

IFS

The Base for Direct Taxation: Commentary

John Kay

Prepared for the Report of a Commission on
Reforming the Tax System for the 21st Century,
Chaired by Sir James Mirrlees

www.ifs.org.uk/mirrleesreview

The Institute for Fiscal Studies

Full Report to be published by
Oxford University Press

E·S·R·C
ECONOMIC
& SOCIAL
RESEARCH
COUNCIL

The
Nuffield
Foundation

The Base for Direct Taxation - commentary

The central theme of the Meade Report was a preference for consumption over income taxation. Soon after the Report was published, a thoughtful commentator said to me ' you will never get the name expenditure tax, but you will get everything else'. And so it has proved. Since 1978, the most important developments in the UK tax structure have been

- a rise in the relative significance of general consumption taxes (VAT) and payroll tax (national insurance) relative to income tax
- the introduction of savings and pension accounts, neutral as between asset categories, providing both TEE and EET reliefs
- a substantial reduction in the number of income tax rates which established an approximately linear structure above an exemption level.

Britain is now in a transitional period at the end of which, as the Report envisaged, most life cycle savings will qualify for TEE or EET treatment. The Report envisaged that this change would be accompanied by the introduction of some form of wealth tax (a proposal which, incidentally, was not pursued in the further discussion of the issues by Kay and King). These wealth tax

proposals have not been implemented and have aroused little subsequent interest either amongst academics or policy makers

The present (Mirrlees) chapter revisits the central issue of the main household tax base. It differs from the Meade Report in looking to optimal tax theory for its rationale. Meade did not approach the question in this way but instead focussed pm more on traditional public finance issues of taxable capacity. While much research on optimal taxation has been undertaken since 1978, the basic framework of optimal tax theory was well established by the time of the Meade Report, and the decision by the Meade Committee to tackle the question of the direct base in a different way was a conscious one. In this commentary, I shall give my own perspective on why the Meade Report used that approach and why, broadly speaking, I still take that view.

There are a number of substantial difficulties in using optimal tax theory to model the choice of household tax base. The most fundamental is the use of a utilitarian welfare function. I will begin by mentioning briefly some other issues, and then return to this basic question.

There is a always difficulty in achieving correspondence between model variables and operational tax concepts. It is one thing to write down 'let y be household income' and quite another to write a law that defines the calculation of household income. The complexity of the present tax code of all developed countries is in

very large part the direct and indirect result of the difficulty of making the economic concept of income an operational tool in a world of uncertainty and financial innovation.

Less obvious, perhaps, is the problem of defining the time period over which income or expenditure is to be measured. Yet this issue is clearly fundamental in considering the basis on which life cycle savings are to be taxed. The longer the period of assessment, the smaller are life cycle savings. If income and expenditure are measured over the whole lifetime, the only difference between income and expenditure is bequests. It is conventional to measure income for both tax and accounting purposes on an annual basis. But this choice probably relates to the agricultural cycle, which seems of little current relevance.

If I chose to emphasise that point, it is as a result of experience after the Meade Report, when a number of practitioners attempted to persuade me that the schemes contained in the report for administering an expenditure tax were not feasible. These practitioners were, as always, ingenious in devising avoidance schemes. Few of their schemes worked: in fact a powerful merit of expenditure taxation and one of the considerations which was influential in persuading the Committee to emphasise expenditure over income is that expenditure taxation is much more robust to avoidance schemes than income taxation.

Expenditure is easier to define than income (there are many fewer VAT avoidance schemes than income tax avoidance schemes and most of these are the result of exemptions within VAT). Most of the avoidance schemes that would have produced tax savings depended on exploiting year end effects. Matters would have been different if tax liability had been calculated on a daily, or five yearly, basis. Is what we tax in our model, daily, or annual, or quinquennial income? and why?

The identification of life cycle savings is closely linked to the treatment of bequests, since it is these two factors, taken together, which make up the difference between income and expenditure. There are two broad perspectives on bequests, as the chapter acknowledges: a purely individual one; or a dynastic one, in which individuals never die but continue to derive welfare indefinitely in the guise of their children (or others) to whom they leave bequests. This is evidently an extension of the questions that arise in deciding whether to take the individual or the household as taxable unit.

As with the taxable unit, it is evident that neither extreme perspective is acceptable. The case for moving towards a dynastic perspective gains strength from the pressures against inheritance taxes which have built up, since the time of the Meade Report, particularly in Britain and the United States: it is striking that the unpopularity of these taxes is widespread despite their progressive

incidence and seems to be felt even among sectors of the population which are most unlikely ever to pay it.

In discussion over Meade, we tended to frame the issue of how bequests should be treated in the form 'did a gift or bequest represent consumption and if so who did it represent consumption by?' While this is a means of beginning debate I do not think it is capable of leading to an answer. In any event, this framework leads away from a utilitarian framework.

Of course, one reason for bequests is that it is impossible (in the absence of perfect annuity markets) to plan to die with exactly zero assets even if that were the goal. This too reflects a larger problem: that the planning of life cycle savings has to be made within the context, not just of specific risks, but undefined and unqualifiable uncertainties, about both personal and collective futures dealt with in necessarily incomplete markets. It is unlikely that individuals do, or could, make well-considered decisions in these circumstances. Many people demonstrably make bad life cycle decisions, and, when they do, society is unwilling to respect these decisions. We are not willing to let people die of starvation in old age even if that is the inevitable consequence of apparently free choices they have made. The implied assumption of rational choice in line with the expression of consistent preferences works particularly badly for life cycle decisions.

The factors I have described above can be modelled, and most have been. But there are many possible models, and the choice between them depends in substantial part on prior decisions about 'fairness'. The model is rarely yielding conclusions, at best helping us to organise the intuitions we already hold.

And even at the time of the Meade Report, it was evident that simple models of the choice of household taxbase yielded no robust results. In a model such as that of Atkinson and Stiglitz¹, a change in the specification of available tax instruments produced fundamentally different results. If we pose the question 'should income from life cycle savings be taxed at the same rate as labour income, or should it not be taxed at all?' – which is the appropriate translation of the question 'should income (as conventionally defined) be the main household tax base, or would expenditure be preferable?' then it is not clear that this kind of modelling can yield a general answer at all.

If it was not these arguments from optimal tax theory of the kind described in the present chapter which led the Meade Committee to favour expenditure taxation, what was the rationale of the Committee's preference? In truth, it was clear from the beginning that the Committee would favour an expenditure tax, and I understood from my very first discussion with the chairman that the task was less to provide objective analysis than to make the case for expenditure tax and to deal with the operational issues that

arose. Nevertheless, I personally found the case that was developed convincing and still do.

So why was expenditure tax both the starting point and the conclusion? I think at a visceral level, James Meade believed in the moral case that people should be taxed on what they took out, not on what they put in. This is not really a satisfactory argument, as he knew. But I have no doubt that he, along with most of the Committee, came to the issue from this sort of perspective. The issue of taxable capacity was key. For the Meade Committee, as for most ordinary people, questions of fairness and taxable capacity would seem to be of critical importance – even exclusive importance – in determining the household tax base.

Everyone who has written about public finance knows that taxable capacity is a slippery elusive concept. On examination, 'taxable capacity' always turns out to be very difficult to define and to be a matter on which opinions will differ rather widely'. Meade (p.14) The present chapter of the Mirrlees Report goes much further

'We reject the Meade Report view that taxes 'should' relate monotonically to taxable capacity. In addition to finding taxable capacity not well enough measurable and not sufficiently uniformly evaluated to be usable for this purpose, we also do not see an underlying normative basis for reaching the conclusion that taxes should be related to taxable

capacity.....minimal sacrifice – equivalent to
optimised social welfare (was) is the appropriate criterion.'

There is sharp, and fundamental, disagreement between the two Reports here. On reading the present (Mirrlees) chapter, and rereading Meade (or, for that matter, Kay and King), I don't find the discussion satisfactory. I can do no more than raise some issues here.

It is certainly hard to disagree with Meade's statement, echoed by Mirrlees, that taxable capacity is difficult to define. But to say that it is hard to define does not necessarily imply that people are not justified in attaching significance to it, or that because it lacks exact meaning it lacks any meaning, or that it is impossible to secure a wide measure of agreement on what taxable capacity is.

We talk of a beautiful face, a kind person, a great work of art or piece of music, without having or being capable of having any quantitative measure of beauty, kindness or greatness. Yet we are able to identify indicators of beauty, kindness and greatness and to achieve substantial, though not necessarily complete, consensus on rankings of beauty, kindness or greatness.

Let me conjecture that most people, asked to describe taxable capacity, would start with income. Let me also conjecture that these people, given examples of people with consumption levels sustainably above their income, would agree that their taxable

capacity was greater than their income. And let me further conjecture that faced with examples of people with consumption levels substantially below their income, most people would feel less inclined to reduce their estimate of taxable capacity. Considerations like these have led me to conclude that average lifetime consumption, plus bequests (with bequests probably valued at less than pound for pound) is probably as good an index of taxable capacity as might be observed. If we must use a single indicator, that should be it. But I am not sure that it is right to use, or seek, a simple indicator. Taxable capacity is a complex concept, probably unobservable, and we must make do with composite instrumental variables. I'll come back to the implications of that.

I think Mirrlees is in a weaker position than Meade to stress the difficulty of measuring taxable capacity. If one is to maximise a social welfare function based on an aggregation of individual circumstances, it is necessary to envisage some agreement on what the individual arguments of that social welfare function (call them utilities) would be. I cannot imagine that it would be easier to secure agreement on the definition of utilities than on the definition of taxable capacities: indeed it is likely that the two definitions would be very similar. I believe it is difficult to argue that it is possible to define utilities but not to define taxable capacities. (Note that saying utility is what a hedonometer or axiomatic system measures simply raises the issue of why society should want to

maximise utility in these senses, a debate essentially analogous to whether income equates to taxable capacity).

And is Meade correct to say that the definition of taxable capacity is 'a matter on which opinions will differ rather widely'? I further conjecture that the subject on which opinions will differ rather widely is not the definition of taxable capacity, on which I would anticipate considerable if not universal agreement. Disagreement would instead focus on the extent to which that liability should increase with the preferred measure of taxable capacity.

The Mirrlees Report discusses horizontal equity in terms of maintaining the ranking of pre and post tax utilities, following an index of Feldstein's, and is rightly sceptical of the available plethora of hypothetical alternatives in the definition of a counterfactual pretax world. But suppose one takes instead the simple criterion that the ranking of direct tax payments should be strongly correlated with the ranking of taxable capacity.

This is a more operational requirement, and probably closer to most intuitive conceptions of equity. It has the obvious weakness of disregarding issues of incidence: taxes are treated, in effect, as lying where they fall. But I am not sure this is truly a weakness. There is a difference between differences in the treatment of largely similar individuals which arise as a result of a deliberate decision to impose differential treatment and differential treatment which is the

incidental outcome of decisions made on other, more general grounds. Such a distinction is familiar in the application of anti-discrimination regulation. We prohibit discrimination on racial grounds but do not require that all policies have effects which precisely mirror the racial composition of the population.

There is evidently a close relationship between the measurement of taxable capacity and concern over 'discrimination', and this issue requires elaboration. The person unfamiliar with the implications of models like those of optimal tax theory might be surprised at the notion that there is potential conflict between the objective of welfare maximisation and the requirement that the tax burden should be an increasing function of the taxable capacity of individuals. There are several possible reasons but the most likely arises from the issue variously labelled tagging, profiling or statistical discrimination.

Almost anyone who has stood in an airline security queue will have ruminated that all passengers do not present the same security threat. If the degree of scrutiny were varied according to criteria such as age, gender and ethnic origin that scrutiny could be targeted more effectively with results which could reduce queuing time for all passengers – not just those subject to light checks – and improve overall security. As queuing passengers note this, however, they will also have reflected on the compelling reasons why this efficient solution is not adopted. The selection of targets

on probabilistic grounds alone is ruled out by other, overriding, social and political considerations.

It needs emphasis that the objection is not to the arbitrary nature of selection. The problem is that such selection is not arbitrary: it has a completely rational utilitarian basis (although there is a history of using bogus statistical evidence to disguise simple prejudice). The issue does not hinge on whether the alleged correlation is correctly observed, but on when and whether it is acceptable to use such correlations at all.

And yet it is impossible to operate a tax system, or indeed make many everyday decisions, except by using instrumental variables in this way. We ask whether our doctor has medical qualifications, not because possession of such qualifications is either necessary or sufficient to secure good advice, but because we judge, with good reason, there is a correlation between medical skill and knowledge and a degree in medicine. In a similar way, tax liabilities are based, not on – probably unobservable – taxable capacity, but on variables which we believe to be correlated with taxable capacity. Statistical discrimination is in practice indispensable.

But when is such discrimination justified and when inappropriate? In Table 1 I list some instrumental variables which have been used as part of the household tax base, and made comments on each. I can see no obvious criterion for distinguishing

these variables which seem to be found generally acceptable and which are generally unacceptable: words such as 'arbitrary' and 'inappropriate' simply reiterate intuitive feelings. Moreover, it is plain that social attitudes change over time: measures move in and out of acceptability. This is a more general phenomenon: the 'discrimination' that arouses public concern is mostly discrimination by reference to criteria – such as gender, race, sexual orientation – which were until recently widely used but which are out of line with current social practice.

Table 1: Components of the tax base

age	<i>becoming less acceptable</i>	height	<i>not acceptable</i>
caring responsibility	<i>becoming more acceptable</i>	illness	<i>probably not acceptable</i>
consumption of immoral goods	<i>becoming less acceptable</i>	income from capital	<i>acceptable</i>
disability	<i>becoming more acceptable</i>	intelligence/skill	<i>not acceptable</i>
earnings	<i>acceptable</i>	marital status	<i>becoming less acceptable</i>
educational experience	<i>not acceptable but becoming so</i>	parental responsibility	<i>varying attitudes</i>
expenditure	<i>acceptable</i>	race	<i>has become unacceptable</i>
expenditure on luxury goods	<i>becoming less acceptable</i>	relationship status	<i>becoming more acceptable (but see marital status)</i>
gender	<i>no longer acceptable</i>	value of property	<i>becoming less acceptable</i>

The present chapter ends with the familiar call for further research. In my view, the further research that is principally required would use focus groups and polls (the possibility is hinted at in the Mirrlees chapter) to elucidate more clearly how people interpret taxable capacity and what criteria are acceptable, and

which not, as elements of the household tax base. The chapter cites Atkinson and Stiglitz in support of 'the idea that some aspects of horizontal equity may best be addressed by viewing them as limitations on allowable tax tools'.² My assessment is that this puts the role of equity and efficiency in the choice of the main household tax base the wrong way round. One should begin by seeking a measure of taxable capacity, with the measurement of taxable capacity constrained by administrative and operational issues and by considerations of efficiency. This was, in essence, the form of reasoning which led the Meade Report to favour a greater role for a progressive consumption tax. I believe that reasoning and its conclusion remain valid today.

3152

¹ Atkinson, A.B. and J.E. Stiglitz, 1976, *The design of tax structure: direct versus indirect taxation*, *Journal of Public Economics* 6, 55-75.

² Atkinson, A.B. and J.E. Stiglitz, 1980, *Lectures in Public Economics*, McGraw-Hill Economics Handbook Series