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Steven M. Sheffrin
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TAX FAIRNESS AND FOLK JUSTICE

Why have Americans severely limited the estate and gift tax – ostensibly targeted at only the very wealthy – but greatly expanded the subsidies to low-wage workers through the Earned Income Tax Credit, now the single largest poverty program in the country? Why do people hate the property tax so much, yet seemingly revolt against it only during periods of economic change? Why are some groups of taxpayers more obedient to the tax authorities than others, even when they face the same enforcement regime? These puzzling questions all revolve around perceptions of tax fairness. Is the public simply inconsistent? A sympathetic and unified explanation for these attitudes is based on understanding the everyday psychology of fairness and how it comes to be applied in taxation. This book demonstrates how a serious consideration of “folk justice” can deepen our understanding of how tax systems actually function and how they can perhaps be reformed.

Steven M. Sheffrin is a professor of economics and the executive director of the Murphy Institute at Tulane University. He is the author and coauthor of several books, including *Property Taxes and Tax Revolts* (with Arthur O’Sullivan and Terri A. Sexton, Cambridge University Press, 2007) and *Rational Expectations* (Cambridge University Press, second edition, 1996). His articles have appeared in numerous scholarly journals, including *American Economic Review*, *Quarterly Journal of Economics*, *Journal of Economic Perspectives*, *Review of Economics and Statistics*, *National Tax Journal*, *Journal of International Economics*, *Journal of Finance*, *Journal of Monetary Economics*, and *International Economic Review*. He received his PhD from MIT.

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To my wife, Anjali

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Preface

Why have Americans severely limited the estate and gift tax – ostensibly targeted at only the very wealthy – but greatly expanded the subsidies to low-wage workers through the Earned Income Tax Credit – now the single largest program to combat poverty in the country? Why at a time when social commentators bemoan the rise of inequality in the United States and throughout the globe do ordinary individuals routinely embrace the astronomical salaries paid to sports stars and entertainers? Why do people hate the property tax so much, yet seemingly revolt against it only during periods of economic change? Why are some property tax reforms successful while others fail? Why are some groups of taxpayers more obedient to the tax authorities than others – even when they face the same enforcement regime? When do tax authorities “cross the line” in their attempts to enforce the law? And, when do some individual tax cheats cross a different line and suddenly become social pariahs?

These puzzling questions all revolve around different aspects of tax fairness. Many would argue that they reveal the extremely limited economic sophistication of the public or its philosophical inconsistency. But there is a more sympathetic and unified explanation for these and similar questions. The key is to recognize and understand the everyday psychology of fairness and how it is applied to taxation. Ordinary individuals hold a set of psychological principles about fairness in taxation that are considerably broader and that differ in systematic and fundamental ways from the ideas of fairness that dominate our public debate today.

For more than a decade now, there has been an increasingly frustrating and indecisive political battle in the United States and elsewhere around the world centered on “tax fairness.” The public dialogue has focused entirely on redistributing income through the tax code. While the proponents of increased redistribution have captured the media interest, there has been

virtually no movement in actual tax rates or fundamental tax structures. Moreover, many of the proposals for redistribution – for example, restoring the top marginal tax rates to those of the late 1990s – were exceedingly modest. While there has been little political movement either way, the preoccupation with redistribution has further polarized a political system already straining to reach compromise on challenging issues.

The thesis of this book is that tax fairness is important, but it is not synonymous with redistribution. To the average person, tax fairness means something else, primarily receiving benefits commensurate with the taxes one pays, being treated with basic respect by the law and the tax authorities, and respecting legitimate efforts to earn income. The average person is not totally indifferent to inequality, but concerns for redistribution are moderated by the extent to which income and wealth have been perceived to be earned through honest effort. We use the term *folk justice* as shorthand for the views of tax fairness held by ordinary individuals.

The emphasis on tax fairness as redistribution comes from academic work in philosophy and economics that, in many ways, stands apart from the concerns that motivate everyday people. The influential writings, theories, and general ideas of John Rawls and James Mirrlees – centered squarely on redistribution – have deeply penetrated into the thinking of a large segment of our society's opinion makers, becoming their instinctive view of tax fairness. We refer to these academic views as expert justice.

The purpose of this book is to resurrect folk justice and bring its emphasis and focus back into the public dialogue. It uses well-founded principles of social psychology to ground the concept of folk justice. Some of these underlying psychological principles – procedural justice, equity theory, and modified notions of fairness – are relatively well known outside the psychology world, while others – moral mandates and system justification theory – are less well known. All of them, however, affect some aspect of public intuitions and feelings about the tax system.

We use these principles of folk justice in several different ways in this book. First, we establish that they illuminate existing policies and practices in a wide variety of actual tax settings. We accomplish this task by applying the principles to explain apparent puzzles in property taxation, income taxation, estate and gift taxation, and taxpayer compliance, some of which we highlight. In essence, we demonstrate with a diverse set of data, observations, and historical examples that the principles of folk justice have real explanatory power for understanding the day-to-day world of concrete tax policy.

Second, we explore the tensions between folk justice and expert justice. For example, what if the policies recommended by expert theories conflict

with deeply ingrained folk notions of fairness? How can policies be implemented in that setting and which policies are appropriate? Finally, we also suggest that in some situations the intuitions of folk justice may provide a better guide to what policy should be than does expert justice. Respecting folk intuitions may, in some cases, enrich our set of both ideal and implementable policies. As such they can provide useful insights and needed corrections to expert policies.

This interdisciplinary project had a number of different roots and influences from economists, legal and tax policy experts, philosophers, and social psychologists. More than twenty years ago, I was encouraged by Joel Slemrod to explore the psychological roots of tax fairness for a conference and volume. This turned out to be a rich area in which many creative psychologists and behavioral economists were beginning to generate a fascinating body of research. During the same period, I was also conducting research into property tax revolts and general tax noncompliance, two areas in which we see concrete manifestations of dissatisfaction with the “fairness” of the tax system. Joan Youngman and Jorge Martinez asked me to draw on my experiences with both the fairness literature and property tax revolts to understand why there was persistent public dissatisfaction with property taxation. Later, Geoffrey Brennan suggested that my insights on folk justice, fairness, and property taxation might carry over to other areas of taxation as well. Qiyang Ong at Nanyang Technological University in Singapore introduced me to new and relevant areas in behavioral economics. From these diverse experiences and influences, I began to understand the differences between what appears to matter to individuals and what appears to matter to the theorists of equality.

In developing the psychological components of folk justice, I received valuable advice from two social psychologists at UC Davis, Alison Ledgerwood and Cynthia Pickett. Each provided me with insights into developing areas of social psychology that were directly related to my folk justice ideas. My colleagues at the Murphy Institute at Tulane, Bruce Brower, John Howard, and Jon Riley, provided very useful feedback on the philosophical setting for this work. I have also presented various aspects of this work at the Tulane Tax Roundtable, the National Tax Association Annual Meeting, and the Maurer School of Law at Indiana University and thank the many participants and discussants for all their comments. Their insights and those from many others that I do not mention here helped enrich the narrative of this book.

I have benefited from excellent and creative research assistance from a variety of talented students. Teny Maghakian and Elira Kuka, as graduate

students at UC Davis, helped with research on income taxation and compliance, respectively. Matt Turner, then an undergraduate at Tulane, worked with me on researching property tax controversies and developments outside the United States and developed the survey instrument for estate and gift taxation.

A reviewer of the manuscript for Cambridge University Press provided many insightful comments that have been incorporated into the book and also provided the idea for a glossary of key terms from psychology, philosophy, and economics that would potentially allow the book to reach a broad audience. Finally, I especially want to thank my editor, Scott Parris, for his support and confidence in this project.

Glossary of Terms in Psychology, Philosophy, and Economics

Capitalization: In economics, the idea that prices of assets, such as housing, incorporate the value of current and future taxes.

Cognitive Dissonance Theory: A psychological theory that individuals will want to reduce differences between their beliefs to relieve anxiety.

Consequentialism: A philosophical theory that says we should judge the moral worth of actions by the actual outcomes from those actions.

Deontological Theories: In philosophy, moral theories that focus on the intentions of actors, their adherence to duties, and rights.

Desert: A philosophical theory that claims that individuals deserve certain rewards on the basis of their actions. There are two versions of this theory. *Pre-institutional desert* asserts that individuals deserve rewards for their actions regardless of the details of the institutional setting in which these actions take place. *Institutional desert* asserts that the individuals are only entitled to rewards because of the nature of the background institutions.

Distributive Justice: The theory of how resources should ideally be divided among individuals.

Equity Theory: A psychological theory that states that individuals prefer to see outputs or rewards closely tied to inputs or effort.

Excess Burden: In taxation, the idea that in addition to raising revenue, taxes distort economic behavior and reduce welfare.

Horizontal Equity: In taxation, treating similarly situated individuals as equal.

Implicit Taxation: In economics, owners of assets may receive reduced returns precisely because the assets have valuable tax advantages. A good

example of this phenomenon is that the interest rates on tax-exempt bonds are less than those of comparable taxable bonds.

Inequity Aversion: An economic theory that suggests that individuals have a distaste for inequality.

Market versus Assessed Value for Properties: In taxation, public officials will declare a value or assessment of a property in order to levy a property tax. Market value taxation means that the assessment is based on the value that the property would sell for in the market.

Modified Notions of Fairness: Experimental evidence shows that individuals are willing to sacrifice their own resources to promote fairness, but the extent of their willingness to sacrifice is tempered by social contexts and beliefs about entitlements to resources.

Moral Mandates: A psychological theory that states that individuals may form seemingly powerful and perhaps irrational attachments to certain moral ideas that override other considerations.

Optimal Income Taxation: A theory in economics that explores how to maximize social welfare while taking into account individual behavioral responses to taxation.

Ordeal Mechanism: Institutions that require individuals to undertake onerous tasks so that the government can separate them into different types.

Political Realism: A political philosophy that focuses on how individuals will actually behave in concrete political settings.

Procedural Justice: The theory in psychology that emphasizes that individuals place a high value on the process by which outcomes are determined.

Reflective Equilibrium: An idea in philosophy that informed judgments about justice must eventually conform to everyday judgments about justice. This occurs through a process by which both types of judgments adapt to one another.

Restorative Justice: Theories of how “wrongs” should be “righted.” It is also known as retributive justice.

Revenue- versus Rate-based Property Tax Systems: In revenue-based property tax systems, tax rates are adjusted to meet revenue targets for the government. In rate-based systems, tax rates are fixed and revenues rise or fall with actual assessments.

Salience: The degree to which economic phenomena are noticed by economic actors.

Social Exchange Theory: A theory in sociology that views interactions between individuals as an exchange of money, power, status, or similar elements.

System Justification Theory: A theory in psychology that emphasizes how individuals need to feel that the social system is just.

Tagging: Using observable characteristics, such as height or race, to deliver benefits or levy taxes on individuals.

Tax Incidence: In economics, the question of who actually bears the burden of taxation.

Tax Morale: The set of attitudes that characterize the willingness to pay taxes.

Utilitarianism: A moral theory that says we should judge outcomes by their effects on individual welfare or utility.

Vertical Equity: In taxation, levying higher taxes on individuals with higher incomes or wealth.

Voice: The ability to express one's views or opinions in social interaction.