

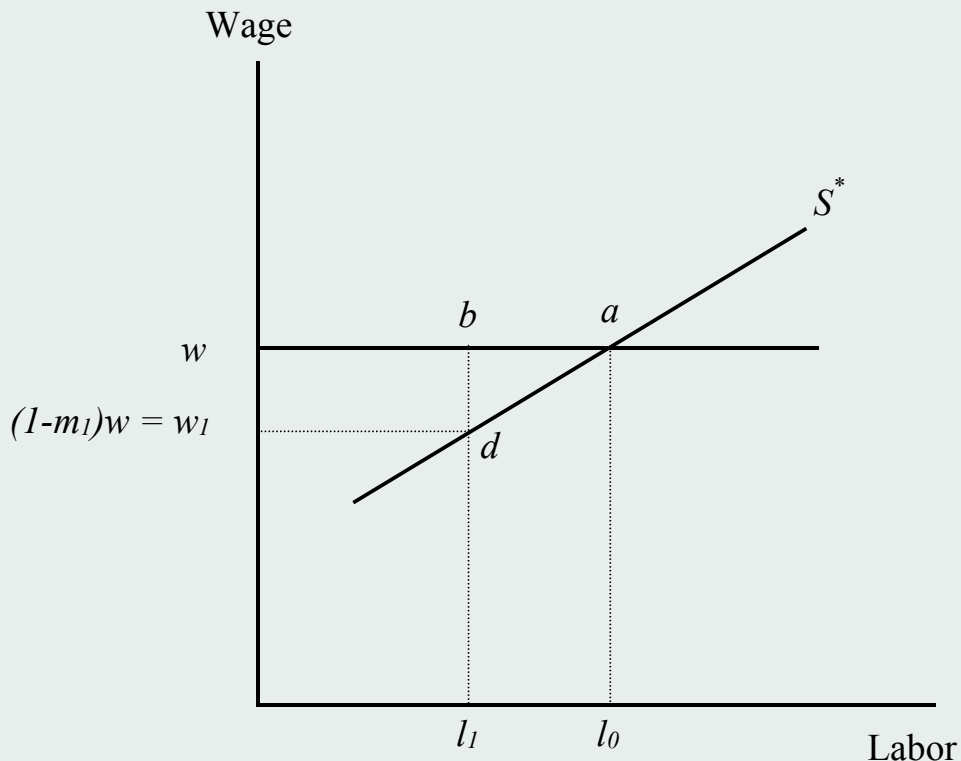
# Appendix

## Welfare Cost Formula

Simply put, the welfare loss of a tax system is the extra burden to taxpayers, in dollar terms, that is above and beyond the tax revenue collected by government. The welfare cost has many components. For example, taxpayers must spend time complying with tax codes of government at various levels, and government must use resources to run the tax system. Since no tax system is foolproof, some taxpayers try to evade tax payments. This imposes costs on both tax evaders and tax collectors. The former conceals tax-eligible economic activities. The latter fights tax-evading behavior. Of course, all costs of tax evasion are ultimately borne by taxpayers.

The most important welfare cost of taxation occurs when taxpayers lawfully modify their behavior to avoid or reduce tax payments. For example, when wages are taxable, workers perceive the value of their labor supply to be below its social value. As a result, they work less than is socially optimal. This welfare cost of taxation derives from the fact that a worker's economic behavior determines his tax payments. In fact, any tax other than a lump-sum tax, which is unaffected by worker activities, distorts taxpayer behavior and causes welfare costs. Thus, to determine the welfare cost of a tax system, the lump-sum tax serves as a benchmark.

Browning (1987) defines this major form of welfare cost from tax avoidance as the difference between the tax revenue that is actually collected and the revenue that could be collected with the lump-sum tax that leaves taxpayers as well-off as they are under the actual tax system.<sup>20</sup> This definition is universally



<sup>20</sup> For footnote 20 see <http://www.ncpa.org/pub/st/st252/st252notes.html#20>.