The Golden Rule of Taxation

Matthew Weinzierl

HBS, NBER

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Introduction: A Welfarist Role for Nonwelfarist Rules

- We (optimal tax theorists) are making a big mistake when assuming that we can fully trace a policy's effects on welfare
  - This assumption is key to Kaplow & Shavell (2001): "Any nonwelfarist method of policy assessment violates Pareto efficiency"
  - Without full information, we will routinely get policy very wrong
- *Nonwelfarist* principles may act as informational proxies
  - A welfarist role for nonwelfarist rules into policy analysis (WRNR)
  - Very controversial, and rightly so
- Two ways to see this argument:
  - Extension of logic for rule utilitarianism from individual ethics
  - Specific version of a general argument to use society's wisdom

Contribution in this paper

- In this paper, I propose a specific example of such a nonwelfarist rule, what I call the Golden Rule of Taxation
  - The rule is Adam Smith's first maxim of taxation: what Musgrave (1959) called Classical Benefit-Based Taxation (CBBT)
  - I will explain why CBBT is the Golden Rule of Taxation by drawing an analogy to the familiar Golden Rule of Ethics
- Embracing the Golden Rule of Taxation will, I believe, increase the impact of optimal tax theory
  - To matter, theory should resonate with how people think about taxes
  - In other words, tax theory is not physics, it's political economy

The Golden Rule of Ethics: a paradox

- "Do unto others as you would have others do unto you"
- A core element of modern common morality
  - Often said to be a tenet of many (most?) religious traditions
  - Related to *impartiality* idea common to many ethical systems
- Paradoxically, largely dismissed by philosophers as an ethical guide
  - Key problem: GR is *subjective*; judgments depend on one's views
  - GR is silent on the fundamental determinants of right and wrong

Resolving the Golden Rule of Ethics paradox

- R.M. Hare's (1975) "two levels of moral thinking":
  - Level 2 thinking is done by an "archangel [with] superhuman knowledge of the facts"
  - Level 1 thinking is done by real people, using "learnt principles, which, in order to be learnt, have to be fairly general and simple"
- Big debate: is Level 1 useful instrumentally (Level 2 better if possible) or fundamentally (Level 2 impossible)
  - Hayek, for example, believed the latter (I tend to agree)
  - If Level 2 thinking is impossible, we need Level 1 rules
  - *Level 1 rules carry information we can't get otherwise*
- The Golden Rule of Ethics is clearly Level 1 thinking
  - General, simple, widely learned (and taught)
  - Not used by those who practice Level 2 thinking (philosophers)

Three strengths of the Golden Rule as a Level 1 rule

1. It relies on decentralized and localized ethical judgments, eliminating the need to know all effects of actions
2. It covers the essence of the ethical dilemma by including both sides, the actor and the acted upon, through an elegant "flip"
3. Its vagueness protects us from grave errors vs. more specific principles: "it is better to be approximately correct than precisely wrong"

Seeking a Golden Rule of Taxation

- I believe Level 2 thinking is just as unlikely in tax theory as in ethics
  - We cannot know all the effects of a tax policy–our knowledge is limited
  - We are kidding ourselves if we think we can build models yielding tax policies that will effectively further a Utilitarian objective
- Therefore, we need a Level 1 rule that can act as a Golden Rule of Taxation

A candidate for the Golden Rule of Taxation

- Consider Smith's first maxim of taxation
  - "The subjects of every state ought to contribute toward the support of the government, as near as possible, in proportion to their respective abilities; that is in proportion to the revenue which they respectively enjoy under the protection of the state."
  - Musgrave (1959) called this "Classical Benefit-Based Taxation"
- In Benefit-Based Taxation, people pay taxes based on the benefit they obtain from the activities of the state
  - CBBT specifies how to calculate benefit; i.e., through the magnification of innate ability
  - So, people should pay taxes based on the income they can earn due to the activities of the state
- I explore CBBT in two recent papers
  - One formally links Smith's idea (seamlessly) with Mirrleesian theory
  - A second shows widespread popular support for CBBT as a tax principle

The Golden Rule of Taxation paradox

- Like the Golden Rule of Ethics, the Golden Rule of Taxation is:
- A commonly cited perspective on tax
  - O.W. Holmes: "I like to pay taxes. With them I buy civilization."
  - IRS: Publication "Why do I have to pay taxes?" starts with the answer: "Taxes Benefit Everyone"
  - Jack Lew: arguing against inversions to "avoid paying taxes here, notwithstanding the benefits they gain from being located in the United States."
  - All of local (property) tax in the United States
- Denigrated by experts (tax theorists)
  - Absent from 5 definitive texts (and BBT criticized if mentioned): Mirrlees Review (IFS, 2010), Atkinson and Stiglitz (1980), Kaplow's (2008), Salanié (2011), Boadway (2012)

CBBT shares the three strengths of the Golden Rule

1. It relies on decentralized and localized judgments, eliminating the need to know all effects of actions
2. It covers the essence of the tax problem by linking revenue to its uses
3. Its vagueness protects us from grave errors

#1: It relies on decentralized and localized judgments

- Taxes are justified based on the individual's direct benefit from government, not as a way to achieve broader social objectives
  - If set fairly, therefore, taxes are justifiable at individual level
- Benefit-based taxes' great appeal, in fact, is based on this local logic (see Lindahl, Moulin, Brennan, Hines)
  - [A new paper with Robert Scherf tries to compare/contrast these models simply]

#2: It covers the essence of the tax problem

- Mirrleesian theory focuses on efficiency vs. equality
  - Important, but the *fundamental* tax problem is to fund a capacious state in a legitimate way
- Related, modern theory separates taxation from expenditure
  - This is fine if people judge tax and spending policy independently
  - But, if people judge based on CBBT, this assumption is faulty
    - ★ If wages depend on state activities, connection is automatic
  - *I believe this may be the single most problematic assumption in modern optimal tax theory*
- CBBT (uniquely) links the revenue and spending side of tax policy

#3: Its vagueness protects us from grave errors

- Our theory's results are notoriously fragile
  - Worse, results can be way off with most people knowing
- Instead, CBBT is self-regulating
  - If benefits do not align with taxes, people will *know it*
  - Moreover, ways of producing benefit will evolve and adjust

Implications and Conclusion

- Just as the Golden Rule remains central to actual ethical reasoning, CBBT should guide our discussions of and thinking about tax policy.
- President Obama understood this:
  - "As a country that values fairness, wealthier individuals have traditionally borne a greater share of this [tax] burden than the middle class or those less fortunate. Everybody pays, but the wealthier have borne a little more. This is not because we begrudge those who've done well — we rightly celebrate their success. Instead, it's a basic reflection of our belief that those who've benefited most from our way of life can afford to give back a little bit more."
- Formally incorporating CBBT into optimal tax theory is not difficult, but many empirical and theoretical challenges remain.
  - I believe the payoff from meeting these challenges, in terms of the impact of optimal tax theory, would be large!