TAX INSTRUMENTS AND THE ACHIEVEMENT OF TAX EQUITY

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Abstract - Deductions and tax credits are instruments usually adopted by tax systems, in addition to marginal tax rates, to get the desired tax revenue, together with other fiscal policy objectives, respecting vertical and horizontal equity requirements. The effect of marginal tax rates, deductions and tax credits is here decomposed in order to detect whether and to which extent each of these three instruments violate tax equity.

Keywords - Equity in personal income tax, Equity violation decomposition, Kakwani-Lambert axioms.

I. INTRODUCTION

A tax system should respect two equity principles: Horizontal equity and vertical equity. The former requires that households with the same living standard before taxation should remain in a similar situation after taxation; the latter requires and households with homogeneous characteristics should contribute according to an increasing function of their incomes. Tax systems generally try to accomplish equity by a proper tax rate schedule, deductions (which lower taxable income) and tax credits (which lower the final net tax). As Kakwani and Lambert [3] (henceforth KL) state, when comparing heterogeneous families, nominal equal incomes are not actual equal incomes (a 2 dollar ice-cream costs 8 dollar, when you have wife and 2 children). Generally a tax system does not specify the adopted equivalence scale, and very often deductions and tax credits depend on various and not necessarily coherent objectives.

The effects on taxes, due to marginal tax rates, deductions and tax credit, were first analyzed by Pfäler [7]; then the analysis was refined by Lambert [3] and, recently by Onrubia et Al. [5]. The Pfäler-Lambert-Onrubia et al. approach only focus on how the redistributive effect is achieved.

This paper explores which features of the tax contribute the most to the removal of a real-world tax from a perfectly fair one.

KL state that tax should increase monotonically with respect to people's ability to pay (Axiom 1); richer people should pay taxes at higher rates (Axiom 2); no re-ranking should occur in people's living standards (Axiom 3). A violation of Axiom 1 automatically entails a violation of Axiom 2, although not necessarily the other way round. Moreover, Axiom 3 can be violated only if Axiom 2 (and consequently Axiom 1) holds. We propose both a step by step procedure and an ex post (overall) one, which allows to decompose the contribution of the tax rate schedule, deductions and tax-credits to the redistributive effect. The ex post approach is inspired by the works by Podder [8] [9] and Podder and Chatterjee [10]. Differently from Pfäler, Lambert and Onrubia et Al, we do not consider explicitly deductions, as we think that their effect can be better evaluated by inspecting the distribution of the tax revenue without deductions, versus the one obtained after their application.

Starting from the proposed decomposition of the redistributive effect, we evaluate the contribution to each axiom violation, due to the tax rate schedule, deductions and tax-credits.

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