A Challenge to Optimal Tax Orthodoxy

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Zachary Liscow, *Is Efficiency Biased?*, __ **U. of Chi. L. Rev.** __ (forthcoming), available at SSRN.

In "*Is Efficiency Biased?*," Zachary Liscow explores the canonic optimal tax claim—sometimes known as the "double distortion premise"—that non-tax rules should be structured efficiently, without regard to distributional consequences, and that tax and transfer rules should then be used to offset any resulting negative distributional consequences and make such further distributional adjustments as are necessary to maximize aggregate social welfare. This standard claim assumes that "if the tax system achieves the appropriate distribution of income, then the distributive impacts of non-tax policies do not matter." Ultimately, claim proponents conclude, "everyone can be made better off through efficient non-tax policies, plus taxes and transfers." The foregoing paraphrases are Liscow's; for a defense of the claim itself, see Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income* and *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income.*

Liscow asks the reader to consider a different possibility: that for a variety of reasons the tax system may not actually achieve an optimal distribution of income. If so, Liscow notes, then policies consistent with the double distortion premise will not maximize aggregate social welfare—indeed, they may produce markedly suboptimal results. Part of the problem, he observes, is that efficient non-tax policies are not generally "legal entitlement neutral"—that is, equally likely to favor rich and poor. This follows from the fact that Kaldor-Hicks efficiency "measures the willingness to pay of the parties affected by a policy and then chooses the policy that maximizes the sum of the willingness to pay of those parties" and that the wealthy tend to be willing to pay more for public goods and other legal entitlements.

Liscow notes that many efficient non-tax policies are instead "rich-biased": "[A]nalysts can measure how willingness to pay changes with income. The answer to that question determines characterization: for rich-biased rules, willingness to pay increases as income increases; for neutral rules, willingness to pay stays the same; for poor-biased rules, willingness to pay decreases at higher incomes." Examples of rich-biased public goods come easily to mind: cleaner air, more and nicer public parks, roads in better repair, better schools, more effective policing, shorter lines in voting booths. Importantly, the efficiency criterion requires that non-tax policies for which the rich are willing to pay more be rich-biased regardless of whether the rich are actually required to pay for them. Policies that take from the poor and give to the rich may well be Kaldor-Hicks efficient.

Liscow concludes: "[E]conomic analysis of law has long been guided by the assumption that the distributive consequences of policies do not matter, since taxes should respond to take care of distributive considerations. But there is little evidence that taxes in fact do respond….E]fficient policies systematically tend to distribute legal entitlements to the rich, exacerbating income inequalities and possibly leading to multiplication over time. At a time of rising income inequalities and growing concern with these inequalities,…it is time to consider adopting policies that reduce efficiency but have fairer distributional outcomes, at least in some circumstances….[T]his article suggests the importance of considering context in deciding whether to deviate from the efficient rule….For efficient rich-biased rules with distributional consequences that are sticky [e.g., not offset by taxes or transfers],…policymakers should adopt explicitly inefficient rules that treat the rich and the poor alike."

The most important implications of Liscow's argument, as suggested by the paper's own conclusion, might appear to relate primarily to non-tax law, not to tax policy. But the paper carries important implications for tax policy as well.

First, the claim in question—that non-tax policies should be structured efficiently, without regard to distributional consequences, and that tax should then be used to offset any negative distributional consequences and make such further distributional adjustments as are necessary to maximize aggregate social welfare—is a central pillar of optimal tax theory. If, as Liscow argues, efficient non-tax rules are predominantly rich-biased, then the distributional burden the claim asks our tax system to carry may be an impossible one.

Second, in response to our tax system's continuing apparent failure to meet the distributional challenge, some tax policy scholars, notably Ed Kleinbard, have urged that redistributive efforts focus on fiscal policy—on spending programs—rather than on making taxation itself more progressive. But spending programs are often "non-tax policies" within Liscow's taxonomy, and are subject to the same rich-bias problems that tort and other more obviously "non-tax" rules present. Liscow himself notes, for example, that decisions on transportation spending have been rich-biased, even under Democratic administrations, because of the use of conventional cost-benefit analysis, which assigns less value to the lives, health, and time of poor Americans than to those of the rich.

Third, conventional tax theory supports the use of Pigouvian taxation to correct externalities—costs imposed on someone other than the actor. In measuring those costs, however, it uses willingness to pay as its metric. Pigouvian analysis thereby itself becomes rich-biased. As Liscow points out, under Kaldor-Hicks, higher levels of carbon taxation or other ameliorative measures are warranted to prevent the negative health consequences of air pollution to the rich than are warranted to prevent identical negative health consequences to the poor.

Finally, and perhaps most importantly, the paper raises questions about the way optimal tax theory measures the size of behavioral distortion and dead-weight loss: it does so by looking at willingness to pay—the core methodological decision that leads Kaldor-Hicks analysis itself to produce rich-biased results. Thus, because the poor are less willing to pay for leisure (because they have to eat), Ramsey tells us that we should tax the poor, not the rich, so as to avoid behavioral distortion and with it deadweight loss. Harberger tells us that taxes on suppliers or consumers with particularly elastic supply or demand curves (read "the rich") produce larger deadweight loss than taxes on suppliers or consumers whose curves are inelastic (read "the poor"). Here, I do not blame either Ramsey or Harberger; they were writing without the benefit of Liscow's insight. But Liscow's insight requires that we rethink their conclusions—not perhaps to abandon them, but to develop a clearer consensus about when those conclusions ought or ought not to affect our decisions.

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