Correct and Incorrect Measures of the Deadweight Loss of Taxation

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Abstract

Deadweight loss of taxation can be measured in two ways: either as the gain that could have been realized if all taxes had been lump sum or as the loss that would remain if all tax receipts would be returned, in a lump sum way, to the consumer. These two approaches yield different loss measures. Morevoer, within each of the two approaches, two loss measures can be defined, one based on the equivalent variation and the other based on the compensating variation. It will be shown that all of the measures based on the compensating variation are unreliable.

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