

Taxes and Justice in Context

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It was Alistair who said, on national television, that being a Tax Officer was the most pleasant work imaginable, like turning on a tap to bring water to parched country. It felt wonderful to bring money flowing out of multinational reservoirs into child-care centres and hospitals and social services. ... He sold taxation as a public good.¹

In tax policy discourse, there are three primary criteria for judging a tax system: equity, efficiency and simplicity. In *The Myth of Ownership: Taxes and Justice* (2002), Liam Murphy and Thomas Nagel take on the criterion of equity, or justice in taxation. Axiomatic to their discussion of tax and justice is that private property is a legal convention, defined by all of the laws and regulatory mechanisms of the state *including* taxation, so that '[t]axes must be evaluated as part of the overall system of property rights that they help to create.'² The corollary is that 'pretax income' is a myth. Analyzing tax fairness on the basis of a benchmark of my 'pretax income' or in terms of my 'tax burden', is a fallacy.

The fundamental argument of Murphy and Nagel is both obvious and controversial. It has attracted criticism by those who suggest it overstates a clear case and by those who argue that it will lead to the end of property and hence capitalism as we know it. This comment is written from the perspective of an academic tax lawyer who is fundamentally sympathetic to the argument. As Peter Carey illustrates vividly in his novel, *The Tax Inspector*, a consideration of tax and justice makes sense only when tax is considered together with public transfers, social services and child-care centres. Tax is just one of the complex of policies that may produce what Colin Farrelly has called 'the fair distribution of the benefits and burdens of social cooperation' — ie, 'distributive justice'.³ *The Myth of Ownership* is an important intervention in the United States debate about justice and taxation. It is no less important or timely in the Australian context. Although an Australian founding myth is that this is the land of the 'fair go', Australian popular debate about taxation is conducted increasingly in

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¹ Peter Carey, *The Tax Inspector* (first published 1991, 1993 ed) 124.

² Liam Murphy and Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (2002) 8.

³ Colin Farrelly, 'Taxation and Distributive Justice' (2004) 2 *Political Studies Review* 185, 185.

terms of a simplistic analysis of the ‘tax burden’ on the individual who owns (and deserves) the entirety of his or her pretax dollars. In a typical example, the Editorial of *The Australian* newspaper sought to ‘[a]xe the taxes for a fair go’:

If you study hard to get a good education, then work hard to gain promotion or build your own business, what happens? You do enough to receive some reward for your efforts and the tax office confiscates half of every extra dollar you earn. ... Under a supposedly free enterprise government, the tax burden has reached record highs.⁴

Yet Murphy and Nagel’s analysis has led to unease in this commentator — and other tax academics. Is it a result of their book that there ‘may be nothing to say about justice and taxation at all’?⁵ Put another way, must we abandon the notion of a *fair tax* based on ability to pay, a notion that has had persuasive force in arguments about distributive justice and tax at least since John Stuart Mill?⁶

This comment makes three points. First, it highlights a less obvious, but fundamental, aspect of Murphy and Nagel’s argument, which is a major cause of the unease they have generated. That is the importance which they give to efficiency and overall levels of welfare in the debate about justice and taxation. Second, it proposes that greater attention be given to tax discrimination as a measure of tax justice that developed out of feminist work on taxation. Finally, it argues that there are circumstances in which the philosophical debate about tax and justice must itself be contextualized.

Equity and efficiency

Murphy and Nagel argue that it is not possible to determine the fairness of a tax system’s marginal tax rates, nor of the definition of the tax base, solely on the basis of the notions of ‘vertical equity, horizontal equity, the benefit principle, equal sacrifice, ability to pay, and so forth’, which are the staple of tax fairness debates.⁷ They require a broader analysis of the distribution of resources throughout society by government regulation. In particular,

⁴ ‘Axe the Taxes for a Fair Go’, *The Australian* (Sydney) 10 December 2002, 10.

⁵ Linda Sugin, ‘Theories of Distributive Justice and Limitations on Taxation: What Rawls Demands from Tax Systems’ (2004) 72 *Fordham Law Review* 1991, 1992.

⁶ This point was made by Professor Cameron Rider of Melbourne University during the Australian Society of Legal Philosophy Book Symposium, December 2004.

⁷ Murphy and Nagel, above n 2, 7.

they require attention to be paid to the overall level of welfare, or resources; the size of the economic 'pie' which may be divided up amongst us all.

By incorporating overall welfare into the debate about tax and justice, Murphy and Nagel do two important things. First, they clearly accept the market as operating to distribute and allocate resources, in spite of their apparent challenge to property rights. Criticism of their position as undermining property and hence capitalism itself misses the point. Their starting point is taxation in a capitalist economy and their position is made explicit when they say that distributive justice must be considered in the context of a comprehensive economic picture 'including expenditures for public goods and redistribution either in money or by public provision, together with the effects of all this on employment, economic growth, and the distribution of wealth and income.'⁸

Second, Murphy and Nagel place tax *efficiency* at the centre of the debate about tax fairness. The notion of overall welfare feeds into tax policy through the principle of efficiency, which is frequently expressed as requiring that taxes should not operate so as to *reduce* the size of the overall pie, or that it should encourage economic growth.⁹ Taxes may have this effect by creating incentives that differ from the market incentives for peoples' behaviour, thereby perhaps affecting decisions, for example, to save or to work, in ways that reduce the gross economic product available for (re)distribution. Murphy and Nagel incorporate efficiency into their framework for discussion of tax and justice when they direct our attention to incentive effects of taxation.

Given their concern for these matters, it is a logical step for Murphy and Nagel to approve of optimal tax theory, which focuses on the implications of tax policy for overall societal 'welfare' in a 'second best' world.¹⁰ In fact, optimal tax theory is the *only* tax theory that they accept as coming halfway towards asking the right question about justice in taxation. They say about this theory:

Most significantly, it approaches the topic in the right way, investigating outcomes rather than the distribution of burdens. ... Its central question is what level of taxation would best promote welfare ... Any theory of justice concerned about levels of welfare, including a theory that gives intrinsic weight to greater equality (though such theories are not usually considered in the optimal tax literature), must confront the fact that while taxes enable redistribution from richer to poorer, they may also depress work

⁸ Ibid 162.

⁹ Eg, Review of Business Taxation, *A Tax System Redesigned* (1999) 13.

¹⁰ James Mirrlees, 'An Exploration in the Theory of Optimum Income Taxation' (1971) 38 *Review of Economic Studies* 175.

effort and thus reduce overall welfare.¹¹

Clearly, behavioural effects of tax law may be important. One could add to ‘depress work effort’ a list of other possible behavioural consequences of taxation that might reduce overall welfare, including ‘enhance tax avoidance’ and ‘send capital and labour overseas’. For example, a tax system that imposes taxation of 40% on interest income, only to produce the outcome that most saving (and hence interest) flees the country to another jurisdiction, is scarcely going to produce an outcome of distributive justice (at least in the home country).

More generally, it seems right that an assessment of effects on overall welfare is necessary in a discussion about taxes and justice. Murphy and Nagel are correct to point out the myopia of tax equity in this regard. Again, as Farrelly observes, Murphy and Nagel, among others, have begun to incorporate the issue of *scarcity* of overall resources into the philosophical discussion about fairness in distribution of those resources.¹²

Yet the embedding of efficiency with equity, and the acceptance of a trade-off between equity and efficiency which seems necessarily to follow, causes unease, and not solely because of concern that economists are taking over control of the tax justice debate. First, incentives are not the same as behaviour, and behavioural effects of taxation are very difficult to measure. Economic theory, being just that — theory — may have a tendency to overstate the importance of incentive effects and hence of overall welfare and understate issues of *relative* distribution as between individuals. Second, as Murphy and Nagel observe, optimal tax theorists have not been greatly interested in increasing equality, or reducing inequality, as a goal of tax policy. Third, there is a more fundamental matter of discourse and power at issue here; the language of economics tends to marginalise and issues of equality and justice, replacing them with the ‘big’ and important issues of economics — such as ‘economic growth’ or ‘global capital mobility’.¹³ At times, as illustrated in the next section, Murphy and Nagel appear to be seduced by economic discourse. It would be ironic if, in seeking to broaden the debate about tax justice, they contributed to the marginalisation of that very issue.

¹¹ Murphy and Nagel, above n 2, 136.

¹² Farrelly, above n 3, 193, discussing the book as an example of ‘non-ideal theory’.

¹³ See the wonderful analysis by Lisa Philipps, ‘Discursive Deficits: A Feminist Perspective on the Power of Technical Knowledge in Fiscal Law and Policy’ (1996) 11 *Canadian Journal of Law and Society* 141. See also a discussion of the effects of tax discourse in Miranda Stewart, ‘Global Trajectories of Tax Reform: The Discourse of Tax Reform in Developing and Transition Countries’ (2003) 44 *Harvard International Law Journal* 139.

Taking tax discrimination seriously

Murphy and Nagel reject considerations of equity even in consideration of the ‘more microscopic’ issue of differential treatment under the tax law of different types of income or expenditure, or of persons with different characteristics. For example:

The decision whether to treat investment income or capital gains differently from wages ... would almost certainly have to be based on large-scale economic effects in regard to growth and the mobility of capital, rather than on intrinsic equity.¹⁴

However, in chapter eight, Murphy and Nagel allow one exception to their general argument. It is possible, they say, to carry out an assessment of ‘carefully targeted tax breaks’ on grounds of justice.¹⁵ This is the issue of *tax discrimination*: ‘an explicitly racial, religious, or sexual ground for differential treatment would not be allowable under our system, even if, somehow, it promoted a desirable end’.¹⁶

In referring to ‘targeted tax breaks’, Murphy and Nagel appear to draw on the notion of tax expenditures, defined by the originator of the concept as ‘a vast subsidy apparatus that uses the mechanics of the income tax as a method of payment of the subsidies’.¹⁷ In the frame of reference of *The Myth of Ownership*, it is not entirely clear why one would pay any more attention to a ‘targeted tax break’ than to any other tax rule, just because it is a subsidy made through the tax system. Surely tax expenditures too must be considered in light of the overall distribution of resources through governmental systems.

Nonetheless, the tax discrimination argument is significant and will stand even without the notion of a ‘targeted tax break’. Feminist tax theorists pioneered tax discrimination analysis. They began by turning their attention to the discriminatory effects of the married tax unit.¹⁸ Murphy and Nagel also illustrate their analysis with a discussion of the married and individual tax rate structures in the United States’ income tax. These rate structures, and their outcomes, are complicated (there is a nice explanation

¹⁴ Murphy and Nagel, above n 2, 163.

¹⁵ Ibid 164.

¹⁶ Ibid 166.

¹⁷ Stanley Surrey, *Pathways to Tax Reform* (1973) 6. Such special tax provisions include deductions, exemptions, tax credits, preferential tax rates and deferral rules.

¹⁸ See, eg, Patricia Apps, Elizabeth Savage and Glenn Jones, ‘Tax Discrimination by Dependent Spouse Rebates or Joint Taxation’ (1981) 53 *Australian Quarterly* 262; Alicia Munnell, ‘The Couple versus the Individual under the Federal Personal Income Tax’ in Henry Aaron and Michael Boskin (eds), *The Economics of Taxation* (1980) 247.

in the book). The authors conclude first, that the explicit limitation of the joint unit to ‘marriage’ is ‘suspect’ because of the many relationships that are left out. Second, the *implicit* bias resulting from the incentive effects of the joint unit (in substance, the married unit taxes married women at higher rates if they work outside the home as secondary earners than if they were unmarried) is suspect, revealing problems of equality of opportunity and sexual bias that deserve attention and, possibly, redress. Effectively, Murphy and Nagel agree with much feminist research on this topic.

Yet the focus on the married tax unit as an example of discrimination — dictated, perhaps, by the terms of the tax policy debate in the United States — means that the power of a discrimination framework for analysis of tax law and policy is understated in the book. A cogent argument can be made that the entire tax law is susceptible to a gender discrimination analysis, not only in its definition of the tax unit or in respect of ‘targeted tax breaks’, but in the definition of the tax base and other core provisions.

Take the example of the appropriate tax rate for wages versus capital gains, argued by Murphy and Nagel to be a problem of ‘economic growth’ and ‘global capital mobility’. Claire Young has shown that in Canada at least (and the same seems likely in Australia and the United States), women own fewer valuable investment assets and derive fewer and smaller capital gains than men.¹⁹ Lighter taxation of capital gains than wages thus provides disproportionate benefits to men over women. That does not mean that economic growth and global capital mobility are irrelevant to the taxation of capital, or that higher taxation of capital gains is necessarily the solution to gender inequity in ownership of capital assets. But it demonstrates that if a discrimination framework is taken seriously, taxation of capital and wages is not *only* a question of efficiency; and that substantive (implicit) gender discrimination in tax law is pervasive. The same could be said for critical race or sexuality analyses of taxation; as Lisa Philipps has written, ‘there are ... many ways in which tax law sustains and deepens patterns of social inequality.’²⁰ In sum, a discrimination analysis of tax law and policy deserves more credit and may be more powerful than is suggested by Murphy and Nagel.

¹⁹ Claire Young, ‘Taxing Times for Women: Feminism Confronts Tax Policy’ in Richard Krever (ed), *Tax Conversations: A Guide to the Key Issues in the Tax Reform Debate* (1997) 261.

²⁰ Lisa Philipps, above n 13, 145. See, eg, Beverly Moran and William Whitford, ‘A Black Critique of the Internal Revenue Code’ [1996] *Wisconsin Law Review* 751.

Tax fairness in context

Finally, this comment puts a case for mitigation of the impact of Murphy and Nagel's general argument about tax and fairness in particular contexts. Specifically, when the political and institutional context in which we debate taxes and distributive justice is taken into account, it may be appropriate, or even necessary, for us to pay attention to the narrower issue of fairness *in* taxation, or to argue for a *fair tax*.

Murphy and Nagel are acutely aware of the politics of taxation. In chapter nine, they acknowledge that '[p]ublic policy is not made by philosopher kings' but '[i]n a democracy it is made by political representatives subject to removal by their constituents, and realistic grounds for action have to recognize the complicated dynamics of this mechanism.'²¹ Their argument against 'pretax income' mobilizes philosophy in the discursive struggle around taxation and distribution. But they tend to assume the meaning of such terms as 'politics', 'democracy' and the 'state'.

A contextualized discussion of the form of the state and political institutions is needed in the tax justice debate for two related reasons. First, the particular institutions and politics of the state have implications for the kinds of tax (and other) policies that may generate distributive justice. Second, an examination of these institutions may reveal that a meaningful debate about fairness is in effect *confined* to the tax system. A way to think about this might be to consider tax and justice in comparative context — how do the arguments and tax reform proposals of *The Myth of Ownership* sit in the context of other mature capitalist democracies?²²

Murphy and Nagel propose a number of concrete tax policies as most likely to produce a fair outcome. In brief summary (with apologies to Lawrence Zelenak²³), these are: (a) an income tax is preferable to a consumption tax; (b) the tax system should be significantly progressive; (c) gratuitous transfers should be taxed as income to recipients; (d) an accessions (inheritance) tax is needed; (e) tax credits are preferable to tax deductions. Zelenak observes that the discussion of Murphy and Nagel on these issues is 'thoughtful' but is not logically compelling and that 'other

²¹ Murphy and Nagel, above n 2, 173.

²² An example of comparative institutional tax analysis is Sven Steinmo who compares the United States, Sweden and the United Kingdom (Sven Steinmo, *Taxation and Democracy* (1993)).

²³ Lawrence Zelenak, 'Taxation: The Myth of Pretax Income' (2002) 101 *Michigan Law Review* 2261.

thoughtful people also concerned about outcomes might reach different conclusions'.²⁴

Zelenak is right that the policies proposed by Murphy and Nagel are not mandated by their view of distributive justice in a capitalist economy. This can be illustrated by the different tax structures of other mature capitalist democracies, which produce equally or more egalitarian outcomes than the United States.²⁵ France, for example, has high taxes on consumption and high payroll (social security) taxes but a low, even inadequate, income tax. Highly egalitarian countries like Sweden and Finland have quite low taxes on capital and heavy taxes on wages and consumption. Australia, which has egalitarian credentials (albeit a little shaky) does not tax inheritance. New Zealand scarcely taxes capital at all. Perhaps the policies proposed by Murphy and Nagel *should* be established in these countries, but this does not necessarily follow from their argument about just outcomes.

Murphy and Nagel's argument for the tax policies they propose may, however, be stronger when the specific institutional structure of the United States is taken into account (here, I diverge from Zelenak). The tax policies proposed in *The Myth of Ownership* make more sense when they are understood as an attempt to achieve distributive justice in the context of the *particular* capitalist market, regulatory state *and* tax policy discourse in the United States. Different policies are possible in theory and even in practice as is shown by tax systems elsewhere, but (in spite of theory) may be less possible in the United States itself. The specific institutions of the state thus affect the debate about tax and justice because they shape the mechanisms that will be effective in producing the outcome of distributive justice *in that state*.

The second, related argument, is that there may be some institutional contexts in which it is appropriate that the debate about distributive justice focuses on the tax system itself. In some contexts, the tax system may take on more significance in generating fair outcomes, while in others, budgetary spending, land reform or regulation of the labor market, may be more feasible, or more effective. If the tax system is the most important means of achieving the overall goal of distributive justice in a particular institutional context, does this render it legitimate, or even necessary, to pay attention to fairness *within* the tax system itself? For example, is it right to pay attention to the progressivity of tax rates in that context?

Take the example of a country where (a) the tax system is relatively stable and politically difficult to reform; (b) budgetary expenditures are

²⁴ Ibid 2268.

²⁵ For a general survey and comparison, see Ken Messere (ed), *The Tax System in Industrialized Countries* (1998).

constantly under review and easily modified by the government in power; and (c) most aspects of the market for capital and labour are in a colloquial sense 'free', that is, government policy does not directly influence outcomes in those markets. In such a country, a 'social justice' reformer may look to budget expenditures to provide distributive justice. However, it seems more likely that the reformer should look with some scepticism at government proposals to use expenditure policies to achieve distributive justice, because of the ease with which such policies could be wound back. It may be better to take a long-term view and argue for progressive income taxation as a means of achieving distributive justice (regulatory mechanisms being unavailable). This is because a progressive income tax, although difficult to achieve, will be more stable and hence may produce better long-term outcomes than any expenditure or regulatory policy. In this context, the debate about fairness, while always conducted against the broad background of fair *outcomes*, will likely come down to the fairness, or progressivity, of the tax law itself.

A possible example is New Zealand, which reformed its tax, transfer and market regulatory systems dramatically in the early 1990s to become one of the 'free-est' of the capitalist economies.²⁶ The Goods and Services Tax ('GST'), a consumption tax, was introduced and income tax rates were flattened; while capital gains are not taxed at all in New Zealand. Welfare payments were set at a rate that would, in theory, compensate the least well-off for the GST and other tax changes. But the payments, if they were ever adequate, soon became inadequate, in part because the cuts in taxation required cuts in expenditure to balance the budget (deficit budgets being unacceptable and 'fiscal responsibility' being compulsory, at least for very small countries). The welfare benefits were top of the list for such cuts.²⁷ In this context, a debate about progressivity or regressivity of the GST and income tax, including an examination of the tax rates, seems important if a just outcome is to be achieved. A similar, necessary debate took place regarding the introduction of the GST in Australia a few years later, when attention was paid both to the compensatory package for the GST including associated income tax changes and welfare payments, and to the regressivity of the GST itself.²⁸

²⁶ New Zealand's reforms attracted international attention and praise from the International Monetary Fund; see, eg, Graham Scott, 'Government Reform in New Zealand' (Occasional Paper No 160, International Monetary Fund, October 31, 1996).

²⁷ Julie Smith discusses these outcomes, and their gendered impact, in Julie Smith, 'Tax Reform, the GST and Women' (Background Paper No 11, The Australia Institute, 1998).

²⁸ See, eg, Peter Abelson (ed), *The Tax Reform Debate* (1998).

In a specific context where tax policy is one of the few remaining mechanisms available for (re)distributive goals, taxation may be a space where distributive justice can actually be discussed. The notion of a *fair tax* can still have meaning in such a context. Murphy and Nagel are right to point out the myopia of tax equity debates, to incorporate overall welfare into the debate, and to challenge tax theorists to find new ways to discuss tax and fairness. But there are times when the philosophical debate about tax and fairness must itself be put into context.