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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:

- J. Alt, I. Preston and L. Sibieta, "The Political Economy of Tax Policy", in:
Dimensions of Tax Design: The Mirrlees Review, edited by S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, 2010, Oxford University Press

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

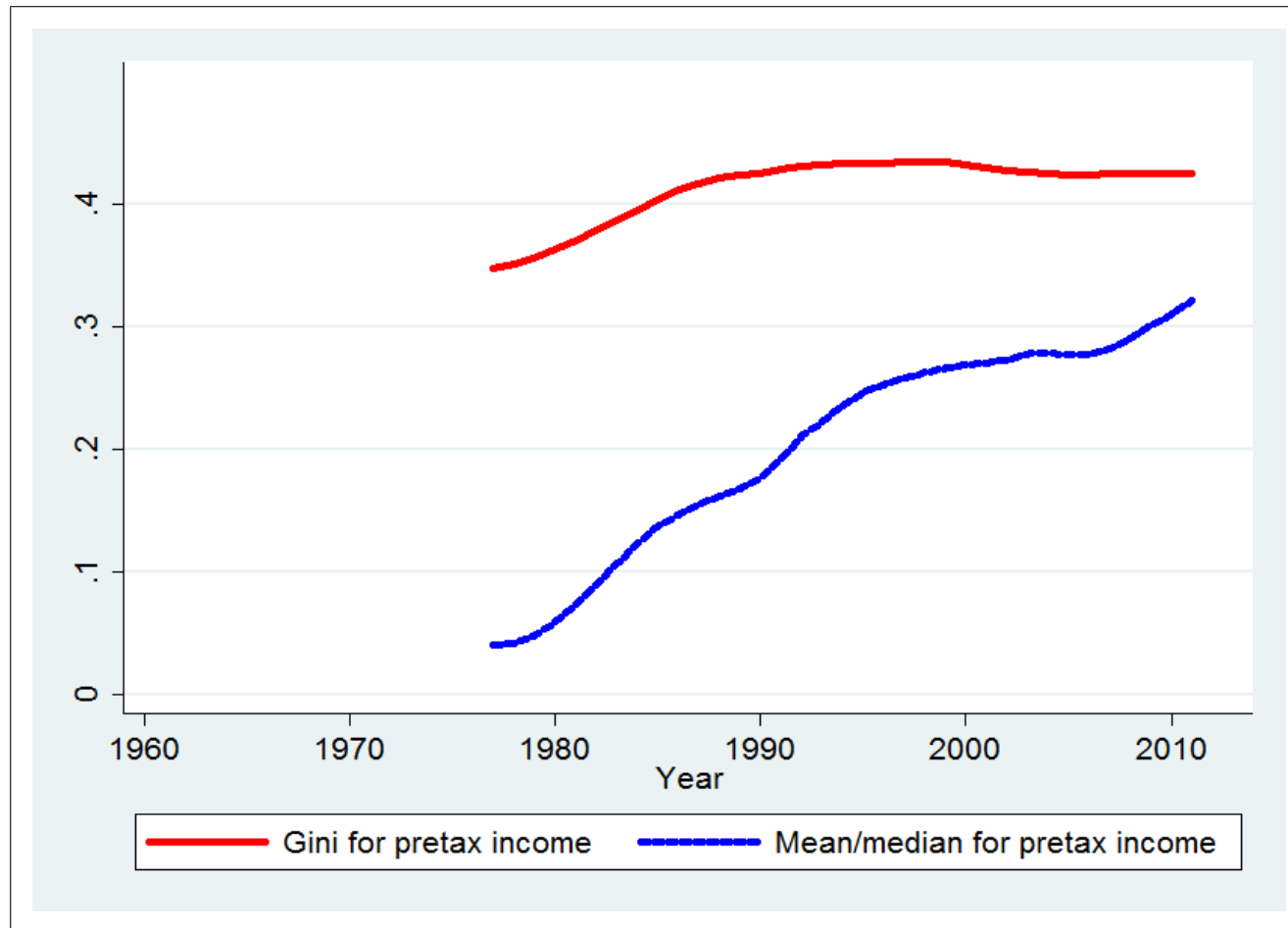
The last 40 years in the UK: pretax inequality

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

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

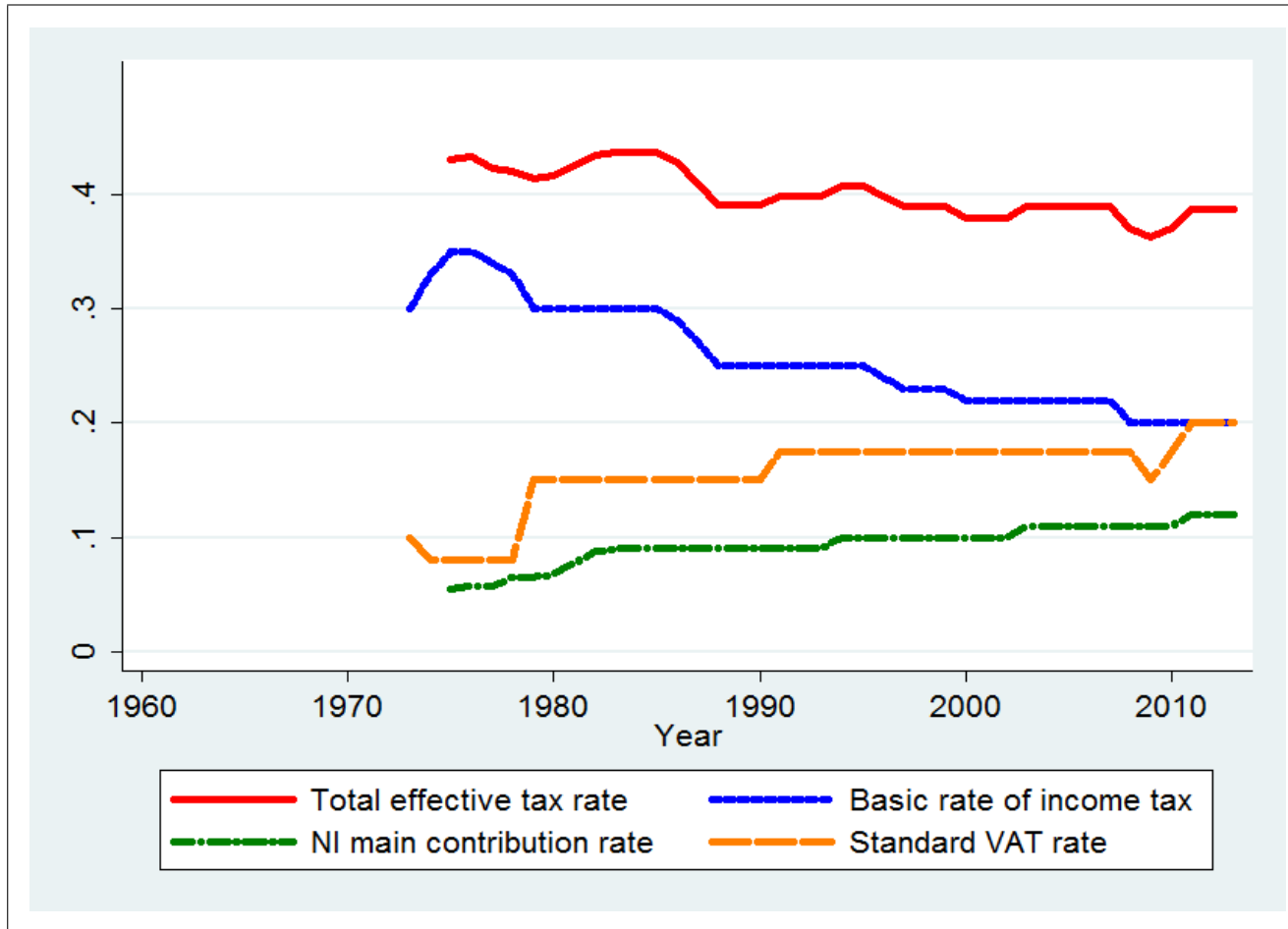
changes to allowances affect the no of people subject to direct tax

Over the 40 years

the effective tax rate on a standard taxpayer has been stable

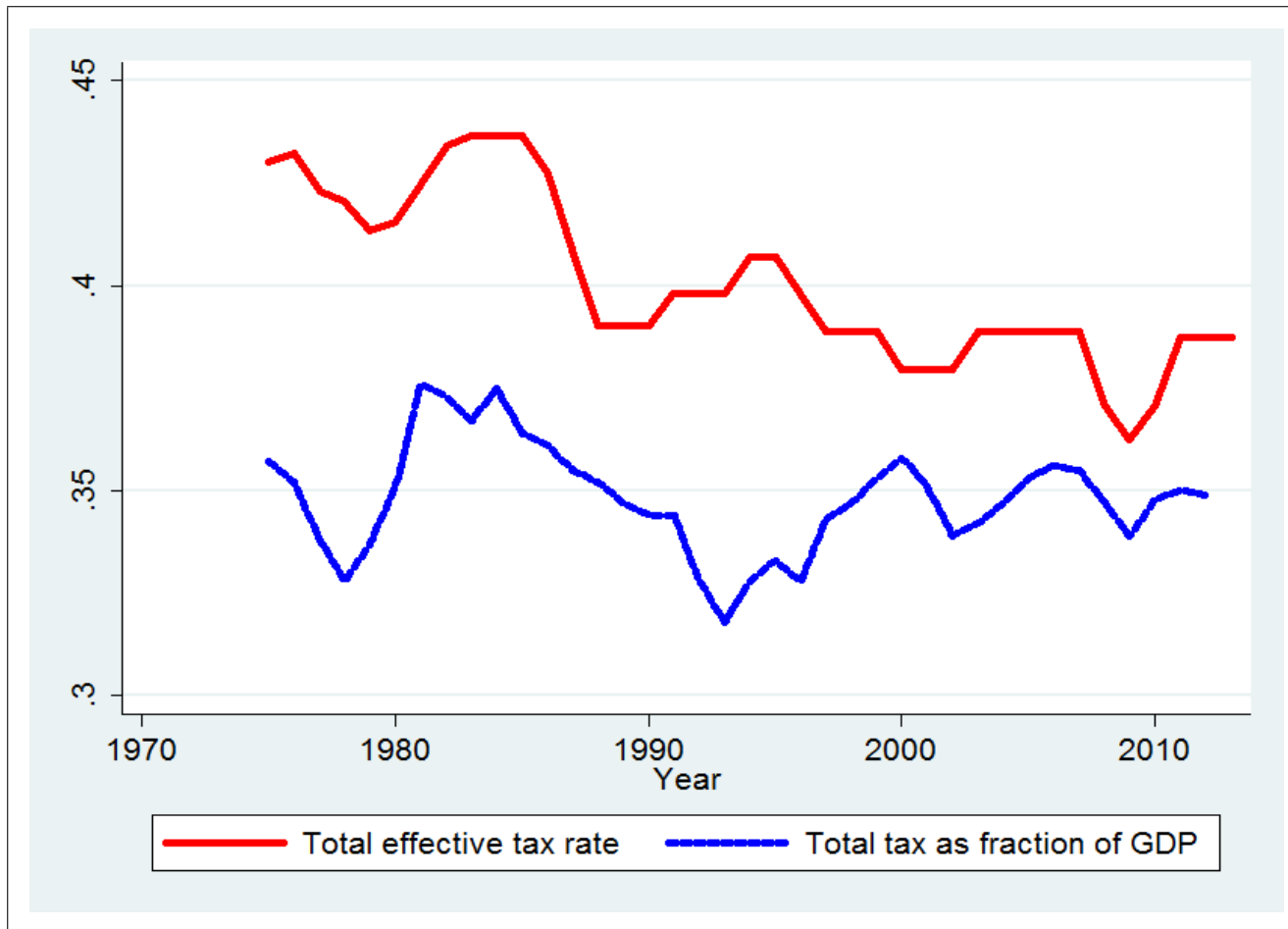
so also has been the tax share of GDP

Tax rates



Source: IFS

Tax receipts



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

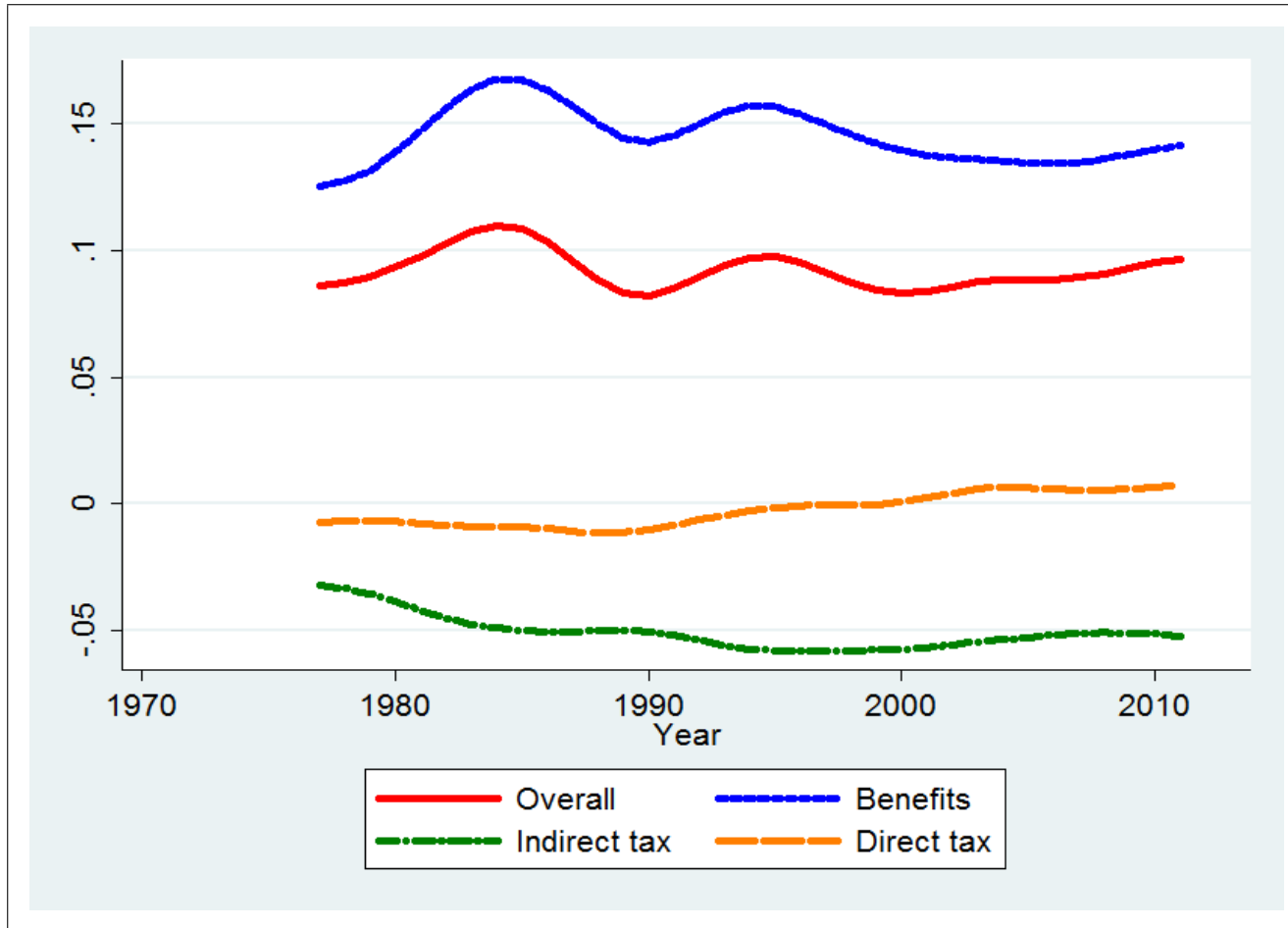
Direct taxes

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

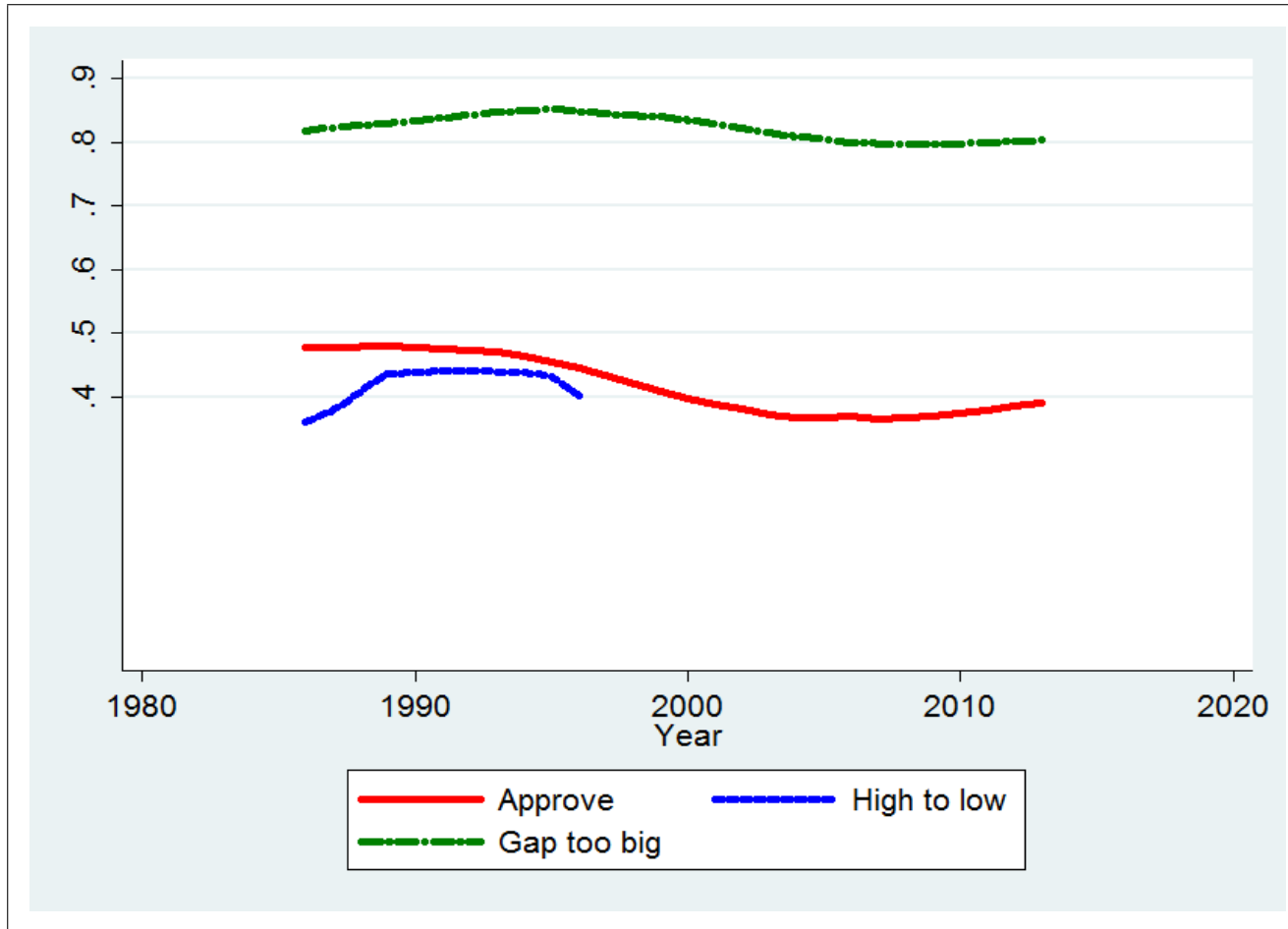
suggests preference for other policies to reduce gap (education, wage controls)

or seen as outside business of government

Support for redistribution declines then picks up again after crisis

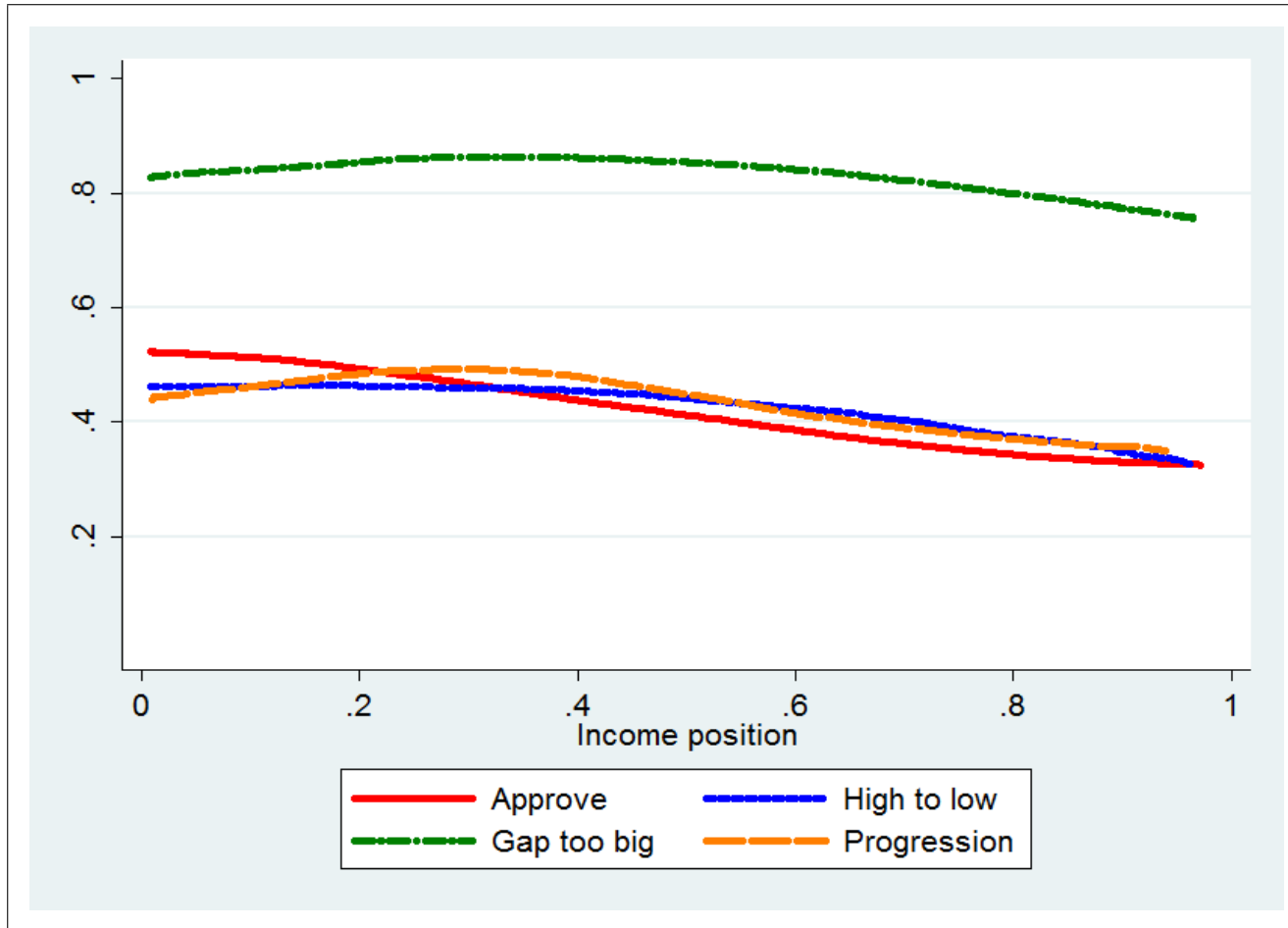
Modestly negatively related to respondent income

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?

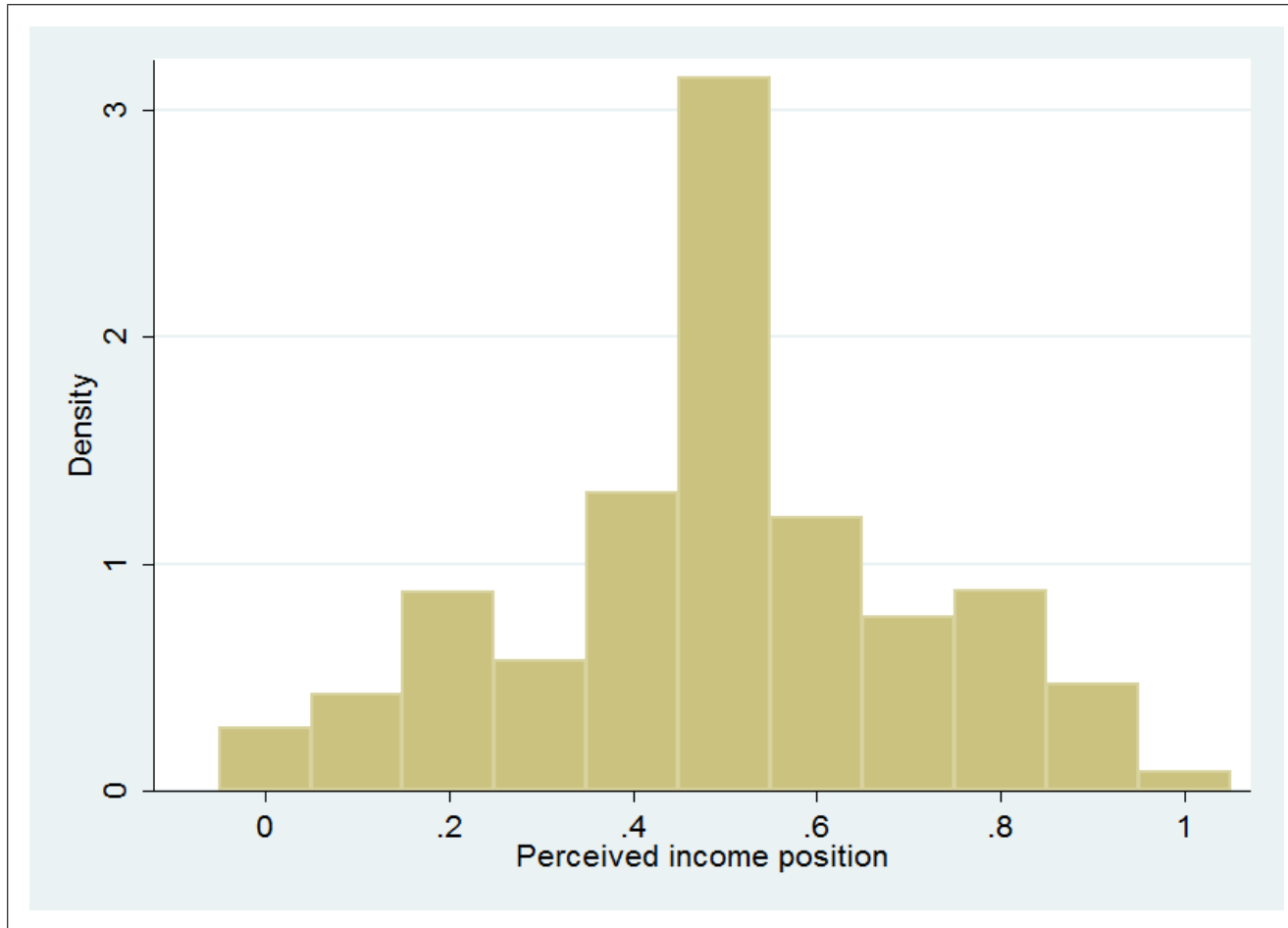
Question in BSA 2004 asks what proportion of population less well off than respondent

Should be uniformly distributed if perceptions accurate

In fact excessively concentrated at centre

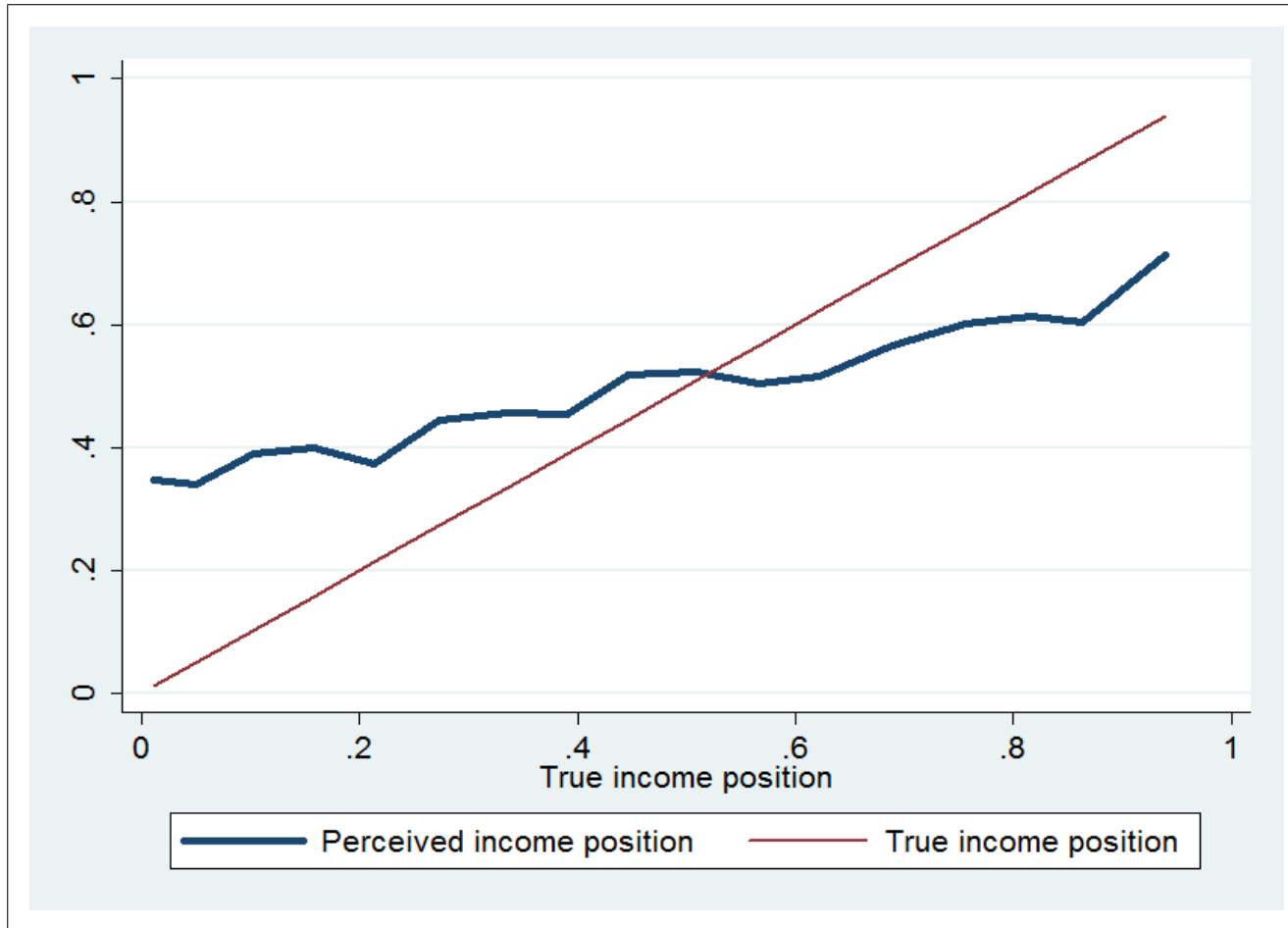
However correlated with true position

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

Self-assessed income	No in sample	Taxes on High incomes		Medium incomes		Low incomes	
		Too high	Too low	Too high	Too low	Too high	Too low
High	460	36.8	19.1	37.8	5.5	71.0	1.5
Medium	8472	17.5	44.6	33.9	4.0	78.2	2.2
Low	8003	14.6	52.9	29.5	8.1	82.9	2.6

Source: BSA

Comparison to self-assessed income

Self-assessed income	No in sample	Redistribution from High to low	High to medium	Medium to low
High	460	16.1	3.0	4.2
Medium	8472	37.8	9.0	2.8
Low	8003	47.6	8.9	6.6

Source: BSA

Redistribution and age

Incomes are in reality neither fixed nor certain

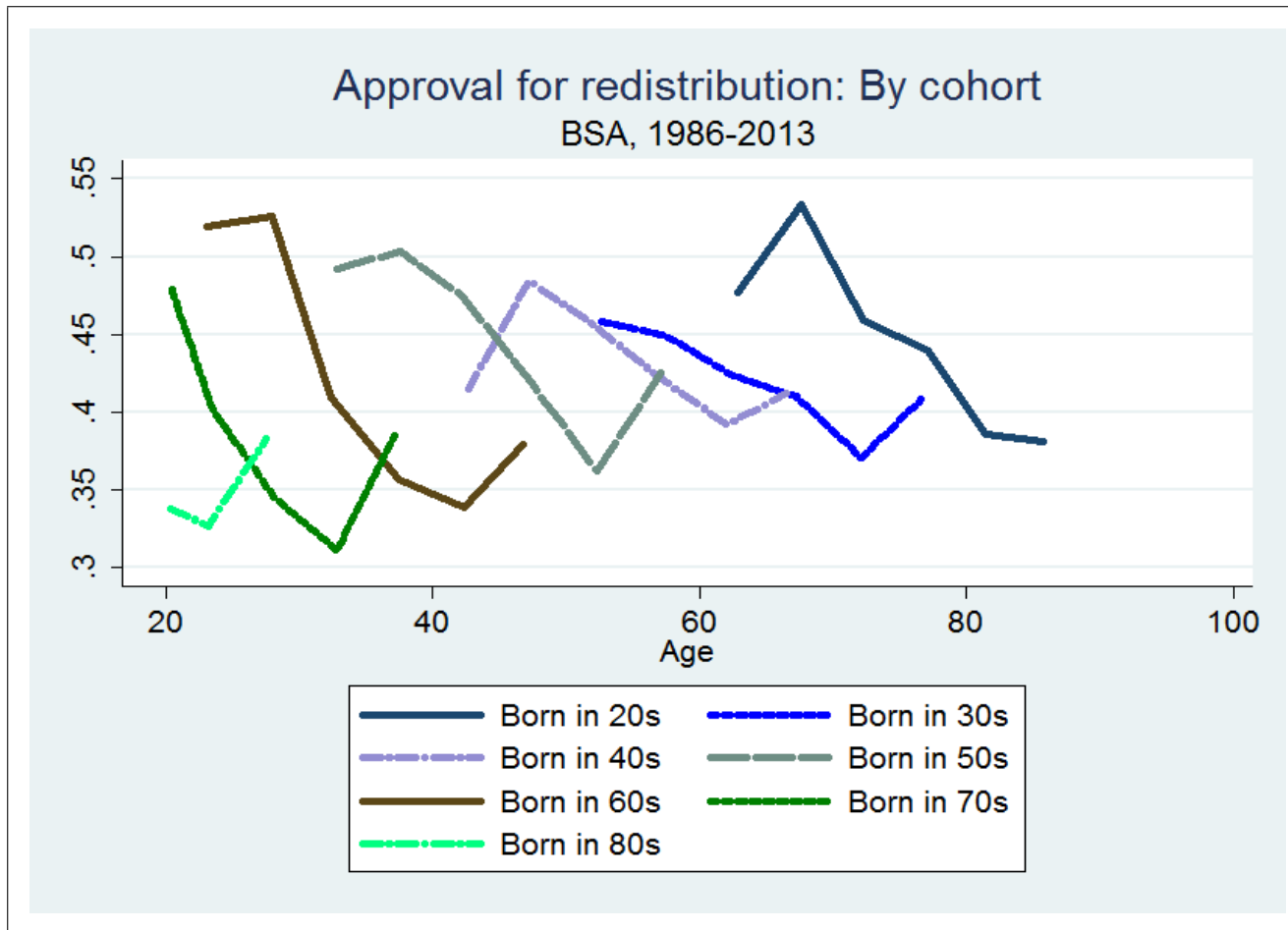
Income taxation provides both lifetime redistribution and social insurance

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)

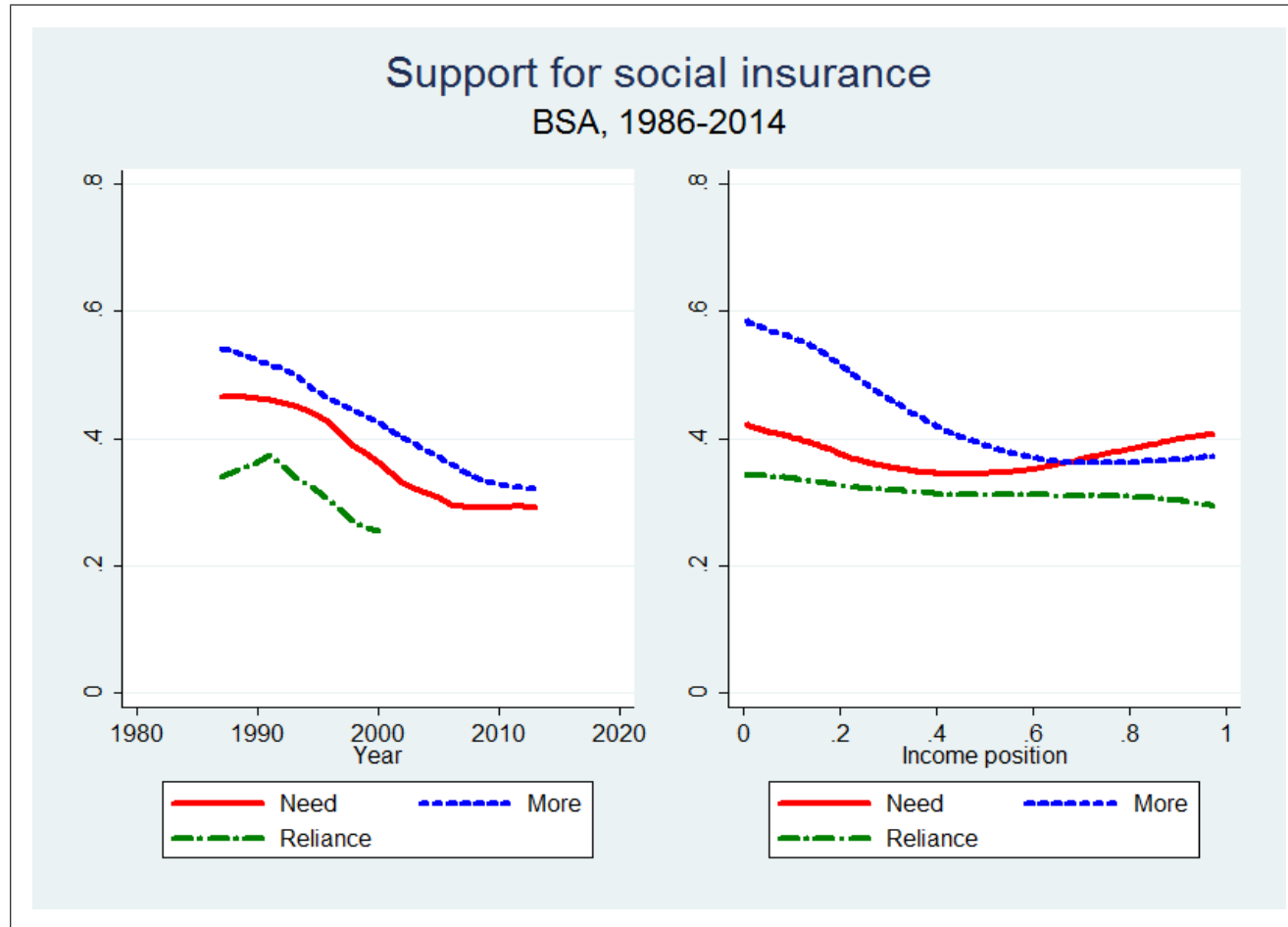
Higher income respondents

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



Source: BSA

Attitudes to public spending

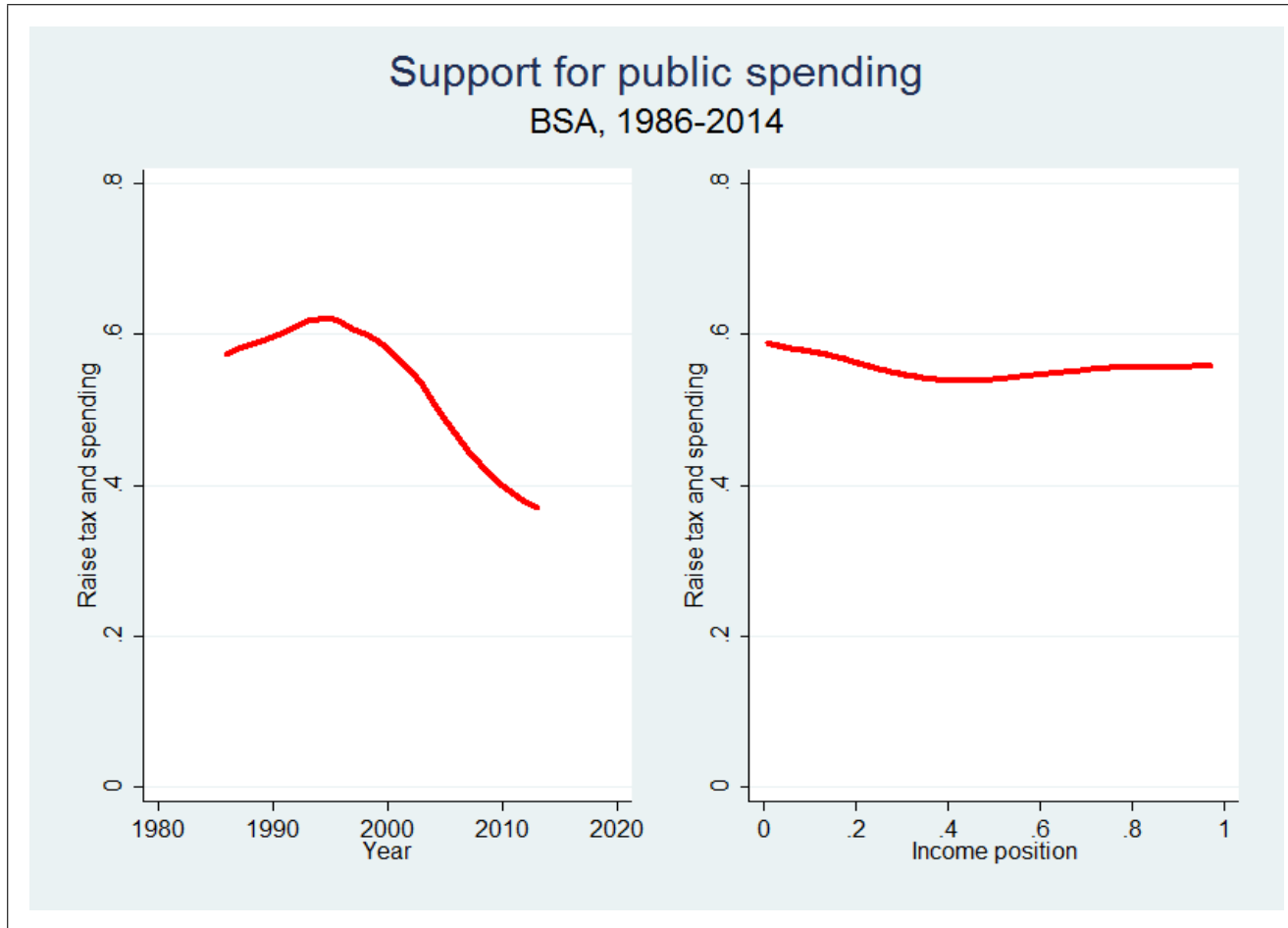
Goods provided through taxation may be income elastic or not

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



Source: BSA

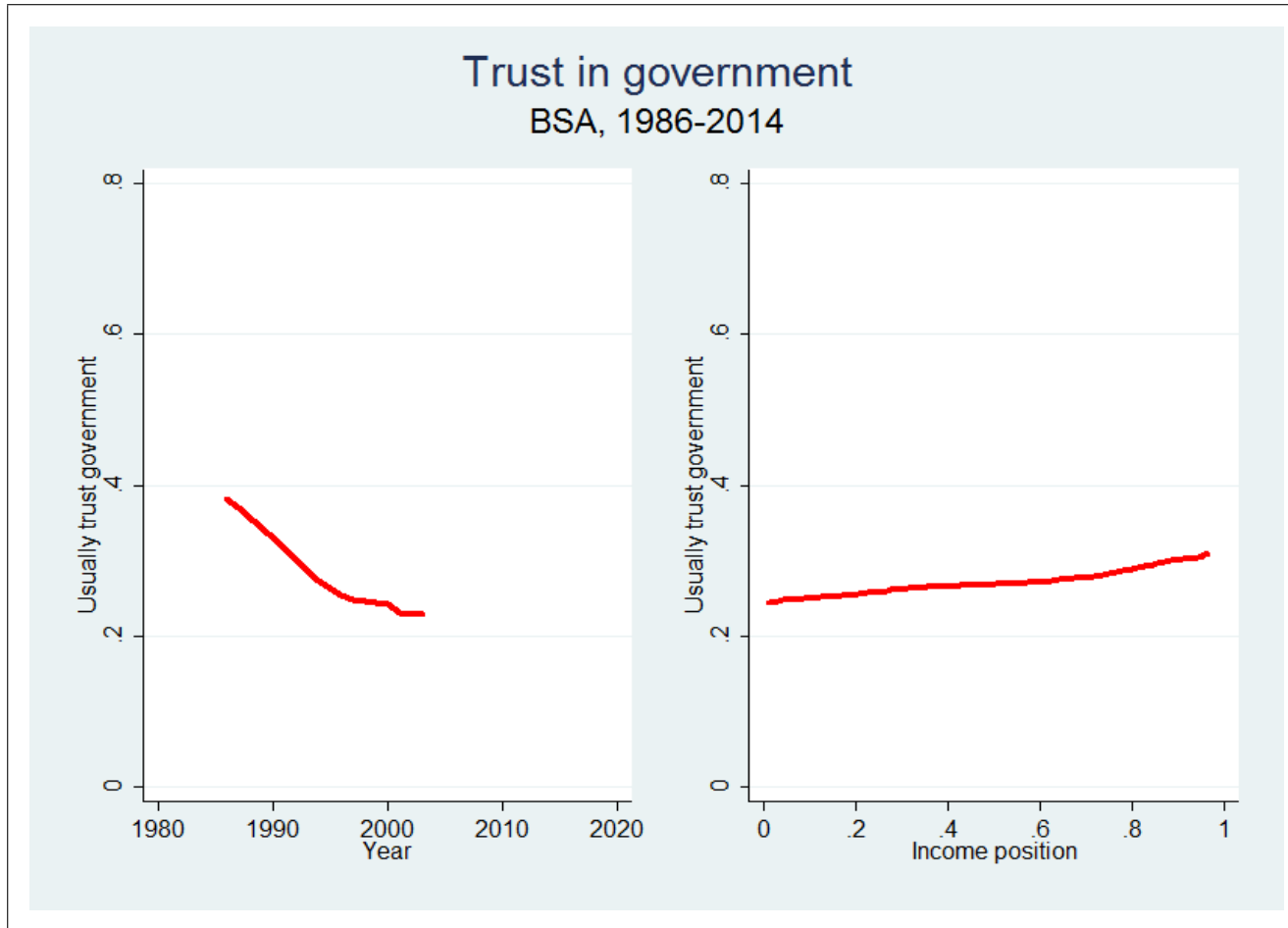
Trust in government

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



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

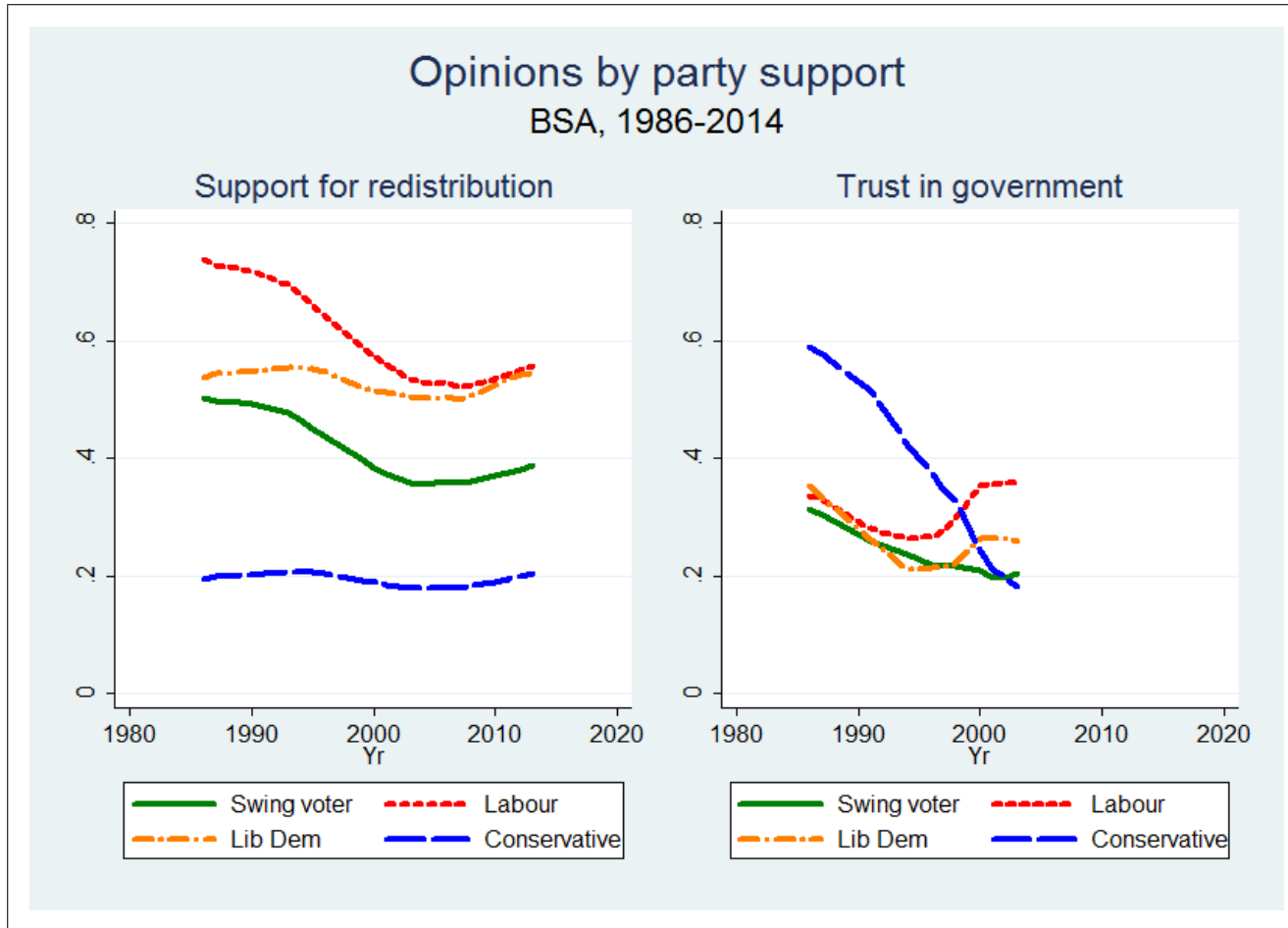
Representation of voter preferences mediated by parties

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



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

Year	Actual	Lab Vote	Lab Rate	Lib Dem Vote	Lib Dem Rate	Con Vote	Con Rate	Median
1979	33	(36.9)	33*	(13.8)	<33	(43.9)	<33	<33
1983	30	(27.6)	30*	(25.4)	30*	(42.4)	<30	30
1987	27	(30.8)	29	(22.6)	27*	(42.2)	25	27
1992	25	(34.4)	25	(17.8)	>25	(41.4)	20	25
1997	23	(43.2)	23	(16.8)	24	(30.7)	20	23
2001	22	(40.7)	22	(18.3)	23	(30.7)	<22	22
2005	22	(35.3)	22	(22.1)	22	(32.3)	22*	22
2010	20	(29.0)	20*	(23.0)	20*	(36.1)	20*	20
2015	20	(30.4)	20	(7.9)	20*	(36.9)	20*	20

Source: Party manifestos 1979-2015

Party positions: top rate

Year	Actual	Lab Vote	Lab Rate	Lib Dem Vote	Lib Dem Rate	Con Vote	Con Rate	Median
1979	83	(36.9)	83*	(13.8)	50	(43.9)	<83	<83
1983	60	(27.6)	>60	(25.4)	>60	(42.4)	<60	>60
1987	60	(30.8)	>60	(22.6)	60*	(42.2)	<60	60
1992	40	(34.4)	50	(17.8)	>40	(41.4)	40*	>40
1997	40	(43.2)	40	(16.8)	50	(30.7)	40	40
2001	40	(40.7)	40	(18.3)	50	(30.7)	<40	40
2005	40	(35.3)	40	(22.1)	50	(32.3)	40*	40
2010	50	(29.0)	50	(23.0)	50*	(36.1)	50*	50
2015	45	(30.4)	50	(7.9)	45*	(36.9)	45*	45

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

	Tax		Spending		Employment	
	Control	Bias	Control	Bias	Control	Bias
Labour		+		+	+	+
Conservative	-		-	-		-
Lib Dem				+		
Other					-	

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