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Dr. Tatsuo Hatta graduated from the Faculty of Liberal Arts, the International Christian University (ICU), and obtained a PhD in economics from the Johns Hopkins University. He has held positions such as an assistant professor at the Ohio State University, professor at the Johns Hopkins University, professor at Osaka University, professor at the University of Tokyo, professor at International Christian University, and president of the National Graduate Institute for Policy Studies. Besides these university positions, he also served as president of the Japanese Economic Association, and played prominent roles such as an expert member of the Government Tax Commission, chairman of the Housing and Land Committee of the Social Capital Commission, acting chair of the Cabinet Office's Council for Regulatory Reform, chairman of The Electricity and Gas Market Surveillance Commission (EGC), a member of the Council on the National Strategic special Zones in the Cabinet Secretariat. He is currently serving as a member of the Cabinet Office's Renewable Energy Task Force.

Does Consumption Expenditure Represent a Person's Utility? —Perspective from the Tax Theory—

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1. The Ability-to-Pay Principle of Taxation

- Fair taxation should be based on “the ability to pay,” or “the capacity to bear the tax burden” of the taxpayer.
- The taxpayer's utility level measures his ability to pay.

2. Consumption as the Source of Utility

- The traditional tax theory regards a taxpayer's consumption expenditure, rather than income, as representing her utility level and hence her ability to pay.
- Tax theory regards person A's utility level as higher than B's if A consumes more than B under identical non-economic conditions, including health.

3

3. Does the Tax Base of VAT Represent the Comprehensive Consumption?

- Individual consumption expenditure level is hard to measure.
- But indirect taxation on consumption is feasible.
⇒ VAT (called "Consumption Tax" in Japan)

4

4. Bases of VAT and Comprehensive Consumption

- The base of VAT is much narrower than the taxpayer's consumption level that represents her utility level.

5

4A. Bequest is a Type of Consumption

- Bequest gives utility to the decedent as a type of consumption.
- **The base of VAT for a person needs to include her bequest** to represent her ability to pay.

6

4A'. Double Benefits of Bequest and Inheritance

- Inheritance (i.e., the bequest by the decedent) provides the heirs an income source of consumption.

⇒ The income tax base must include inheritance to represent the heirs' ability to pay.

7

4A''. Bequest to Avoid VAT

- A person may try to avoid taxation by leaving a large amount of bequest, reducing her consumption.
- Of course, one could argue that her offspring would be taxed when they use the inherited property in their consumption. But her offspring could forever postpone the consumption from the inheritance if they chose to do so.

8

4B. Imputed Rent

- In Japan, the VAT taxes the value of purchased but not inherited housing stock. This treatment favors inherited housing over purchased housing.
- To make it fair, the VAT base should include the imputed housing rent.
- It should neither include its purchased value nor its inherited value, although it should include her own bequest.

9

4C. Imputed wage

- Suppose a widower has a full-time housekeeper who also tutors his children. Then the domestic service fee he pays her represents his consumption.
- Suppose that he marries her. She continues to provide the same service to this household as before.
- So, the **VAT needs to include the imputed wage (= service consumption) of domestic work in its tax base.**

10

4D. Comprehensive Consumption as a Tax Base

Define the taxpayer's **Comprehensive Consumption** as the consumption level that represents her utility level. Then it is given by:

Comprehensive Consumption

$$\begin{aligned} &= \text{Consumption Expenditure} \\ &+ \text{Imputed Income} + \text{Bequest} \end{aligned}$$

11

5. Comprehensive consumption may not Represent Ability-to-Pay

- People with identical comprehensive consumption do not necessarily have equal ability to pay.

12

5A. Medical Expenditure

- A healthy person receives a higher level of utility than a sick person with the same amount of consumption, including medical expenditure.
- **But the VAT**, which regards medical expenditure as a part of consumption, **can not give a medical deduction to its tax base, unlike income tax.**

13

5B. Family Size Matters

- The living standard of two people can increase if they live together and share a kitchen, shower, toilet, and utensils.
- **The tax base of VAT needs to reflect the family size.**

14

5C. Direct vs. Indirect Taxes

- To adhere to the ability-to-pay principle, the government should impose a direct tax on consumption rather than an indirect tax.

15

6. Lifetime Equivalence of Income and Consumption as Tax Base

- Consumption Expenditure
+ Imputed income + Bequest
= Primary monetary income (= wage + pure profit)
+ Imputed income + Inheritance

16

7. Conclusion

- Ability-to-pay Principle is Compatible with
Income Tax rather than as VAT.