What Political Philosophy should learn from Economics about Taxation[1]

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1. Introduction

The aim of this essay is to outline three broadly economic approaches to the analysis of taxation and discuss what, if anything, each has to offer to the more general normative political philosophy of taxation. The three approaches to be considered may be characterised as the mainstream Optimal Tax (OT) literature, the Political Economy (PE) literature and the Tax Constitution (TC) literature. While all are economic in their basic approach, these three literatures differ from each other in many ways, and among the questions I will address is whether these literatures are best viewed as complements or substitutes, and how they might be combined in order to contribute to any more general and more philosophical discussion of taxation.

The motivation for this paper derives from the observation (or assertion) that normative political philosophy lacks any widely shared, systematic or detailed account of taxation, or even any general approach to taxation, while often relying on very broad claims about progressivity, redistribution or other aspects of taxation. Taxation is often regarded as a sort of 'black box' technology that can be called upon to put into effect whatever distribution of economic benefits and burdens that is required by the normative theory

[1] This essay benefitted from discussion at the Conference on Political Philosophy and Taxation at UCL and at the Social and Political Theory Seminar in the Research School of Social Sciences at ANU, I particularly thank Martin O'Neill, Shepley Orr, Jonathan Wolff, Marc Fleurbaey, Geoffrey Brennan, Alex Rosenberg and Henry Richardson for helpful comments.

under discussion, without the need to consider the more detailed properties of the 'black box' itself. At the same time, there is a tradition of resisting the 'economic' analysis of taxation at a variety of levels, as exemplified in Murphy and Nagel's (2002) discussion. The tactic in this essay will be to start from an account of the range of contemporary economic approaches, and then attempt to show their value to normative political philosophy.

Tax theory and tax policy are complex, multidimensional issues. We might focus on the overall progressivity of the tax system and its impact on the distribution and redistribution of income, wealth, resources or some more general indicator of well-being; we might focus on the pattern of taxes across sectors and/or activities so as to consider impacts on patterns of production or economic activity; we might focus on the balance of indirect vs. direct taxation so as to address issues of personal responsibility and the visibility of taxation; we might focus on the relationship between taxation and levels and patterns of public spending to address issues of representation and the hypothecation of taxation; we might focus on the role of corporate taxes, in order to address issues concerning the role of non-natural agents in public life; we might focus on the taxation of capital and savings, in order to address issues concerning the inter-temporal aspects of economic life; we might focus on international taxation, tax havens and tax competition to focus on issues of global justice; and so on.[2]

Clearly, we cannot hope to consider all of these matters here. In fact, we will refer explicitly only to issues concerning progressivity and distribution, and the balance of taxes between direct and indirect taxes. Rather than attend to the range of issues raised within the analysis of taxation, we focus on the basic approach to the analysis of taxation that might carry implications for all of the more particular issues listed above. By this means, I believe that the discussion presented here provides a basis for the more detailed exploration of the variety of issues within tax theory, since the general lessons drawn from the discussion here are relatively robust across particular settings.

[2] Many of these aspects of taxation are discussed in Kaplow (2011). For discussion of progressivity see Diamond and Saez (2011); for discussion of the balance between direct and indirect taxation see Cremer, Pestieau and Rochet (2001); for discussion of tax competition see Wilson (1999).

While there may be a place for taxation within ideal theory, tax policy may be argued to be an essentially non-ideal issue, for several inter-connecting reasons concerning the motivation of agents and the availability of information. In the political philosophy literature, the distinction between ideal and non-ideal theory is widely deployed despite there being no widely accepted definition of the precise nature of the distinction.[3] On some accounts, ideal theory is reserved for the analysis of social institutions under the assumption of full compliance with appropriate moral norms by all (or almost all) agents, so that problems associated with agent motivation are absent. At the same time, ideal theory is often taken to apply only in circumstances of full information. If this view is adopted, an ideal account of taxation would take all political and economic agents as well motivated and fully informed, but then it might be argued that the widespread use of an essentially coercive instrument like taxation would have at most a minor role to play in an ideal setting, since ideally informed and motivated citizens would surely know what they should contribute and be willing to make that contribution voluntarily.[4] In this way, the general topic of genuinely coercive taxation seems more at home in the context of non-ideal theory.

A second aspect of taxation that suggests its generally non-ideal nature relates in more detail to the epistemic context in which taxation operates and focuses on the information available to the tax authorities. In the economics literature a distinction is commonly made between first-best tax policy and second-best tax policy (where second-best is taken to include third-best and so on). The point of this distinction is simply that in a first-best or ideal world the taxing authority has full, perfect and costless information on all economic agents and activities and is itself perfectly motivated to pursue the public good. In such a first-best world tax policy is relatively simple. The taxing authority could achieve almost all of its ends, including ends relating to the distribution and redistribution

[3] See, for example, Mills (2005) Robyns (2008) Simmons (2010), for discussion and further references see Hamlin and Stemplowska (2012), Stemplowska and Swift (2013).

[4] Some apparently coercive taxation might be relevant even in an almost ideal context, for example where it was difficult for individuals to assess their own contribution and where the tax authority played the role of providing information to individuals which allowed individuals to coordinate their actions (although in a fully ideal world, citizens would be taken to be fully informed). This assumes that the tax authorities have full information, even if citizens do not; an assumption discussed in the next paragraph.

of resources, by a set of agent-specific, lump-sum taxes. So that each economic agent would simply be assessed as owing a particular amount in tax, or entitled to a particular amount of additional income in the form of benefits or negative tax payments, without those taxes/benefits being expressed as taxes on any particular economic variables or activities. Such lump-sum taxes are argued to be first-best or ideal in the sense that they have no impact on decision making at any margin and so do not distort economic activity away from its first-best or ideal outcome.[5] To the extent that the taxing authorities may legitimately wish to have an impact on decision making at the margin in some specific cases (for example, in order to internalize externalities such as pollution) specific non-lump-sum taxes and subsidies could be used alongside lump-sum taxes, but such regulatory or corrective non-lump-sum taxes and subsidies would not be used in a first-best world as a means of revenue raising.[6] Almost all of the economic analysis of taxation therefore relates to the discussion of taxation in the non-ideal setting in which tax authorities lack sufficient information to implement first-best or ideal policies.

The third and final point relating to the non-ideal nature of most economic discussion of taxation picks up on the motivation of the tax authority or government itself. If decision making on tax matters is in the hands of agents motivated by considerations that depart from, or go beyond, some agreed idea of the public interest, or if there is some risk that this will be the case; or if tax decisions are influenced by some political process (democratic or otherwise) that is not guaranteed to track the public interest perfectly, then we might expect the tax system to depart from the ideal. And in guarding against such an outcome we might wish to put in place structural or other constraints to limit the extent of such departures. But such constraints will themselves be costly and so will place the system as a whole in non-ideal territory.

[5] The basic idea is that a tax on an activity will generally have two effects: one to raise the relative price of the taxed activity thereby causing taxpayers to substitute away from that activity, the other to reduce the real income of the taxpayer. Roughly, a non-distortionary (lump-sum) tax is one in which there is an income effect but no substitution effect. For a text book discussion see Myles (1995).

[6] Of course regulatory measures other than taxes and subsidies could also be employed to internalize relevant externalities in at least some cases. Following on from the previous footnote, a perfect corrective tax is one that has a desired substitution effect, but no income effect. This means that any revenue raised by a corrective tax should be returned to the taxpayer as a lump-sum, so that ideal corrective taxes raise no revenue.

In each of these senses, which will be explored in more detail in what follows, the specifics of tax policy are a matter that will be influenced by a multitude of non-ideal factors and considerations. And it is precisely because of the relatively complex nature of taxation in a non-ideal world that normative political philosophy may need to attend to the lessons that can be drawn from the economic analysis of taxation.

The remainder of this essay is organised as follows, the next three sections outline the OT, PE and TC approaches to taxation in turn, sketching their basic characteristics. Section 5 then offers some discussion of the three approaches, addresses the issue of the relationship among the approaches and considers the lessons that may be drawn for a more general normative political philosophy of taxation.

2. The Optimal Tax Approach

The OT approach is now firmly established as the mainstream approach within the economics literature, although it is important to note that this has only been the case since the 1970s. The previous 'Public Finance' orthodoxy was based on a range of normative principles and analytic ideas including 'taxable capacity', 'horizontal and vertical equity', 'willingness to pay' and 'ability to pay'.[7]

Optimal tax theory is essentially normative and essentially holistic. Normative because it derives its claim to optimality from the explicit specification of a value function; holistic because it attempts to design an entire tax and benefit system, rather than treating individual taxes and benefits separately.[8] Although it is known as the optimal tax approach, the approach is not restricted to the study of taxes but includes the distribution of benefits and subsidies (which might be construed as negative taxes). The OT approach

[7] For a presentation see Musgrave (1959) or Allan (1971). It is worth noting that it is this earlier orthodoxy, rather than the OT approach, that provides the target for many of Murphy and Nagel's criticisms. In the UK context the Meade Report (1978) was the last major review of tax structure that employed the Public Finance view. The most recent review, led by James Mirrlees, IFS (2010), adopts the optimal tax approach.

[8] By contrast the previous Public Finance orthodoxy might be considered to be rather piecemeal in its approach, typically analysing the implications of specific normative principles for specific forms of tax/benefit, or comparing two or more forms of tax/benefit.

conceives of the basic problem of designing a tax and benefit system as a form of double maximization problem. Government is modelled as choosing a tax/benefit system to maximize a value function subject to the fact that agents (both individuals and any non-individual economic agents) will take the tax/benefit system as given when making their own maximizing choices. In this way, the OT approach builds the optimizing behaviour of economic agents into the structure of the tax design problem. More specifically, it does not assume that there exists some pre-tax situation in which all economic agents have a right to their income (or wealth or consumption), so that taxes and benefits have to be justified relative to that baseline. Rather, the tax/benefit system is seen as one of the factors that shape the behaviour of economic agents and so influence economic outcomes (including both pre-tax and post-tax levels of income, wealth, consumption). To put the same point otherwise, economic outcomes are determined in part by the tax/benefit rules (and other rules) in place and in part by the behaviour of agents under those rules. In the absence of specific tax/benefit rules, or if alternative rules had been in place, behaviour would have been different and both pre- and post-tax allocations of economic burdens and benefits would also have been different. In recognising this point, the OT approach attempts to look through the optimizing behaviour of economic agents in order to put in place that set of tax rules which can be expected to yield the optimal outcome in terms of the specified value function, once all agents have reacted to those rules.[9]

OT theory is concerned with constrained optimality rather than full optimality; that is, it explicitly identifies constraints that might be expected to prevent us from reaching the fully optimal or ideal situation and seeks to identify the best available tax/benefit system given those constraints. Most fundamentally, as already sketched, the exercise is constrained by the nature of the behaviour of economic agents and by the information available to the tax authority or government. In relation to the first of these, the intention is to model economic agents as they are rather than as they should be; although, as with any modelling exercise there is inevitably a degree of abstraction from reality. Agents are modelled as rational rather than moral, in that they are assumed to pursue their own

[9] Among the classic papers in the development of the optimal tax approach are Ramsey (1927), Mirrlees (1971), Diamond and Mirrlees (1971, 1971), Atkinson and Stiglitz (1976). For influential surveys see Stiglitz (1987) and Slemrod (1990).

interests rather than the social value function that underlies the normative status of the OT approach itself. In this way, the overarching purpose of the OT approach is to determine the pattern of tax/benefit rules which maximally serves the defined public interest on the assumption that economic agents operate rationally under those rules.

In relation to the second set of informational constraints, as already noted, if all information were fully and freely available to government, the first-best tax/benefit system, involving lump-sum taxes on, and benefit payments to, individual agents, would be available. But these optimal lump-sum transfers will typically depend on underlying characteristics of individual agents and specifics of economic activity that are, in practice, unobserved.[10] Exactly what details are observable, and therefore which tax/benefit systems are feasible in informational terms will vary from time to time and place to place, and we will return to this point below. The unobservable or unobserved nature of potentially relevant information may be seen as a key aspect of the non-ideal nature of the OT approach.

We may now turn to the structure of OT theory itself. As already indicated, the normative nature of this approach derives from the requirement to specify the value function that is taken to represent the public interest or social welfare. In fact, the value functions actually employed in the OT literature are generally welfarist in nature, defined in terms of the levels of utility or welfare of each individual in society with parameters to reflect inequality aversion. Clearly the interpretation of 'utility' or 'welfare' is very flexible, as is the degree of inequality aversion that may be specified, indeed one of the points of the exercise is to see how responsive the design of the optimal tax system is to different detailed specifications of the social value function.

Once a value function is specified the next step is to model the population of agents. And it is here that the potential complexity of the model is most apparent. In the simplest

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[10] Some relevant information may be unobservable in principle, other information may be observable only at high cost, where that cost may be financial or in terms of other aspects of relevance to overall social value (e.g. in relation to the value of privacy). An example of the former might be an individual's true ability (rather than proxy measures such as educational attainment); an example of the latter might be each individual's consumption of particular goods such as tobacco or alcohol.

possible model we might assume that all agents are essentially identical, so that no issue of (re)distribution can arise. In moving away from this extreme case we might introduce heterogeneity in just one dimension, so that individuals differ only in respect, say, of their productivity. The next step might be to allow individuals also to differ in their preferences; and so on.

As already noted, everything then depends on what information is assumed available to government and so what types of taxes are taken to be feasible. In some situations, perhaps particularly relevant in less developed countries, it might not be possible or practical to monitor all employment, so that an income tax might not be feasible. In such cases the only feasible taxes might be a range of commodity taxes, including taxes on imports and exports, since transactions in commodities are relatively easy to monitor. In more advanced economies, which have invested in the infrastructure of data collection, a much wider range of taxes might be feasible.[11]

Since commodity taxes are usually thought of as less informationally demanding than income or wealth taxes, the simplest, benchmark example of the OT approach is one in which only commodity taxes are considered and all individuals are assumed to be identical. This is the setting of Ramsey's original 1927 paper which first introduced the structure of the double maximisation problem and so marked a distinct step from the prevailing literature which operated on the normative basis of a number of relatively *ad hoc* principles rather than an integrated value function, and which tended to treat taxes individually rather than the whole tax system. In this context, where we are only concerned with efficiency, since the issue of distribution does not arise, the optimal tax structure will involve a set of differentiated commodity taxes, with higher tax rates on those commodities that are relatively price insensitive and lower taxes on commodities that are more price sensitive. In this way, the marginal distortion associated with taxing each commodity can be equalised and the total efficiency distortion minimised.

[11] For discussion of issues concerning taxation in developing countries see Burgess and Stern (1993), Gordon and Li (2009).

To illustrate the way in which assumptions on the heterogeneity of the population and the feasibility of alternative taxes affect the optimal design of a tax system, we should consider cases which differ from each other in just one respect. For example, if we continue to assume that income taxes are infeasible and only commodity taxes are available, but allow heterogeneous agents, so that distribution becomes an issue, we must now use our commodity taxes not only to raise revenue with as little efficiency loss as possible, but also to influence the distribution of welfare. In this case, the optimal tax system would still exhibit differential commodity taxes, but the pattern of tax rates would now reflect two forces: one, as before, reflecting price responsiveness and efficiency loss, the other placing higher rates on commodities that might be thought of as luxuries, and lower rates on necessities, so as to generate a degree of progressivity into the system.[12] Since there is no guarantee that these two forces will pull in the same direction, we can expect that the desirable redistributive impact of the tax system will imply greater distortions to efficiency. The greater the inequality aversion built into the underlying value function, the greater the emphasis on the redistributive aspect of taxation and the greater the resultant loss in efficiency. Even in this very simple case, then, we see that the OT approach is essentially concerned with balancing the various costs associated with a necessarily imperfect tax system, so as to produce the optimal overall result. [13]

If now we consider a situation in which both income taxes and commodity taxes are available, a progressive income tax will typically be the optimal means for addressing distributional issues, with commodity taxation addressing efficiency issues. This will typically imply a wide commodity tax base with a uniform tax rate, although higher rates may be levied on goods that are complements with leisure and to internalise specific externalities (such as specific taxes to address issues such as environmental pollution).

While the tax/benefit system that is revealed as optimal may vary considerably from case to case, reflecting both different informational constraints and different specifications of the social value function. OT theory provides a framework in which an explicit

[12] Where 'luxuries' are those goods and services whose consumption is strongly positively correlated with income, and 'necessities' those where consumption is largely independent of income.
[13] See, for example, Kaplow (2008).

normative value function is set in the context of relevant feasibility constraints to derive the appropriate overall tax and benefit structure. There are a number of practical implications of the OT approach that are relatively robust across detailed settings. Mankiw, Weinzierl and Yagan (2009) identify eight general, structural lessons from OT theory and discuss the extent to which these lessons have influenced actual tax policy. The eight are:

1) Optimal marginal tax rate schedules should depend on the distribution of ability (rather than merely the distribution of income or wealth);

2) The optimal marginal tax schedule could decline at very high levels of income, (even in systems which are overall progressive);

3) A flat tax, with a universal lump-sum transfer, will often be close to optimal;

4) The optimal degree of redistribution rises with wage inequality;

5) Direct taxes should depend on personal characteristics as well as income;

6) Only final goods (rather than primary or intermediary goods used in the production of final goods) ought to be taxed, and typically they ought to be taxed uniformly;

7) Capital income ought to be untaxed, at least in expectation;

8) In stochastic, dynamic economies, optimal tax policy is complex.

Merely listing these lessons is sufficient to indicate that while tax reforms in many countries have moved in the direction indicated by some of these lessons, the pattern is by no means uniform or complete. It is certainly the case that in many advanced economies the top marginal rates of income tax have declined, direct tax profiles flattened, and commodity taxation moved toward uniformity often via versions of value added tax (VAT); but the patterns of reform in capital taxation and universal benefits are much less clear. Of course, the eighth and final lesson is that optimal tax systems will be complex and different across setting, but even so the impact of the OT approach on tax reform in practice has been rather slow and partial; perhaps for reasons to be discussed below and in the following sections.

Common criticisms of OT theory focus on the specification of the value function employed, issues surrounding the identification of relevant agents and the lack of political analysis. I will touch on each area in turn.

At the most basic level, the specification of a value function, whatever its details, indicates that the OT approach is essentially teleological in its structure, seeking to maximise overall net benefits, whatever the detailed account of benefits and costs may be.[14] While it is true that the OT literature is presented in teleological and consequentialist terms, this does not imply that OT is incapable of recognizing at least some more deontological claims: specifically, those that can be expressed as constraints which may be built into the OT exercise of constrained maximization. Of course, to the extent that such constraints dominate, there may be little scope for optimization within the permissible set of tax policies, so that the optimization idea will lose much of its force. But the idea that deontic considerations (almost) fully determine tax policy seems extreme, and the OT structure seems to be a suitable means of balancing those deontic considerations that can be modelled as side-constraints with more teleological and consequentialist considerations.

Within the teleological structure of the OT approach, one might also criticize welfarism as an appropriate basis for identifying social value.[15] And it is true that, in the OT literature there is a general assumption that efficiency and equity in relation to welfare are the only relevant normative categories, but again, this does not seem essential to the OT approach per se. All that is essential here is that there should be an explicitly specified value function. Now, of course, the requirement that the value function be explicit forces clarity and, if the intention is to perform a practical exercise, the need to specify the value function in terms that are tractable may force a degree of simplification, but there is nothing in the structure of the OT approach (as opposed to any particular application of that approach) that involves a deep commitment to welfarism or any other substantive

[14] For a discussion of the consequentialism/deontology distinction in the context of taxation see Murphy and Nagel (2002) pp 41-45.

[15] The debate here is wide-ranging and the literature huge, see, for example: Dworkin (2002), Kaplow and Shavell (2002), Cohen (2008), Sen (2009).

view of the nature of the value to be maximized. In principle, at least, the OT approach is capable of working with any well specified value function, whatever its more philosophical underpinning.

On the question of the identification of the relevant agents for the purposes of tax policy formulation, OT theory, and all other approaches to taxation, face a significant issue. One obvious problem lies in the treatment of individuals and families (or other groupings of individuals); another issue revolves around the status of corporations and other institutional agents. OT theory is sometimes criticized for being too individualist and ignoring corporations. Now, any practical tax policy will have to come to some view on these questions – but it is not obvious what that view should be or how the factors that influence our choice of position on these questions interact with the OT approach (or any other approach). Whether we treat individuals or families or households as the appropriate units for tax and benefit purposes is a complex issue, and our answer may be different in different parts of the same system (e.g. we might tax individuals, but provide benefits based on families), and much may depend on issues of information availability and reliability (as is stressed by the OT approach). Similarly, whether we view corporations and other institutions as taxable units in themselves or treat profits and other such variables as accruing to individual shareholders is a complex matter, and will again depend on a variety of factors. And these questions would have to be answered, at least provisionally, in designing any tax system, but once they are answered, and however they are answered, there is still a need to design the tax system on the basis of those answers, and this seems to be the point at which the OT approach becomes relevant.[16] In other words; the OT approach does not in itself answer all of the questions that require answering about a tax/benefit system; it merely provides a structure of analysis that both helps to identify the relevant substantive questions and organizes the answers to those questions in a manner that balances all of the concerns identified as important.

[16] Another area in which genuine questions arise relates to the specification of time periods for tax purposes. In the context of income taxation, for example, should we be concerned with weekly income, monthly income, annual income or lifetime income? See Fennell and Stark (2005), for the specific issue of the taxation of savings see Atkinson and Sandmo (1980).

The final criticism of OT theory to be considered here is that it ignores politics. This criticism has two aspects; first that the OT approach adopts the heroic assumption that government itself is ideally motivated (while economic agents are modelled in non-ideal terms as rational rather than moral), and second that while focusing on informational feasibility, it ignores political feasibility. These criticisms clearly carry weight, but might also be said to be criticizing the OT approach for failing to do something which it does not set out to do. OT theory is not intended as a model of the process of tax design or reform, rather it is a framework for articulating the normative standards relevant to the design of tax/benefit systems. The political challenge is taken up by the PE and TC approaches.

3. The Political Economy Approach

By contrast with the OT approach, the PE approach may be seen as broadly positive rather than normative in nature and focussed on providing an analysis of a tax/benefit system seen as the outcome of a democratic political process. While the analysis of the political process is broadly economistic, in the sense that it builds on the ‘public choice’ school of rational actor political analysis, the analysis does not depend on any specific economic analysis of the tax/benefit system itself.[17] The essential question addressed by the PE process is, what tax structure might we expect to emerge from, and be supported within, a democratic political process, and how might the answer to this question depend on the details of the democratic process.

The PE approach builds on the Downsian model of democracy.[18] In this setting neither the tax authority nor individuals are modelled as ideal moral agents. Politicians are taken to be motivated by the prospect of winning elections, so that they offer whatever expenditure / tax / benefit package will maximise the probability of winning the next election; while individuals, as voters, are assumed to vote rationally in pursuit of their

[17] For an overview of the public choice literature see Mueller (2003), for a review of its application to tax policy see Holcombe (1999).
[18] See Downs (1957), for extension to representative democracy see, for example, Besley and Coate (1997).

self-interest. A benchmark case in this literature is the case of majoritarian voting for a purely redistributive tax/benefit system involving a simple flat-rate income tax which finances equal lump-sum payments to all citizens. The argument here brings together three points. First, a simple analysis of the logic of the tax system under discussion: if, for simplicity, one assumes that the tax system itself is costless to operate, so that all taxes raised are returned as benefit payments, and (for a moment) that pre-tax incomes are independent of the tax rate, it is clear that anyone with pre-tax income below the mean level will gain from a system which taxes income proportionately and distributes benefits as lump-sums, while anyone with pre-tax income above the mean will lose. The second point derives from the basic idea of the Downsian median voter theorem, which indicates that, in a simple majoritarian election between two candidates or parties we can expect the policy offered by the candidates to converge on the policy that would be chosen by the median voter. The third point is then an empirical claim, that the typical distribution of income is skewed so that median income is less than mean income. Taking these three points together indicates that the majority would vote for a redistributive tax scheme: indeed, in the simple case sketched, the majority would vote for full equalization of post-tax incomes by imposing a 100% tax rate and redistributing all revenues equally.[19]

Of course, moving away from this simple and extreme case in the direction of realism modifies the result. Most obviously, if one drops the assumption that pre-tax incomes are independent of the tax rate, so that the tax rate will have a disincentive effect on income generation, it is clear that 100% tax rates would never be chosen. Nevertheless, the simple model will still give rise to redistributive taxation, limited by the extent of the disincentive effects. In essence, redistribution will occur up to the point where the marginal benefit to the median voter associated with any further increase in the tax rate is zero.

[19] Among the classic papers in this tradition are Foley (1967), Romer (1975), Roberts (1977) and Meltzer and Richard (1983).

This type of analysis can be extended to consider commodity taxes and other taxes alongside income taxes. The models become more complex, but the essential structure remains: as part of political (i.e. electoral) competition, rival parties will face incentives to design tax structures that, for any give level of total tax revenue, maximise political support. The basic result is that the tax structure that arises as a political equilibrium is such that the marginal loss of political support per £ of tax revenue raised is equalized across all taxes, and across all tax payers.[20]

Of course, full equalization of political support at all relevant margins may not be feasible in practice; it may be necessary, for reasons of cost and convenience, to group commodities and individuals and treat elements of each group equally. However, grouping of this sort implies political losses, so the question of how to group in order to minimise these political losses arises; that is, how many tax bands for income tax, how many groups of commodities with different tax rates, are politically sustainable? The logic of the PE approach on such questions is that political parties seeking election will simply balance administrative costs against political costs, and so offer the pattern of grouping that minimises total costs as they perceive them.[21]

The PE approach predicts complex tax structures with the number of rate bands and commodity groups being constrained by administrative costs and political considerations. Tax structures, rates and exemptions are all determined jointly in political equilibrium and so will reflect the relative voting power of groups in society. Political parties, in this approach, can be seen as playing groups of voters off against each other in attempting to raise revenue at minimal political cost in terms of votes lost. This approach also suggests that the tax/benefit system may not be stable over time. Shifts in underlying technical, economic, demographic and political variables will induce shifts in the political equilibrium. Tax reform will be politically driven, rather than responsive to more

[20] The point here is that, if this marginal loss were not equalised, it would always be possible to increase political support at no cost in terms of tax revenue by marginally increasing the tax in the area with the lower marginal loss and decreasing the tax in the area with the higher marginal loss. Thus, equalisation of marginal loss is a necessary condition for the maximisation of political support for any given level of tax revenue.

[21] For a detailed analysis that considers the grouping of taxpayers and economic activities see Hettich and Winer (1988).

fundamental economic or social analysis. The tax and benefit system will be open to political manipulation by special interest groups, so that we would expect to see log-rolling and other political manoeuvres. In particular we would expect to see relatively small well organised groups lobby successfully for tax breaks at the expense of relatively large but disorganised groups. There is certainly no guarantee that the tax/benefit system that emerges as a political equilibrium will satisfy any particular efficiency criteria, or any more general normative criteria.

The PE approach is not directly normative in its approach, it seeks to explain the observed pattern of taxes and benefits rather than make proposals for reform. However, to the extent that it provides the basis for a diagnosis of political failure in the tax and benefit setting process, it might be taken to provide a counterbalance to the OT approach's identification of an optimal tax and benefit system. The extent to which the PE approach actually explains the observed pattern of taxes and benefits, how tax systems evolve and how they differ across jurisdictions is limited by the relative paucity of detailed empirical studies, but it is hardly surprising that there is at least considerable evidence that political factors and the operation of the democratic process itself does influence both the structure and the detail of tax policy.[22]

4. The Tax Constitution Approach

The TC approach returns to a more explicitly normative standpoint but one that emphasises the political dimension, albeit in the more contractarian, constitutionalist perspective associated with the constitutional political economy literature.[23] While the PE approach stresses the direct control of tax policy through electoral competition, the TC approach focuses more broadly on the need for constitutional controls on the discretionary power of government elites, whether those controls operate via electoral competition or otherwise. In contrast to the OT approach, the TC approach does not assume that governments are benignly motivated to maximize an appropriate value function, but rather assumes that government will pursue its own objectives (which will

[22] See, for example, Steinmo (1989), Slemrod (1999), Hettich and Winer (2005).
[23] For an overview of the constitutional political economy literature see Brennan and Buchanan (1985) Brennan and Hamlin (1995) Buchanan (2004).

include, but not be limited to, the seeking of re-election) constrained by binding constitutional arrangements. From this perspective, then, the TC approach argues for a fiscal constitution that limits governmental discretion, both by restricting the set of tax policies that the government can implement and, perhaps, by imposing substantive limits on tax revenues, or fiscal deficits, or other relevant variables.[24] In common with the OT and PE approaches, the TC approach models individuals as rational rather than moral.

The benchmark case in this literature assumes that government is a revenue maximizer and then investigates the constraints on the power to tax that would be supported by a representative citizen behind an appropriate constitutional veil of ignorance.[25] The general observation is that the incentive to limit exploitation of tax bases cuts across many of the arguments from OT theory. For example, standard economics and the OT approach tends to support broadly defined tax bases (a comprehensive definition of income, a wide range of commodities, etc.) on the grounds that the broader the tax base, the less distortionary will be the optimal tax rate structure associated with any given level of revenue to be raised. However, the TC approach points out that, in the absence of well-motivated government, broader tax bases clearly provide greater opportunities for tax exploitation, so that constitutional restrictions on allowable tax bases might be motivated despite their narrowly economic inefficiency.[26] One way of viewing this point is that by restricting access to certain tax bases, a tax constitution would ensure that there are some tax-free areas of the economy to which citizens can escape, or exercise an exit option, so limiting governmental power.

[24] The classic reference in relation to the tax constitution is Brennan and Buchanan (1980). The tax constitution might be seen as a part of a more general fiscal constitution that also applies constitutional controls to expenditure policies and, importantly, borrowing. See Buchanan and Wagner (1977), Buchanan (1987). The TC approach may be seen as an example of the 'Principal-Agent' approach to constitutional politics, where citizens are the principals, politicians the agents, and the constitution is the 'contract; that seeks to limit the agents power to exploit the citizens.

[25] The logic is extended in Brennan and Buchanan (1985) see also Hamlin (2014).

[26] One possible restriction on the set of allowable tax bases that might meet generally shared moral intuitions as well as limiting the scope for tax exploitation might involve disallowing a commodity tax on basic food. In the UK most food for human consumption is zero-rated for VAT, as are some other goods, although this zero rating is not constitutionally entrenched.

Similarly, the TC approach might motivate restrictions on rate structures aimed at reducing the monopoly power of government: imposing a requirement of a common rate of tax on different commodities, and/or a common rate of tax on different individuals will reduce the ability of government to 'discriminate' and so raise additional revenue; equally, a requirement that the rate structure be progressive will typically reduce the maximum revenue that a government can raise, since unconstrained revenue maximization will normally imply regressive taxation. In some cases these conclusions run counter to the mainstream OT theory (e.g. on the broad vs. narrow tax base), but in other cases they are consistent, but derived from very different logic (e.g. on progression, or on uniform rates).

A further aspect of a tax constitution concerns the allocation of taxation powers across levels of government. In the OT approach, it is standard to think of a single government designing the entire tax/benefit system; not least since (given the assumption of a well-motivated government) there will be efficiency gains from an integrated approach to tax policy. But in the TC approach the separation of tax raising powers across agencies within a broadly federal structure may be appropriate, to reduce an effective monopoly power and to set up forms of internal tax competition.[27]

The constitutional nature of the controls envisioned implies that the controls must be relatively general, and this in turn implies that they cannot hope to achieve fine-grained control. If constitutional requirements are thought of as applying equally at all times, but tax policy is thought of as varying over time both cyclically and in response to particular economic events, it is clear that any constitutional controls motivated by the TC approach face a trade-off. If they constrain government too tightly, they will disallow the flexibility that may be required for tax policy to respond to circumstances, but if they are loose enough to allow governmental discretion to manage in the face of varying circumstances, they will also allow at least some tax exploitation. In this way, a tax constitution has to

[27] Tax competition may take a number of forms, some relying on mobility of agents between regions/jurisdictions, others relying on voters using practice in other jurisdictions as a yardstick against which to judge their own government, see Wilson (1999).

balance inefficiency (and/or ineffective redistribution) against greater insurance against political exploitation.

There is also the question of the most appropriate nature of the constitutional controls to impose in attempting to limit governmental power. If, as in the benchmark case, the central concern is that government may over-use its tax raising powers, it might seem natural to specify the relevant constitutional control in terms of a maximum scale of tax revenues (e.g. as % of GNP), leaving the details of how this tax is raised flexible. Although if the concern is with over expansion of government expenditure, such a constitutional constraint may simply incentivise public borrowing, so that it might be more appropriate to place the constitutional control directly on expenditure levels rather than on taxation. However, if the concern is with the generally invasive nature of government power, any control on either taxation or expenditure might simply incentivize regulatory activity by government which may have still more damaging effects than taxes or expenditures.

At a broader level, we can see that there is a clear relationship between the PE and TC approaches, in that both are recognise the constitutional control of government power. In the PE case, the focus is on the positive effects of electoral competition or other procedural aspects of the policy making process, while in the TC case the focus is on the normative justification of constitutional constraints over and above the idea of electoral competition that attempt to restrict specific powers of government. In considering the constitution as a whole, it is clear that both forms of control may have a part to play. Just as invoking specific substantive controls on the tax raising power of government limits governmental discretion and so provides insurance against exploitation, so specifying the nature of the political process (voting systems, frequency of elections, term limits, etc.) will reduce governmental discretion by effectively empowering the electorate; but, as we have seen, there is no guarantee that either reducing governmental discretion or empowering the electorate necessarily results in a tax system that is optimal in the sense of OT theory.

5. Normative Political Philosophy of Taxation

In an ideal world, tax policy would be relatively simple. If all agents are fully moral in their motivations and behaviour, all are fully informed and other ideal institutional arrangements are in place, it is conceptually straightforward to translate from the relevant normative principle (whatever it may be) to the financial contribution required from each agent to the state (if any), or from the state to particular agents (if any). As all three of the economic approaches to taxation agree, the tax and benefit system in such an ideal world would consist mainly of lump-sum taxes and benefits, with little or no need for taxes levied on particular economic activities – no general income, wealth or property taxes, no general commodity taxes.[28] But such an ideal is scarcely a guide for a tax system in a non-ideal world. The OT approach makes the points that even if governments and their agencies are well motivated, first-best lump-sum taxes are informationally infeasible and that second-best tax systems must account for the reactions of economic agents, so that second-best tax systems will generally be very different in structure and character to first-best systems. The PE approach makes the further point that if we consider tax and benefit systems as the outputs of political processes, rather than as the direct products of normative theorising, we should expect the properties of the relevant political processes, and the motivations of the agents that operate within them, to be reflected in the tax system which is then very unlikely to achieve the standard of the second-best. The TC approach builds on this political point to identify a range of constitutional controls on the political system as a primary means by which we might structure and constrain the power to tax, particularly when there can be no guarantee that those in political control of day-to-day tax policy making will be well motivated.

Identifying the key points of each of the three economic approaches to taxation in this way serves to underline the claim that these three approaches are best understood as complements rather than substitutes. Of course each approach focuses on a different aspect of the general problem of the design and operation of a tax and benefit system and

[28] As noted above, it is possible that there might still be a need for some corrective taxes, to the extent that these were not rendered redundant by the ideal conditions.

offers distinctive insights; and it is sometimes claimed that the approaches are in opposition - particularly where the OT and TC approaches seem to offer contrary recommendations, for example in relation to whether tax bases should be defined as broadly as possible to minimise inefficient distortions or restricted to constrain governmental discretionary power. But there is no deep conflict here. Rather, the approaches differ in terms of the extent to which they factor in political as well as informational and motivational constraints on the ideal. The OT approach focuses on the narrowly defined economic relationship between government and tax payers, while the PE approach focuses on the essentially political relationship between voters and political candidates when tax policy is seen as part of the political agenda, the OT approach then adopts a normative position that attempts to structure the political and constitutional environment in such a way as to favour the interests of citizens in general rather than political elites. Thus, to return to the apparent conflict between the PT and TC approaches in relation to the breadth of tax bases, combining the insights of the two approaches allows us to identify the trade-off that is most relevant in determining the optimal overall configuration: the broader the tax base, the lower the costs of inefficient distortions associated with raising any given amount of tax revenue, but broader tax bases also increase the extent (or the risk) of excessive taxation. Balancing these two costs (as well as others) is the key to identifying the tax system that is optimal all-things-considered. It is this idea of explicitly identifying the constraints that are most salient to the tax design problem, recognising the nature of the costs associated with each such constraint (whether those costs are economic, social or political in nature), and balancing these various costs at the margin, that identifies the essence of the economic approach.

The three economic approaches to taxation broadly correspond to three relatively familiar approaches to normative political philosophy: the direct derivation of institutional or policy implications from explicit normative criteria; the explication of legitimate policy through an analysis of democratic procedures; the use of constitutional devices to constrain and channel political behaviour. The essential complementarity of the three economic approaches reflects the essential complementarity of these general approaches to normative political philosophy.

Of course, a hallmark of all of the economic approaches to taxation canvassed here is that they are optimising approaches – differing in the detailed specification of the constraints that combine to limit the attainment of normative ideals. It is always open to the political philosopher to reject the optimising approach altogether as evidence of a mistaken consequentialism. But it is difficult to believe that there is no place for at least some consequentialist considerations within the domain of political philosophy, and it should be very clear that the emphasis of the second-best economic approaches to taxation lies very much on understanding and investigating the constraints that restrict the domain of optimisation rather than on optimisation per se.[29] While the optimising approach may not exhaust the normative political philosophy of taxation, it must surely be very significant part of it.

If we accept, as suggested at the beginning of this essay, that taxation is essentially a non-ideal topic, then at least a major part of the normative political philosophy of taxation has to operate in the imperfect context implied by recognizing at least the major constraints imposed by the real world.[30] An important question then is; what are the most salient constraints and imperfections to incorporate into our normative political philosophy of taxation? The three economic approaches to taxation outlined here pick out several leading candidates: the motivations of individuals subject to taxation, the motivation of governing elites, the availability of relevant information, the political and constitutional structures that shape the policy making process. Furthermore, they offer an analytic framework within which these various constraints and their interactions can be studied in some detail. In so doing they offer valuable lessons to the normative political theorist.

Optimal Tax theory stresses the significance of specifying the optimand explicitly and delimiting the feasible set. The Political Economy approach stresses additional

[29] It would be entirely possible to include within the economic approaches formulations other that simple maximisation subject to identified constraints – for example by considering satisficing models that might relate to sufficientarian ideas, for discussion of sufficientarianism and further references see Gosseries (2011), Shields (2012).

[30] The suggestion that political theory should take a more realistic stance in order to contribute more forcefully and directly to debates on public policy is, of course, not restricted to the area of taxation, see, for example, Swift (2008) and Wolff (2010).

procedural constraints and the necessity of embedding the normative within a positive model of the political process. The Tax Constitution approach stresses additional substantive constraints, and the issue of the motivation of political agents. All stress the importance of defining the issue at the level of the tax and benefit system taken as a whole (not, for example, tax by tax, or separating tax analysis from benefit analysis). A key point here is that the tax and benefit system cannot properly be seen in isolation from other aspects of the institutional structure of society. Most obviously, the tax and benefit system has to be seen as being operated within the overall political system, so that details of the political system such as the structure of representation, the pattern of delegation of tax and benefit matters across sub-national jurisdictions, or the voting system are likely to carry implications for the tax regime that is supported and sustained under those political arrangements. Causal influence may also run in the opposite direction with tax systems influencing voting, campaigning and lobbying coalitions and political outcomes that may go well beyond the tax system itself.

At the same time, other institutional and regulatory aspects of society may bear on both the political and economic aspects of tax theory. One obvious and direct way in which wider issues relating to the institutional and policy arrangements surrounding health care, education, overseas aid and all other major areas of policy concern will bear on tax theory is by influencing the overall level of public spending, and hence the overall demand for tax revenues, but it may also be the case that these other structural aspects of society impact less directly on tax policy through the operation of the political system. While the three economic approaches to taxation outlined here go some way to embed the discussion of the design of the optimal feasible tax and benefit system in a more political setting, and to make that process explicit by being clear as to exactly which economic and political factors are being identified as relevant constraints on feasibility, it is clear that one might wish to recognise rather different constraints in order to analyse their impact on the design of a tax and benefit system.

None of the three economic approaches outlined here offers the answer to the design of the optimal feasible tax system; and even the combination of the three approaches will fall short of such an ambition. Nevertheless, I would suggest that, taken together, they do offer valuable lessons to the normative political philosopher who wishes to adopt a less than ideal approach to the design of social and political institutions including, but not limited to, a tax system. Looking inside the ‘black box’ of tax theory, recognizing that second-best proposals may differ markedly from first-best proposals and being explicit about the many potential economic and political trade-offs that operate to identify second-best proposals are important steps towards a more mature and general debate on the role of taxation.

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