

What Is Lost in Translation? From Theory to Practice in Tax Policy

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Alan Auerbach, [Tax Equivalences and Their Implications](#), 33 **Tax Policy and the Economy** 81 (2019).

In *Tax Equivalences and Their Implications*, [Alan Auerbach](#) reviews some of the commonly invoked equivalences that have been incorporated into the vocabulary of tax policy discussions during the last half-century. He offers a quick (and refreshingly accessible) summary of the analysis economists have used to break down the study of tax instruments so that their predicted impacts can be compared in terms of their overall effect on the economy. More important, he points out the situations in which these generally useful assumptions about equivalence across tax instruments will not hold, and, in doing so, hints that arguments from equivalence may have sometimes played a perhaps oversized role in tax policy discussions.

Equivalence for Auerbach's purposes generally refers to the idea that identified tax policies have, in his words, "the same impact on fundamental economic outcomes." One key economic outcome is the extent of the misallocation of resources resulting from the dead-weight losses taxes always entail. Under an economist's view, for instance, a labor income tax can be seen as equivalent to a consumption tax as long as there is no initial wealth (and therefore earnings are only derived from labor) and all earnings are consumed.

Not so very long ago, governments seeking revenue had to grab it wherever they could. The possibility of adequate revenue collection, given the physical and political constraints faced by a government, was pretty much the only relevant criterion in tax base design. Consideration of the impact of any particular levy in the overall economy was an indulgence few governments could have undertaken, even if they had had the analytical tools to do so. Gaining popular acceptance of a tax, based on such theoretical analysis, was rarely imagined.

This situation has been reversed over the last century or so. Choices among tax policies now take into account more than just the relative likelihood of collections adequate to meet the demands of the government's creditors. Proposed revenue measures are regularly subject to economic analysis to predict their impact on the economy, and implemented revenue measures are subject to scrutiny (albeit less often) about whether these predictions have been fulfilled. Indeed, the theoretical endorsement of economists has become a primary motivator of innovations in tax base design.

Prominent in the arguments used in these endorsements has been the possibility of equivalences among various stylized tax bases. These potential equivalences have been the drivers behind many tax policy proposals—both for entirely new tax structures and for tweaks in old ones. The potential equivalence between a value added tax and a wage tax combined with a cash flow business tax (an equivalence that relies on normal returns to all factors) was the driving insight behind the "flat tax" proposals of the 1980s. (P. 86.) The potential equivalence between a destination-based cash flow tax and a value added tax with a deduction for wages was both the analysis behind, and the downfall of, the tax urged as part of the 2016 Republican platform. (P. 103.)

Some of the equivalences Auerbach explores may only be of academic interest, and then only to those legal academics least concerned with on-the-ground implementation. The conditions under which changes in investment portfolios can render a tax on risk-free returns equivalent to a tax on wealth (P. 89) may be one such discussion. So might the presentation of a retrospective capital gains tax as equivalent to a realization-based capital gains tax. (Pp. 100-01.)

But there is much here that would help a legally-trained student of tax policy who is making an initial attempt to engage

with the economists' contributions to tax policy debates. One such benefit is a warning about the possibility that the economist is stating her conclusions about rates as they would apply to a tax-inclusive base rather than a tax-exclusive base. (A 20% sales tax, as normally stated in tax statutes, imposed on a tax-exclusive sales price base could be sold as a 17% tax, if the proponent is referring to a rate stated on a tax-inclusive base; 20 is 20% of 100, but less than 17% of 120. (P. 85.))

Another payoff is in Auerbach's acknowledgment that the equivalence assumed in economic analysis will often not be honored under traditional ways used by lawyers and other non-economists to classify taxes. He further observes that classifications, because they are often codified in constitutions and other grants of revenue-raising power, can operate as serious real-world constraints on tax policy.

Auerbach's observation here is both more timely and more timeless than he may realize. Unmentioned is the additional complicating fact that each different classifier may approach the classification differently, even when the same label is applied—the “direct tax” constraint that the U.S. Congress faces probably does not apply to the same group of tax instruments that are covered by treaties addressing “direct taxes.” It is somewhat ironic that imagining equivalence among taxes was the essence of the 1796 Supreme Court's early approval of the federal carriage tax as not a direct tax. Congress could, everyone conceded, have imposed an excise tax on the purchase of a carriage. Given that this result was permissible without apportionment and therefore regardless of the geographical aspects of the economic impact of the tax, why couldn't Congress, in effect, require that tax to be paid in installments over the life of the carriage instead of on its purchase? If one assumes all carriages have a similar life (and ignores any problems that might be associated in transition with the imposition of a retroactive excise tax), the equivalence holds, as the opinion of [Justice Paterson](#) effectively argues in [Hylton v. United States](#).

The biggest reward to the reader is in the discussion of the circumstances in which the equivalences that can be so useful as assumptions in theoretical analyses can break down in the real world. Market imperfections can be one source of breakdown. Labor taxes will be harsher than consumption taxes with the same present value if the earner cannot borrow against future earnings. (P. 92.) Immediate expensing can be better than deductions with the same present value for similarly liquidity-constrained firms. (Pp. 92-93.) Expensing will not be equivalent to exemption in the face of above-market returns. (P. 93.) In other circumstances, the full implications of equivalences can be obscured because of inadequacies in information and its reporting. Auerbach calls out government accounting rules, that use truncated timing windows (P. 95) and financial accounting rules that use nominal rather than discounted values (P. 96), as culprits here.

In his conclusions, Auerbach stresses the importance of considering the ways in which equivalences may fail. He further notes that this consideration is useful in understanding the political reasons for choosing one approach over another. Here, he seems to be implicitly conceding that the rhetoric based on theoretical equivalence may sometimes receive oversized importance.

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