

The Political Economy of Tax Policy: Commentary

Guido Tabellini

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The political economy of tax policy – A comment*

Guido Tabellini
IGIER, Bocconi University

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1. Introduction

The political economy of tax policy is a huge topic, and this chapter does an excellent job at discussing some of the most relevant issues. It succeeds in linking real world policymaking in the UK to the recent background literature in political economics. And it produces several novel insights that enhance our understanding of how tax policy is made in the UK.

The chapter contains a very rich and complete discussion of several issues, but essentially it develops three main themes. First, UK tax policy is very centralized, and it emanates from one key institution: the Treasury. Second, the political, economic or ideological convictions of individuals in this key policymaking institution are the main drivers of UK tax policy; political opportunism, organized interests, or voters' demands seem to play a less important role. Third, voters don't understand well the tax system; from a positive point of view, this enables politicians to take advantage of this ignorance to pursue their political goals; from a normative point of view, voters' ignorance is undesirable and calls for much greater transparency in tax policy.

Here I briefly comment on each of these three themes, and conclude by raising an important general question that the chapter leaves unaddressed.

2. The institutional framework

The claim that UK tax policy emanates from the Treasury's office and reflects the will and opinion of key bureaucrats and policymakers in that institution is very convincing. The UK tax system is very centralized, the executive is controlled by a single party with absolute majority in Parliament, and the Chancellor has strong agenda setting prerogatives with regard to both the Cabinet and Parliament. Hence, the authors are right in insisting that, to understand the determinants of UK tax policy, we must start from the organization of the Treasury's office.

To someone trained in monetary economics like myself, this raises a natural question. Why is there such a big difference in the institutional framework of tax policy vs monetary policy? And is this difference desirable? In monetary policy, decisions are delegated to an independent and accountable agency, with a very transparent decision making procedures. Similar delegation has taken place with many regulatory policies.

* Comment on the chapter "The political economy of tax policy", by J. Alt, I. Preston and L. Sibieta, prepared for the Mirrlees Review.

When it comes to taxation, instead, decisions are directly controlled by a political office, even to the smallest detail. Naturally, bureaucrats also operate inside the Treasury. But unlike in monetary policy, they do not enjoy independent decision making power. Their influence on policy decisions has to be conquered through persuasion or exploiting the inattention of their political principal. And outside observers have very little knowledge of how decisions are taken inside the Treasury and for what true reasons.

Of course, this is not a peculiarity of the UK. But we cannot simply dismiss this question with the answer that tax policy is “too political” to be delegated to independent bureaucracies, or that representative democracy has developed precisely on the principle that there cannot be taxation without political representation. One can imagine alternative arrangements whereby political representatives choose general features of the tax code, but then delegate the execution to independent and accountable bureaucrats according to efficiency or other pre-established criteria, just like in regulation or other policy areas.

Personally, I doubt that there is a valid normative reason for current arrangements. There are several reasons of political expediency why office holders do not want to delegate away control over any aspect of tax policy. But from a normative perspective, retaining full political control is likely to result in socially suboptimal outcomes under a robust set of assumptions.¹

The observation that voters don't have a full understanding of the tax system reinforces this conclusion, because it increases the need for a more transparent decision making procedure. Sections 5 and 6 of the chapter, on institutional checks and balances over tax policy, briefly discuss the role of non-political or external institutions to audit revenue figures, or to offer advice. But their logic is one of oversight, rather than delegation of specific responsibilities.

Even retaining the focus on oversight, as opposed to delegation, the authors seem reluctant to advocate a greater role for an independent bureaucracy. They instead lean towards asking for greater accountability towards Parliament. I am skeptical that this would be effective, for two reasons. First, because in a Parliamentary democracy (unlike in a Presidential regime) there is no real separation of power between executive and legislative authority. The opposition of course would have the right incentives to question government choices in Parliament. But, and this takes me to the second reason, tax policy unavoidably hinges on many technical details that are bound to escape the attention of public opinion, and often also of elected representatives. Such details are better discussed by trained professionals, which calls for relying on independent and well trained bureaucrats rather than political opponents in Parliament.

3. Passive voters and ideological politicians

Is tax policy mainly driven by the policymakers' convictions or by the wishes of the voters? The chapter leans towards the first answer. It presents two empirical arguments

¹ Blinder (1997) advocated bureaucratic delegation over aspects of fiscal policy, and Alesina and Tabellini (2007a,b) discuss political vs bureaucratic delegation in a more abstract setting.

in support of this conclusion, one from voters' opinions and party manifestos, the other from a case study of how the R&D tax credit were enacted.

While I find the R&D case study interesting and persuasive, the interpretation of voters' opinions and party manifestos is very ambiguous and open ended. According to the opinion polls surveyed in the chapter, British voters are concerned about rising income inequality, but since the mid 1980s they are less supportive of redistributive policies and have less trust in government. A majority would also be prepared to pay more taxes if this extra tax revenue were used to increase public good provision.

What to make of this evidence, and how to relate it to actual tax policy, is not clear. If anything, these attitudes reveal that most voters would like a different mix of public spending (more public good provision and less redistributive transfers). But this is not surprising, since it is well understood that political competition induces politicians to under-provide public goods in favor of targeted redistribution to influential groups. Whether the observed reduction in statutory tax rates (but not in tax revenue, as the authors correctly remark) was a reaction to electoral concerns, or whether instead it was induced by the ideological agenda of partisan politicians, is hard to say based on this evidence.

4. Transparency of fiscal policy

We often take it for granted that more policy transparency is always good in a democracy. Implicitly this chapter seems to share this presumption. An interesting recent paper by Gavazza and Lizzeri (2005) clarifies that this simplistic view is incorrect.

The important distinction is between transparency of individual vs aggregate tax payments. Full transparency of individual tax payments means that the individual voter fully understands how much taxes he is paying to the government. Full aggregate transparency means that he knows aggregate tax revenue (i.e how much other tax payers are contributing).

Individual transparency, as defined above, generally improves government incentives. Intuitively, if voters fully understand how much they are paying to the government, they are more likely to demand something in return. Hence, individual transparency discourages corruption and wasteful redistribution, because it raises the political cost of government spending.

But aggregate transparency can be counterproductive, unless it is accompanied by a full understanding of how the government uses tax revenue. Suppose that voters are not sure about the true size of the budget deficit or surplus. In this case, as shown by Gavazza and Lizzeri (2006), transparency of aggregate tax revenues encourages "fiscal churning". The reason is that voters mistakenly interpret higher aggregate tax revenues as a higher budget surplus (rather than as more targeted redistribution to others). Thus, they reward the government if aggregate tax revenue is higher, which encourages politicians to have

more distorting taxation than would be necessary to sustain the same amount of net redistribution (i.e. they encourage fiscal churning).

In general, wasteful redistribution is discouraged if voters observe the taxes that they individually pay, and the targeted benefits that others receive. On the contrary, wasteful redistribution is encouraged if voters observe the targeted benefits that they individually receive, and the taxes that others pay. Unfortunately, opportunistic politicians have strong incentives to provide the wrong kind of transparency. To maximize consensus, they want to increase the visibility of the individual gifts they provide, and to hide the individual costs; to appear virtuous, they also want to show that they collect large amounts of aggregate tax revenues and do not spend a lot. Hence, we should expect to always have the wrong kind of fiscal transparency. This is important, because it has implications for what are the systematic distortions that need to be corrected.²

5. What systematic deviations from optimal taxation?

The theory of optimal taxation has strong implications for how the tax structure ought to be designed, and how tax rates on different tax bases ought to react to shocks to government spending. Are there systematic deviations from these optimal prescriptions, and if so can they be explained by systematic political distortions? Perhaps this is the single most important question in the political economics of tax policy.

Despite many contributions on politics and fiscal policy, this question has generally remained unaddressed in the literature. There is just one important exception: the time inconsistency problem. As is well known, lack of commitment imparts a systematic bias to tax policy. Whenever the elasticity of a tax base differs in the long run and in the short run, a benevolent government who cannot commit neglects the long run elasticity. This implies over taxation of the tax bases that are more elastic in the long run, like any capital stock. Unfortunately, despite its many interesting insights, this chapter does not fill this gap in the literature, nor does it discuss the practical relevance of the time inconsistency problem with regard to the UK tax structure.

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² There is evidence that voters often ignore how much they individually pay to support redistributive programs. For instance, Boeri and Tabellini (2007) show that individual employees in countries in Continental Europe generally ignore by large margins the contribution rate that they or their employer pays into the social security system.

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