



# The base for direct taxation

by

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Presentation and comments by

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- ◆ Tax base/tax rate: difficult distinction
  - ◆ 10 minutes presentation cannot do justice to such a rich paper.
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Meade report: objectives of a good tax system

- ◆ Beveridge system
- ◆ Progressive expenditure tax
- ◆ Progressive wealth (+ inheritance) tax.

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Here focus on labor versus capital  
*income tax*

- age varying tax
- deduction for saving

Normative viewpoint

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# Outline

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- ◆ Lessons from the optimal tax literature
- ◆ Broader issues
  - Social welfare criterion
  - Time frame
  - Information
- ◆ Conclusions

# Part one: Optimal taxation of capital and labor income

- ◆ Assumptions:
  - Single budget constraint
  - Real terms
  - Competitive behavior
  - Exogenous wages
  - Flexible labor supply
  - Capital and labor income observable
  - Different saving models
  - No wealth transfers
- ◆ Tax tools:
  - Non linear tax
  - (Un)desirable targeting (height versus age)

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# Five alternative settings

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## 1.1. 2 periods/1 labor supply:

- ◆ Atkinson/Stiglitz: no tax on saving
- ◆ Caveats:
  - Separability
  - Endogenous relative wages
  - Rates of return are not constant
  - Other characteristics (e.g. wealth, longevity)
  - Incomplete markets

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## 1.2. 2 periods, 2 labor supplies:

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- ◆ Age varying taxes
- ◆ Uncertainty about future earnings
- ◆ Implementation of mechanism design

## 1.3. 3 periods, 2 labor supplies:

- ◆ Special tax treatment for retirement saving
- ◆ Partial myopia
- ◆ Diversity: tax for some, subsidy for others

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## 1.4. OLG

- ◆ Dynamic efficiency
- ◆ Capital income taxation substitute for age – varying earnings taxation

## 1.5. Infinite horizon agents

- ◆ No taxation of capital income in the long run
- ◆ Restrictions: uncertainty, different discount rates, bequests

## 1.6. Behavioral models

- ◆ Fruitful but complex

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# Part two: Broader tax base issues

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## 2.1. Social welfare

- ◆ Problems with the standard approach: concave function of identical individual utilities
  - correlation between skill and other characteristics
  - benevolence of the government as a benchmark
  - political constraints (e.g. commitment)
- ◆ Preferences with altruism, procrastination, dual self that call for paternalism

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## 2.2. Fairness and inequality

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- ◆ Concern for income and not utility can lead to unattractive outcomes
- ◆ Possible conflict between welfare max and horizontal equity
- ◆ No monotonic relation between taxation and taxable capacity.
- ◆ Equal marginal sacrifice is the appropriate criterion

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## 2.3. Complexity and observability

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- ◆ Variable (wisely) neglected: hours worked, height
- ◆ Variable (wrongly) neglected: age
- ◆ Cost of observability

## 2.4. Time frame and commitment

- ◆ Chamley-Judd result: with full commitment heavy tax at the outset – no tax in the long run
- ◆ Annual tax may be more attractive

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## 2.5. Transition

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- Concern for stability and flexibility. Importance of a policy process incorporating awareness of future changes
- Grandfathering

## 2.6. Saving and uncertain earnings

- No saving because of myopia or prodigality
- Bequest motives and preference for wealth

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# Conclusions

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Don't rely too heavily on any single model

- Age varying taxes
- Capital income and earnings taxation: can be different
- Deduction for retirement saving (EET): too much?

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# Comments

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My comments focus on a number of points that are omitted from this chapter or that are too quickly dealt with though being important.

- ◆ Which observable characteristics are we taking into account?
  - Height versus age
  - Issue of tagging
  - Tagging might be efficient but politically or ethically questionable

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- ◆ What about the Roemerian distinction between responsibility and luck, that is associated with the issue of equal opportunity?
    - Welfarist versus non welfarist approach.
  - ◆ Taxation of couples. Joint or separate. Joint taxation can be optimal or not depending on whether the possibility of divorce is taken into account. Women being pushed out of the labor market is undesirable.

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- ◆ After 55, implicit taxation on prolonged activity has to be taken into account. Less important in the UK than in the Continent.
    - Lower marginal tax rates after 55.
  - ◆ With Rawls, an income based objective clearly leads to unacceptable conclusions.
  - ◆ Behavioral models
    - Foundation of "new paternalism"
    - Does it apply to governments?
  - ◆ Uncertain longevity
    - ➔ Utilitarian approach does not apply

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- ◆ Issue of indistinguishability: leisure-prone and disabled workers with the same formal utility.