The Political Economy of Tax Reform

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(drawing on joint work with James Alt and Luke Sibieta)
The Need for Political Economy

Economic theory establishes principles for well designed tax reform

Empirical economics estimates relevant features of income distribution, economic behaviour

Implementation requires reforms to be

- sustainable
- given public opinion
- within political institutions
The Mirrlees Review

Presentation partly based on:


Draws on

- extensive interviews
- analysis of attitudinal data

Brought up to date here using more recent data
Tax Policy in Practice
Income taxation

Starting point of analysis is economic model where voters

like consumption and public spending

dislike effort

Government’s policy options multidimensional

Fiscal budget constraint reduces freedom in policy setting by one tax parameter

Assuming, for example, that administrative constraints impose linearity makes policy space manageable
Optimum taxation / Political economy

Optimum income taxation:

Tax rate should depend on

pretax economic inequality

strength of labour supply disincentives

Political economy:

Tax rate should depend on

pretax economic inequality (median/mean)

strength of labour supply disincentives
The last 40 years in the UK: pretax inequality

Pretax inequality on standard measures increased significantly in the latter half of the 1980s

Comparatively stable since

Ratio of median to mean pretax income has been rising
Pretax inequality

Source: Author’s calculations from ONS data
The last 40 years in the UK: income tax changes

The basic rate of income tax – the headline tax rate – has fallen in successive reforms.

However

this is partly a relabelling of direct taxes – NI rates have risen

dthis is partly a switch from direct to indirect taxation – the standard rate of VAT has also risen

changes to allowances affect the no of people subject to direct tax

Over the 40 years

the effective tax rate on a standard taxpayer has been stable

so also has been the tax share of GDP
Tax rates

Source: IFS
Tax receipts

![Graph showing trends in tax receipts from 1970 to 2010. The graph displays two lines: one for Total effective tax rate and another for Total tax as fraction of GDP. The source is IFS.](image)

Source: IFS
Redistribution and tax inequality

Distribution of tax payments and benefit receipts can be compared year-on-year to distribution of original income

Offers one possible way to decompose redistributive effect

Redistribution mainly due to benefits

Direct taxes

distributed fairly similarly to original income

become modestly more redistributive as pretax inequality increases

Indirect taxes increasingly regressive in effect
Redistribution and tax inequality

Source: Author’s calculations from ONS data
**Political economy puzzle**

Why does the most salient tax rate fall, effective tax rate remain stable and redistribution not increase more strongly when pretax inequality is rising?

Possible sources

- shifting voter opinion
- electoral politics
- institutional failure
Voter Opinion
British Social Attitude Survey
Representative survey of British electorate
Annual data 1984-2013
Around 3000 households per year
Consistent and reliable
Approval for redistribution

Several questions asked about redistribution in BSA over 30 years

For example

agreement that government should redistribute from the better-off to the less well-off

agreement that gap between incomes of rich and poor too large
Approval for redistribution over time

Dissatisfaction with size of gap high and stable
Much higher than support for redistribution

suggests preference for other policies to reduce gap (education, wage controls)
or seen as outside business of government

Support for redistribution declines then picks up again after crisis
Modestly negatively related to respondent income
Approval for redistribution over time

Source: BSA
Approval for redistribution against actual income

Source: BSA
Voter understanding of income distribution

How well do voters know their position in the income distribution?

Question in BSA 2004 asks what proportion of population less well off than respondent

Should be uniformly distributed if perceptions accurate

In fact excessively concentrated at centre

However correlated with true position
Voter knowledge

Source: BSA
Voter knowledge

Source: BSA
Comparison to self-assessed income

In some years, respondents asked

to rate own income as high, medium or low

to give opinion on taxes on high, low and medium incomes

Not many rate selves as high income but those who do are much more likely
to see taxes on those with high incomes as too high

Can use answers to reconstruct redistributive preferences
Comparison to self-assessed income

<table>
<thead>
<tr>
<th>Self-assessed income</th>
<th>No in sample</th>
<th>High incomes</th>
<th>Medium incomes</th>
<th>Low incomes</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>Too high</td>
<td>Too low</td>
<td>Too high</td>
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<td>High</td>
<td>460</td>
<td>36.8</td>
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<td>8003</td>
<td>14.6</td>
<td>52.9</td>
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</table>

Source: BSA
## Comparison to self-assessed income

<table>
<thead>
<tr>
<th>Self-assessed income</th>
<th>No in sample</th>
<th>Redistribution from High to low</th>
<th>Redistribution from High to medium</th>
<th>Redistribution from Medium to low</th>
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<tr>
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<td>47.6</td>
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<td>6.6</td>
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</tbody>
</table>

Source: BSA
Redistribution and age

Incomes are in reality neither fixed nor certain

Income taxation provides both lifetime redistribution and social insurance

Possible to follow generations across repeated cross-sections by grouping respondents according to date of birth

Younger cohorts are less supportive of redistribution than were older ones at similar ages

Declining support for redistribution, picking up in the most recent years, is a common feature across generations (except for the oldest)
Approval for redistribution across ages and cohorts

Source: BSA
Redistribution and social insurance

Questions asked about social insurance

should government spend more on benefits for poor even if means higher taxes?

do people on social security deserve help?

does welfare state make people less willing to look after themselves?

Support for social insurance payments declining (even in most recent years)

Higher income respondents

not notably less prepared to recognise need

or to worry about effects on self-reliance

but are less supportive of increased payments
Redistribution and social insurance

Support for social insurance
BSA, 1986-2014

Source: BSA
Attitudes to public spending

Goods provided through taxation may be income elastic or not

Asks specifically about support for higher spending on health, education and social benefits

Also, in one year, about more specific items, with very precise tax consequences

analysed by Hall and Preston – little evidence of strong income gradients
Attitudes to public spending

Support for public spending
BSA, 1986-2014

Source: BSA
Trust in government

Willingness to trust government to spend in public interest may be declining
Not directly addressed in BSA but indirectly touched upon
Fall greatest among better off households
Trust in government

Trust in government
BSA, 1986-2014

Source: BSA
Electoral Politics
Electoral politics

Canonical model is median voter model

Requires strong assumptions on preferences

Preferred taxes of median voter is Condorcet winner

Attractor for non-partisan two-party competition
Alternative models

In fact

tax decisions multidimensional

elections address together with other nontax issues

Parties can still be modelled as seeking winning coalitions but multiple equilibria

Probabilistic voting models have parties choosing tax parameters to maximise voting support

Focus still on voters sensitive to tax choices

Theoretical foundations shaky – outcomes vulnerable to deviant coalitions
Electoral institutions and parties

Elections according to variety of systems

Representation of voter preferences mediated by parties

Nature of party system dependent on nature of electoral institutions

Constraints placed by party competition can affect tax outcomes

Majoritarian systems give decisive influence to swing voters in important constituencies
Swing voters

Opinions by party support
BSA, 1986-2014

Support for redistribution

Trust in government

Source: BSA
Electoral offers

Reading of party manifestos allows tracking of median offers (weighted by votes)

Median position is not always electorally victorious

Median position tends to follow actual tax rate
## Party positions: basic rate

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual</th>
<th>Lab Vote</th>
<th>Lab Rate</th>
<th>Lib Dem Vote</th>
<th>Lib Dem Rate</th>
<th>Con Vote</th>
<th>Con Rate</th>
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Source: Party manifestos 1979-2015
## Party positions: top rate

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<th>Year</th>
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<th>Rate</th>
<th>Vote</th>
<th>Lib Dem</th>
<th>Rate</th>
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Source: Party manifestos 1979-2015
Electoral bias

Not necessary to win median voter to implement reform under majoritarian system with multiple constituencies

Geographical basis to voting favours parties whose support is geographically concentrated enough to win seats

not so geographically concentrated as to waste votes

Systematic electoral advantage can give parties security to implement policies divergent from voter interests

Evidence from local government that electoral bias affects tax and spending outcomes to ideological advantage of incumbents

Investigated for local government by Besley and Preston
## Electoral bias

<table>
<thead>
<tr>
<th></th>
<th>Tax Control Bias</th>
<th>Spending Control Bias</th>
<th>Employment Control Bias</th>
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<tr>
<td>Labour</td>
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<tr>
<td>Lib Dem</td>
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<tr>
<td>Other</td>
<td></td>
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</tbody>
</table>

Source: Besley and Preston 2007

Standard errors in parentheses
Government Institutions, Transparency and Public Understanding
Governmental institutions

Electoral representation determines composition of legislature but nature of government institutions also matters

Nature of legislative and executive institutions affects quality of tax outcomes

Transparency, nature of scrutiny and accountability important
Scrutiny of tax reform

Parliament underresourced

No pre-legislative scrutiny and post-legislative scrutiny weak

External bodies important

Office for Budget Responsibility is public body

provides forecasting, scrutinises costing, undertakes independent research

private bodies such as Institute for Fiscal Studies perform important function in scrutinising proposals
Public understanding

Weak public understanding drives focus on visibility of reform
Downward drift of basic rate is example of misleading appearance
Reality is

- shift to indirect taxation
- relabelling of direct taxation
Shift to indirect taxation

Partly deliberately based on aim of lower distortion to labour supply

Misunderstanding to think distortion reduced in itself by switching tax from one side of budget constraint to another

May reduce distortion to saving but *increase* it to labour supply

Achieves progression only through nonuniformity distorting goods choice
Shift to national insurance contributions
Difficult to rationalise as driven by good policy design
Little difference between NI and income tax
Both tax earned income, both withheld at source
Hypothecation illusory
May affect pensioners differently and therefore redistribute intergenerationally
Conclusion

Growing pretax inequality coincides with

- drift down in headline rate of tax
- stable overall effective tax rate and tax burden

Public support for redistribution declining over most of period covered

May be connected to decline in trust

Visibility and framing important