Why (and How) Income Tax should be Imposed at the Household Level?

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Government intervention is required for the following two main purposes: correction of market failures and promotion of distributive justice. The tax and transfer system is a major tool at the government's disposal. For example, if left to the free market, public goods would be underprovided due to a free-riding problem. The government imposes taxes to finance public goods. It could levy lump sum taxes, but that would violate distributive justice. Distributive justice requires transferring resources from individuals that are better off to those that are worse off. By better off, we usually mean having higher earning ability. Earning ability cannot be directly observed by the government. It uses income or consumption as proxies. Income is the ability to consume, hence, it is consumption (or the increase in the ability to consume, in the case of an income tax) that the government wishes to tax.

Consumption takes place in households. A household may consist of one person or more. What matters for tax purposes is that consumption is financed by pooled resources. This is true for most households. Children are certainly not expected to consume only what they earn, and spouses usually share their incomes. There are economies of scale due mostly to the existence of fixed costs that are shared by the household members. For example, preparing a meal for several people is much cheaper per-person than a meal prepared for one person only. The time required to prepare the meal is not that different in the two cases, lowering the per-capita cost when cooking for more people.

In light of the above, if the government wishes to tax individuals according to their ability to earn as reflected by their consumption levels, it should tax households. This could be done by adding up the household's income and dividing it by the number of individuals living in the household (sharing their income and consumption). To account for economies of scale, the number of individuals in the above calculation should be standardized based on equivalence scales.

In reality, countries do not tax individuals this way. France and Luxembourg tax household income divided by the number of individuals living in the household but do not take economies of scale into account. Most other countries tax spouses jointly or separately, and give some kind of tax concession (credit or deduction) for children.

In the past few months a minor reform regarding the taxation of families in Israel is being promoted by a major party in the current coalition. The paper will present a theory of household taxation and analyze the proposed legislation.