Journal of Economic Behavior & Organization 90 (2013) 137–153

Contents lists available at SciVerse ScienceDirect

Journal of Economic Behavior & Organization

journal homepage: www.elsevier.com/locate/jebo

Tax structure and government expenditures with tax equity concerns ☆

Tobias Koenig *, Andreas Wagener

School of Economics and Management, Leibniz University of Hannover, Koenigsworther Platz 1, 30167 Hannover, Germany

ARTICLE INFO

Article history:
Received 4 October 2010
Received in revised form 7 February 2012
Accepted 19 April 2012
Available online 8 May 2012

JEL classification:
H20
E62
P16
Z10

Keywords:
Justice
Fairness
Taxation
Policy mix

ABSTRACT

We augment a standard tax model by concerns about tax equity: people get upset when labour is taxed more heavily than capital. Even the slightest concern for tax equity invalidates the common tenet that capital remains tax-exempt in small open economies. This holds for exogenous as well as for endogenous government expenditures and irrespective of whether concerns with tax equity only cause emotional discomfort or also impact on work incentives. If concerns with tax equity get more intense, the economy may choose higher taxes on labour and move to the downward sloped part of its Laffer curve. For endogenous government spending, stronger concerns with tax equity may lead to a larger size of the public sector.

1. Introduction

A central insight in taxation states that small open economies should not rely on capital taxation. This result, originally derived in Gordon (1986), emerges from the assumption of an infinitely elastic capital supply which small countries face. Under this assumption, the burden of a tax on capital will be entirely shifted onto workers or other immobile domestic factors. But if those factors bear the tax burden anyway, it is less costly to tax them directly and, by this, avoid the excess burden associated with capital flight.

Zero capital taxation, thus, is desirable in this class of models – it maximizes the representative household's utility and is also the policy outcome that people actually want and would vote for. However, in reality the prospect of zero taxes on capital hardly looks popular. It flies in the face of concerns with equity, fairness, and equal treatment in taxation – which remain unmodelled in the standard framework of (international) taxation. Over the past decades a large body of evidence has been compiled suggesting that people not only care for, or are solely driven by, material self-interest but also by values, norms and equity concerns. Such ethical preferences have been embedded into various economic contexts, but only little is known about how they affect the tax setting behaviour of governments.

☆ The authors thank Panu Poutvaara, four referees, Thomas Gaube, Grégoire Rota Graziosi, Marco Runkel, Robert Schwager, Matthias Wrede, and conference and seminar participants in Athens, Barcelona, Istanbul, Marburg, Magdeburg, Las Vegas, and Venice for their helpful comments and suggestions on earlier drafts. The usual disclaimer applies.

* Tel.: +49 511 762 8214; fax: +49 511 762 4574.
E-mail addresses: koenig@sopo.uni-hannover.de (T. Koenig), wagener@sopo.uni-hannover.de (A. Wagener).

0167-2681/$ – see front matter © 2012 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.jebo.2012.04.019

In this paper, we study the mix of capital and labour taxation in the presence of tax equity concerns, i.e., when citizens hold the view that the tax rates on capital and labour incomes ought not to differ too widely. Such an approach can be motivated along several lines, both principled and pragmatic:

- First, tax systems that exclusively or disproportionately rely on taxes on labour income may conflict with people's normative views on equity or justice.[1] The most general and fundamental of such principled views is reflected in the idea of horizontal tax equity, to which most tax systems pay at least lip service. Demanding that equal incomes should be taxed at equal rates (Musgrave, 1959; Kaplow, 1995), the principle forms part of the rationale underlying the comprehensive income tax (of the Schanz-Haig-Simons type), a normative ideal to which many countries (used to) adhere and that taxpayers cherish (Kirchler, 2007, pp. 78ff).[2] Discrimination between similarly situated tax payers – such as zero or low taxes on capital in the presence of positive and high tax rates on labour – violates this principle. Tax discrimination also offends its relative, the ability-to-pay principle, stating that all members of society have a duty to pay taxes in accordance with their economic capabilities; tax legislation warps this principle when tax privileges are not based on ability to pay.[3] Finally, since reducing inequality is a major rationale for taxation in modern societies, the exemption from taxation or low tax rates for capital incomes let the social compact for redistribution appear shaky – which many people find undesirable (Brooks and Manza, 2006).
- Second, zero or low tax rates on capital income in the presence of high tax rates on labour income cause discontent, anger, and envy. The rich, capital income earners or profitable businesses getting away without being taxed adequately makes wage earners with (perceived) high tax burdens angry (The Economist, 2009). The "common man", paying a substantial share of his moderate income in taxes, is upset when – as it happens in many countries – capital incomes are subject to rather symbolic income or capital gains taxes, exempt from contributing to social insurance, and given various preferences and privileges. Likewise, the (perception of a) growing imbalance in the taxation of labour and capital incomes (allegedly induced by globalization) nourishes political discomfort. Generally, policies that discriminate across comparable circumstances or individuals appear to create resentment, possibly also endangering social stability. This view finds strong support from social psychology where it is shown that *relative deprivation* – via unequal treatment, exclusion, or discrimination – negatively impacts both on individual well-being and on social cohesion and welfare (Runciman, 1966; Podder, 1996).[4] As argued by Elster (1991, p. 66) in general and by Boskin and Sheshinski (1978, p. 590) for taxation, a society that tries to assuage its envy may well adopt policies that damage its material interests.

To summarize, people seem to care about the tax structure in itself (and beyond the extent by which it affects their own incomes). They find it important that tax rates on different factors or types of income do not differ too much. Tax rate differentials affect individual well-being via concerns for equity, equality, and sentiments of relative deprivation or envy. In this paper we analyze the implications of such concerns for the tax structures in small open economies. To keep terminology simple, we shall henceforth and invariably refer to the view that the tax burden on incomes from capital and labour should be equal as "tax equity concerns". This term is an imperfect container for a wide range of partially overlapping concepts that are difficult to disentangle: principles of horizontal tax equity, envy, fairness perceptions, feelings of relative deprivation or discrimination, etc. Their common denominator is, however, that large discrepancies between tax rates on different types of income are unpopular.

From a modelling perspective, harbouring tax equity concerns mean that tax rates (or the tax structure) enter directly into one's utility function, irrespective of whether one's material well-being or other economic interests are affected or not. Concerns for tax equity may matter in at least two different ways: perceiving a situation as inequitable may cause discomfort (level effect) and it may also trigger adjustments in labour supply (incentive effect). The level effect reflects that people experience a reduction in their well-being when they see normative positions they cherish violated. The motivation for including incentive effects comes from empirical and experimental evidence that suggests that uneasiness felt in the context of taxation indeed affects work incentives. Dissatisfied individuals spend less effort on work, show higher rates of absenteeism, etc. (see, e.g., Lévy-Garboua et al., 2009; Cornelissen et al., 2012, or in a theoretical framework, Boadway et al., 2007). In social psychology, adverse behavioural reactions of this type have since long been discussed under the label "equity theory" (Adams, 1963). The experimental literature provides ample and general evidence that the violation of perceptions of "fairness" significantly impact on individuals' subjective well-being as well as on individuals' behaviour (for a survey see Fehr and Schmidt, 2006). From a citizen's perspective, equity constitutes an important criterion for the legitimacy of a tax system; it shapes tax compliance (Bordignon, 1993; Wenzel, 2003), political support (Taylor, 2003,

[1] For surveys on tax equity concerns and their implications for tax policy see, e.g., Barker (2006) or Kirchler (2007, Section 3.5).

[2] These aspects also matter in the debate on dual income taxes: by applying different tax treatments to incomes from different sources, dual income tax generate problems of horizontal inequity (see, e.g., Sørensen, 1994).

[3] Moreover, burdening only one subgroup of the population (i.e., workers) could also be in conflict with the benefit principle of taxation, stating that the taxes an agent pays should somehow reflect the benefits that (s)he receives from the goods and services supplied by the state (for a discussion of the benefit and sacrifice principles of taxation see, e.g., Neill, 2000). Since everybody benefits from the provision of public goods, the benefit principle calls (as a minimum) for a positive share in taxes for everyone.

[4] While economists tend to reduce relative deprivation to shortfalls of income or consumption, Runciman's original concept is far wider and applicable to abstract or intangible social objects, including policy measures such as tax rates.