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# The Uses of the Concept of Efficiency in Tax Analysis

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## COMMENTS

# THE USES OF THE CONCEPT OF EFFICIENCY IN TAX ANALYSIS

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VARIETY MAY WELL BE THE SPICE OF LIFE, BUT it is a daunting challenge to the discussant of the papers in this session, a session that brings together four insightful and thought-provoking papers that seemingly have little in common (other than being insightful and thought-provoking). Alex Raskolnikov applies the certainty-versus-severity concept from criminology to the enforcement of tax laws. Kirk Stark looks at whether the government's credibility in committing to different policy regimes should affect the type of consumption tax that we might choose to replace the income tax. Darryll Jones examines whether "special allocations" in partnership taxation should be limited as a means to prevent equity losses. Finally, Mitchell Kane addresses recent developments in the theory of international taxation, suggesting that the ownership of capital as well as its location—and the interactions between the tax effects on ownership and location—are important policy concerns.

Fascinating topics all, drawn from areas of tax law so diverse that they can profitably be taught in entirely different courses: Tax Administration, Tax Policy, Partnership Tax, and International Tax. Despite these obvious differences, however, the theme that ties them together is that each author, in different ways and with different degrees of emphasis, is concerned with efficiency. Whether advocating policy changes that would improve the efficiency of the tax system or reconsidering efficiency in light of other concerns, efficiency looms large over each of these papers.

It is, of course, hardly news that efficiency is a major concern of those who analyze tax matters. The very breadth of the issues addressed in this session, though, invites a comparison of the uses and definitions of the concept of efficiency in various areas of tax law. Do all efficiency analyses rely on the same basic definition of the concept, or is the word "efficiency" standing in for more than one core idea? If the latter, is that necessarily a bad thing, or is the very flexibility of the term a strength rather than a weakness? While these necessarily brief comments can only scratch the surface of these questions, beginning the process of thinking through some answers is worthwhile.

Economists use the term efficiency in a variety of contexts. Most fundamentally, of course, we know that there is an essential difference between partial and general equilibrium. Even while invoking the foundational notion of Pareto efficiency, therefore, we understand that what looks like a Pareto improvement in one market could possibly be a movement away from Pareto efficiency if our scope is expanded to include the general interactions among all markets. The concept of "second-best" policy making, first developed by Lipsey and Lancaster (1956), captures this distinction. This can lead to profound differences in policy implications, of course, but the notion of efficiency (maximizing net social welfare, properly defined) remains.

On this panel, Raskolnikov explicitly notes not only that setting optimal penalties (first-best efficiency) is unrealistic but that optimizing marginal deterrence (second-best efficiency) is itself nearly impossible to achieve, given the current state of theory and given difficult measurement issues. He thus aims to improve tax enforcement not by *optimizing* marginal deterrence but simply by *improving* marginal deterrence—that is, by changing penalties to deter more tax cheating at the lowest possible cost. Stark (who helpfully uses the term neutrality rather than efficiency, though the two terms are often used interchangeably) focuses on the two arguable benefits of moving to a consumption tax base: neutrality with respect to the timing of consumption expenditures, and capturing inframarginal returns. Jones accepts (for the purpose of his argument) the standard definition of Pareto efficiency, arguing that any efficiency gains from the use of "special allocations" may be outweighed by equity concerns. Finally, Kane confronts the interactions of two

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types of distortions: those that change the location of capital among nations versus those that change the ownership of capital assets.

While Raskolnikov and Stark are clearly aware of general equilibrium notions of efficiency, therefore, they explicitly focus on non-ideal, real-world policy choices that proceed from narrower definitions of efficiency. Jones and Kane, on the other hand, are directly concerned with defining and critiquing the broad concept of efficiency in their respective policy contexts, questioning whether supposed efficiency gains are worth their costs or, indeed, are efficiency gains at all.

As noted above, the flexibility and ubiquity of the term efficiency in tax analysis can be a double-edged sword. While tax scholars are naturally drawn to the notion of efficiency, with its implied virtues of eliminating waste and of guiding policy choices through objective, non-normative analysis, the danger exists that we can lose sight of which type of efficiency we are talking about when we invoke the concept. What one scholar calls efficient might be quite inefficient under the definition or perspective used by another scholar. In future work, I plan to explore these distinctions in a broader analysis of the existing tax literature, searching for more consistent and clear definitions of the different types of efficiency that tax scholars study.

## Reference

Lipsey, Richard G. and Kelvin Lancaster. The General Theory of Second Best. *Review of Economic Studies* 24 (January 1956): 11-32.