TAX LAW

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Summary

Tax laws both reflect and perpetuate certain social values. Governments must choose how much revenue they wish to raise through taxation as well as what social policy objectives they feel a tax system can achieve. In order to accomplish these objectives, governments enact a variety of different taxes that are generally based on either an income or a consumption base, or some hybrid combination of both bases. In addition, governments choose an appropriate tax rate to apply to the chosen tax base: progressive taxation tends to enable wealth redistribution from relatively wealthier taxpayers to those who possess less wealth. All of these choices involve normative implications concerning what is a just society.

1. Introduction

Tax laws are surely among the most important laws a nation can enact. The chief function of tax laws is to ensure that a government can raise sufficient revenues to pay for the public goods demanded by its constituents. But tax laws play an additional important social engineering role within many modern market democracies. For example, a progressive income tax system, such as the one employed by the United States, redistributes wealth from relatively wealthier households to relatively poorer families.

Section 2 discusses the main purposes of tax laws, including the revenue-raising functions and the use of taxes to accomplish public policy objectives. This section additionally discusses how governments strive through their tax laws to enforce these laws while at the same time avoiding overly intrusive enforcement measures that could interfere with the personal liberty of their citizens. Section 3 sets out the main types of taxes that governments use to accomplish their desired revenue and/or policy objectives. This section emphasizes the differences between income tax bases and consumption tax bases as well as the impact of progressive tax rates. The paper concludes that tax laws play an important role in defining a vision of a just society, although the normative premises upon which these laws are founded are rarely articulated.

2. The Purpose of Tax Laws

2.1. Objectives

This section discusses, in broad outline, the two main objectives of tax laws. The chief function of tax laws is to ensure sufficient revenues are raised to pay for public goods. A secondary objective of tax laws is to modify taxpayer behavior in some way to assist with achieving some public policy goal. The next section discusses how tax laws strive to balance the government's need to achieve its specified objectives while at the same time preserving other interests such as the need to protect individual personal liberty.

2.1.1. Revenue Collection

Under the social contract theory of the state, individuals renounce their inalienable rights to do whatever they please in order to enter into a cooperative state where, it is thought, they will enjoy even greater freedoms. Accordingly, individuals agree to transfer certain functions and duties to state agents. For example, we renounce the right to seek private vengeance by authorizing a state-controlled police force to arrest and apprehend those individuals who have breached criminal laws enacted by the state. In times long past, payments akin to taxes would be made to the local sovereign or cleric to pay, at least in part, for protection of person and property.

Similarly, individuals in modern market democracies have authorized state agents to collect taxes, pool the collected revenues and disburse payments for the public goods and services demanded by government constituents. As Oliver Wendell Holmes once noted: "Taxes are what we pay for a civilized society." It is clear that any legal system must mandate the collection of these taxes; otherwise the system will be unworkable or, at best, inefficient. Consider the example of a national defense budget that benefits all citizens by protecting their persons and property. In absence of laws that force taxpayers to pay taxes, many individuals may be tempted to refuse to fund defense expenditures, forcing other volunteers to make up any shortfalls through greater payments. Tax laws that mandate tax payments strive to avoid these free-rider problems. Legal rules that punish uncooperative taxpayers are subsequently discussed.

The choice of where to spend tax revenues falls on government agents who respond to the collective wishes of the electorate or, under a more cynical view, the desires of special interests who lobby legislators for perks. Through this process, each nation decides how the collected revenues will be disbursed. For example, the United States government collected $1,722 billion in fiscal year 1998 and disbursed $1,653 billion (leaving a surplus of $69 billion) under the following breakdown: 37% for social security, Medicare and other retirement; 18% for national defense, veterans, and foreign affairs; 17% for social programs; 14% for net interest on debt; 8% for physical, human and community development; 4% for surplus to pay down federal debt; and 2% for law enforcement and general government spending.

2.1.2. Behavior Modification

In addition to revenue collection, tax laws often strive to modify the behavior of taxpayers. Behavior modification has become a more important aspect of tax laws as the modern welfare state has expanded. Tax laws try to change behavior by increasing or decreasing the after-tax cost of engaging in a certain behavior. For example, if the government imposed a 50% sales tax on potatoes, people would tend to switch to a potato substitute, perhaps rice. The extent of the behavior modification depends on the elasticity of the demand for the good, service or activity which is taxed. A 100% tax on breathing air will not greatly change a taxpayer's behavior because oxygen is critical to survival. But a harsh tax on most goods or activities will tend to reduce the demand for the good or discourage the activity in question. As a result, governments enact a host of different types of taxes to accomplish their public policy objectives. Take excise taxes imposed on certain goods where reduced demand is desired; hefty taxes—so-called sin taxes—on items such as cigarettes or alcohol tend to discourage the purchase of these items, achieving the desired social engineering objective. Such taxes sometimes lead to schizophrenic tax policy where the government wants (and needs) to collect tax revenues and at the same time strives to discourage an activity that produces these revenues.

With respect to modification of individual behavior, the list of social engineering attempts under tax laws appears almost limitless. United States tax laws try to promote or discourage, among many other things, marriage, procreation, child care, elder care, the purchase of medical insurance, employee non-cash benefits, charitable donations, investments in life insurance, sales of property, recoveries for personal injuries, mortgage interest deductions, sale of personal residences and medical expense deductions. Governments similarly offer an array of incentives or disincentives to businesses surrounding the purchase of capital assets, research and development, mineral extraction, hiring employees, manufacturing, leasing and so on.

The extent to which taxes actually influence behavior continues to remain an area of controversy among tax economists who try to gauge who bears the ultimate burden—the tax incidence—of particular taxes. Consider an income tax that reduces the returns an individual realizes from working. On the one hand, the taxes reduce the incentive to work since they make alternatives (like leisure) more attractive (the so-called "income effect"). On the other hand, the taxes act as an incentive to work harder since greater amounts of income are necessary to enjoy a set standard of living (the so-called "substitute effect"). The net effect of the income tax on the individual's behavior is hence unclear. In fact, even a direct tax on wages may not fall on an individual; the business may simply have to raise the wages to take into account the tax if the business is unable to shift the additional tax burden to its workers.

Alternatively, consider a consumption tax like a retail sales tax. Consumption taxes often also reduce the ability of individuals to command resources and hence the returns from working. Take the example of a retail sales tax of ten percent imposed on a good such as a car. The sales tax could raise the retail price of the car by ten percent, thus reducing an individual's purchasing power by the same amount. But if the sales tax is imposed only on cars allowing consumers to substitute this item for another good or service such as taking the bus, a car dealer might not be able to raise the price of the car by ten percent and could be forced to absorb all or part of the sales tax. In this circumstance, the sales tax does not appear to reduce the individual's returns from working at all.

Finally, the ability of taxes to influence behavior is often unclear due to the interaction of so many complex tax provisions: it is difficult or perhaps impossible to disentangle the various incentives offered by a multitude of different tax provisions on different economic actors.

2.2. Balancing Interests

This section discusses how tax laws strive to reach a balance between raising requisite revenues or achieving some other tax policy goal while at the same time avoiding unduly interfering with the personal liberty of taxpayers.

2.2.1. Enforcement

As discussed above, tax laws mandate the payment of taxes to the modern-day sovereign. Individuals or businesses that fail to meet their legal obligation to pay taxes may be subjected to civil and/or criminal penalties. Under U.S. tax law, civil penalties for non-payment of taxes include interest penalties and fines based on the amount of underpayment. The tax laws try to increase the severity of the sanction when a taxpayer's conduct is more egregious. A mechanical calculation error will call for lesser civil sanctions in comparison to, say, claiming a beloved pet parrot as a deductible dependent expense.

Criminal penalties include fines and/or imprisonment and are generally imposed on serious non-reporting of sources of income (i.e., tax evasion). As the famous case of Al Capone demonstrates, authorities sometimes resort to criminal sanctions resulting from tax evasion charges when they are unable to obtain convictions on non-tax related criminal allegations. Capone was alleged to have committed many crimes, including murder, illegally selling alcohol and running speak-easies. But the government could never successfully prosecute Capone on any of these allegations and resorted to criminal charges of tax evasion based on Capone's failure to report income from his various business operations. Capone had never filed an income tax return, but owned nothing in his own name.

Frank Wilson from the Internal Revenue Service's (IRS) Special Intelligence Unit was assigned to investigate Capone. Wilson accidentally found a cash receipts ledger that not only showed the net profits for an illegal gambling house, but also contained Capone's name. In 1931, Capone was indicted for income tax evasion and subsequently found guilty of this charge (and others) and was sentenced to eleven years in federal prison.

Taxpayers should certainly have the right to dispute the allegation of non-payment or underpayment of taxes and tax laws provide due process remedies to avail taxpayers of this right. Under U.S. tax law, a taxpayer can first challenge the government's case before an IRS administrative hearing. If this route fails or is skipped in the first instance, taxpayers can then appeal the IRS's allegations through a choice of different federal courts and then onto the relevant court of appeals.

To enforce these mandatory tax collection laws, governments can resort to the traditional mechanisms to collect debts and pass tax laws enabling garnishment of wages, tax liens for personal or real property, or the seizure and sale of this property.

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Biographical Sketch

Arthur Cockfield is an Assistant Professor at Queen's University Law School in Kingston, Ontario, Canada. Professor Cockfield previously taught at Thomas Jefferson School of Law in San Diego. Professor Cockfield's scholarship focuses on the taxation of electronic commerce and he has written a number of articles in this area, including most recently "Tranforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation, 85 Minn. L. Rev. (forthcoming 2001), which is available as a Stanford Technology Law Review Working Paper at http://stlr.stanford.edu/STLR/Working_Papers/index.htm. In addition, Professor Cockfield has two forthcoming books: Cyberspace Law: Cases and Materials (New York: Aspen forthcoming 2002) and International Tax Policy under NAFTA (Toronto: University of Toronto Press, forthcoming 2002). Professor Cockfield has a B.A. from the University of Western Ontario Business School, a LL.B. from Queen's University and J.SM. and J.S.D. degrees from Stanford University Law School.