TAX POLICY

Principles and Lessons

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Abstract: Tax policies are informed by principles developed in the tax theory and policy literature. This Element surveys the policy lessons that emerge from optimal tax analysis since the 1970s. We begin with the evolution of tax policy principles from the comprehensive income approach to the expenditure tax approach to normative tax analysis based on social welfare maximization. We recount key results from the optimal income tax analysis inspired by Mirrlees and extended by Diamond to the extensive-margin approach. We emphasize analytical techniques that yield empirically relevant concepts and show the equity–efficiency trade-off at the heart of tax policy. We discuss various conceptual issues with social welfare maximization, including interdependent utilities, heterogeneous preferences, behavioural economics, social norms and the source of the social welfare function and their implications for optimal taxation. We also extend the analysis to recent literature incorporating involuntary unemployment and policies like welfare and unemployment insurance.

Keywords: tax policy, optimal taxation, social welfare maximization, redistribution, income taxation

JEL classifications: H21, H23, H24, I38, J68

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