MPRA

Justice and Taxation

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30 December 2010

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A Reconsideration of the social contract

between State and Citizens

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1. Introduction

The problem of **Justice and Taxation**, is an interesting theme because it is not only an economic question which invested a lot of the best intelligence in the history from Smith to Hayek, but also an argument which is crucial for many different economic categories: firms, Individuals, and investors who very often consider alternative scenarios including the fiscal option.

In general the **progressive taxation** is considered morally correct and for this reason it is recognized by the major economies as the best solution for the **distribution of income**.

The objective of taxation is to provide resources for financing public services which are useful for the collectivity but not marketable.

Which kind of public services include, depend on the role of the state or in philosophical terms on the contents of the **social contract**.

In strict terms, some of the tasks of the state are the following:

- assuring its defense (which is strictly linked with the sovereignty of the state inside and outside).
- The administration of justice.

Public schooling, the health system, and many others services related to the welfare state may be included in the tasks of the state or alternatively satisfied by the market. It is evident that if the state includes more tasks, the costs proportionally increase and the **amount of internal revenues** must consequently increase in absolute terms.

Returning to the fiscal system our interrogative is:

What are the principles of functioning of flat taxation, compared to progressive taxation ?

2. Definition and characteristics

In order to simplify the task we consider only income taxation which is part of the indirect taxation, in our argumentation; however many arguments are applicable to systems with similar mechanisms.

The key characteristic of flat taxation is that the rate applied to the **gross salary**, remains the same without considering the total income. If, for example, the government with the Fiscal Ministers or the fiscal agency fixes the taxation rate at 30%, this percentage is applied to all the incomes which are included in the **taxation area**. This kind of taxation was adopted initially in Estonia in 1994, in Lithuania in 1994 and then in Latvia in 1995 and Russia 2001. Today the great part of Eastern

European Countries adopted the flat tax[1].

The following table provides a view of the countries which adopted this fiscal system:

Country	Year of Adoption	Current Personal income Tax Rate(s)
Estonia	1994	21%
Lithuania	1994	15%
Latvia	1995	26%
Russia	2001	13%
Serbia	2003	12%
Slovakia	2004	19%
Ukraine	2004	15%
Georgia	2005	20%
Romania	2005	16%

Sources: www.taxrates.cc.

As showed in this list the major Eastern European Countries starting from the 90s adopted the flat tax, with only one or in some cases two percentage.

On the contrary, the progressive taxation is founded on the principle that the tax percentage is variable and increases with the increase of the income. For example in my country, Italy, the progressive taxation is configured based on the following system:

Gross annual income	Tax Rate	Gross amount of taxation
From 0 to 15,000	23%	23% of the Gross Annual Income
From 15,000.01 to 28,000	27%	3,450+27% on the part exceeding 15,000
From 28,000.01 to 55,000	38%	6,960+38% on the part exceeding 28,000
From 55,000.01 to 75,000	41%	17,220+41% on the part exceeding 55,000
Over 75,000	43%	25,420+43% on the part exceeding 75,000

Sources: www.agenziaentrate.gov.it.

*The monetary data filled in the first and third column are expressed in Euro

Following this configuration, the amount of taxation is calculated considering different percentage of tax rate.

For example, if the Gross Annual Income is: **60,000 €**, using the aforementioned rule the gross amount of taxation becomes:

17,220+ (60,000-55,000.01)*41% = **19,270 €**

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[1] Cfr.: R. Murphy - *A Flat Tax for the UK? the Implications of Simplification* – An ACCA Discussion Paper, June 2006. pp. 20-24.

So the percentage of taxation, compared to the Gross Annual Income, becomes:

19,270 / 60,000 = **32%**

Now, hypothesizing a gross annual income of **90,000 €,** the gross amount of taxation become:

25,240+ (90,000-75,000)*43% = **31,870 €**

31,870 / 90,000 = **35%**

Starting from the same amount of taxation the corresponding **flat tax rate,** is:

(19,270+31,870) / (60,000+90,000) = **34%**

Therefore to obtain the same **amount of internal revenue the government has to apply the percentage calculated above.**

From this simple calculation it is possible to deduce the following **assertion:**

Different kinds of taxation (progressive or flat) can produce the same internal revenue.

This is an important result because the **flat tax rate** can guarantee **the same internal revenue for the government**, significant differences are focused about other aspects.

Following our investigation other questions will be explored. In particular:

is **progressive taxation** more efficient for the government?

Is **progressive taxation** more equal? Or in other terms does it reflect the ethical principles more adequately?

This aspects are examined in the following paragraphs which illustrate the advantages of flat tax system.

3. *The advantages*

In order to introduce the advantages of **flat taxation** in comparative terms it is necessary from my point of view to examine the objectives of the two parties: the government and the taxpayer.

Imaging that each party is represented by two different objective functions, the equilibrium is localized in the intersection of the graphic which represents the two functions. Therefore following this assumption it is necessary to analysis the objectives and find a possible coincidence of interests.

The objective function or **interests of the government** are to obtain the **internal revenue predicted**. Naturally, it is necessary to predict a legal sanctions system, and an efficient monitoring system for the tax evader. A deficit in the internal revenue is problematic for the government, because it obliges the government to increase taxation in its different forms or reduce public spending.

The **interest of the taxpayer** is clearly to pay as little as possible, because taxation reduces the income available for personal choice, but at the same time, to receive good public services. To this end it is useful to remember that more public spending is not synonymous with better public services.

Where is the interests meets ?

This question is widely treated in the literature, which is known as "Laffer Curve". This theory,

although attributed but not invented by the US economist Arthur B. Laffer[2], illustrates the trade-off between tax rates and tax revenues. The curve shows that governments can **maximize** tax revenue by adopting a tax rate at the peak point of the curve and that raising tax rates thereafter reduces tax revenues. The logic is that the disincentive effect of tax paid does, above a certain tax rate, reduce effort expended by the **taxpayer**.

It suggests that the **optimal tax rate** (T%) is at the **peak of the curve**, and it will be noted that a fixed level of taxation revenue can, according to this idea, be raised with two taxation rates at all levels except the optimal rate. It must be stressed that there is no reason why the curve is evenly shaped as shown. T% could be anywhere between 1% and 99%.

Our scope is to show that it is possible obtain an **optimal tax rate**, without renouncing **fairness.**

In general the quality of public services (for example: justice, police, defense) is not strictly correlated with the resources attributed to them. An increasing number of resources available for public services not accompanied by a clear strategy do not produce benefits; therefore it is not correct to adopt as **index of efficiency of public services, the resources attributed to it. On the contrary an amount of resources directed to the internal revenue is a significant part of capital which is subtracted from the possibility of alternative uses which increase economic activity.**

For these reasons the problem of **optimal taxation** is a question which invests the micro and macro category. Following these considerations one starting question is:

How much time is dedicated to absolve the fiscal obligation by the taxpayer ?

It is evident that the **progressive tax system** needs more sophisticated calculation, which must be done by the taxpayer.

For the U.S. one good measure of tax complexity may be the number of sub-chapters in the Internal Revenue Code. Between 1954 and 1994 the number of sub-chapters increased from 103 to 698. A flat tax would eliminate much of this complexity[3].

Moreover, it is evident that with a easier taxation system such as the flat tax suggest, it is not necessaries the support and the management of a chartered accountant or equivalent, which represent an advantage in terms of **time** and **costs** for the taxpayer.

The simplification implies other advantages; the possibility of calculating the tax due is an important element in an economic system, because the exact knowledge of the **amount tax due**, reduces the uncertainty respect to the decisions of the economic operators mainly taxpayers. On the contrary, the unclear calculability of the **tax due** to increase in the state of uncertainty which is transfered in the entire system through prices, incomes, and profits. In fact, as a result of:

Net Income = Gross Income – Taxes

Net Profit = Gross Profit - Taxes

But when the **amount tax due** is not known at first sight, there are evident consequences. In the long term, this phenomenon generates an recessive effect because disincentive the investments, in particular the direct investment which are not attracted from aleatory scenarios.

The advantages of a simplified system are extended to another important issue related with the tax question. Hypothesizing the same **amount of tax due** in two different taxation systems (flat, progressive) following the example above illustrated, we have:

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[2] Cfr.: A. B. Laffer - *The Laffer Curve, Past, Present and Future. Retrieved from the Heritage Foundation -* June 1, 2004. No. 1765. pp. 1-18.
[3] Cfr.: Institute Brief, Vol. 3, No. 7, July 1996. pp. 1-2.

- flat taxation system,   -   **19270 €**

- progressive taxation system,   -   **19270 €**

Starting from **the parity of gross amount** the first amount reported (which is the result of flat tax) is clearly preferable, because it is easier to calculate, which means that the correctness of the declaration is more verifiable from the government. So, the key question become:

How many resources are spent by the government and (in ultimate instance from the taxpayer) for monitoring the correctness of the declaration?

It is all evidence that the monitoring activity of the flat taxation system is clearly less expensive, respect to a progressive system, so coming back to the aforementioned amounts the first amount absorbs a cost of **monitoring** approximately 1% whereas the second amount absorbs 5% of the same amount.

For these reasons, I think that the only category which can obtain advantages from the complexity of the taxation system is the category of **tax evaders.**

This introduces another important issue related to the organization of the taxation system. **Tax evasion** is a complex phenomenon which invests not only economic aspects. However, it is clear that the decision to evade depends rationally on three factors summarized in the following equation:

$$T = P * S$$

T - The **amount** of the taxes evaded.

P - The **probability** to be discovered from the fiscal agency.

S - The **sanctions** due to the government by the **tax evader** discovered.

In order to reduce the phenomenon of evasion, which produces many problems for the individuals and the economy, it is necessary to manage the variables to this end.

Naturally every single variable needs a treatment, although our scope is not to deal with tax evasion; there are many issues relative to tax evasion which are related to the different taxation systems[4].

Leaving apart the **first**, and the third **variables**, of the equation which need of a deeper analysis comprising national peculiarities, and other aspects often subjected more to political, than economic considerations; the second variable (i.e. the probability of being discovered which is the correlated with the complexity of the taxation system) is increasable simply by reducing the complexity of the taxation system; this is an operation which can seriously support **the battle against tax evasion.** The **simplification** can produce advantages for all the different economic operators.

Another advantage of **flat taxation** compared to **progressive taxation** is related with the absence of **fiscal drag**. Fiscal drag is an increasing of the fiscal pressure originating from progressive taxation and an increase of nominal income. This phenomenon is particularly evident in an inflationary context. During the 70s and 80s, the nominal increasing of income was in great part translated in an increase of the **internal revenue**.

The tax scheme is fixed with reference to the nominal income, which is not adjusted for inflation, for this reason supposing three parties in the negotiation:

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[4]   Cfr.: V. Selan - *Elementi di scienza delle Finanze* – G. D'anna 1986. p. 65-71

- The employee
- The employer
- The government

Supposing a gross annual income perceived by an **employee** equal to 55,000 €, an increase of the nominal income or a bonus equal to 2,000 € represents an increasing of cost for the **employer**. Now the question is:

how is shared the amount or the bonus, between the employee, and the government?

In a flat tax system the last 2,000 € are taxed with the same tax percentage, but in a progressive system the 2,000 € are taxed with the marginal tax rate which is higher, following the progressive system. So paradoxically an increase of income taxed with a higher percentage becomes discouraging.

In other words, in the first case the advantage is neutral, whereas in the second the advantage is for the government, which obtains more, compared to the first case.

This is another motivation which attests to how **progressive tax system** is not **fairer** than a flat tax system. The reductions in marginal tax rates stimulate economic effort, expanding the size of the taxable economic pie. An Increased economic activity represents a benefits for the entire society.

4. *Proposal and Conclusion*

The Proposal of adoption of a flat taxation system from the policy maker and the great part of opinion maker is commonly accompanied by negative comments and mystifications which are usually the results of a prejudice and scarce knowledge.

Commonly the opinion makers stress the presumed **lack of equity** embedded in the flat tax system.

However, as presented in many surveys and I hope in the present paper, this argumentation is weak; with the flat tax system the fiscal pressure is more manageable and the advantages are more determinable by the taxpayers.

Some of the main advantages were explained in the previous paragraphs, although the argumentations in favor of the flat tax rate are more articulated and need more space, my objective is present an coherent and applicable model with incentives for the implementation of a flat tax rate.

The model includes two important characteristics which can act as incentives.

Let's suppose a **ordinary** flat tax rate of **26%** for the **Gross annual income**.

Starting from the assumption that the monitoring regarding the declaration is easy and rapid, for every taxpayer who doesn't receive sanctions after five years it receive a **discount in the flat rate from 26% to 24%**, the discount of 2% represents a **fidelity premium,** (financed by reducing the cost of monitoring) which is a premium for the correct behavior of the taxpayer. This incentive reduced the monitoring and the relative costs increased the probability that the government receive the **amount due**, and moreover makes **tax avoidance** and **tax evasion**, less advantageous rewards fair behavior.

On the contrary whoever receives **two sanctions** for fiscal irregularities (tax evasion) in 5 years, is obliged to an increase of the flat tax rate from 26% to 30%.

In the **long term** this situation is stable; in fact the expectation of discount embedded in the model,

improves the economic environment, and strengthens virtuous behaviors.

Another crucial point of the model is obtained from the **battle against tax evasion.** Tax evasion is a complex problem which regards not only the taxpayers but the entire economy. For this reason the model predicts which advantages coming from the **battle against tax evasion,** are shared from all. The practical **norm** is that every recovery of extra-revenue is translated in a discount in the general **flat rate**, with benefits for the entire community. The scope respecting the equity is to obtain the same **internal revenue** with more equity distribution of the tax charges, recognizing that in the presence of tax evasion the honest tax payers are creditors (because they pay more than the right amount) to the **government** whereas the tax evader is a debtor to the government.

The objective is to create a conflict of interests between the **taxpayer** and the **tax evader**, and not from the **taxpayer** and the **government**. The principle is respect for the **honest taxpayer**, and the delivery of the extra amount paid due to the **tax evader**.

Summarizing the model becomes:

Ytot   Total Gross Domestic Product

Yo   GDP Ratio referred to the ordinary flat tax rate.

Ytp   GDP Ratio referred to the virtuous tax payers.

Yte   GDP Ratio referred to the tax evaders.

Ftr   Ordinary flat tax rate 26%.

Tg   Gross Internal Revenue.

Tnet   Net Internal Revenue.

Cm   Cost of monitoring (which include part of the costs needs for detect the tax evader)

$$\mathbf{T_{net} = (T_g - C_m) = 26\% Y_o + (24\% Y_{tp} + 30\% Y_{te})}$$

In this model government starts the fiscal policy fixing the **Tnet (net internal revenue)** for a long enough horizon, for example the entire legislature, and after using the variables included in the formula following an order established to obtain the results expected.

The reduction of **Costs monitoring** implies an increase in the **Net Internal Revenue,** without an increase in the fiscal pressure. Therefore the model in the long term produces an increasing of the **Tnet** which represents an improvement in the efficiency of the fiscal agency which is translated in a reduction of **taxation rate**.

An increase of the GDP, implies and increase of the **Gross internal Revenue**, and correspondingly of the **Net internal revenue,** without regressive or disincentive effects as in the progressive taxation system. Moreover another aspect must be considered, this system with the flat tax produce and internal revenue more stable which becomes an auto stabilizer. In fact in many OECD countries the problem is the wide variability of the Internal revenue, which instead of becoming a stabilizer becomes a source of instability[5].

The taxation is considered in many discussions, particularly by the policy makers not only an instrument for collect resources for the functioning of public services, but even an instrument for promote equity and social justice.

However, this argumentation is weak because the "natural justice" imply a system of values stratified in the national culture, and the *ratio of law* or *L'esprit des lois*, could include the system of

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[5]   Cfr.: F. Schneider - *The Size of the Shadow Economies of 145 Countries all over the World: First Results over the Period 1999 to 2003* - IZA DP n. 1431, December 2004. pp. 6-54.

values. In others terms the market may be the judge of the economic situation, which promote or reject the economics activity. For this reason is desirable that the interference of the political power be minimal, and finalized only to improve the situations which are not really resolvable within the market.

In Conclusion, the flat tax rate, represents a fair system of taxation which implies a different relation from citizen and government or as **pointed out** in my title **a *Reconsideration of the social contract between State and Citizens.***

It is useful to remember that the relation between citizen and state must be imbued with **confidence** and respect of the **norms**, but to this end the norm must respect the **individuals**, and the **diversity**, the oppressive norms produce mistrust and the violation of the norm itself. Paraphrasing Hayek, the knowledge **in advance** of an act of the state is a general **rule of law** and doesn't represent a **coercion**.

December 2010

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