

# The Economic Approach to Tax Policy

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Presentation to CPA BC 2019 Symposium for Accounting Educators and  
Academics

May 24, 2019

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- Maximize Income or wealth?
- Maximize production?
- Minimize poverty?
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Maximize social welfare

# How to maximize social welfare

- Let consumers balance income vs. leisure/other pleasures.
- Let consumers decide what good/services to consume.
- Produce things efficiently.
- Keep an eye on distribution (fairness) of outcomes.

Note: these things may conflict against each other: tradeoffs

# What is efficiency?

## Consumers:

- Absence of waste: Given your budget, consume most pleasing bundle of goods.

## Producers:

- Absence of waste: Whatever you're producing, do it in the least costly way.

# How to make the economy efficient?

- Benchmark construct: Omnipotent social planner.
- Adam Smith: rely on the `invisible hand' of market prices.

# Should we rely on prices?

Prices may not be efficient!

- Externalities: my choices have an impact on your consumption.
- Public goods: markets struggle when firms can't charge prices.
- Market power: prices may reflect monopoly power, not resource scarcity.
- Information: when key factors are unknown, market prices can fail.



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This can provide motivation for government action to:

- Modify prices.
- Directly provide goods/services.

# Key concept: neutrality

Imagine prices are efficient....

...if taxes then change relative prices of different goods, we lose efficiency.

So, we would prefer taxes that don't change relative prices and don't affect choices....

...we call this tax neutrality.

# Efficiency and neutrality

So, if we want the economy to be efficient, we should strive for tax neutrality.

This simply means that the tax system doesn't push our decisions one way or the other; personal and business decisions are made on their own merits as signalled by prices.

Exceptions for cases when prices may not be naturally efficient (externalities etc....)

# Efficiency and neutrality

So, if we want the economy to be efficient, we should strive for tax neutrality.

This simply means that the tax system doesn't push our decisions one way or the other; personal and business decisions are made on their own merits as signalled by prices.

Exceptions for cases when prices may not be naturally efficient (externalities etc....)

Q: If we want to get close to tax neutrality for economic choices, what does this mean for taxing necessities vs luxuries?

# What is fairness?

Who gets how much: consumption, income, wealth.

- Some people care most about equality of outcomes. (Consequential justice.)
- Others care more about equality of opportunity. (Procedural justice.)
- Economists try to respect people with different views:
  - There is no right or wrong answer; depends on one's life view.
- But, this doesn't mean fairness doesn't matter:
  - Through our political system voters get a chance to push the system the way that they want.

# How to make economy fair?

Can use the tax system and other tools to influence fairness.

- Explicit redistribution: tax some more and give the money to others.
- Change pre-tax outcomes: minimum wages, price regulation.
- Social insurance: Insure against adverse economic outcomes
- Ensure equal opportunity: income transfers to kids; provision of services to kids.

# Newer perspectives

New focus of economists on:

- Salience and transparency
- Complexity
- Compliance burden on taxpayers
- Collection costs of government.

These factors can have impact on the efficiency and fairness of different tax choices.

# Summary: Economists' goals for tax system

1. Raise enough money to fund needed spending (public goods; social insurance)
2. Possibly influence distribution and fairness.
3. Be as efficient as possible, subject to 1. and 2.



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How does this contrast with the goals of tax professionals?

e.g.

- Minimize clients' tax burden, within the law.
- Minimize compliance costs & risk.

# Efficiency-fairness tradeoffs: Example 1

## The Poll Tax

A poll tax is an example of a ‘lump sum’ tax.

- Everyone pays the same; doesn’t depend on choices or circumstance.

Considerations:

- What happens to prices? Is this efficient?
- Is this fair?
- Is this transparent? Complex? Easy to collect?

# Efficiency-fairness tradeoffs: Example 2

## Increase tax on food

Imagine a new excise tax on all food.

Considerations:

- What happens to prices and choices? Is this efficient?
- Is this fair?
- Is this transparent? Complex? Easy to collect?

# Efficiency-fairness tradeoffs: Example 3

## Taxing luxuries

Imagine increasing the excise tax on imported jewelry.

Considerations:

- What happens to prices and choices? Is this efficient?
- Is this fair?
- Is this transparent? Complex? Easy to collect?

# Efficiency-fairness tradeoffs: Example 4

## Value-added taxation

Let's analyze the economic case for a VAT, like Canada's GST/HST:

Considerations:

- What happens to prices and choices? Is this efficient?
- Is this fair?
- Is this transparent? Complex? Easy to collect?

# Bonus: Why tax only final goods; not business inputs?

Key feature of a VAT/GST/HST: exempt business inputs; tax only final goods.

- Why do economists like this?

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## Tax on inputs:

Distorts business production decisions

Distorts final consumption decisions

Raises revenue.

## Tax on final goods:

~~Distorts business production decisions~~

Distorts final consumption decisions

Raises revenue.

# Final thoughts

Economists focus on price distortions of taxation

- Neutrality.

Economists focus on efficiency / distribution tradeoffs.

- Both are valid goals; tax policy needs to balance.

Economists now seriously integrating complexity, salience, and administration

- Lots to learn here from tax professionals, psychology, and other fields.



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