Optimal Tax Theory and Family Taxation

Prof. (em.) RAY REES, Wales (Großbritannien)*

I. Introduction

The economic theory of taxation sees taxes as having two main effects: first, they distort the decisions people make concerning the activity being taxed, and secondly, they cause a loss of wellbeing, usually referred to as "utility", because of the loss of real income resulting from paying the tax. For example a tax on employment income may cause people to reduce the number of hours they work, or choose jobs requiring lower levels of effort and responsibility, or even leave the labour force entirely, and these are usually called the "(dis)incentive effects" of the tax. Paying a tax will also obviously reduce how much one can spend on consumption goods and saving, and so make one materially worse off. Moreover, the structure of the tax system, the set of rules determining how taxes have to be paid, inevitably means in practice that a tax will have different effects on different people, and an important area of tax analysis in economics is to try to clarify how the incentive effects and effects on wellbeing are distributed across the population being taxed.

These are the main factors that determine how a tax system should optimally be designed, as economists see it. We should try to find the appropriate balance between: keeping down the cost of the distortions to incentives on the one hand, and taking account of society's views concerning the fairness or equity of the distribution of the burden of taxation across the population on the other.

Although there is a very large economics literature concerned with analysing income taxation along these lines, only a small part of it is concerned with income taxation in the context of the family, despite the fact that the majority of taxpayers live in family households, defined broadly to mean households consisting of at least two adults with or without dependent children, or of one adult with one or more dependent children. The reason for this is that the body of economic theory that tax economists normally draw upon was developed for the case of a single decision taker, dividing his time between work and leisure, and using the income from employment to buy goods and services for his own consumption.

The obvious descriptive inaccuracy of this model was sometimes recognised, increasingly so as over the 1960’s to 1980’s family structures changed dramatically, with falling fertility and increasing female labour force participation. Nevertheless, the temptation was strong to try to analyse issues of income taxation as if the family could be treated as a single individual, so that standard methods and techniques could be applied. This is still the dominant approach, but at least over the past three to four decades some economists have tried to develop models of family decision taking and to apply them to issues in family taxation.

The stimulus for this work, and its central theme, has been the issue of the choice of tax base for the personal income tax system, whether this is to be joint or individual income in the prototypical two-earner household. This body of work will be the focus of the present review. The following section outlines the main characteristics of the types of income tax system that are typically in existence. Section III reviews some theoretical

* Prof. (em.) Ray Rees war bis zum Jahr 2008 Professor für Volkswirtschaftslehre an der Ludwig-Maximilians-Universität München und bis zum Jahr 2013 Programme-Direktor des dortigen Center for Economic Studies (CES).

1 In all but the most recent textbooks, the decision taker is always a man.

2 See for example the most recent book by a leading tax theorist, Tuomala (2016).

3 Tax theorists also consider forms of tax systems, usually referred to as "nonlinear taxation" that have no exact real world counterparts, the aim being to explore more general ideas of how tax systems could and should be structured.