Consolidation measures on the revenue side: Which tax bases to use to safeguard social equity?

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• Meanings of ‘social equity’ at time of crisis
• Fiscal consolidation options
• Broad spending reductions and general tax increases
• Specific measures:
  (1) VAT base broadening
  (2) Increasing carbon prices
  (3) Capital and related taxes
  (4) Targeted spending cuts
• Conclusions
Meanings of ‘social equity’ in fiscal consolidation

- Unwarranted gains are removed (e.g. in cash benefits or services that ran ahead of other incomes)
- Everyone makes an equal contribution – lump sum (poll) taxes or loses services/benefits of equal value
- Contributions/losses of services are in proportion to resources (e.g. disposable income), i.e. is distributionally neutral
- Fiscal consolidation is carried out in way which offsets other changes in inequality
- Contributions are balanced between generations
- Contributions are progressive, with ‘broadest shoulders’ carrying greatest burden
- Contributions come from those who had the largest gains prior to the crisis
- Contributions come from those who caused it (financial sector? politicians?...)

Each of these would imply a different evaluation of measures
Fiscal consolidation options

- Broad spending reductions
- Spending reductions targeted by income or other criteria
- Specific indirect taxes – tobacco/alcohol, motoring, etc
- VAT rates/ VAT base broadening
- Environmental taxes/ Carbon price
- Income tax rates; income tax allowance/deduction withdrawal
- Social insurance contributions: rates; broadening base beyond earnings or eg to retired population
- Investment income/capital gains
- Tax privilege reduction: owner-occupation, pension contribution and savings reliefs
- Property/wealth taxes
- Wealth transfers/inheritance (donor or donee)/gifts
- Company taxation
- Financial transactions
- Loopholes/avoidance/tax havens; Tax evasion
Distributional effect of austerity measures in six countries, 2007-2011

Source: Callan et al. (2011), EUROMOD working paper EM6/11. Bars for each country are impact on successive decile groups by equivalised disposable income using EUROMOD. In-kind services excluded.
Net distributional impact of austerity measures in six countries, 2007-2011

Source: Callan et al. (2011), EUROMOD working paper EM6/11. Lines for each country are impact on successive decile groups by equivalised disposable income using EUROMOD. Includes impact of public sector wage reductions. In-kind services and changes to VAT or excise duties excluded.
UK case: Loss as percentage share of household disposable income from deficit reduction equivalent to £1,000 per household (£27 billion per year)

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<tr>
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<th>Poorest fifth</th>
<th>Richest fifth</th>
<th>All</th>
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<tr>
<td>Equal cuts in all social benefits and services (including in-kind)</td>
<td>11.9</td>
<td>0.9</td>
<td>3.5</td>
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<tr>
<td>Equi-proportional increases in all allocated taxes</td>
<td>3.4</td>
<td>3.7</td>
<td>3.5</td>
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*Source*: Based on Office for National Statistics analysis of distributional effects of taxes and benefits on household incomes in 2008-09 (Barnard, 2010). Embodies particular assumptions about incidence of both taxes and public services.
Taxes as percentage of gross income (UK, 2009-10)

VAT revenue as percentage of yield from all consumption at standard rate, 2005

Source: Crawford, Keen and Smith (2010), *Dimensions of Tax Design*, table 4.2. Figure shows C-efficiency – VAT revenue divided by standard VAT rate times final consumption expenditure (minus VAT).
UK case: VAT broadening with and without compensation (gain/loss as % disposable income)

Source: Crawford, Keen and Smith (2010), *Dimensions of Tax Design*, figures 4.1 and 4.2. Figures based on unifying VAT at 17.5% in 2005-06. Compensation is 15% rise in means-tested social assistance and tax credits.
Compensation for VAT broadening: issues

- Nearly all EU member states could raise substantial revenue by removing zero and reduced rates. In UK case, at least, without compensation this would be regressive.
- Compensation packages could use revenue to leave net gains on average to low income groups (usually with some losers) – eg main Mirrlees Report recommendations spend all of the revenue raised (on increases in tax allowances and thresholds, tax credits, other means-tested benefits, state pensions, and child allowances plus cut in main income tax rate).
- But context here is fiscal consolidation – aim would be revenue-raising, so compensation would be more limited.
- In long-run issue is would compensation measures ‘stick’? Depends on normal indexation rules for benefits and tax thresholds. If compensation involved above (automatic) average inflation effects, ‘real value’ of benefits would later be seen to have increased, potentially leading to pressure for reduction (in UK case, at least).
Greenhouse gas emissions (kg CO$_2$e) per £ of household income (UK, 2006)

Source: Gough et al. (2011), CASE paper 152, London School of Economics, figure 8. Includes indirect emissions (eg from imported goods).
Impact of carbon price (£30/tonne CO$_2$) on domestic fuel (UK, 2008-09)

Source: Hills (2009), table 15.6, based on Dresner and Ekins (2006). Compensation uses all revenue raised to increase means-tested benefits and tax credits.
Carbon taxes and proxies: issues

- Increasing cost of carbon is logical part of response to need for climate change mitigation and is potentially revenue-raising.
- But by itself doing so is regressive, whether looking broadly at all emissions (including indirect ones) or narrowly, e.g., at domestic energy.
- Compensation through transfers can offset regressive effects in general, but implies an increase in means-tested benefit/tax credit spending – reducing net revenue, increasing public spending, and raising effective marginal tax rates.
- Even with strong compensation there are significant low-income losers.
- Corollary is then need for direct measures to reduce causes of high spending for some low-income households (e.g., tackling ‘fuel poverty’ by improved energy efficiency).
Capital and related taxes

- Direct taxes often narrowly focused on earned incomes
- Wealth offers additional component of personal economic resources which could be larger part of tax base, especially as wealth is now larger multiple of income than in past (in UK, at least)
- Inequalities in wealth much greater than those in incomes and earnings, making wealth taxes attractive in distributional terms
- More opportunity to tax ‘fixed factors’, with fewer economic distortions, eg inheritance/land, and taxing windfalls could be seen as more equitable horizontally
- Therefore potentially attractive for both economic efficiency and social equity?
- So why have capital taxes become less important over time (eg in UK falling from 2.0% of GDP in 1948 to 1.1% in 2010)?
Capital and related taxes: Issues

- Lack of a cash flow for tax authorities to intercept before receipt
- Invisibility of returns in kind (e.g., owner-occupiers’ imputed rents and capital gains) creates public acceptability barrier
- Potential distortions/inequities if tax only levied on, e.g., realisation of capital gains (lock-in effects)
- Barrier presented by ‘income poor/asset rich’ households
- Revaluation issues for property taxes: if only periodic, relative changes will be large, and ‘losers’ more vulnerable than ‘gainers’ – but out-of-date relativities are inequitable
- Technical difficulties in reducing tax expenditures (e.g., measuring true increase in value of pension rights as life expectancy increases or prospective long-term returns fall)
- Public attitudes resistant to, e.g., inheritance taxes on family home (the ‘death tax’)
- The very inequality of wealth holdings creates a very powerful lobby to resist higher wealth taxes
‘Progressive’ spending cuts to avoid increasing tax rates?

• Governments prefer spending cuts to tax rises to avoid increases in marginal tax rates
• But equity arguments discussed above suggest across-the-board cuts are regressive
• Alternative approach would be focussed cuts with protection for certain groups, either categorical (eg age) or by resources (means-testing)
• But this also affects economic incentives
• An example: UK government has recently (this month) cut general subsidies to university tuition, with most universities increasing fees towards £9,000 per year.
  • Repayments are contingent on future earnings – levied at an additional 9% rate on earnings above £21,000 per year
• But worries about prospect of increased student debt deterring students from low-income backgrounds have led government and universities also to develop means-tested bursaries and fee reductions based on (recent) family income
Government and university support: first year (students starting October 2012)

Gross family income (after limited deductions) (£000s)
Mean marginal support withdrawal rate (%) on ‘residual income’ per £1,000, average for 27 universities
Combined effective marginal tax rate (%) per £1,000 (single earner couples with one child going to university, one still at home): Average for 27 universities

- Underlying marginal tax rates from taxes and benefits
- Total marginal tax rate including effects of student support system

Residual income (£000s) vs. Combined effective marginal tax rate (%)

Graph showing the relationship between residual income (£000s) and combined effective marginal tax rate (%) for single earner couples with one child going to university, one still at home. The average is calculated for 27 universities.
Conclusions (1)

• What is benchmark for ‘social equity’?
• Most conceptions imply impact of fiscal consolidation should be at least distributionally neutral, if not progressive.
• But across-the-board cuts in public spending are very likely to be regressive.
• By contrast, general tax increases are roughly proportional to income (in UK case).
• Within taxes, progressivity of direct taxes offsets regressivity of indirect taxes.
• Most EU members states have scope for VAT broadening. But this is likely to be regressive unless at least part of revenue used for compensation.
• But compensation reduces contribution to fiscal consolidation – and increased use of transfers implies higher spending, and may run up against constraints on acceptable transfers.
Conclusions (2)

• Strong case for more use of environmental taxes as way of correcting market failures. Particularly strong case for raising effective price of carbon.
• But carbon emissions are larger in relation to income for those with low income, so raising carbon price is regressive.
• Revenues can allow protection of poor on average, but not of those with highest energy requirements – the ‘fuel poor’. Corollary is need for direct measures, eg energy efficiency improvements (further reducing net revenue).
• Efficiency and equity case for more use of taxes on personal wealth – but decline in their importance not entirely accidental, creating series of challenges to greater use.
• In theory spending cuts can be selective, protecting poor. But doing so implies greater use of means-testing. If poorly designed, may have far worse incentive effects than tax rates increases which intention was to avoid. Scope for doing so varies considerably between countries.
Conclusion: Which tax bases to use to protect social equity?

Answer to question posed in the title:

It is hard to avoid conclusion that use of all available tax bases – and tax rates – is necessary to protect social equity, rather than there being a choice between them, and that doing so is likely to be more equitable than most forms of spending cut.

But even the most attractive options for extending the tax base bring a series of issues that make them difficult, to say the least …
In-kind benefits by quintile group as share of disposable income (%): 27 OECD countries

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<tbody>
<tr>
<td>Education</td>
<td>30.6</td>
<td>18.5</td>
<td>14.2</td>
<td>10.4</td>
<td>5.6</td>
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<td>Health care</td>
<td>34.9</td>
<td>22.2</td>
<td>15.8</td>
<td>11.8</td>
<td>7.2</td>
<td>13.9</td>
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<td>Social housing</td>
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<td>0.7</td>
<td>0.4</td>
<td>0.2</td>
<td>0.1</td>
<td>0.4</td>
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<tr>
<td>Early years and childcare</td>
<td>4.5</td>
<td>3.0</td>
<td>2.4</td>
<td>1.5</td>
<td>0.8</td>
<td>1.8</td>
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<tr>
<td>Elderly care</td>
<td>4.0</td>
<td>1.9</td>
<td>0.7</td>
<td>0.4</td>
<td>0.2</td>
<td>0.9</td>
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<td><strong>Total</strong></td>
<td><strong>75.8</strong></td>
<td><strong>46.4</strong></td>
<td><strong>33.5</strong></td>
<td><strong>24.3</strong></td>
<td><strong>13.7</strong></td>
<td><strong>28.8</strong></td>
</tr>
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Range of effective marginal tax rates from direct taxes and cash benefit withdrawal in 27 countries (2007)

Source: Calculated from EUROMOD by Alberto Tumino, Institute for Social and Economic Research, University of Essex (provisional results).