And Equal (Tax) Justice for All? (Part 6 of 8)

Part Six: Determining the Tax (and Expenditure) Base

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The theory of equity has a powerful influence on those who craft policy. Its practice, however, raises a variety of difficult considerations. Whether one talks about horizontal or vertical equity, it is necessary to define who are equals and who are unequals. To be put into practice, some scale or base—or multiple scales—must be used. And even if a simple scale is used, it must be amenable to practical measurement.

Take the idea that equals will be determined according to ability. With what scalar does one measure ability? For many centuries ability in the field of taxation was measured by property. Before the rise of the middle class, the propertied classes were largely considered to be those "able" to pay, the rest of the population often lived at a level close to subsistence. Property, in turn, was largely defined by land. Along with tariffs, the property tax tended to be the primary source of revenues even as late as the 19th century. In the United States during that period, local property tax collections were normally far in excess of state and local taxes or federal tariffs and other federal revenue sources.

But property had many limitations as a measure of ability. Although the term "human capital" is a relatively modern one, it has long been clear that some individuals are capable of earning more than others, and that differences in earning power are as important, if not more important, than differences in ownership of physical capital. The hoarder might have more property, but the enterprising worker might have much higher levels of both income and consumption.

It was especially with the rise of the middle class that attention was turned toward income, a measure of ability base on a flow concept, rather than property, which is a stock concept. As merchants, manufacturers, and their workers expanded in numbers and economic significance, skills and human capital became more and more recognized as major sources of income. Yet it was only with the rise of the corporation and other large organizations that income could be accounted for with enough accuracy and thoroughness that it could move to center stage in the evolution of tax systems.

Consider the situation even in developed industrial countries in the middle of the 19th century. Most people still lived on farms, their income was often in-kind in the form of crop yields, and markets were still likely to involve significant barter without the exchange of money (for example crop sharing, exchange of services among farmers, exchange of meat and produce). Whether the farmer kept good books or not, there seldom was anyone on the other side of the ledger whose books could be cross-checked by a tax agent. Even today income taxes assessed on farmers and sole proprietors are estimated to be underpaid by as much as one-half.

The corporation, on the other hand, had a powerful need for good income accounting even if it meant creating records not easily hidden from the tax agent. To figure out optimal investment patterns, the large business needed to know which of its many enterprises and branches were profitable (yielded net income). It had to keep track of wages paid to its many employees in its many divisions. To keep a second set of books for tax purposes is quite difficult for a large organization when so many people are involved, while collusion is also harder. Moreover, the books kept by the wage earner on wages received could now be checked against those of the large organization on wages paid, and vice-versa. Thus, the rapid advance of the income tax in the 20th century went hand-in-hand with the development of accounting systems whose records could be tapped for enforcement purposes.

Income had another advantage as well. It could be applied as a measure of ability not just to those who paid taxes, but to those receiving expenditures. Welfare and other means-tested programs in most countries now rely primarily on income as the measure of well- being and as a primary determinant of the amount of subsidy or expenditure that is provided.

Income, however, has never been fully accepted either as an appropriate measure of who are equals for tax purposes, or the base on which progressivity, if any, should be assessed. Localities and states still retain real estate taxes, as well as personal property taxes levied against such items as automobiles—indicating some tendencies to revert back to property as a measure of ability. Estate taxes also are levied against property value passing in an estate.

Wage taxes are also assessed quite widely. In theory, they represent a tax on the returns from human capital and work effort only, but in practice it is almost impossible to separate wage from capital income unless there is a large formal separation of capital owners, as in the corporation. Within the small business, seldom are returns for the business easily separable into capital and labor components, so that most noncorporate business owners pay wage taxes such as social security tax on their capital, as well as labor, income.

Wage taxes, however, are usually associated with some form of social insurance, which ties the tax directly or indirectly with a particular benefit being financed, such as social security, unemployment compensation, or workers compensation. In those cases, equity tends to get defined within each program as a whole. Were there not redistribution within those programs beyond that normally associated with private insurance, the taxes could be considered as mandates to purchase insurance for oneself, and the principal equity issue that would arise would be whether the mandate itself was fair. However, those programs also redistribute and often hide the redistributive function within the insurance function. That tends to complicate analysis of whether the programs are fair in the way they treat households in similar circumstances (horizontal equity), provide a fair insurance policy for the premium or tax paid (individual equity), and redistribute to those with the greatest needs (progressivity).

Perhaps the major tax debate in modern times has centered on the notion that consumption, not income, should represent the principal base for taxation. States themselves have often assessed excise taxes and general excise taxes on the purchases of goods and sometimes services. In most countries around the world, a value-added tax (VAT) is a major source of revenues and is designed to allow deductions for investment in such a way that it can be considered a consumption tax. While the VAT often competes with, it seldom displaces, the income tax. Recent consumption tax proposals, on the other hand, have also offered progressive rather than proportional consumption taxes as a complete substitute for progressive income taxes—often attempting to place the focus on the appropriate measure or scalar to use rather than on the degree of progressivity.

Among the many equity issues that arise is whether it is fairer to assess tax on what an individual consumes or on what he earns. Also of importance is whether two individuals with equal lifetime earnings and inheritances should be taxed the same, or whether the one who saves more—and, hence, generates more capital income—should be taxed more over time. Interestingly, advocates of consumption taxes over all other tax bases have yet to integrate into their thinking how ability can be measured consistently between tax and expenditure programs and in explicit taxes and implicit taxes that phase out benefits as ability increases. For example, if we assessed all taxes and transfers on the basis of consumption, then we would want to provide welfare benefits to millionaires with low levels of consumption.

In practice, most governments have tended to use a variety of these measures—property, income, wages, or consumption—as a tax base or a base for determining eligibility for expenditures. This does not mean that equity does not matter—else almost any base would qualify without reason or rationale. But it does reflect the difficulty of reaching consensus on just who are equals before the law and who are unequal enough to pay more tax or receive more benefits. In the end, only democratic processes are able to resolve those differences.

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