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Tax reform and growth

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ESRC ECONOMIC & SOCIAL RESEARCH COUNCIL

Growth and welfare

What we really care about is ‘social welfare’, not national income:

1. Distribution of income matters as well as its aggregate level
2. Money isn’t all that matters

Three broad guidelines for increasing both output and welfare:

1. Minimize disincentives where they matter most
2. Avoid unnecessary distortions to commercial decisions
3. Simplify and reduce uncertainty where possible

Labour supply and personal taxes and benefits

➢ Can we increase labour supply without redistributing less?

- People respond more to incentives at certain stages of the life-cycle
  - Mothers of school-age children
  - People aged 55-70

- Strengthening incentives for these groups, and weakening them for others, could increase total employment without increasing inequality
  - Simulations suggest tens, or hundreds, of thousands more in work

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The 50% tax rate: what do (and will) we know?

Based on Brewer, Browne & Johnson, Chapter 9

- Revenue yield is very uncertain
  - Government forecast £2.7bn (vs. £6.5bn with no behavioural response)
- Chancellor has asked HMRC for an estimate in time for the Budget
  - Tax returns due tomorrow will tell us how much tax was paid in first year
  - But not how much would have been paid without the reform
  - And first year may not be representative
- Revenue effect is an insufficient basis for policy-making
  - How much do we value the welfare of the rich?
  - Less damaging ways to raise revenue from a similar group?

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Investment and business taxation

Two main reasons corporation tax discourages UK investment:

1. Stops marginal investments being worthwhile
2. Induces some investments to move (or stay) abroad
   - With perfectly mobile capital, in effect an inefficient way to tax labour

- Introducing an ‘Allowance for Corporate Equity’ (ACE) would solve (1)
  - While still collecting revenue from highly profitable activities
  - And would remove other distortions, e.g. bias towards debt
- Choice of statutory rate then depends on mobility of high-profit activities
  - ACE doesn’t have to be paid for within corporation tax

- Business rates are a huge disincentive to develop and use property
  - Replacing with a land value tax would remove this disincentive

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Environmental taxation

1. Congestion charging could reduce a major cost to the economy

- Government estimates potential welfare gains may be 1% of GDP
- Fuel duties and vehicle excise duty not well targeted at congestion
  - But far too high to justify by carbon emissions alone
- So national road pricing should replace much of fuel duty

2. A more consistent carbon price would minimize the cost of reducing emissions

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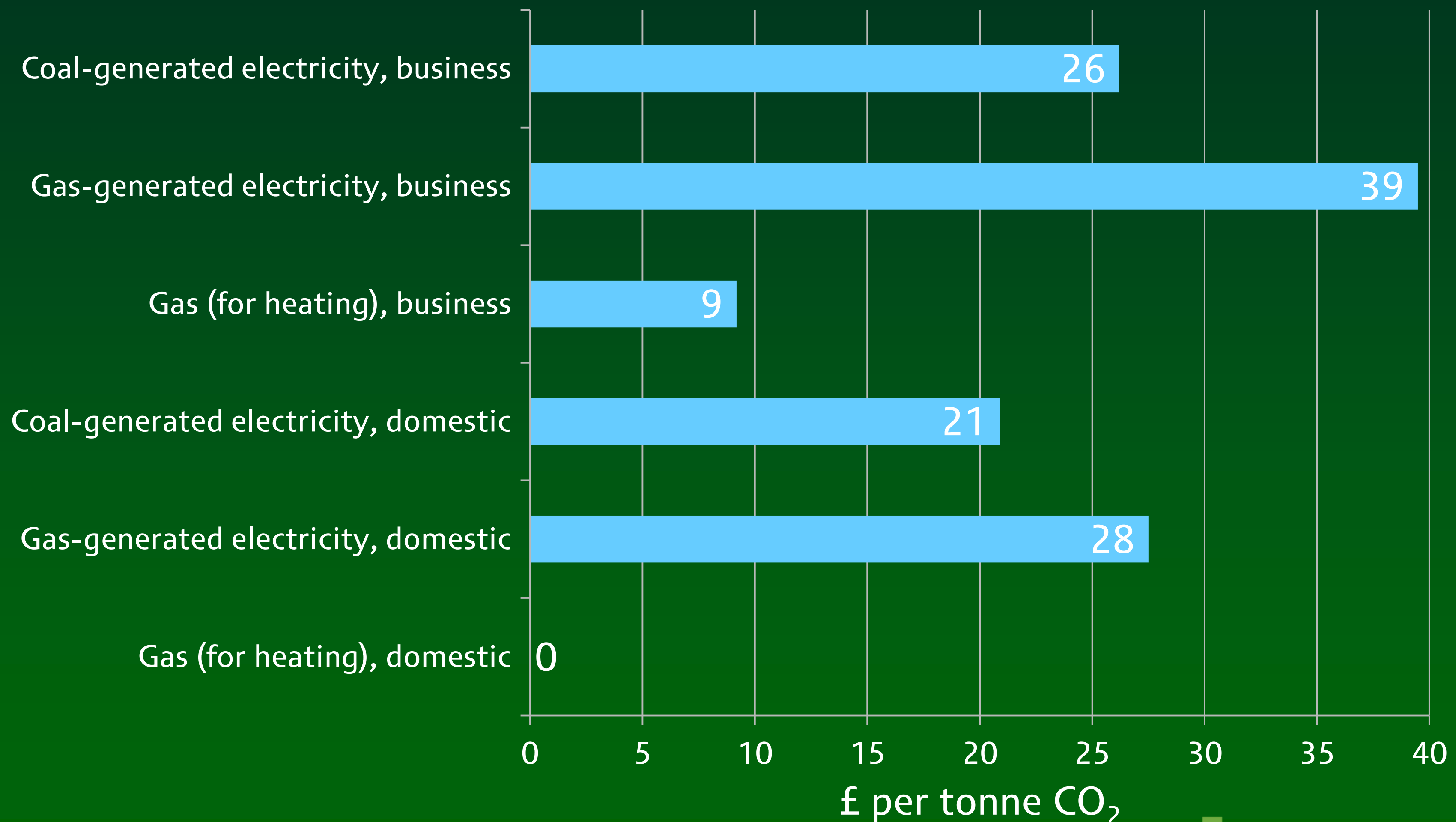
Implicit carbon taxes, 2011-12

Excluding VAT subsidy of domestic energy



Source: Figure 8.2

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Taxes and growth: the OECD's ranking

Property taxes

Supply (and demand) respond little to incentives

Consumption taxes

Personal income taxes

Consumption taxes DO discourage work but:

✓Are less progressive

✓Impose a windfall tax on existing wealth

✓Don't tax the 'normal' return to capital

Corporate income taxes

'An inefficient way to tax labour'?

Do profits respond more to incentives than other tax bases?

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Conclusions

- Short-term recovery is rightly the policy priority at the moment
- But it pays to think now about life beyond the crisis
- Tax reform can contribute to medium-term growth
  - Individual taxes could be made more efficient
  - A shift in the tax mix might also boost output
- But growth should not be the only criterion for assessing these