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Principles of tax design

Stuart Adam

Main objectives of taxation

1. Raise revenue to finance public spending

2. Redistribute from the better-off to the needy

We make no judgement as to the appropriate extent of these

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Characteristics of a good tax system

For a given revenue yield and distributional outcome, what matter are:

"proportionality"

- Economic efficiency
  - Minimise effects on behaviour except to correct market failures

"efficiency"

- Operational efficiency
  - Minimise admin and compliance costs

"convenience"

- Transparency

"certainty"

- Fairness
  - Due process, non-discrimination, respect legitimate expectations, etc.

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For a given revenue yield and distributional outcome, what matter are:

- Economic efficiency
  - Minimise effects on behaviour except to correct market failures
- Operational efficiency
  - Minimise admin and compliance costs
- Transparency

Simplicity

- Fairness
  - Due process, non-discrimination, respect legitimate expectations, etc.

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Two rules of thumb

- Stability. Helps to avoid:
  - Change-related distortions (forestalling, off-putting uncertainty, etc)
  - Operational costs of transition
  - Having to learn about new system
  - Disappointing legitimate expectations
  - ➢ But upheaval sometimes justified if existing system costly
  - ➢ Don’t introduce ill-thought-through policies in the first place!

- Neutrality, i.e. treating similar activities similarly
  - Tends to be simpler, fairer and less distortionary
  - Not always – but should have a high hurdle to justify exceptions

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Consider the system as a whole

- Effects of the system are the combined effects of all policies
- Pay attention to interactions between different parts
  - e.g. income tax and NI; personal and corporate taxation
- Not all taxes need to be green, or progressive
  - Choose the right tool(s) for each objective
- Avoid hypothecation (earmarking particular taxes for particular uses)
  - Either the amount raised determines the amount spent…
  - ➢ *Inefficient: no reason spending exactly that amount should be optimal*
  - …or it doesn't
  - ➢ *In which case it's meaningless at best, dishonest at worst*

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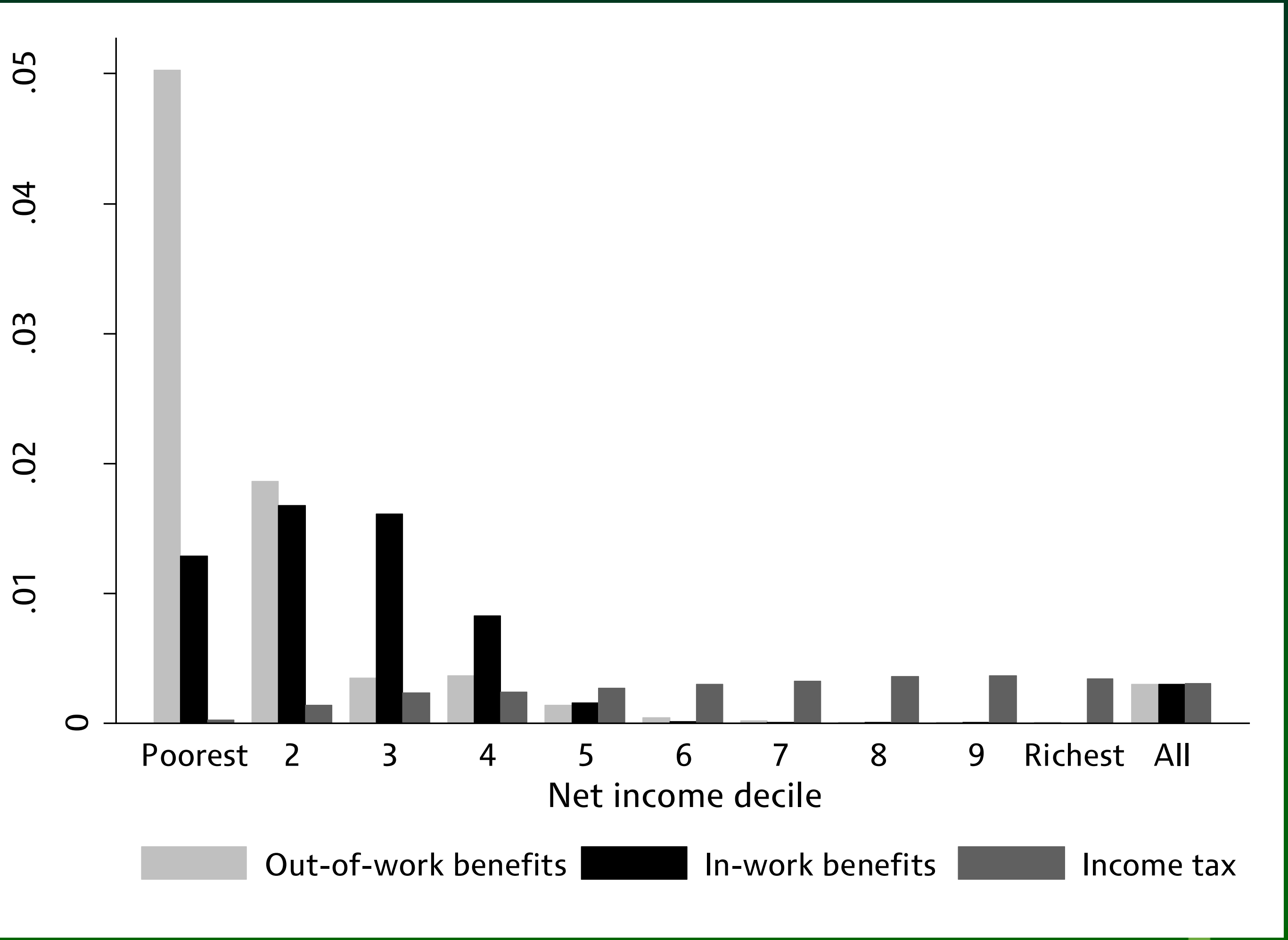
Redistribution

- Overall system matters
  - Including benefits as well as taxes (and, in principle, public services)

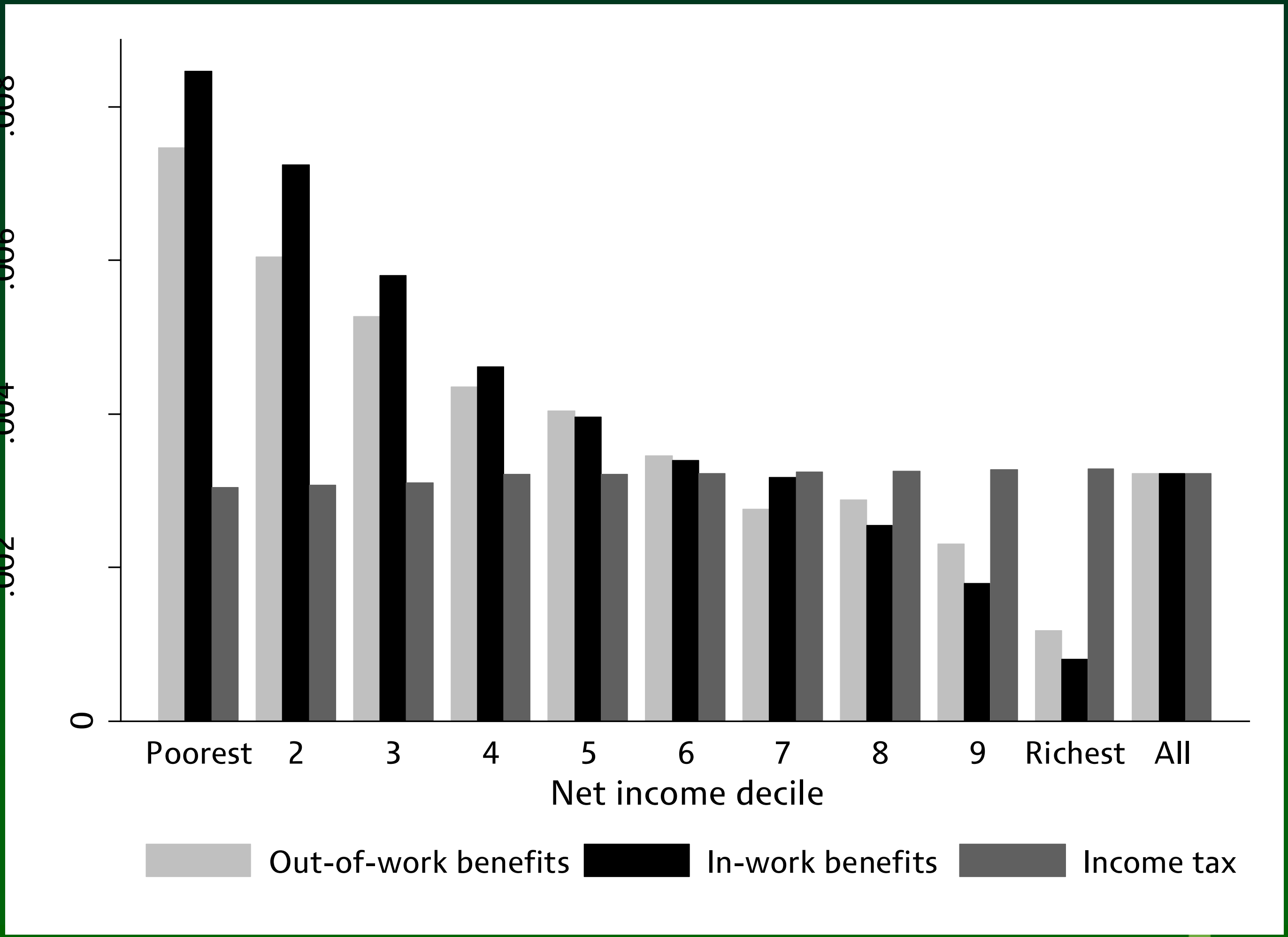
- Consider a lifetime perspective

In cross-section, increasing out-of-work benefits is most progressive



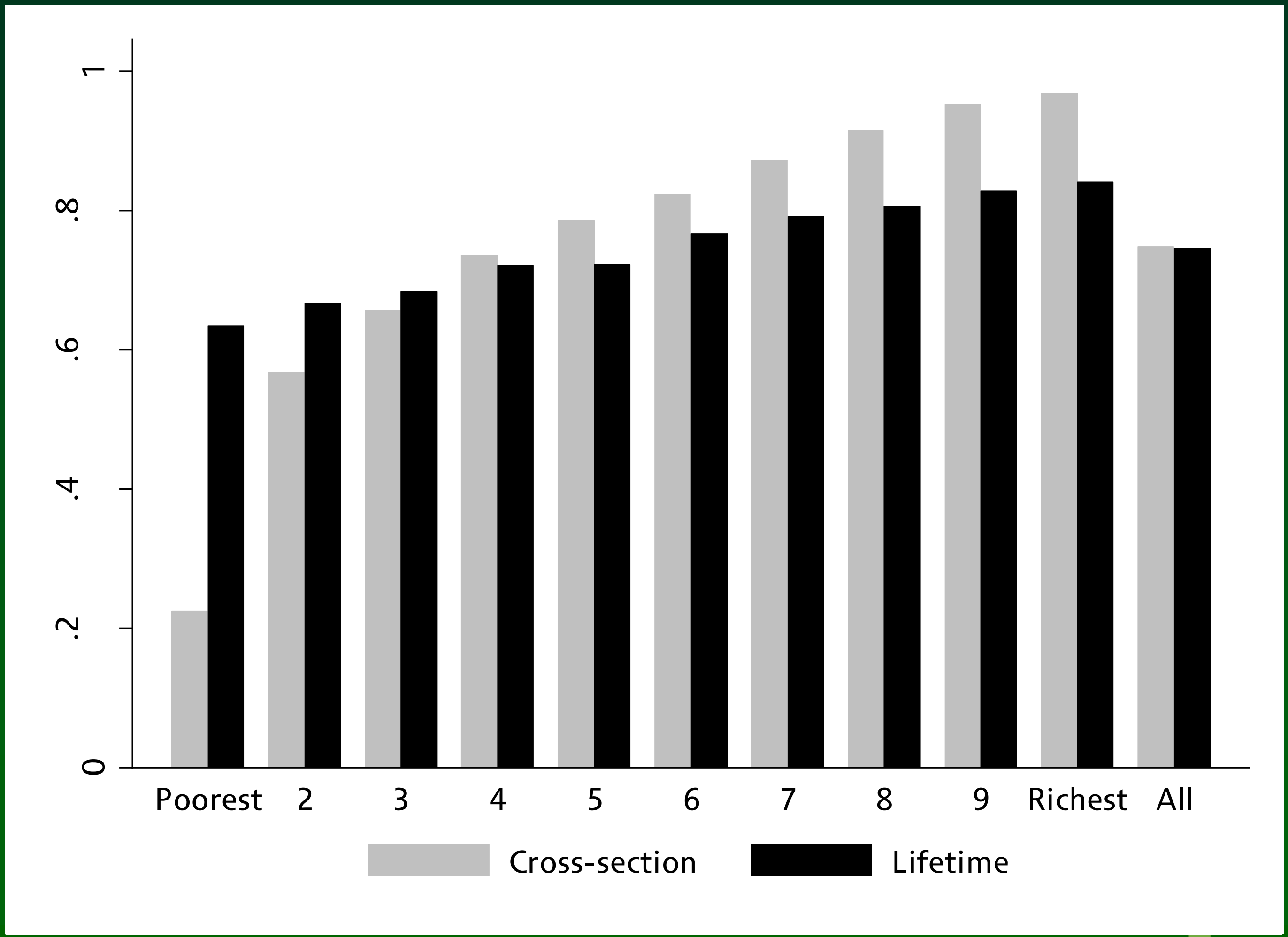
Source: Levell, Roantree & Shaw (2015)

Over a lifetime, increasing in-work and out-of-work benefits equally progressive



Source: Levell, Roantree & Shaw (2015)

Explanation: the poorest individuals spend most of working-age life in work



Source: Levell, Roantree & Shaw (2015)

Redistribution

- Overall system matters
  - Including benefits as well as taxes (and, in principle, public services)

- Consider a lifetime perspective
  - Much low income is temporary
  - Particularly important for indirect taxes
  - If only have snapshot data, think about expenditure vs income

- But lifetime perspective isn't the only relevant one either
  - Short-term hardship matters too
  - Existing population has only part of their lifetime left
  - Intergenerational issues increasingly prominent

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Redistribution and work incentives

- Taxation discourages work
  - Includes means-testing and taxes on consumption and saving: "What can I get in return for working (more)?"
- There is an inevitable trade-off
  - Redistributing from rich to poor reduces incentive for poor to get richer
- Ultimately requires political value judgements
- But optimal tax theory has useful lessons on efficient redistribution
  - High marginal rates in earnings bands that few people *in*, but many *above*
  - Low PTRs for low earners if responses mainly employment, not earnings
  - Low tax rates when people most responsive: around retirement; mothers with school-age children
  - Can use proxies for earning potential, need or responsiveness that are harder to change than income – though some dangers with this approach

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Tax base vs rate schedule

- Tax (and benefit) rate schedule is usually the most efficient way to trade off redistribution, work incentives and revenue
  – Directly control how net tax liabilities depend on total resources
  – Taxes based on spending and saving patterns generally poorly targeted
  – Some disincentives to work are inevitable, but distortions associated with the choice of tax base usually worse and avoidable
- Choose efficient tax base and leave it alone!
  – Don’t reform tax base on distributional or revenue-raising grounds
  – But do consider distributional consequences of tax base reforms
- Again, this is a rule of thumb rather than theoretical optimum
  – But real-world departures generally not in the direction of optimality!

Tax income less the costs of generating income

- Unfair and inefficient to favour:
  - income taken in some forms over others
  - low-cost-low-revenue activities over equally valuable high-cost-high-revenue activities
- Most major taxes broadly reflect this idea, albeit imperfectly
  - Income tax and NICs, corporation tax, capital gains tax, VAT
- But not all
  - VAT exemptions, stamp duties, business rates, insurance premium tax
  - Also some sensible exceptions, mostly environmental taxes
- Major difficulty distinguishing consumption from work expenses
  - Pervasive: mixed-use assets; childcare; education and training; travel;…
  - Same issue for VAT as for direct taxes

Taxing saving and investment

- Saving and investment are costs of generating future income
  - Put aside money today to generate (more) money in future
- Key to effective capital taxation is neutrality across:
  - Consumption today vs tomorrow
  - Different assets
  - Different forms of return
  - Different legal vehicles
  - Different sources of finance
  - Varying inflation rates
- It is possible to achieve all of these…

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Taxation of saving and investment

- Saving and investment are costs of generating future income
- So give full deductions for amounts saved/invested…
- …then tax income (after these deductions) in full
- More than one way to give deductions
  - Upfront deduction *(pension contributions; Annual Investment Allowance)*
  - Stream of allowances with same present value: tax only returns above a 'normal' rate (*Rate of Return Allowance; Allowance for Corporate Equity)*
  - If no above-normal returns, just exempt returns (*ISAs; main home; NICs)*
- This would eliminate advantage of income shifting while avoiding disincentives to save and invest
  - Also avoids distorting asset choices, debt-equity bias, sensitivity to inflation, capital gains lock-in effect, etc.

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Summary: a progressive, neutral system

- Consider the system as a whole
  - Use the right tools for the right objectives
- Achieve progressivity as efficiently as possible
  - Personal taxes and benefits are the best tools for redistribution
  - Target incentives where they matter most
  - Take a lifetime perspective, considering income and expenditure
- Neutrality as an important benchmark
  - Tends to be simpler, fairer and less distortionary
  - Not always – but should have a high hurdle to justify exceptions
- Develop a long-term strategy for the tax system
  - Avoid reforms that move in the wrong direction!
- We should "have a tax system which looks like someone designed it on purpose" former US Treasury Secretary William E. Simon

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