Key Issues in the Reform of Personal Income Taxes

Comment to Richard Goode

by Hans-Werner Sinn

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Richard Goode provides an excellent discussion of the key issues in designing a comprehensive income tax. I was impressed by his paper. What he has to say on income taxation is well worth listening to, it is the fruit of a lifetime's study of the subject – indeed, he was writing on such matters before I was born.

Let me nevertheless dare to criticize him.

The author primarily uses equity arguments to defend the comprehensive income tax, but he also alludes to efficiency. The problem I have with this is that he is putting the weight on the wrong thing. I would prefer to shift the weight from equity to efficiency for, in my opinion, most of the traditional equity arguments are misplaced. In most cases, a meaningful policy recommendation can only be made on efficiency grounds, and, when it comes to efficiency, the income tax does not seem very attractive. Let me give three examples to illustrate why I think that efficiency arguments dominate equity arguments even when equity is the prevailing concern.

The first example is capital gains taxation. Goode argues that equity implies taxation of all accrued capital gains and he adds that efficiency considerations lead to the same conclusion. In my opinion, the reference to equity is unjustified, for, whatever the tax treatment of capital gains, asset prices will adjust to roughly equate the net rates of return on all assets. Those who invest their wealth in assets yielding capital gains are no better off than others who invest in fully taxed assets. It is true that the preferential treatment of capital gains must have created windfall profits at some stage. However, this typically happened in some remote past when the tax laws were introduced. There is no way for the government to identify the recipients of the windfall profits and no way to tax them today. Introducing a capital gains tax would produce immediate windfall losses for the current asset owners, not for those who enjoyed the windfall gains. In an economy that has experienced frequent asset trade since the introduction of its tax law, whatever this may be, it is impossible to defend the capital gains tax on equity grounds. It can, perhaps, be defended on efficiency grounds, for only an inclusion of capital gains in the income tax base is compatible with an efficient allocation of capital to competing uses. As I will explain below, however, even this may not be the last word on the problem.

The second example I want to address is progressive taxation. Progressive taxation is the traditional field for equity considerations, but even here these considerations do not lead as far as one would hope. The author observes that progressive taxation has not significantly evened out the income distribution. Why is this so?

In my opinion, at least two reasons can be given for the limited redistributive power of progressive taxation. The first is the Shapiro/Stiglitz (1984) theory of efficiency wages. According to this theory, the income hierarchy must be such that there are sufficiently large utility gaps between the hierarchy positions to ensure that the fear of being fired is a sanction just strong enough to prevent employees from shirking on the job. The theory implies that it is impossible to reduce the differences in net incomes between the ranks in the hierarchy by making the income tax more progressive. Any such attempt would violate the no-shirking conditions and would, in the long run, induce adjustments in pre-tax wages to compensate for the change in progressivity.

A second reason is risk-taking. Income redistribution through progressive taxation can be seen as an insurance device that stimulates risk-taking. More progressivity implies more risk-taking and a wider gap between the pre-tax incomes of those who had good luck and those who had bad. Thus an increase in the progressivity of the income tax schedule increases the inequality in pre-tax incomes. This counteracts the direct equalization effect of progressive taxation. It can be shown that, when the individual opportunity sets involve constant trade-offs between the mathematical expectations and standard deviations of the attainable probability distributions, usual assumptions on risk preferences imply that more progressivity in the tax schedule may well result in more, rather than less, inequality in the net-of-tax income distribution (Sinn, 1981). Progressive taxation may be an inappropriate tool for making the income distribution more equal: it may, for example, be inferior to changes in endowments and entitlements. In my opinion, its primary effect is to increase the amount of unskilled labor and reduce that of skilled labor. Efficiency rather than equity considerations may be appropriate even when it comes to comparing alternative income tax schedules.

The third example is the increase in the real capital income tax burden that inflation causes when the tax system is not indexed. Goode is right in pointing out that this tax increase does not affect all assets equally, because the tax system offers unequal exemptions and other provisions to compensate for the burden caused by inflation. I would like to add the systematic reason that, in the presence of historical cost accounting, inflation hurts short-lived assets more than long-lived ones. For long-lived assets, annual depreciation is small and thus the devaluation of depreciation allowances brought about by inflation does not count for much. Despite these asymmetries, however, I again claim that the market does its best in compensating for expected inflation and equating the real net rates of return on all assets. Government measures that try to compensate for asymmetrical tax effects resulting from anticipated inflation will necessarily result in unjustified windfall gains and losses for current asset owners and cannot compensate those who experienced the losses in the first place. These measures cannot be justified on the basis of equity considerations. Of course this does not mean that they should not be undertaken. The well-known intersectoral, international and intertemporal distortions resulting from inflation in the presence of historical cost accounting are certainly severe. My point is that efficiency matters more than equity, not because equity is unimportant, but because a move towards comprehensive income taxation would not improve equity.

Goode is particularly concerned about the asymmetries that characterize the hybrid tax systems that exist in reality. This concern is certainly shared by many advocates of the consumption tax. They too seem to prefer a comprehensive income tax to a hybrid tax. I am not sure, however, that it is wise from the viewpoint of economic efficiency to share this opinion. Perhaps the more exemptions from the income tax, the better. A comprehensive income tax is a device that punishes all kinds of capital formation equally and will therefore lead to an efficient allocation of any given aggregate capital stock. However, the capital stock is not given, it can be increased through savings, and a sector's true opportunity cost of capital may be the consumers' rate of time preference rather than other sectors' marginal product of capital. Why should we not allow for unpunished savings channels, i.e. for economic sectors whose cost of capital equals the true opportunity cost of capital? Why should we be worried about exemptions from the income tax? I am not just speculating here but refer to a joint paper with Ngo Van Long (1984) that was published some years ago. That paper discussed the question of whether natural resources should be subjected to capital gains taxation given that man-made resources are taxed according to the S–H–S principles. It showed that a second-best solution is, in general, incompatible with a taxation of the resource sector according to S–H–S principles even if these principles are applied to the rest of the economy. It was even possible to construct a special example where a consumption-type tax on the resource sector turned out to be the optimal efficiency solution to accompany an existing income tax on other sectors. In my opinion, this result can be generalized. I have nothing against hybrid tax systems because I do not see why the farmer whose cows have died should kill his sheep for the sake of symmetry.