Tax reform and growth
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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
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?
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
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
Implicit carbon taxes, 2011-12
Excluding VAT subsidy of domestic energy

- Coal-generated electricity, business: £26 per tonne CO₂
- Gas-generated electricity, business: £39 per tonne CO₂
- Gas (for heating), business: £9 per tonne CO₂
- Coal-generated electricity, domestic: £21 per tonne CO₂
- Gas-generated electricity, domestic: £28 per tonne CO₂
- Gas (for heating), domestic: £0 per tonne CO₂

Source: Figure 8.2
Taxes and growth: the OECD’s ranking

Property taxes

Supply (and demand) respond little to incentives

Consumption 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

Personal income taxes

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