Main objectives of taxation

1. Raise revenue to finance public spending

2. Redistribute from the better-off to the needy

We make no judgement as to the appropriate extent of these
Characteristics of a good tax system

For a given revenue yield and distributional outcome, what matter are:

- **Economic efficiency**
  - Minimise effects on behaviour except to correct market failures

- **Operational efficiency**
  - Minimise admin and compliance costs

- **Transparency**

- **Fairness**
  - Due process, non-discrimination, respect legitimate expectations, etc.

- **proportionality**

- **efficiency**

- **convenience**

- **certainty**
Characteristics of a good tax system

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- **Fairness**
  - Due process, non-discrimination, respect legitimate expectations, etc.
Two rules of thumb

• Stability. Helps to avoid:
  – Change-related distortions (forestanding, off-putting uncertainty, etc)
  – Operational costs of transition
  – Having to learn about new system
  – Disappointing legitimate expectations
    ➢ But upheaval sometimes justified if existing system costly
    ➢ Don’t introduce ill-thought-through policies in the first place!

• Neutrality, i.e. treating similar activities similarly
  – Tends to be simpler, fairer and less distortionary
  – Not always – but should have a high hurdle to justify exceptions
Consider the system as a whole

• Effects of the system are the combined effects of all policies

• Pay attention to interactions between different parts
  – e.g. income tax and NI; personal and corporate taxation

• Not all taxes need to be green, or progressive
  – Choose the right tool(s) for each objective

• Avoid hypothecation (earmarking particular taxes for particular uses)
  – Either the amount raised determines the amount spent…
    ➢ *Inefficient: no reason spending exactly that amount should be optimal*
  – …or it doesn’t
    ➢ *In which case it’s meaningless at best, dishonest at worst*
Redistribution

- Overall system matters
  - Including benefits as well as taxes (and, in principle, public services)
- Consider a lifetime perspective
In cross-section, increasing out-of-work benefits is most progressive

Source: Levell, Roantree & Shaw (2015)
Over a lifetime, increasing in-work and out-of-work benefits equally progressive

Source: Levell, Roantree & Shaw (2015)
Explanation: the poorest individuals spend most of working-age life in work

Source: Levell, Roantree & Shaw (2015)
Redistribution

• Overall system matters
  – Including benefits as well as taxes (and, in principle, public services)

• Consider a lifetime perspective
  – Much low income is temporary
  – Particularly important for indirect taxes
  – If only have snapshot data, think about expenditure vs income

• But lifetime perspective isn’t the only relevant one either
  – Short-term hardship matters too
  – Existing population has only part of their lifetime left
  – Intergenerational issues increasingly prominent
Redistribution and work incentives

• Taxation discourages work
  – Includes means-testing and taxes on consumption and saving: “What can I get in return for working (more)?”
• There is an inevitable trade-off
  – Redistributing from rich to poor reduces incentive for poor to get richer
• Ultimately requires political value judgements
• But optimal tax theory has useful lessons on efficient redistribution
  – High marginal rates in earnings bands that few people in, but many above
  – Low PTRs for low earners if responses mainly employment, not earnings
  – Low tax rates when people most responsive: around retirement; mothers with school-age children
  – Can use proxies for earning potential, need or responsiveness that are harder to change than income – though some dangers with this approach
Tax base vs rate schedule

- Tax (and benefit) rate schedule is usually the most efficient way to trade off redistribution, work incentives and revenue
  - Directly control how net tax liabilities depend on total resources
  - Taxes based on spending and saving patterns generally poorly targeted
  - Some disincentives to work are inevitable, but distortions associated with the choice of tax base usually worse and avoidable

- Choose efficient tax base and leave it alone!
  - Don’t reform tax base on distributional or revenue-raising grounds
  - But do consider distributional consequences of tax base reforms

- Again, this is a rule of thumb rather than theoretical optimum
  - But real-world departures generally not in the direction of optimality!
Tax income less the costs of generating income

• Unfair and inefficient to favour:
  – income taken in some forms over others
  – low-cost-low-revenue activities over equally valuable high-cost-high-revenue activities

• Most major taxes broadly reflect this idea, albeit imperfectly
  – Income tax and NICs, corporation tax, capital gains tax, VAT

• But not all
  – VAT exemptions, stamp duties, business rates, insurance premium tax
  – Also some sensible exceptions, mostly environmental taxes

• Major difficulty distinguishing consumption from work expenses
  – Pervasive: mixed-use assets; childcare; education and training; travel;…
  – Same issue for VAT as for direct taxes
Taxing saving and investment

• Saving and investment are costs of generating future income
  – Put aside money today to generate (more) money in future

• Key to effective capital taxation is neutrality across:
  – Consumption today vs tomorrow
  – Different assets
  – Different forms of return
  – Different legal vehicles
  – Different sources of finance
  – Varying inflation rates

• It is possible to achieve all of these…
Taxation of saving and investment

• Saving and investment are costs of generating future income
• So give full deductions for amounts saved/invested…
• …then tax income (after these deductions) in full
• More than one way to give deductions
  – Upfront deduction (*pension contributions; Annual Investment Allowance*)
  – Stream of allowances with same present value: tax only returns above a ‘normal’ rate (*Rate of Return Allowance; Allowance for Corporate Equity*)
  – If no above-normal returns, just exempt returns (*ISAs; main home; NICs*)
• This would eliminate advantage of income shifting while avoiding disincentives to save and invest
  – Also avoids distorting asset choices, debt-equity bias, sensitivity to inflation, capital gains lock-in effect, etc.
Summary: a progressive, neutral system

• Consider the system as a whole
  – Use the right tools for the right objectives

• Achieve progressivity as efficiently as possible
  – Personal taxes and benefits are the best tools for redistribution
  – Target incentives where they matter most
  – Take a lifetime perspective, considering income and expenditure

• Neutrality as an important benchmark
  – Tends to be simpler, fairer and less distortionary
  – Not always – but should have a high hurdle to justify exceptions

• Develop a long-term strategy for the tax system
  – Avoid reforms that move in the wrong direction!

• We should “have a tax system which looks like someone designed it on purpose” former US Treasury Secretary William E. Simon