, including distortionary influences, such as political lobbying efforts and special interest groups (in the U.S. case). As such, perhaps the answer is not so binary as to redistribute or not. Perhaps, much like a sliding scale rather than an on-off switch, the question can be better framed as: what amount should be redistributed, and what should not?

<sup>15</sup> This phenomenon correlates with the implementation of lower marginal tax rates (i.e., tax cuts), as espoused by the Reagan and Thatcher years. The counterargument is *cum hoc ergo propter hoc* ('correlation is not causation'), and further, that many other equally relevant variables likely exist to explain the correlation.

**Figure 4.** Top income shares in the United States (1915-2015)



Note: Income is annual gross income reported on individual tax returns, excluding capital gains and government transfers (such as social security, unemployment benefits, and welfare payments) and before individual income and employees' payroll taxes.

Source: Saez (2016).

An interesting threshold question is whether the U.S. case relating to the top 1 percent is an outlier or the median? Saez (2016) not only argues that a rising share by the top income earners in the U.S. exist (see above figure), but goes on to assert that the U.S. case is not an outlier, but rather in conformity with other OECD economies, which have experienced a similar phenomenon, albeit less pronounced than in the United States.

Another pertinent question is how tax design affects income equality? A more progressive tax design would generally lower income inequality, everything else being equal.<sup>16</sup> In the U.S. case, although federal taxes have become increasingly progressive, federal taxes also were lowered in 2001 relative to before-tax income, due to tax cuts by both the George W. Bush and Barack Obama administrations. Interestingly, during this period, a lower average tax rate offset the effect of increased tax progressivity. The net effect, in the U.S. case at least, was only a nominal effect of federal taxes impacting income inequality.

The Gini index (or Gini coefficient) is one measure of income inequality (as referenced earlier). Under this metric of applying the Gini coefficient, inequality in the U.S. case has been constantly lower for after-tax income relative to before-tax income from 1979 to 2014, based on recent U.S. Congressional Budget Office data (Congressional Budget Office, n.d.).

Income inequality is also less pronounced among OECD economies relative to the U.S. In the mid-1980s, the Gini coefficient was 0.28 among

<sup>16</sup> Before-tax income inequality has risen in the U.S. case since the 1970s, even though government transfer payments increased during this same period. Since high-income earners, such as the top 1 percent, pay higher average federal tax rates than others, federal taxes (separate from other taxes) generally reduce income inequality. However, after-tax income inequality has increased roughly in a similar amount as before-tax inequality (Congressional Budget Office, n.d.).

For tax policymakers, in a bounded optimality (resource-constrained) world, experts must decide on the balancing of competing interests between tax objectives, economic growth, political viability, optics of action (versus inaction), and perceived fairness, to name a few. For many policymakers, such factoring in of such myriad of coordinating and competing interests are critically important, but at the same time, can be complex and hard to apply in a cohesive tax design strategy.

Economics and equity, in particular, are often where trade-offs must be made within a resource-constrained economy. Beyond economics and equity, policymakers can also consider the overall effects of tax design as a whole, rather than narrowly focusing on individual taxes, and their respective progressiveness or regressiveness (i.e., the forest versus the trees perspective). Viewed as a whole, tax design can be viewed in terms of both taxes and tax benefits.

working-age populations, on average in the OECD economies. However, twenty years later in the mid-2000s, the Gini coefficient increased to 0.31, signaling greater income inequality for the same working age group (Carter, 2012).

The research of Smith, Yagan, Zidar, and Zwick (2019) concluded that a 'typical top earner derives most of her income from human capital, not financial capital' (p. 1676). This has profound implications since if the top 1 percent are indeed a class of 'active business owners,' taxing their wealth could prove antithetical to the tax objective of increasing tax revenue. Across a broader view within a global dataset, top marginal statutory personal income tax rates have fallen from 66.8 percent in 1981 to 41.7 percent in 2010<sup>17</sup> (Carter, 2012).

The next section provides several policy approaches whereby inequality can be incorporated into tax design.

## 5.2. Specific inequality and tax policy approaches

This section provides a non-exhaustive analysis of some tax policy approaches that can incorporate efficiency and inequality.<sup>18</sup>

A progressive tax can be perceived by some as 'fair,' since it is based on the ability-to-pay principle. However, it is likely to have a distortionary effect on incentives. Conversely, a lump-sum tax, whereby the same tax is applied to all taxpayers, regardless of income or ability to pay, achieves tax efficiency, but may be perceived as unfair. Such perceptions of tax unfairness can lead to socio-economic ramifications. As Alesina, Glaeser, and Sacerdote (2001) have argued whether income inequality should be mitigated with tax policy is a function of perception. If high incomes are perceived as a function of luck (randomness within a chaotic, entropic system, such as a given economy), then high progressivity is often favored as a form of a social safety net (i.e., socio-economic failure insurance policy). If, however, high incomes are perceived as a function of hard work and intelligence, then low rates of progressivity are often favored to further incentivize risk-taking (Alesina et al., 2001). Recent quantitative scholarship has supported the Kuznets hypothesis - which suggested a U-shaped curve between inequality and economic growth - in terms of gross and net income, based on data from 1981 to 2005 (Duncan & Sabirianova Peter, 2008; Kuznets, 1955). Other scholars have taken different methodologies on how the tax system's increasing progressivity has played a role in 'exacerbating or offsetting' trends towards income inequality (Slemrod, 1994).

Raising indirect taxes, such as consumption taxes of goods or services is a tax policy that will lower inequality in certain circumstances. Benefits of consumption taxes include efficiency, low administrative costs, and relatively lower

<sup>17</sup> The OECD also faced the same trade-off threshold question of economics versus equity. In the years directly following the 2008 subprime crisis, whereby the proverbial pendulum shifted more towards equity (Carter, 2012). But where is the pendulum today in 2019, and where ought it be going forward? Should additional tax revenues be derived from broadening the tax base to increase the taxability of the upper quintile income earners? Or should marginal statutory tax rates also be raised? These are some critical questions that can arguably define the current tax era.

<sup>18</sup> Per above, the suggested tax policy analysis is purposely non-specific in terms of jurisdiction, given the highly imperfect information available for each and every economy worldwide, including social, economic, legal, regulatory, tax, and cultural variables.

distortionary effects. However, such taxes would, at best be neutral, and in many cases, be regressive. Within the scholarship, one researcher argues that evidence 'demonstrates that tax shifts from income to consumption taxes have inequality reduction implications, given the higher progressivity degree of income taxes when compared to other tax sources' (Johansson, 2016, p. 3; Alves & Afonso, 2019). Interestingly, consumption taxes represent larger budget proportions for developing countries (relative to developed countries), even though they can be regressive.<sup>19</sup> However, viewed as a whole, such taxation's impact on fiscal policy can still be progressive, assuming that the effects are offset by other tax and tax benefit policies.

Value-added taxes (VATs), another form of consumption tax, may also represent a means to achieve overall progressive policymaking objectives. However, given real-world realities and optics, lower or even zero VAT rates for deemed 'necessities' may be a more plausible policy option for certain countries. Further, in terms of comparison tax data, an interesting scholarship by Weller and Rao compare higher progressive taxation with VAT (Weller & Rao, 2010).

A tax on equity (colloquially referred to as a 'wealth tax' or 'capital tax') is another tax design option. Although its application varies in different jurisdictions,<sup>20</sup> it can apply to the total value of personal assets, or a smaller subset, with or without liabilities deducted (effectively, a 'net wealth tax'). Some have equated a wealth tax to a consumption tax (Fama, 2019b). Arguments against a wealth tax include capital flight (including human capital among the highly affluent and mobile, although the U.S. may or may not be an outlier case, given the IRS' global source income taxation jurisdictional scope), net tax revenue loss (given the high administrative cost), liquidity and valuation issues, creative accounting (by making businesses artificially appear less valuable with accounting and valuation methods utilizing specific assumptions), tax avoidance (due to complexity and higher tax obligations), as well as disincentives to innovation and risk-taking (Blinder, 2019). In the current U.S. political election, a wealth tax on the richest 0.1 percent by Democratic presidential candidate Elizabeth Warren<sup>21</sup> was created with academic assistance from Emmanuel Saez and Gabriel Zucman (UC Berkeley), which used

U.S. data showing that the current federal tax system is mildly progressive up to the 99.99th percentile (with a 33 percent effective tax rate (ETR)), but that those in the top 0.01 percent only bear a 23.3 percent ETR. Under the Warren wealth tax plan, such householders would instead pay a 45 percent ETR (Saez & Zucman, 2019).

From an international context, varying versions of wealth taxes with varying degrees of success have been applied internationally, such as in France, Canada, Iceland, Norway, the Netherlands, and Switzerland to name a few. However, several European economies no longer apply wealth taxes, including Austria, Denmark, Germany, Finland, Luxembourg, and Sweden. In the UK case, property taxes in the form of a Council Tax, and municipal property taxes are imposed, which are often the main source of an individual's assets. A London School of Economics (LSE) 2011 study examined the UK's consideration of a wealth tax in the 1970s, which were never implemented. Factors for non-implementation included the notion that Spain's wealth tax may have contributed to a banking crisis, while France's wealth tax was viewed as overly complex and unpopular. Former British Chancellor, Denis Healey, surmised that a wealth tax would be a tax policy mistake: 'We had committed ourselves to a wealth tax, but in five years I found it impossible to draft one which would yield enough revenue to be worth the administrative cost and political hassle' (Davies, 2012).

Raising marginal tax rates on personal income tax for upper-quintile earners, as a counterfactual policy prescription, although appearing to implement a policy of everyone paying their 'fair share' of taxes (as in the case of a wealth tax), may not bring in net greater tax revenue. This is due to a plethora of factors, including income and substitution effects (i.e., purchase, career, and leisure-related decision making based on rational factors), tax avoidance (i.e., tax planning, particularly for higher income individuals and entities), and even behavioral factors (i.e., mental accounting, loss aversion theory, framing effects). As Alstadsaeter, Johannesen, and Zucman (2019) have demonstrated using empirical evidence, the correlation of the 0.01 percent richest households tended to evade tax relating to 'about 25 percent' of their tax obligations, based on administrative wealth records in Scandinavia, which can arguably be extrapolated to other developed tax regions and could even be more pronounced with higher levels of income inequality, including the United States. Moreover, other datasets from HSBC reflected a higher number in terms of tax evasion, to nearly half, while datasets from the recently leaked Panama Papers showed an 'even steeper wealth gradient' (Alstadsaeter et al., 2019). Even tax amnesty-related cases demonstrated that tax evasion rose sharply with wealth<sup>22</sup> (Carter, 2012).

Piketty and Saez (2013) have also argued for a simplified optimal inheritance tax model. The main rationale for such tax is based on the 'meritocratic Rawlsian criterion.' Rawls (1971) argued that a society should be constructed based on a 'veil of ignorance' and 'original position'. Applied to this

<sup>19</sup> An OECD 2012 report suggests that 'shifting the tax mix' to less distortionary tax policies, such as away from corporate and labor income taxes towards consumption and real estate taxes would be beneficial, since this would lead to greater work incentives, savings and investments (Carter, 2012). Although such tax measures could diminish equity, such effect could be offset with cash transfers, however, the redistributive effect of such transfers vary tremendously across regions, with some countries having highly-targeted small cash transfers (e.g., the UK and Australia), while others having large cash transfers over a life cycle with relatively low progressivity (e.g., France and Germany) (Carter, 2012). The Andrew Young School of Policy Studies Research Paper also concluded that 'general consumption taxes, excise taxes and customs duties' exacerbate income inequality (Martinez-Vazquez, Moreno-Dodson, & Vulovic, 2012).

<sup>20</sup> In the U.S. case, wealth tax critics, such as Barry Isaacs, argue that a wealth tax may constitute as a direct tax under Article 1, Section 9 of the U.S. Constitution (i.e., it could be construed as unconstitutional), requiring either a constitutional amendment or reversal of current case law and stare decisis. Overall, however, no clear legal consensus in the U.S. currently exists regarding the wealth tax issue (Isaacs, 1977).

<sup>21</sup> Another U.S. Democratic presidential candidate, Andrew Yang, a tech entrepreneur and Columbia Law School graduate, has advocated for universal basic income (UBI), in the form of a 'freedom dividend' of \$12,000 per year (i.e., \$1000 per month), regardless of income. However, certain findings suggest that a universal benefits may have a relatively nominal incentive effect, and may also entail tax revenue to finance such universal benefits (Carter, 2012). Some scholars have argued for a 'robot tax' to fund UBI initiatives (Oberson, 2019).

<sup>22</sup> However, since tax breaks often favor high income earners, reviewing the evidence for such tax breaks, among an interdisciplinary team of experts, may be worthwhile. Doing so may help achieve social equity, both in terms of substance and socio-economic political optics.



essay, tax policymakers would not know who would fit in what socio-economic category within the society in question (Rawls, 1971; Sugin, 2004). The tax policy rationale is to maximize welfare for those receiving no inheritances.

Optimal inheritance tax rate:

$$\tau B = 1 - b/1 + e(b) \quad (1)$$

whereby:  $e(b)$  = elasticity of aggregate bequests; and  $b$  = relative bequest left by zero-bequest receivers.

Tax revenues can also be gained from increasing and expanding property and estate taxes (colloquially referred to as 'McMansion taxes'), which is arguably under-utilized in many jurisdictions and economies (Slack, 2010). An argument exists that increasing incurrent taxes on immovable property would be fair yet have relatively low distortionary effects, based on the perception (and perhaps even factual basis) that the top income earners own more expensive property.<sup>23</sup> A counterargument is that it is not only the wealthy that own property, since middle and even some lower-income earners who also own property, albeit at lower levels, may also be negatively affected by higher property-related tax rates.<sup>24</sup> Since property-related tax is often a function of property valuations, one negative distortionary effect relates to outdated property valuations and liquidity issues that do not keep up with current market conditions and prices, as Yale Law School's Listokin suggests (Listokin, 2011). This phenomenon has the effect of distorting property markets since it makes the property and labor markets less liquid. This is because individuals are discouraged from moving homes to seek more rewarding employment opportunities and living conditions elsewhere. The IMF also advocated for the greater use of not only more property-related but also energy-related tax schemes, such as a carbon tax, for both developed and developing economies (IMF, 2014).

A tax policy to increase progressivity, thus factoring inequality and fairness into the equation would be reducing tax relief measures for mortgages and mortgage interest payments, as well as reducing capital gains (from secondary residences), carried interest and stock options.

Reducing tax expenditures, which typically benefit high-income groups, can also allow for reduced marginal tax rates and greater equitable distribution of income (Carter, 2012). Another efficiency cost benefit would be that reducing tax relief and loopholes would lower distortionary effects of resource distribution and reduce tax complexity, such as the reduction of tax relief for stock options and carried interest. Doing so would likely increase tax compliance and administrative efficiency, and perhaps even allow for the possibility of lowered marginal tax rates for greater tax revenue, as originally espoused by the admittedly controversial Laffer curve.

## 6. CONCLUSION

Piketty (2014) was one of the first contemporary scholars to utilize compelling data sets to address issues of inequality to an audience of academics and policymakers. Based on such historical analysis, Piketty's conclusory analysis that returns on capital outpaced those of returns to labor served as the precipice to a policy prescription of imposing an annual wealth tax of up to five percent, combined with a progressive income tax of up to 80 percent. Certain commentators contest Piketty's policies, arguing that disparate wage levels are merely a function of bargaining outcomes. But this begs the question of whether equal bargaining positions truly exist to reach fair bargaining outcomes. If not, then inequality levels will likely only exacerbate. On the political stage, certain policymakers have incorporated the inequality debate into election platforms, as seen by several U.S. Democratic Party candidates during the 2020 presidential primary race.

Increasing inequality has correlated with a rising inequality explosion from the 1980s onwards, but has historical roots (Piketty & Saez, 2003). Progressive taxation began in 1917 in the U.S., four years after introducing income taxation, whereby marginal tax rates as high as 67 percent were imposed on top income earners. The U.S. was also the first country to impose a wealth tax in the form of an inheritance tax, which was not seen at the time in Europe. Despite the rise of inequality, however, the U.S. tax policy has since shifted towards a substantially less progressive tax policy approach, as evidenced by substantially lower tax rates in the U.S. and elsewhere within the past few decades (Saez & Zucman, 2019).

Perceptions of inequality also play an unconscious, behavioral role in the debate, as noted by Thaler and Sunstein (2009). If high income levels are largely attributed to luck and good fortune, then a higher tolerance (elasticity) often exists with a higher tax rate on income. However, if higher income levels are largely attributed to hard work and effort, then a lower tolerance (elasticity) often exists with a higher tax rate on income. No matter what side of the policy spectrum, a growing awareness of addressing inequality has arisen in a contemporary context.

On a more esoteric, philosophical level, the inclusion of inequality into tax policy can be approached from an "original position" behind a "veil of ignorance" within the greater rubric of a "justice as fairness" principle, as proffered by the eminent political philosopher, John Rawls. Behind such a cognitive veil, one would form policy prescriptions based on knowing nothing of one's own (or others') abilities or position in society, in which all individuals are determined to be rational, free, and morally equal. As such, a tax policy prescription would be formulated prior to knowing one's traits within any given society, such as education, geography, race, gender or income. A tangential rebuttal was later suggested by philosopher Harry Frankfurt, who argued that the issue of inequality is not that some individuals have less than others, but that some individuals simply do not have enough in the form of basic,

<sup>23</sup> An argument can be made that property taxes, in particular, are a derivative form of a wealth tax (Pomerleau, 2019). The rationale is that a correlation exists between wealth and property, in which low income earners tend to rent than buy property, and high income earners tend to buy than rent property.

<sup>24</sup> The recent subprime crisis also has negatively effected a wide array of income earners who own (immovable) property.

minimally-needed resources, such as decent healthcare, housing or education. Under Frankfurt's view, if the worst-off in society had sufficient resources and could lead to decent livelihoods, then the fact that other individuals had more resources and wealth would be less problematic. This area of debate, albeit related yet outside the scope of this article, poses yet another opportunity for further scholarship on how tax policy and governance should be formulated.

To conclude, the theoretical literature on inequality and tax policy is ripe for further analysis. Some tax policies appear as equity-efficiency tradeoffs. Other tax policies reflect attempts at equity complementing efficiency, narrowing income inequality while also attempting to increase economic growth. Overall, weighing and incorporating the relevant research literature, evidence and related policy arguments, which

suggests improved equity (lower inequality levels) can correlate with improved efficiency, this article takes the view that inequality measures incorporating equity and fairness should be a tax policy objective. As such, this article's findings will be noteworthy for academics as well as practitioners in the area of tax policy and design, particularly for those facing rising inequality levels. The limitation of this study is that further data and metrics are needed to incorporate a broader array of inequality metrics from a diverse range of jurisdictions, which can be challenging given the potential constraints of tax data quantity and quality collection and analysis across countries and regions. In the future, a subsequent paper could also focus more on these issues from an international and/or comparative perspective, which would represent another notable contribution to the existing literature on inequality and tax policy and governance.

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