

Topic: Optimal taxes and their applicability - essay.

## **Is efficiency efficient?**

Once I have read, that generally public policy follows the scientific advices with approximately forty years long gap. This theory was (very) roughly supported by evidence such as the delay between emergence of Romanticism and French revolution or between Marx's manifesto and raise of communist movement; more examples were given from recent years, supporting idea, that theory is still actual. It is not very important now how this oversimplified theory holds in many other cases – let's just take it as an intuitive insight to how quickly public opinion (which after all is the driving force of change ) or state bureaucracy should adapt to new ideas leading to higher efficiency.

The important point here is, that if such theory can survive for such time, then it can be considered potentially useful. Furthermore its expected gains of its introducing have to overweight expected losses of its implementation, if it is to be realised. There is certainly much more issues to discuss here, such as spreading or fading out of policies implied by theory, but I want to focus on different topic for which I need one simple conclusion from this – that there IS some convergence of policy towards efficiency, driven by previous scientific development.

Now we get to the optimal taxation theory, which seems to ignore this conclusion. The ideas of Ramsey tax (1927) or lump sum tax (I couldn't find when the idea originated, but certainly it's even older) exist for much longer time than forty years. Academically they are still widely perceived like best and second-best solution of tax raising problem. My question is obvious – how come that these optimal policies are regarded (almost) just by theorists, for such a long period? Common answer is, that even though they are efficient, they cannot be introduced, as it is politically impossible. This implies, that there is no convergence towards efficiency, at least in this case. Democratic process leads to sub-optimal outcomes, even in long run. Optimal taxation remains to be a theoretical concept, because even though it should bring pareto-improvement (and therefore it should be democratically plausible), voters do not realize it. And this is precisely the idea, which I want to challenge in this work.

Let's forget about technical problems, which are connected with real implementation of Ramsey tax e.g. that obtaining optimal parameters for Ramsey tax (involving intertemporal substitution) shows up to be nearly impossible task.<sup>1</sup> Contrary to this – in case of lump sum tax, there wouldn't be any bigger obstacle. But forget about this, I want to argue, that even if such

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1 Slemrod[1990:161]

problems were solved, these taxes wouldn't be efficient, in somewhat broader than purely microeconomic sense.

My first argument is quite straightforward, but goes a little bit behind borders of economy, as exact science. It states, that distortion in consumer and producer behaviour is not the only distortion caused by taxation. Heavily taxing basic food, or forcing some kind of poll tax leads to quite desirable outcomes in terms of dead weight loss, but it causes damage which is a much broader and harder to quantify. It is the way how the *idea* of such taxation disrupts the social coherence. Even if low income group agreed with economic theorists and supported such “efficient” solution, there would be no way, how to evade ostracization of social groups. This is the goal, which is fulfilled by flat tax, or even better by progressive income tax, but the “optimal” taxes will probably fail. Because they (at least seemingly) miss the solidarity principle, in quite large degree. In terms of optimal tax theory – not first, not even the second best solution, maybe third or fourth is the right one.

The tendencies towards equality are the very basic part of human psychology,<sup>2</sup> and although they cannot be fully satisfied, it's not good to presume they can be fully suppressed, or even turned upside down. I believe that even if everyone in society *rationally* knew, what dead weight loss is, and why new tax system is optimal in economic sense, there would still be strong opposition against it. Not because of rational, but because of moral reasons. In economic terms, utility gain from efficient tax system is more than compensated by utility loss steaming from it's unfairness.

Well, economist could say, efficiency is (roughly) objective term, but moral can somehow adjust over time – at least if the evolution does it's job, the countries with more efficient tax systems prevail. Again I have to say no. There is no room to discuss it here, but I believe there is some kind of rationality, that can see further than today's microeconomy does. No matter that this rationality is based on instinct called moral, and it is not fully perceived by individual himself. The message I wanted to give here is, that the social impact, which can inequality<sup>3</sup> bring, can lead to much higher losses, than DWL of largest scale. And that is precisely the information contained somewhere deep in our moral instincts, but ignored by microeconomic models.

I would like to start this part containing my second argument against optimal taxation theory with an example, then I'll return to it in more general way. So, when we spoke about effect of tax on substitution between labour and leisure, I felt some inconsistency between two concepts. First one

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<sup>2</sup> See Ridley[1996] for further discussion

<sup>3</sup> Just to note – I am fully aware, that e.g. Ramsey tax at the end of the day taxes rich more than poor etc. There are two caveats in this. Firstly this happens because rich *choose* to pay more in terms of their consumer decision. The solidarity is voluntary in fact. Secondly, and more generally, none of the „optimal“ tax systems (as far as I know) is progressive enough to capture social divergence between poor and rich. Just for getting the intuition – in extreme case this divergence can lead to state which Marx described as a division of society into two antagonist classes.

was that it was considered efficient to tax individual so, that he supplies maximal amount of labour. Another was the concept saying, that tax system should maximize *some* kind of welfare function. The difference is clear I think – are we maximizing utility or GDP? It's most probable, that it was me, who got the idea wrong, but that does not matter now. Such mistake is somehow typical for an economist, now I'll try to explain, why I think so.

Many has been written about the possibility and impossibility of construction of some social utility function. The consensus stabilized that it is impossible to construct such function.<sup>4</sup> This certainly seems to be a reasonable conclusion, but it apparently has no room in optimal tax theory. The reason is clear – it's better to optimize at least some very imperfect kind of such function than to adjust tax rates ad hoc. So we try to construct some aggregate utility functions, although we know, we can never get even close to the true ideal.

Economy, especially this part considers itself to be exact science. If (and only if) we set our problem precisely enough, we can derive precise results (good example of such result can be Ramsey tax). Everyone knows, that our setting abstracts a lot from the real world. If we are lucky enough, then this leads us to some doubts about our results. But in fact we have no other choice than to trust these results, as we are not able to obtain better ones.

Ok, where is the connection to the example? My idea is following – we always tend to substitute ideal data by some hard numbers, which we are able to obtain. Switching between public welfare and GDP happened in my mind almost automatically. And I believe this is the typical reason(in economy), why some results happen to be overestimated. I wouldn't remind this common problem, if I didn't think, that optimal tax theory is exactly the case, where results from unreliable model are used for practical suggestions.

Back to the ground. Over-abstraction is of course quite general problem of social sciences. Why have I chosen to highlight it here, in topic of optimal taxation? It's because I believe, that here the problem is far more important. That's because construction of *any* social utility function, which optimal taxation uses, requires extreme amount of abstraction. As I said – OK, it is the best we can do here, but we have *at least* to triple-check, whether our results can be of any use.

Let's say it in short first: I believe, that in this special case public opinion can have more wisdom than the exact science. Some reasons for this belief are partially described above, one more I'll try to provide now. I'm going to answer my question from the very beginning which is : How come, that the convergence between suggestions of theorists and real policy does not occur in case of taxation?

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<sup>4</sup> But even if it was possible, there is no guarantee, that policy which it would imply will be politically possible. Slemrod [1990:158] arguments economic theory often underestimates real policy problems. Even approach, which brings pareto-improvement in all measurable means does not have to be politically possible!

Up till now, I've tried to explain why the real policy cannot be directed towards suggestions of theorists. Let's turn around and try to see, why opposite convergence cannot be achieved. I mean convergence of theory *towards* real policy (this should be the right one, if my previous theses are true). Part of the problem is definitely the exactness of economy as a science. It simply cannot move towards conclusions which is nearly impossible to support with any data. Nature of subject in this case does not allow us to capture it into *any* model without losing some important part of reality. I don't mean to express any scepticism here, I'm just trying to explain my opinion, that up till now all the models which were trying at least to roughly describe some kind of subjective utility failed.

In my opinion, we (meant as economists) are too stuck in our graphs and DWL minimizing. The problem is, that the cornerstones of optimal tax theory are made of assumption, that simple microeconomic changes of behaviour such as substitution for leisure are the biggest (if not the only) evil caused by taxation. I believe, that more complex effects, such as motivation and social coherence are *very* underestimated when tax efficiency is regarded. Maybe it's because of their disadvantage that they can be hardly quantified (if at all) and therefore do not fit into exact science.

As a conclusion to this work, I would like to make clear two things: firstly, this was really meant just as an essay. I have tried to answer few questions which emerge when one studies optimal taxation, by myself. None of opinions described here is supported by any evidence, and I even believe it can not be. My second point is, that (apparently) I don't like writing sterile boring papers.

But. In whole work I did not consciously use any misleading argument and up till now I am convinced, that there could be something in some of them. I would appreciate any brief explanation why I am wrong and why theory stays on. There certainly is one, but I was not able to figure it out by myself.

Sources:

Riddley, Matt, *The Origins of Virtue*, Viking 1996

Slemrod Joel, *Optimal Tax Systems*, *Journal of Economic Perspectives* 1990 source: jstor.org