

## The Political Economy of Tax Policy

*James Alt, Ian Preston, and Luke Sibieta\**

James E. Alt is Frank G. Thomson Professor and Director of Graduate Studies in Government and a faculty associate of the Institute for Quantitative Social Science at Harvard University, where he was Founding Director of the Center for Basic Research in the Social Sciences. He is a member of the American Academy of Arts and Sciences and was a Guggenheim Fellow 1997–98. His research has been mainly in the fields of political economy, fiscal policy, and comparative politics. His PhD is from the University of Essex.

Ian Preston is Professor of Economics at UCL and a Research Fellow at the IFS. His recent publications in the field of public economics notably include ‘Electoral Bias and Policy Choice: Theory and Evidence’ (with Tim Besley) in the *Quarterly Journal of Economics*, and his research interests also include consumer demand and household welfare, the distribution of income, immigration and the labour market, and public economics. He has been a managing editor of *Fiscal Studies*.

Luke Sibieta joined the IFS as a Research Economist in 2005. His research focuses on education policy and income inequality. He has written about many aspects of these areas, including trends in the incomes of the very rich, progress towards the UK government’s poverty targets, school finance, and socio-economic differences in educational attainment. He also has a keen interest in using the tools of political economy to uncover the reasons behind changes in economic policy.

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## EXECUTIVE SUMMARY

This chapter reviews major changes in British tax-setting institutions in the past thirty years and highlights four key points about the politics of tax policy, which are summarized below. The chapter also makes policy recommendations, such as for improving scrutiny and parliamentary accountability; these are also summarized below.

**A 'passive' movement to the right**

The chapter analyses whether changes in voter preferences and strategic party positioning could explain declines in statutory rates of income tax. What we discover is that electoral support has moved to the right, though voters seem to have followed rather than led the changing content of party manifestos. Voters have always favoured redistribution, particularly from those with the highest incomes to those with the lowest incomes. Whilst preferences for redistribution have been declining over time, it is notable that the large cuts in statutory rates of income tax took place at a time when attitudes to redistribution were at their most favourable, and when a majority of voters voted for parties who did not favour these cuts. Whether this move to the right will persist and to what extent it is now a fact of political life is hard to say.

**Policy drift and persistence**

Our case study of the R&D tax credit provides a number of lessons, the primary one being that enacting tax policy can create interest groups and constituencies in favour of that policy. Even when they did not lobby for the policy in the first place, like the large firms in our study, they will lobby both for persistence and extensions that allow policy to drift from its original motivation. Therefore, any potential tax reformer should remember that any new allowances enacted or favourable tax treatments provided to particular groups could prove difficult to remove and may be distorted into something different over time.

While the example of the R&D tax credit vividly illustrates policy persistence as well as drift, the past thirty years has seen other areas of specific tax privilege phased out, most notably the married couples allowance and mortgage interest tax relief. The timing of these reforms suggest that it is helpful to phase out changes gradually and during a period when it can plausibly be claimed that other taxes are being cut or rationalized.

### Disconnected tax debates

The framing of tax policy debates can be crucial. Framing the VAT zero-rating of children's clothing in isolation has helped maintain it; framing the estate tax in isolation also helped those lobbying for its abolition in the US. Such framing could easily result from a lack of public understanding about the interconnectedness of the tax system.

However, in order to pursue sensible tax policy it is essential to see the tax system as a *system* rather than to consider its different elements in isolation. So disconnected tax debates may be particularly counter-productive for tax policy as compared with other areas of public policy. This has a lesson for the Mirrlees Review, which may need to combine tax reforms in different areas to provide a broad-based set of reform measures, making clear that there is give and take across different population groups.

### Transparency and accountability

There is a limit to how well-informed the electorate can be expected to be for the purpose of holding the government to account and ensuring good quality tax policy. However, institutional reforms which improve transparency and public understanding would help avoid situations where government can make increasing use of tax policy instruments that are either ill-understood by voters—as in the case of the relationship between National Insurance contributions, NHS spending, and state benefit spending—or those that are less visible or transparent to voters—such as VAT or fiscal drag.

Do other institutions play an accountability role where the electorate leaves off? Parliament plays some role, but lacks informational resources to play it well, and is hardly involved at all in the crucial pre-legislative stage. External organizations provide some level of scrutiny and accountability, helping to improve tax legislation and making it more likely that the economic impact of proposals is fully thought through.

### A proposal for greater scrutiny

A degree of parliamentary accountability through greater levels of pre-legislative scrutiny of tax policy would be highly desirable. Of course, a lack of effective parliamentary accountability extends to other areas of policy, beyond taxation, and is a general political concern. However, the degree of

pre-legislative parliamentary scrutiny is even weaker for tax policy, since in other areas policy proposals are regularly published in White Papers or Green Papers. Although there is pre-legislative scrutiny of draft tax proposals by tax professionals and other interested parties, Parliament is rarely involved in this process.

The best vehicle for pre-legislative scrutiny is the select committee system. We leave it as an open question as to whether scrutiny of tax policy is best undertaken by the existing Treasury Select Committee or by a new select committee on taxation. But it is clear to us that ensuring higher levels of pre-legislative scrutiny should be a priority for government.

Alongside this, in order to undertake effective pre-legislative scrutiny, MPs require more resources. At present, much advice and support comes through external organizations, and this could be extended. However, another possibility is a formal in-house service akin to the Congressional Budget Office in the US, which could be explicitly charged with providing analysis of tax policy for MPs.

More broadly, we believe that serious thought should be given to instituting a body to oversee the public finances. A group of experts with genuine knowledge of the operation of tax systems could be put in place to offer advice and to audit revenue and spending figures. This body could be accessible and accountable to Parliament as well as to the executive with appointments appropriately scrutinized. As well as scrutinizing government plans, the body could offer advice to all parties, particularly around election times. To provide meaningful scrutiny and advice, any such body would require access to more data than is currently provided to Parliament. As well as providing more data to this body, providing more data to the public could improve external scrutiny, for example, by publishing all assumptions behind fiscal forecasts.

### 13.1. INTRODUCTION

After an authoritative and exhaustive economic analysis of options for tax reform, the Meade Report concluded that:

We believe that the combination of a new Beveridge scheme (to set an acceptable floor to the standard of living of all citizens), of a progressive expenditure tax regime (to combine encouragement to enterprise with the taxation of high levels of personal consumption), and a system of progressive taxation on wealth with some discrimination against inherited wealth, presents a set of final objectives for the structure of direct taxation in the UK that might command a wide consensus of

political approval and which could be approached by a series of piecemeal tax changes over the coming decade.<sup>1</sup>

However, whilst some piecemeal changes such as changes to taxation of certain forms of saving did move the UK tax system towards these final objectives, there was no ‘new Beveridge system’ nor implementation of a wealth tax. In order that the Mirrlees Review would give greater consideration to which reforms ‘might command a wide consensus of political approval’, we were charged with writing a chapter that explicitly analysed the political economy of taxation.

Beyond considering what reforms might be politically feasible, we believe that the purpose of studying the political economy of taxation, ultimately, is that a good tax system has to be politically sustainable within the institutions of government, and political economy helps us understand political sustainability. Empirically, there are some policy outcomes that are hard to understand without political economy but less puzzling with it. Some British examples that will be discussed below include the passage and subsequent repeal of the poll tax, absence of VAT on children’s clothing, and the co-existence of National Insurance and personal income tax. However, we will look closely at two cases: why lowered top and basic rates of income tax have proved sustainable in an era of rising income inequality and why a tax credit for research and development aimed originally at small finance-constrained companies has grown so much.

When looking at examples like these, it is not new to say ‘it’s political’, but we are trying to do more than that. We want to be more systematic in studying politics, and to study it in ways that are consistent with the tools and methods of economics, in order to draw lessons. Looked at this way, our purpose might seem to be part of specifying the constraint set, but it is again more than this. In tax policy, distributional issues are central, so getting to sustainability is not going to be just an issue of getting good advice on efficiency from economists. Administration is also part of this, but sustainability is not just an issue of collectability. Tax policy should be credible, especially in a dynamic setting, so considering elections and information is critical. We analyse specific features of the political system that shape tax reforms to give insight into specific institutional remedies that can improve the quality of tax policy. In all these ways political economy makes us think more rigorously about constraints on policy, about what recommendations are feasible and sustainable.

Political economy research suggests three main conflicts of interest that tax policy resolves through institutional processes. The first is a *class-interest view*

<sup>1</sup> Meade (1978).

*of politics*: citizens have different views about taxation based on their position in the income distribution. In a world in which citizens have different views about how taxes should be levied, political systems affect whose interests are represented and how. The second is between *organized and unorganized interests*: organized interests typically have advantages in securing favourable policy outcomes in return for electoral contributions that can be used to persuade voters. One issue is whether electoral incentives are sufficient to limit any misappropriation of public money. The third conflict is that between *citizens and government*. Making economic activity taxable allows decision makers in governments to appropriate resources for their own objectives and to use them in ways that citizens may not like. Our case studies (below) emphasize these conflicts and issues.

This chapter will make much use of previous research on political economy, but will also consider attitudinal data from the British Social Attitudes (BSA) Survey and data on tax shares collated by the OECD. For the purposes of further understanding the political economy of taxation, we felt that it was important to gain insight from those at the heart of the process. Therefore, we conducted a series of interviews with individuals who have been intimately involved in the tax policy process over the past thirty years. These include former special advisors, senior civil servants, and individuals on the other side of the process in the business community. These interviews sometimes confirmed our own lines of enquiry, but also opened new ones. With their permission, we have included quotes from some of these individuals, since their own words often best described the features or problems of the process. In order to hide their identity, these individuals are referred to as Persons A–G. However, we owe a great debt of gratitude to *all* those whom we interviewed.

Section 13.2 will describe the process of how tax policy is made in the UK and how this has changed since the Meade Report was published. It will also compare the process with how tax policy is made in other countries, such as the USA and Germany, with different institutional frameworks. The main point to emphasize here will be the dominance of the executive over tax policy, particularly HM Treasury. Section 13.3 will discuss in turn interesting developments—from the point of view of political economy—in income tax, indirect taxation, corporate tax, and other forms of taxation in the UK, and beyond. It will also set the scene for more detailed analysis later on in the chapter.

With these observations in mind, we will move on towards using the theory of political economy to explain them. Section 13.4 will begin by seeing if the trends in income taxation can be explained through an examination of electoral interests and voter behaviour. This will encompass discussion

of empirical information on voters' opinions and behaviour, the classical Meltzer–Richard model—where the position of the median voter is seen as crucial—and more recent developments in the field. Section 13.5 will then move on to discuss the nature of interest-group politics in the UK through a case-study of the R&D tax credit.

Section 13.6 will examine the level of transparency and accountability in the UK tax policy process. Section 13.7 will conclude by summarizing the chapter, discussing the implications of our conclusions for potential tax reformers, and presenting our recommendations for how the tax policy process could be changed for the better.

## 13.2. THE UK TAX PROCESS

### 13.2.1. Description and comparison of institutional frameworks

Exactly *how* is tax policy made in the UK? What follows is a concise overview of this process and how it differs from the experience in other countries.

We begin by selectively illustrating the specific UK political institutions relevant to tax policy. The first-past-the-post electoral system used for the House of Commons usually allows single parties to govern with significant legislative majorities. Ministers responsible for tax policy (those at the Treasury) will be selected from the ranks of the governing party's MPs by the Prime Minister. This power of patronage is a major reason why these large legislative majorities also tend to be cohesive, with government bills almost always being passed by a subservient House of Commons. One should also note that the British tax system is exceptionally centralized by international standards: little actual discretionary power is located anywhere outside central government. In 2003, over 95% of UK tax revenues were raised by central government—amongst major OECD countries, only Ireland had a greater share of tax revenues accruing to central government.

The key point is that Britain has a narrow base from which policy initiatives can be made: the only body that can put forward tax policy proposals to Parliament is the Treasury.<sup>2</sup> This is a tremendous advantage to the government and empowers ministers to propose tax measures in the annual Finance Bill following the Budget—a major event in the parliamentary calendar. The unelected House of Lords has no power to block finance bills. Council tax

<sup>2</sup> Very occasionally a tax-related provision turns up in some other bill (e.g. partnership law) but it would have to be cleared with the Treasury (Person A interview).

rates are set locally, and the Scottish Parliament can change the basic rate of income tax in Scotland by up to 3p, but the power to alter the tax system remains overwhelmingly the prerogative of central government.

It is hard to over-play the dominance of the executive over tax policy, the Treasury in particular. This is because as well as enormous agenda-setting powers, the resources available to the Treasury are vast when compared with those of most MPs. The Treasury can draw on much policy and practical expertise, as well as analysis conducted by HM Revenue and Customs (HMRC). MPs have many fewer resources at their command throughout the year. When discussing the annual Finance Bill, they must generally rely on outside organizations for advice. Parliament thus finds it difficult to provide effective scrutiny of tax measures, and measures are nearly always enacted unchanged in the annual Finance Bill that follows the Budget. As Person A put it,

Debate on the Finance Bill is poorer because there is no expert support available to MPs. Typically an Opposition MP will be briefed by an accounting firm and will have a question to ask during the committee stage, the minister has been briefed by officials and gives an answer, but the individual MP is unable to evaluate the response and cannot pursue a sensible discussion. So debate is utterly meaningless.<sup>3</sup>

Such criticisms could be made of parliamentary scrutiny of other areas of policy, with executive dominance evident in many others areas of public policy. However, in contrast to other areas of policy, the House of Lords cannot amend the Finance Bill and therefore has limited powers of scrutiny. It is also the case that tax measures receive far less pre-legislative scrutiny than other areas of policy. This is because most departments first announce policy in White Papers, or produce consultation documents called Green Papers discussing policy options. White Papers and Green Papers tend to receive much scrutiny in and outside Parliament. The effectiveness of this scrutiny is another question, but tax policy doesn't even receive this level of pre-legislative scrutiny. However, it does have to be said that pre-legislative consultation of tax professionals is widespread and has become more so in recent years, which should surely help in the development of good tax policy.

The lack of effective parliamentary scrutiny could be a problem for many reasons. First, it may be a problem in its own right, since the House of Commons has a constitutional responsibility to provide effective scrutiny of tax measures, which it is clearly failing to do at present. Secondly,

<sup>3</sup> Person A interview. In fact, 'It has happened that the Minister picks the wrong answer off the list, but the MP doesn't know and is satisfied with the answer.'



effective scrutiny may prevent policy-makers from making policy mistakes, and improve the tax system.

What are the direct sources of ideas for tax policy reforms within the executive branch? The first source will be proposals from civil servants within the Treasury, crafted to meet particular ministerial objectives. These ministerial objectives could be quite narrow and particular, for example, Nigel Lawson's main aim was widely seen to be promoting tax neutrality. Or they could be more general and wide-ranging, such as Gordon Brown's stated agenda of organizing public finances 'to encourage work, savings, investment and fairness'.<sup>4</sup> How these goals are defined varies from minister to minister. They could be personal views or they could be crafted for manifestos to achieve maximum electoral support. Clearly external influences—such as think tanks, tax practitioners, and the media—could persuade politicians of suitable ministerial objectives for a tax system, but there is also room for external influences in generating tax policy ideas that meet given ministerial objectives.

A second source of tax policy proposals concerns measures to prevent tax avoidance. In administering the tax system, staff in HMRC are able to identify loopholes in the tax system that allow agents to avoid paying tax. They are then able to propose ways to close such loopholes, or other ways to protect revenues. There is also a clear opportunity here for other specialist tax practitioners to suggest ways to reduce tax avoidance.

A third source of tax policy is more political, that made directly by ministers and advisors. This could come from election manifesto promises implemented soon after election, like the windfall tax on privatized utilities in 1997, or the cutting of top marginal rates of income tax in 1979. It could also be tax policy made between elections directly by ministers and their advisors, with or against the advice of tax policy officials.

The way tax policy is made in the UK is very different to the situation in many other European countries, particularly those with systems of proportional representation and powerful veto players. For instance, in Italy where coalition governments are the norm, tax policy is made as a result of negotiations within coalitions, and third parties, such as trade unions, are often consulted much more than in the UK. A good recent example from Italy is the cut in income tax enacted by Silvio Berlusconi in 2004. Before this became possible, agreement was required between all members of the governing coalition, who sometimes had quite different priorities. For instance, the far-right National Alliance wanted more to be spent on the south

<sup>4</sup> Pre-Budget Report 1997.

of Italy, whilst the Christian Democrats were keen to protect the privileges of public sector workers.

The cuts in corporate and incomes tax undertaken by Gerhard Schroeder's government, starting in 2001, are an example from Germany which shows how important are veto players. Ganghof (2008) shows that despite an apparent preference for the introduction of a dual-income tax system over across the board cuts in corporate and income tax rates, the latter was instituted instead. The dual-income tax system was primarily a non-starter in Germany because the constitutional court had already let it be known that differential tax treatment of income and capital would most probably be ruled unconstitutional.

Steinmo (1996) has already identified the role of committees and legislative bargaining as being crucial to understanding how US tax policy has evolved over time. In comparison with the US, Michael Keen wrote:

To the outsider, the most obvious contrast is in the degree of consultation in the formation of tax policy. In the United States, major tax policy initiatives are developed, marketed, analyzed, and negotiated . . . In the United Kingdom, they are commonly announced.<sup>5</sup>

Put another way, in the UK the processes of analysis, negotiation, and marketing take place much more within the executive branch than in the legislature, or indeed in politicians' campaigns for election. The executive has extensive agenda power, and government proposals are rarely subject to significant amendment, let alone veto.<sup>6</sup> The centralization of revenues, lack of information and expertise in Parliament, rarity of coalition bargaining, and absence of any powers of initiative and referendum reinforces the familiar executive dominance of British politics.

It should be noted that such arrangements do have some benefits, particularly with regard to levels of government debt. By international standards (based on OECD and IMF data reviewed in Alt and Lassen (2006)) Britain has a relatively transparent budget process, which weakens political incentives to manipulate revenues (and spending) for purposes of electoral gain. At the same time, Britain only very infrequently has coalition governments, which have higher debt levels at least in bad economic times, due to the relative

<sup>5</sup> Keen (1999).

<sup>6</sup> A rare example of Parliament significantly affecting the course of tax legislation is the so-called Rooker–Wise Amendment, introduced in the 1977 Finance Bill Committee by two Labour backbenchers. This ensures that an Act of Parliament is required in order to increase income tax allowances by less than the increase in RPI, which means that the default option is that they be uprated in line with RPI. Note that this amendment was introduced at a time when the governing Labour Party did not have a majority.

inability of multiparty coalition governments to respond quickly to economic shocks (Roubini and Sachs (1989)). In part at least for these reasons, Britain has had a comparatively low level of debt for most of the period since Meade.

### 13.2.2. Changes in executive process since Meade

This section will discuss changes in the executive process since the Meade Report was published, together with a short introduction to the fiscal rules that were introduced ten years ago.

The classical view of how executive goals evolve into policy sees civil servants producing tax policy recommendations that seek to achieve these policy goals; the more visible a politician's policy goals are to civil servants, the better they can respond. The classical view prevailed into the 1990s, but the last decade saw significant changes: a comprehensive reorganization of policy development in the Treasury, a major increase in the importance of political special advisors, and the adoption of some fiscal rules.

First and foremost, the organization of policy planning in HM Treasury (HMT) and HMRC has changed dramatically. Previously, according to Person B, in HM Treasury during the early 1990s,

There was one 'team' for fiscal policy with three branches: taxes, indirect taxes, and budget coordination, with at most 2–3 people per branch. It was a big challenge to get anything done. Revenue and Customs produced material that was very technically phrased, but HMT was deeply dependent on the others for input.<sup>7</sup>

Now, by contrast, following the O'Donnell Review (O'Donnell, 2004) which proposed the merger of the Inland Revenue and Customs and Excise to create HMRC, the heart of policy development is in HMT, and new ideas could even come from policy teams there.

Policy teams reflect ideas from outside. The organization of teams is formally structured. There are three subdirectorates and 19 teams: 2 for strategy, 1 for budget delivery, but the other 16 are policy teams, organized either by tax (for example, corporate) or labour market or sector (property tax). The idea is to have any policy proposal contained within a team but real policy is too wide, so there is typically Department for Work and Pensions (DWP) involvement and also across other directorates.

The consequences are not all benign according to Person A:

the reallocation weakened the link between HMT and assessment of what happened in the field. Now the process has a clear divide with policy in HMT, but real-world

<sup>7</sup> Person B interview.

experience is at HMRC and they don't communicate as well as if they were all in one organization. It also affects career structures: now, if you are interested in tax policy, you go to HMT. If you start there the chance you will understand what happens in the field or on the ground is low. Policy becomes divorced from an understanding of how it is affecting behaviour in the field.<sup>8</sup>

These organizational changes have thus increased the power of the Treasury over tax policy, which were already quite substantial, at the expense of HMRC. But it does have another very important consequence. Sometimes the teams are deliberately used in a competitive environment, to get different people giving different views. For instance, as the R&D tax credit was shepherded through the institutional process, the input from multiple departments:

gives ministers broader choice. It works well if the three have equal power. Revenue controls costings; Productivity team ... had the eyes and ears of Special Advisers and Ministers because innovation was valued; Tax Policy sat in the middle with the scorecard trying to balance; each had its own focus. No-one has to tell HMT to get lined up with Enterprise [productivity] and Policy [tax] because you need them to fight for you.<sup>9</sup>

Second, partly as a consequence of the first set of changes, the process is now far more 'political' than before, at the special adviser and ministerial level. Special advisers were a feature of the political process even at the time of the Meade Report, however, they have become more important over time, especially during the past ten years. As Person C described the process during Brown's Chancellorship:

you had enfranchisement of political advisors far deeper than would have been the case before ... Special advisors were the real motive forces. Some are brought in because they have specialist knowledge of a topic, acting as a key expert witness within HMT. In HMT they were far more part of the day-to-day work, and, while they couldn't instruct anyone in the Civil Service, given that they talked to ministers all the time, they were often considered to be the mouthpiece of the minister. One always wanted to talk to the Special Advisor to figure out where the minister was coming from<sup>10</sup> and you might have four meetings with a Special Adviser, then one with the Chancellor. The result was that you would get much clearer policy direction much earlier.

<sup>8</sup> Person A interview.

<sup>9</sup> Person C interview.

<sup>10</sup> Person C interview. This point applies equally to representatives of outside interests and to those within HMT crafting policy proposals.

This change has created a systematic demand for information that can only be provided by outside organizations. For example, in the case of the R&D Tax Credit that we examine below,

HMT at the time was trying to build more direct contact with business. Previously, all contact had been via the Inland Revenue and the Department for Trade and Industry (DTI) . . . and Treasury wanted to have direct company input in order to resist its intentions being constantly trumped by ‘this won’t work’ statements from the others who had such direct contact. Furthermore, the Inland Revenue suffered from a negative external reputation as the tax collector and HMT had the advantage that it was seen by business as a policy group, not just the people who take your money.

Finally, the direct access to company ideas meant that the ideas were delivered ‘unwashed’ to special advisors, rather than being ‘normalized’ through the Budget process. This led to a large initial set of vibrant ideas, with special advisers being involved in the weeding out process.<sup>11</sup>

The period we review, and specifically Brown’s Chancellorship, may have been the peak of special advisers’ importance in tax policy-making. According to Person E:

Nearly a year after the move of Gordon Brown from the Treasury it is clear that special advisers are no longer the absolutely key element in the policy making process that they were between 1997 and 2007.

Nevertheless, tax policy is more ‘political’ than it used to be, with a greater role for special advisers than at the time of the Meade Report. Partly as a result of this, there has also been a fusion of tax policy goals with other political goals. The fusion of legislative input with the desire for social engineering is usually used to explain why the US tax code is so much more complicated than the UK code:

The British example shows that the American tax code could be much simpler if Americans were willing to reduce the extent to which [they] tried to administer social policy through the tax code (Gale (1999)).

However, as already stated, this difference may be eroding:

Mr. Brown’s penchant for fine-tuning taxes has doubled the size of the tax code to 8,300 pages . . . the second-longest in the world’s 20 top economies, after India. (*Wall Street Journal*, 3/21/07, p. 1)<sup>12</sup>

Increased fusion of tax policy with other political goals, Treasury assuming responsibility for tax policy input, and the increased politicization of the

<sup>11</sup> Person C interview.

<sup>12</sup> Citing a report by the World Bank and PriceWaterhouseCoopers.

whole tax policy process mark significant recent, though by no means certainly permanent, changes in the British tax policy process.

Finally, another important institutional innovation in the past thirty years is the introduction of the fiscal rules. The Labour government chose to impose two fiscal rules in 1998. The first was known as the ‘golden rule’ which demanded that the current budget be balanced over an economic cycle. The second rule was known as the ‘sustainable investment’ or ‘net debt’ rule. This said that net debt should remain at ‘a stable and prudent level’, which the government chose to define as below 40% of GDP. These rules were instituted in order that there be transparent public finance goals to which the government could be held to account, thereby ensuring responsible management of the public finances. We do not discuss the fiscal rules in much more detail since they relate more to the difference between levels of public spending and taxation, rather than levels of taxation.

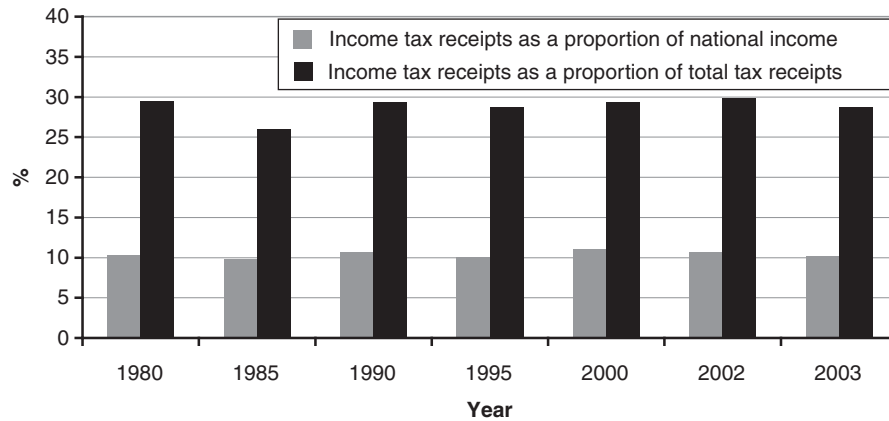
### 13.3. TAX POLICY IN PRACTICE

This section describes how tax systems have been reformed over the past thirty years in five broad areas—income, social security contributions, indirect, corporate, and property taxes. It will concentrate on drawing out which political forces and ideas have driven the process, with a particular focus on the UK, though also contrasting and comparing the cross-country experience.

#### 13.3.1. Income tax

One of the main headline changes of the last thirty years has been the fall in statutory marginal tax rates, with the top rate falling by the most. In the UK, following their election victory in 1979, the Conservatives cut the top rate on earned income from 83% to 60%, and the basic rate from 33% to 30%. Over the 1980s, these continued to be cut, with the top rate falling to 40% in 1988.

The Labour Party opposed these cuts throughout the 1980s, stating in its 1987 general election manifesto that, ‘We will reverse the extra tax cuts which the richest 5 per cent have received from the Tory government and allocate that money instead to the most needy.’ However, by 1997 the Labour Party under Tony Blair had changed its tune, with its general election manifesto stating that, ‘There will be no increase in the basic or top rates of income tax.’



Source: OECD Revenue Statistics.

Figure 13.1. Income tax receipts as a proportion of GDP and total tax receipts

Drawing out the political reasons behind why statutory rates fell during the 1980s will be a key question for this chapter, as will why there has been a convergence on the status quo amongst the main political parties in recent years. We will attempt to answer these questions in Section 13.4 through an examination of voter preferences and models of political economy.

In contrast to the decline in statutory rates, it seems clear from Figure 13.1 that the overall burden of income tax—as measured by income tax receipts as a proportion of national income—has changed little over the past thirty years. This is because whilst statutory rates have been cut, thresholds and allowances have tended to rise in line with inflation, whilst earnings have risen more quickly, leading the number of higher rate tax-payers to grow from 674,000 in 1979–80 to 3.3 million in 2006–07—this process is known as ‘bracket creep’ or ‘fiscal drag’. Moreover, certain major tax expenditures, such as mortgage interest tax relief, have been withdrawn, leading to a broadening of the income tax base. It is worth noting that ‘fiscal drag’ does not just affect income tax, it affects all taxes where the tax base grows faster than allowances and thresholds used for that tax. In fact, the Treasury estimates that ‘fiscal drag’ on all taxes contributes an additional 0.2% of national income to tax revenues every year.<sup>13</sup>

Looking at this from a political economy standpoint, it is odd how important the statutory rate has been in political debate relative to thresholds, given their joint importance in determining the tax burden. Income tax ‘cuts’

<sup>13</sup> Paragraph A24 of HM Treasury, *End of Year Fiscal Report*, December 2003 <[http://www.hm-treasury.gov.uk/media/324/70/end\\_of\\_year\\_352%5B1%5D.pdf](http://www.hm-treasury.gov.uk/media/324/70/end_of_year_352%5B1%5D.pdf)>.

appeared to be quite popular in the 1980s and how much you pay in income tax is quite observable and transparent. Yet the overall burden of income tax has hardly budged. This observation also raises the question of fiscal illusion—the idea that voters systematically underestimate the amount they are paying in tax. We will discuss how well informed the public are about the tax system in Section 13.6, together with a discussion of overall levels of transparency and accountability.

### 13.3.2. National Insurance contributions

The other major tax that is levied on earned income in the UK is National Insurance contributions (NICs). Over time the main NIC rates have risen for both employees and employers, rising from 6.5% in 1979–80 to 11% in 2006–07 for employee contributions (10% to 12.8% for employer contributions).

It is not clear that NICs should be treated as conceptually different from income tax, and whether a comparison with other countries' social security contributions is a valid one. This is because there is only a weak connection between contributions made and entitlement in the UK, compared with a much stronger one in other countries, particularly those in continental Europe. Moreover, in contrast to other countries where social security contributions are often earmarked for specific areas of public expenditure—a process known as hypothecation—NICs are not hypothecated in any meaningful sense. These two points suggest only minimal differences between paying income tax and NICs, something further underlined by a gradual alignment of their respective schedules.

Despite this, the fact that NICs and marginal rates of income tax have followed different trends over the past thirty years suggests that raising NICs is more politically acceptable than is raising income tax. Section 13.6 will discuss this issue further in the context of models of political economy where voters are imperfectly informed.

### 13.3.3. Indirect taxation

When VAT replaced purchase tax in 1973, it was not particularly controversial though it was considered complex and some believed it to be a source of price inflation. However, its structure has been a source of controversy, for instance, such controversy forced Labour to derogate from the EEC 6th VAT Directive in 1977 to maintain a zero rate for children's clothing.



Since 1979, the main rate was increased twice by the Conservatives: in 1979, from a two-tier system of 8% and 12.5% to a single higher rate of 15%, to help pay for lower statutory rates of income tax; and then again in 1991, from 15% to 17.5%, to help pay for reductions in the poll tax. Partly as a result of these changes, the proportion of GDP taken up by indirect tax receipts rose from 8.3% in 1979 to reach 11.2% by 2005. This overall change in the burden of indirect taxes does not tell us much about the change in its composition. There has in fact been a shift away from specific taxes on goods and excise duties towards the broadly based and uniform VAT. (More specific details can be found in Chapter 1 (Adam, Browne, and Heady).)

As already stated, the structure of VAT has been a more pertinent political issue than the main rate. All parties have attached a high salience to the zero-rating of children's clothing, food, and other items. Demonstrating this is the fact that the Labour Party has included a pledge in all of its recent general election manifestos: pledges along the lines of 'We renew our pledge not to extend VAT to food, children's clothes, books and newspapers and public transport fares' (taken from the 1997 Labour manifesto).

Similarly, the Labour Party made much political capital from the Conservatives' imposition of VAT on domestic energy at 8% in 1994, and from their role in preventing the Conservatives increasing this to 17.5% in 1995, as was the original intention. Labour then symbolically cut the rate to 5% in the summer budget of 1997, the first budget after the new Labour government had been elected. The taxation of petrol was, however, to prove even more costly for Labour. In response to high levels of tax on petrol, protests in September 2001 almost brought the country to a standstill and caused Labour to lose its lead in the polls for the first time since it was elected in 1997.

In our analysis of the role of interest groups in Section 13.5, we discuss how and why certain elements of indirect taxes have proved to be so politically controversial. Our discussion will emphasize the role that analysing individual taxes on their own rather than as part of the tax system has played in making these issues so controversial and reform so difficult. We will also extend this discussion to the present debate on council tax.

Coming back to this issue of why steady rises in the overall rate of VAT have proven to be politically sustainable, perhaps this is because it helped to pay for things voters valued more, such as lower rates of income tax or a lower poll tax. However, it is impossible to discuss VAT without reference to the increasing role played by the EU in this area. In fact we see that many current

members of the EU have increased or introduced VAT over the past twenty-five years. This list includes founder members such as France, Germany, Italy, but also includes newer members such as Spain, Greece, and most of the former communist countries of Central and Eastern Europe. From Chapter 1 by Adam, Browne, and Heady, we also know that it is EU countries who raise relatively high proportions of revenue from indirect taxation. This is particularly the case when comparing major EU countries, such as Germany and France, with other major OECD economies, such as Japan and the USA.

In stark contrast to the largely uncontroversial raising of VAT in the EU, Canada, Australia, and Japan have all introduced a Goods and Services Tax (GST) or consumption tax over the past thirty years amid a wave of political controversy. One reason for the relatively controversial introduction of indirect taxes in Canada, Australia, and Japan could be the administrative differences between the operation of their indirect taxes and VAT in the EU.<sup>14</sup> More important though may be the increasing role of the EU in VAT policy, which has largely been to aid the creation of the Single Market. The 6th VAT Directive of the EU, introduced in 1977 (amended in various years and complemented by other directives since then), states that all EU countries must have a VAT rate above 15%, which goods can be granted reduced-rate status and that new exemptions for goods and services must be agreed to by the EU. This means that voters in current or aspirant members of the EU have to weigh the benefits of membership of the EU and the single market against any reservations about being forced to increase/introduce VAT. The intertwining of the issue of VAT with the issue of EU membership may thus largely defuse the introduction/extension of VAT as a potential political concern in a large number of European countries.

#### 13.3.4. Corporation tax

Almost all major OECD countries show a very similar pattern in the timing and nature of reforms to their corporate taxation systems. One phrase can sum it up: 'Gradual cuts in the statutory rate of corporation tax, combined with base-broadening measures.' This has occurred across almost all

<sup>14</sup> Note that there has never even been a serious political attempt to implement a VAT in the US, where 90% of the states have retail sales taxes, a majority dating from the Depression. Exemptions and allowances vary widely across states. Increases in sales taxes are controversial, often occurring in response to fiscal crises, when it is often expedient to label them as temporary. For instance, Rhode Island's current 7% sales tax rate was raised 'temporarily' from 1 to 6% in the 1970s, and again 'temporarily' from 6 to 7% in the early 1990s to bail out the state's failed credit unions.

countries, no matter the political persuasion of governing parties nor the institutional setting. Moreover, there is little evidence to suggest that corporation tax has been a major issue in elections in any of these countries. Corporate tax receipts as a proportion of GDP have remained fairly constant in all major OECD countries. Base-broadening measures have largely offset the effect of falling statutory rates (see the chapters on taxing corporate income by Auerbach, Devereux, and Simpson, Chapter 9, and international capital taxation by Griffith, Hines, and Sørensen, Chapter 10, for more details).

The structure of corporation tax is complicated the world over. Cross-country comparisons are best illustrated in the separate chapters focusing on corporate tax and on international issues. However, in order to examine the role of interest groups in the development of corporate tax policy, we have chosen to conduct a detailed case-study of the development of the R&D tax credit in the UK (Section 13.5). Therefore, it is important to note the following facts.

First and foremost, the fact that Britain now has an R&D tax credit is not particularly surprising. Many governments offer R&D tax incentives to firms in research-intensive industries as part of a strategy to promote domestic innovation and competitiveness. As of 2006, R&D tax incentives are available in 18 of the 30 OECD countries, up from 12 countries in 1996.<sup>15</sup> These R&D incentives usually take the form of a tax relief, with the amount provided being determined by the extent of R&D activity undertaken.

Britain established a relatively generous credit by international standards. Billings and Paschke (2003)<sup>16</sup> confirm that the US provides one of the lowest incentives in the world for R&D. However, in a series of interviews, senior managers at leading pharmaceutical firms confirmed that from an investment perspective, the US continues to be the most attractive location; when asked to name potential future challenges to US leadership, not a single interviewee mentioned tax incentives as a significant consideration (Xu (2007)). Sedgley (2006) presents data that disputes any simple correlation between a country's share of OECD R&D spending and the generosity of its tax incentives (France and Germany, for instance, have less generous R&D tax incentives but higher shares of R&D than the UK). On the other hand, Berger (1993), Hall (1993), and Bloom, Griffith, and Van Reenen (2002) all present evidence that such credits can lead to increases in R&D.

It is also notable that international bodies have become increasingly important in the development of corporate tax policy, including the OECD and the

<sup>15</sup> Sedgley (2006), p. 42.

<sup>16</sup> Calculation methods are published in a paper in *Tax Notes International* in 2003.

EU. We note this fact, but leave it to Chapters 9 and 10 (Auerbach, Devereux, and Simpson; Griffith, Hines, and Sørensen) to discuss it in more detail.

### 13.3.5. Property and local taxation

The years since Meade saw one major attempt at innovation in property taxation. As already highlighted, less than 5% of total tax revenue is raised locally. Over recent history, practically all of this has been through various kinds of property taxes. As a result, it is thus quite difficult to separate out issues relating to property taxes and the degree of centralization in tax setting powers.

Up to and including the 1980s, local authorities funded part of their spending through a system called domestic rates. Every property had a 'rateable value', which was then multiplied by a tax rate called the 'rate poundage' set by each local authority to calculate the amount of domestic rates payable by residential households. There were rate rebates for poorer households. A similar scheme of rates also existed for business properties. The rest of local authority spending was funded through grants from central government, which were adjusted in order to equalize tax raising powers across local authorities.

By the late 1980s, 'rateable values' had not been adjusted since 1973 and thus were out of line with current patterns of property values. Domestic rates were also unpopular as some low-income households faced high rates bills, but had fairly modest incomes, for example, single pensioners. The unpopularity of rates can also be seen in the numerous instances of 'rate capping' during the 1980s, whereby the government prevented councils raising rates by more than a given amount.

The government also argued that this system was detrimental to local political accountability as

All too often this accountability is blurred by the complexities of the national grant system and by the fact that differences arise among those who vote for, those who pay for and those who receive local government services.

In place of domestic rates, the government proposed to introduce a flat-rate charge for each adult in a household (with a few exemptions and rebates).<sup>17</sup> This charge was officially known as the community charge, but became known as the 'poll tax'. The intent of these proposals was to create

<sup>17</sup> Regarding non-domestic rates, they proposed equalizing rates on business properties across the country combined with a centralization of revenue collection. It also proposed replacing the scheme that equalized resources to correct for an uneven distribution of rateable values with a need-based assessment of spending requirements.

a system whereby each extra pound of local spending had to be funded through the poll tax rather than central government grants, with a view to increasing local political accountability by linking local government spending and local election voting. As well as improving political accountability, it was also argued that the community charge would be more equitable, since it would ensure that everyone contributed something to the provision of local services.

These proposals were included in the Conservative Party's general election manifesto in 1987. However, the Labour Party remained largely silent on the poll tax during the campaign in order to avoid reminding voters of the perceived profligacy of so-called 'loony Left' councils. Despite the opposition of the Chancellor at the time, Nigel Lawson, and an attempt by the Conservative MP Michael Mates to make the poll tax dependent on banded household income, the proposals were enacted and came into effect on 1 April 1990 (they came into effect one year earlier in Scotland). However, the poll tax proved to be very unpopular: there were riots in central London and many individuals were sent to court for refusing to pay the 'unfair' poll tax. The unpopularity of the poll tax is widely seen as a major contributory factor of the downfall of Margaret Thatcher that would follow later that year.

Why it was controversial is not that hard to explain. Most people felt its level and structure were deeply unfair, with many people being worse off by relatively large amounts. Many voters in social and economic groups C1 and C2 expected to be worst hit by the new poll tax (according to a poll conducted by NOP for the *Local Government Chronicle*). Moreover, the riots in Trafalgar Square were attended not just by the 'usual suspects', but also by these middle-income voters who expected to lose relatively large amounts from the poll tax. Therefore it is not surprising that many Conservative MPs felt their seats threatened. This fear almost certainly motivated many of them to vote for Michael Heseltine (who promised to get rid of the poll tax) against Margaret Thatcher in a leadership election in November 1990, resulting in her downfall.

What is surprising is how such a policy was even contemplated, let alone proposed and implemented. According to Butler, Adonis, and Travers (1994), it was a natural result of the set-up of British political institutions and nothing has changed to prevent such a blunder from happening again. According to them, apart from the already mentioned circumstance that Labour was unable to oppose the poll tax proposals effectively during the 1987 general election, the electoral system still guarantees safe legislative majorities,

especially when the Opposition seems incapable of forming a government. Governing parties are still able to come up with policies without consulting outside the party or cabinet. Frequent cabinet shuffles still prevent most ministers from looking at policies from a considered long-term point of view. Governing parties are still largely able to force legislation through the Commons, even if their own backbenchers oppose it, through the promise of patronage. Finally, the House of Lords is still heavily restricted in its ability to scrutinize tax policy changes.

The experience of the poll tax thus provides very useful lessons for potential tax reformers. The UK institutional set-up permits a huge freedom of action for policymakers, with little effective scrutiny of tax policy after it has been announced. This may seem to be a blessing for a policymaker keen on reforming the tax system in a particular direction. However, insulation from effective scrutiny may allow them to implement deeply unpopular policies, resulting in severe punishment from a disgruntled public. For example, a brief legislative defeat over the poll tax might have been preferable to the rioting in Trafalgar Square. We will discuss measures that could improve effective scrutiny in Section 13.6 and in our final section on policy recommendations for the institutional process.

The poll tax was gradually unwound from 1991 onwards, with an increase in VAT in Budget 1991 paying for a reduction in average poll tax levels. The poll tax was then replaced with the council tax in 1993, which is not that dissimilar from the old domestic rates system though there are some important differences: council tax is calculated according to banded property values and there is relief for single occupants. Council taxes were originally set at a lower level than domestic rates, and now provide barely one-sixth of local authority expenditure. The net result of the poll tax experiment and changes to non-domestic rates has been a greater centralization of tax revenues. There is just as much uncertainty as to how increases in local taxation translate into greater local spending and, consequently, just as little local political accountability over local spending levels.

The council tax seems to be just as unpopular as domestic rates. For instance, when a YouGov poll for the Taxpayer's Alliance in August 2007 asked respondents which out of a set of potential tax reforms they favoured, the most popular was lower levels of council tax. Why council tax might be so unpopular will be discussed in relation to interest-group theory in Section 13.5, and with relation to voters' understanding of the tax system in Section 13.6 where we will also explore measures that could improve central and local political accountability.

#### 13.4. INCOME TAXATION AND ELECTORAL INTERESTS: A CASE STUDY

Although personal taxes as a share of national income have remained at about the same level, a main headline change of the period since Meade has been the fall in statutory marginal tax rates in Britain (and elsewhere). This has happened over a period of rising and increasingly unequal pre-tax incomes in Britain. Nevertheless this increase in pre-tax income inequality has not been met by an increasingly progressive income tax structure. (See Adam, Browne, and Heady, Chapter 1). This is potentially puzzling to both political economists and optimum tax theorists: under fairly straightforward assumptions, in a system in which taxes and transfers are either chosen by a majority of rational self-interested voters or set by a benevolent social welfare maximizer, an increase in pre-tax income inequality would usually be offset by changes in taxation. The fact that this did not happen—and has frequently been observed not to happen in other contexts—suggests that we should look closely at the information, beliefs, and attitudes of voters. For example, did top rates come down and stay down because people changed their minds about the desirability of redistribution? We also need to consider how closely the politics of tax policy choice approximate majority voting. Political economists take note of wide institutional variation in how elections are conducted: majoritarian versus proportional representation is an aspect of this, along with the nature of parliamentary authority, accountability of the executive, whether politicians are term-limited, and whether there is scope for direct democracy.

Lowered top and basic income tax rates in Britain have proved politically sustainable for some time. In this section, we discuss this within the context of a fairly generalized model of political economy, relating changes in top and basic income tax rates to evidence and theory on voters, electoral interests and political parties. It is a case study: we discuss issues of theory and modelling at a fairly general level and tie this back to the policy and institutional issues in the UK. We stress the significance of voter loyalties to polarized parties, how the parties' manifesto pledges in turn affect voters' choices, and how voters connect the desirability of redistribution to their confidence in the government as their agent for public provision.

For this purpose we draw on the best source of consistent and reliable data on the evolution of attitudes in the UK, which is the British Social Attitudes survey. Since 1984 this has provided evidence on social attitudes of nationally representative samples of British residents and

questions asked include several pertinent to the level and structure of taxation.

### 13.4.1. What taxes do voters want?

#### *The standard model*

Analysis of determination of tax rates under democracy begins with analysis of voter preferences. The standard model here proceeds from the same fundamentals as the optimum income tax literature. Voters like private consumption—and possibly also publicly provided goods—but not work. Taxation (interpreted broadly) determines individuals' private budget constraints linking the two and individual hours' choices then link tax schedules to realized utility at differing wage rates. The issue for political economy, as in the optimum income tax literature, is to study determination of the tax function from within some feasible set, restricted to satisfy the public sector budget constraint and possibly other administrative requirements.

Consider individual preferences over tax schedules. Self-interested individuals prefer tax schedules which maximize their own utility subject to the government budget constraint. Let us suppose for the moment (as in Romer (1975), Roberts (1977), and Meltzer and Richard (1981) for example) that the tax functions under comparison are linear and there are no publicly provided goods. We can think of there being two effects to positive tax rates. First, income is redistributed from the better off to the worse off and secondly, hours' choices are distorted and resources wasted in collection, creating a deadweight loss. The latter effect benefits no one but the former is to the advantage of those below mean pre-tax income<sup>18</sup> at the expense of those above it. Individuals whose wages are such that incomes would fall above the mean in the absence of taxes therefore favour zero taxes whereas those with lower wages are prepared to trade off the efficiency costs against the redistributive gains and therefore favour positive rates. Meltzer and Richard (1981) argue that desired tax rates will increase as one moves down the wage distribution. Eventually one reaches wage levels at which individuals would choose not to work at their desired tax rate and for all such individuals the best tax rate is simply that which maximizes the revenue available to fund

<sup>18</sup> Since the tax is linear and there is no other form of public spending, the government budget constraint requires the individual with mean pre-tax income to pay zero tax.



their government-provided post-tax income, a tax rate nonetheless less than 100% because of the incentive effects of taxation.<sup>19</sup>

With a linear tax schedule and a government budget constraint there is only one degree of freedom in tax setting and individuals are restricted to comparing taxes simply along the single dimension of the marginal tax rate. With more flexibility in feasible tax schedules the scope for individuals to design tax schedules which benefit them while placing the burden on others is increased. In particular, if we were to allow for, say, systems with two marginal rates then those on lower wages would be able to choose systems which have lower rates of tax on their own incomes but which make up revenue through higher rates on those on higher wages.

Some of the starker predictions of this sort of theorizing about individual preferences over tax setting—for example, no support for taxation at all from those above mean income—arise from a particularly crude assumption of self-interestedness. Even without our assuming altruism, the rich may believe that high levels of inequality would cause problems of crime and social unrest which would make their lives uncomfortable. If we allow for the possibility of altruistic concern as a complementary motivation then support for redistribution from better-off individuals becomes even less surprising. If we suppose, say, that individuals choose tax rates which maximize some weighted average of their own and other's utilities then a desire for positive tax rates will be present even at high incomes. The extent of altruism may differ between societies—and it has been argued, for example by Alesina, Glaeser, and Sacerdote (2001), that it is promoted by factors such as social and racial homogeneity—in which case the steepness with which desired tax rates decline with income should be greater in societies less disposed to altruism. Georgiadis and Manning (2007) point out that uncertainty about future income may have implications somewhat similar to altruism in inducing concern about tax rates at other points in the distribution. We return to discussion of the insurance role of taxation below.

### *Beliefs and attitudes on the distribution of income*

The foregoing analysis suggests that support for taxation and redistribution should be related to position in the income distribution. For evidence

<sup>19</sup> These observations essentially all apply in the simplified model used by Bolton and Roland (1997) and subsequently by McCarty, Poole, and Rosenthal (2006) in which voters are interested solely in post-tax income, the redistributive gain is linear and there is a deadweight loss which is quadratic in the tax rate. The latter effect is therefore small relative to the former for small tax rates but becomes increasingly important for larger tax rates.

on this we turn to the BSA which has contained information on household income and on attitudes to redistribution throughout its duration. Information on income is banded and bands change with time but we can construct a measure of income position which is reasonably comparable across years by calculating for each respondent the number of other respondents placing themselves in lower income bands in the same year.<sup>20</sup>

One might worry, before using this measure, as to the extent to which individuals perceive their position in the distribution accurately. The BSA in 2004 asked respondents specifically what proportion of the population they believed to be less well off than themselves (Sefton (2005)) and it is interesting to compare this to actual position. Figure 13.2 shows that perception is strongly positively related to true position<sup>21</sup> though there is some evidence that those at the top underestimate how well off they are and those at the bottom underestimate how badly off they are<sup>22</sup> (in line with the observations of Taylor-Gooby, Hastie, and Bromley (2003) and Evans and Kelley (2004)) with the result that the perceived income distribution is a good deal flatter than the true distribution. We have checked using the 2004 data to see whether relating other survey responses to actual income position gives a misleading impression of relation to perceived position and there seems little evidence that this is an important issue.

BSA has asked a number of questions about support for income redistribution as an objective of government and we base analysis on the most consistent and longstanding of these.<sup>23</sup> Figure 13.3 shows how support for redistribution has evolved over time and also how it varies across the income

<sup>20</sup> As a measure of household living standard this is only rough since there are obvious arguments for adjusting for needs as reflected in household size and composition. Our measure of position is based crudely on gross household income without any such adjustment. It is questionable whether such an adjustment is needed in the current context anyway since it is position in the distribution of tax payments that matters and not position in the distribution of living standards. Since survey responses rates are known to vary with income we are careful to use weighting factors appropriately. Respondents in the same income band are assumed, for simplicity, to be half at higher incomes and half at lower.

<sup>21</sup> The figure shows a non-parametric regression of perceived position on the truth. Imprecision in measurement of true position means we should not expect a 45 degree line even if individuals knew the truth, but the deviation is sufficiently large to think there may well be considerable misperception.

<sup>22</sup> Hall and Preston (2000) present evidence from an earlier year's BSA showing that perception of hypothetical income-related tax payments is also reasonably accurate.

<sup>23</sup> Respondents are asked to place themselves on a scale from strong agreement to strong disagreement with the statement that 'government should redistribute from the better-off to those that are less well-off'. We create a binary variable whereby those 'agreeing' or 'strongly agreeing' are counted as approving redistribution.

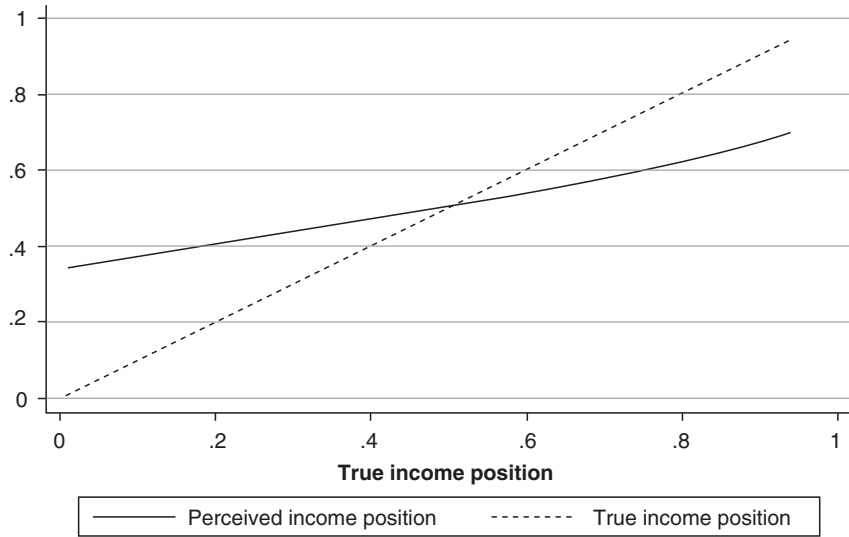


Figure 13.2. Income distribution: Perception and reality (BSA, 2004)

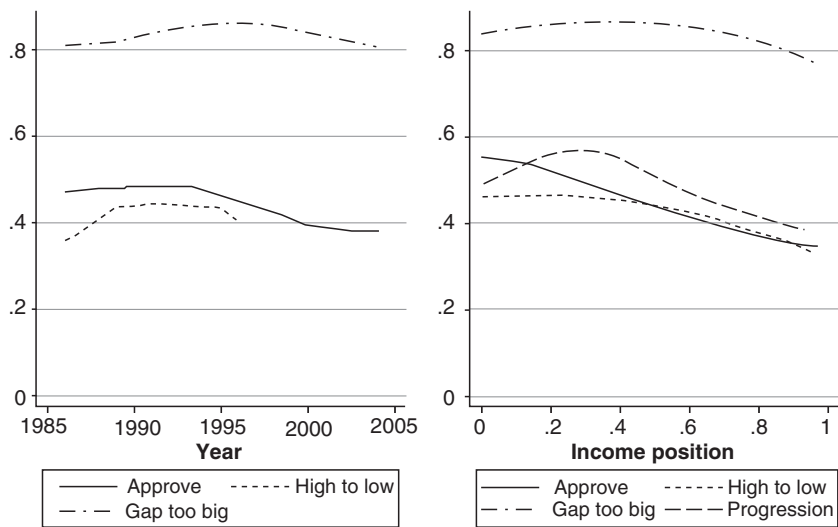


Figure 13.3. Support for redistribution (BSA, 1986–2004)

distribution.<sup>24</sup> The line in question is the unbroken line labelled 'Approve'. Approval close to 50% through the late 1980s and early 1990s drops somewhat in the mid-1990s but remains at over a third.<sup>25</sup> Georgiadis and Manning (2007) link this data to similar questions in British Election Surveys from ten years earlier, suggesting that support for redistribution was then considerably higher so that the decline is long term. They suggest that the decline over time can be linked to 'changing views about the workings of the economy, both in terms of the importance of incentives and the justness of the pre-tax distribution of resources' (p. 32), though cautioning that directions of causation between different attitudes are highly problematic to identify. Hills (2002) and Svallfors (1997) argue that declining support for redistribution may be a case of attitudes following policy making.

Sefton (2005) and Orton and Rowlingson (2007) point out that the proportion of the population expressing themselves as in support of government redistribution is consistently considerably smaller than the proportion who declare themselves in the same survey to view the gap between incomes of rich and poor as too large (labelled 'Gap too big'), which remains over 75% throughout the period. Plainly many individuals think either that governments should reduce the gap by other means (such as education policy or wage controls, say) or that ameliorating the gap is not the business of government.

The relationship to income is very clearly declining as one would expect, though it is notable that, even at the top end of the distribution, agreement with redistribution as an appropriate activity for government is, on average over the period, as high as a third of the population. Georgiadis and Manning (2007) point to correlations of attitudes with several other household characteristics—men, those in the middle years of life, those unmarried, and those without children and ethnic minorities, for example, are all more favourable than others to redistribution.

### *Beliefs and attitudes on taxation*

Questions on the structure of taxation have not been asked in a consistent fashion over the entire period. An interesting set of questions, enquiring

<sup>24</sup> In this, as in similar figures below, the relationships are smoothed by taking running means. The relationship with year shows the evolution of the unconditional mean, whereas the relationship with income is taken after subtraction of year effects.

<sup>25</sup> By comparison the percentage disapproving of redistribution is typically between a quarter and a third over the period covered (though it exceeds the percentage approving for the first time in the final year).

**Table 13.1.** Opinions on taxes by self-assessed income group

Self-assessed income	No of respondents	Taxes on					
		High incomes		Medium incomes		Low incomes	
		Too high	Too low	Too high	Too low	Too high	Too low
High	460	36.8	19.1	37.8	5.5	71.0	1.5
Medium	8,472	17.5	44.6	33.9	4.0	78.2	2.2
Low	8,003	14.6	52.9	29.5	8.1	82.9	2.6

**Table 13.2.** Opinions on redistribution by self-assessed income group

Self-assessed income	No of respondents	Redistribute from		
		High to low	High to medium	Medium to low
High	460	16.1	3.0	4.2
Medium	8,472	37.8	9.0	2.8
Low	8,003	47.6	8.9	6.6

whether tax rates<sup>26</sup> on high, medium, and low incomes were too high, about right or too low, were asked in several years up to the mid-1990s. Individuals were also asked at the same time to assess their own income relative to these categories allowing us to draw inferences about how individuals saw their own tax rates. As Table 13.1 shows, not many individuals saw themselves as having a ‘high’ income but those that did were much less likely to see taxes on high incomes as too low—a rather popular view in the rest of the population. Those seeing their own incomes either as ‘medium’ or as ‘low’ were least likely also to see taxes on their own income group as too low, albeit that neither of these views was well supported in general.

Table 13.2 reports on the results of combining answers to different questions to draw inferences about attitudes to redistribution through taxes. If someone declares both that they believe taxes on high incomes are too low and that taxes on low incomes are too high it seems reasonable to think that they would support, at least to some extent, redistribution from high to low incomes<sup>27</sup>—we call this attitude ‘High to Low’. Such individuals are more and

<sup>26</sup> The question is not specific as to whether it concerns average or marginal rates.

<sup>27</sup> The reverse opinion is too rare to be worth investigating. Although an appreciable number of individuals regard taxes as too high at the top end, these same individuals seldom regard low incomes as taxed too little.

more common the lower one looks in the self-assessed distribution. (Redistribution from high to medium incomes and from medium to low incomes also turn out to be most popular with recipients and least popular with those being taxed.) Figure 13.3 shows also that this alternatively defined measure of support for redistribution (labelled 'High to Low') varies negatively with actual position in the income distribution—in particular, that it declines sharply at high incomes. Tracking over time, we see that this view gained support in the mid-1980s—probably not coincidentally as marginal tax rates on high incomes were cut—but then showed hints of a decline (similar to that for the other measure considered earlier) in the mid-1990s at which point the question ceased to be asked.

Finally, a question asked only once, in 2004, offered respondents the alternative of funding a hypothetical increase in government spending by a flat additional tax payment, a proportional increase in taxes, or a progressive increase. Sefton (2005) reports that about half the population agreed with progression as an appropriate structure. The final line on Figure 13.3 shows that support for progression as indicated in responses to this question tended also to decline with income.

Altogether the clear income gradient in answers to these questions suggests that at least some of the preference for redistribution is linked, consciously or not, to self interest though the support for redistribution evident even in the richest groups of the population surveyed shows this is less than the whole of the picture.

Redistribution of pre-tax incomes earned with certainty is only one view of the purpose of progressive taxation and state welfare. Another view sees the goal of redistributive policy as providing insurance against uncertainty in incomes or in employment rather than or in addition to redistribution. Introducing such uncertainty raises new issues, for example as to how income risk and risk attitudes vary with income. Moene and Wallerstein (2001, 2003) show that self-interested support for state-provided insurance might in principle rise with income under reasonable assumptions about risk aversion. On the other hand, unemployment risk might be felt to decline with income, giving the well-off less reason to support welfare state redistribution. Indeed, Cusack et al. (2006) find that the demand for redistribution is related to exposure to labour market risk. Fong (2001) emphasizes the importance of beliefs about effort, luck, and opportunity of the less well advantaged in determining support for redistribution. Extending the Meltzer–Richard framework to a model in which taxed wage earners receive publicly provided goods but also face risks of temporarily joining a class of permanently unemployed in receipt of state benefits, Moene and Wallerstein (2001) demonstrate that how

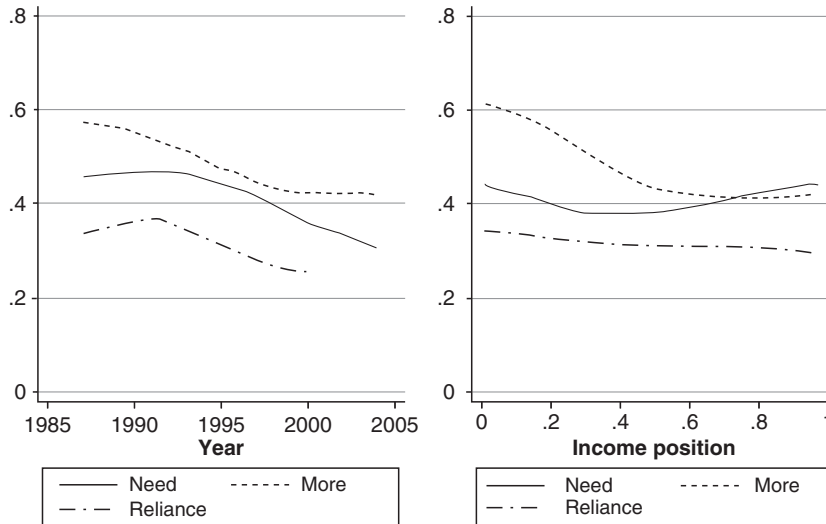


Figure 13.4. Support for social insurance (BSA, 1986–2004)

support for taxation varies with income depends upon assumptions made about the pattern of state spending.

Figure 13.4 presents a little more detail on attitudes within the BSA to welfare payments to the poor. While the evidence above suggests support for that aspect of redistribution which involves taking from the relatively rich, that need not mean comparable popularity for the distribution of funds through welfare spending to the relatively poor. The dashed line labelled ‘More’ shows support for increased payments to the poor.<sup>28</sup> This has fallen over time and is markedly lower among those with above average incomes. The other two lines are concerned with beliefs about the deservingness of the poor—that labelled ‘Need’ regards beliefs that the poor genuinely need the help given<sup>29</sup> and that labelled ‘Reliance’ regards the belief that self-reliance is not undermined by welfare state payments.<sup>30</sup> Again these views have become more negative over time though there is little evidence of any clear relationship to income within periods.<sup>31</sup>

<sup>28</sup> Specifically the question asks for agreement or disagreement with the opinion that ‘the government should spend more money in welfare benefits for the poor, even if it leads to higher taxes’.

<sup>29</sup> Specifically the question asks for agreement or disagreement with the opinion that ‘many people who get social security don’t really deserve any help’.

<sup>30</sup> Specifically the question asks for agreement or disagreement with the opinion that ‘the welfare state nowadays makes people less willing to look after themselves’.

<sup>31</sup> There are other questions in BSA relating social security to lack of self-reliance. Georgiadis and Manning (2007) draw attention to the association between these beliefs and support for

If we introduce expenditure on public provision of goods as another potential outlay of public funds then the demand for the goods provided becomes an issue in how voter attitudes differ. If taxes are raised proportionally to income and publicly provided goods are income elastic then this may be a reason for better-off voters to demand higher *levels* of taxes, for example. If there are different types of expenditure then not only will the composition of public spending be a source of political contention but expectations about how that contention is resolved will affect support for taxes and the way in which this varies with household characteristics.<sup>32</sup>

One question asked in almost every year of the BSA concerns whether or not the respondent would support an increase in the level of taxes and spending on health, education, and social benefits. For these particular items of spending, responses to this question provide the best long-term evidence on preferences regarding the size of the public sector and associated level of taxation. Figure 13.5 plots the proportion of respondents expressing themselves to be in favour of such a change over the period from 1986 to 2004. Those favouring an increase consistently exceed half of respondents and are at their highest, exceeding 60%, over the 1990s. There is little cross-sectional association with income, which may well be a consequence of the question grouping together goods of rather different income elasticities.

Given the apparent strength of support for increases in public spending over this period it is worth asking why politicians showed such reluctance to be seen favouring the associated increases in taxation. If the public doubts the likelihood of funds raised being spent as desired then this will obviously dampen support for tax increases. Hypothecation of tax revenues may be seen as a potential solution to the agency problem involved here but the essential fungibility of public funds makes credibility problems with any attempted promise to direct particular resources to particular uses inescapable. Even in a purely redistributive setting, there is the possibility that 'a fraction of total tax revenue that passes through the government's hands on the way from one set of citizen's to another is "lost" . . . either through incompetence or venality' (Georgiadis and Manning (2007)). In the terms used earlier, such losses

redistribution and the apparently increasing strength of opinion that social security encourages dependence as evidence that declining support for redistribution is driven partly by changing views on incentive effects of the tax and welfare system. Unfortunately, BSA has little evidence regarding views on the incentive effects on high earners.

<sup>32</sup> Several papers, surveyed for example in Rubinfeld (1987), have sought to estimate demands for locally publicly provided goods using variation across localities in levels of provision and tax prices. Hall and Preston (2000) report on a largely unsuccessful attempt to separate tax price effects from income-dependent variation in demand for national public goods by randomization of tax instruments in questions in the BSA.



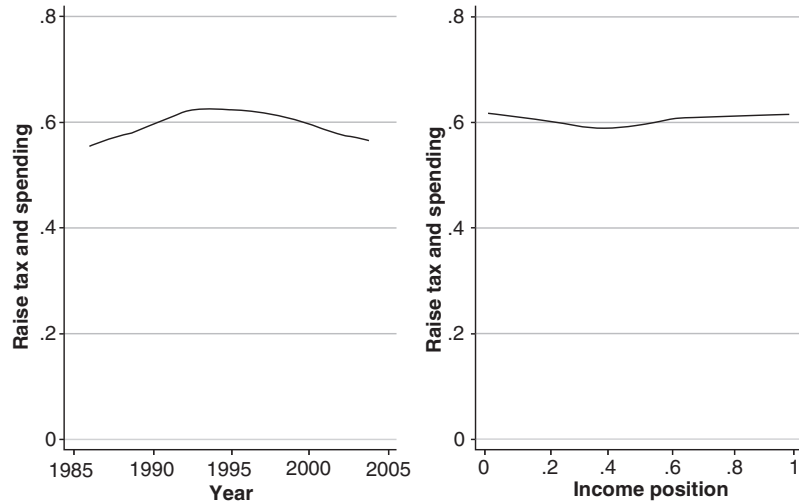


Figure 13.5. Support for public spending (BSA, 1986–2004)

would be viewed as another aspect of deadweight costs and declining trust in government competence or integrity interpreted as a perceived increase in those costs.

Unfortunately BSA asks no question addressing directly the issue of how effective the government is believed to be in directing public funds to desired uses but there are questions on trust. Specifically, for example, there is a question on whether the respondent trusts the party in government to put the interests of the country before those of the party.<sup>33</sup> Figure 13.6 shows a sharp and continuing decline in such trust, particularly over the 1980s and early 1990s. If this is reflective of a general erosion of confidence in government to use public money to deliver the public services demanded by voters then it may help explain why raising the headline rate of income tax is so politically difficult.

#### *So what taxes do voters want?*

Generally speaking, individuals favour redistribution, particularly that from 'high' to 'low' incomes. They also favour increases in public spending, and

<sup>33</sup> Specifically the question asks 'how much do you trust British governments of any party to place the needs of the nation above the interests of their political party'. We count someone as usually trusting government if they answer 'just about always' or 'most of the time' rather than 'only some of the time' or 'almost never'.

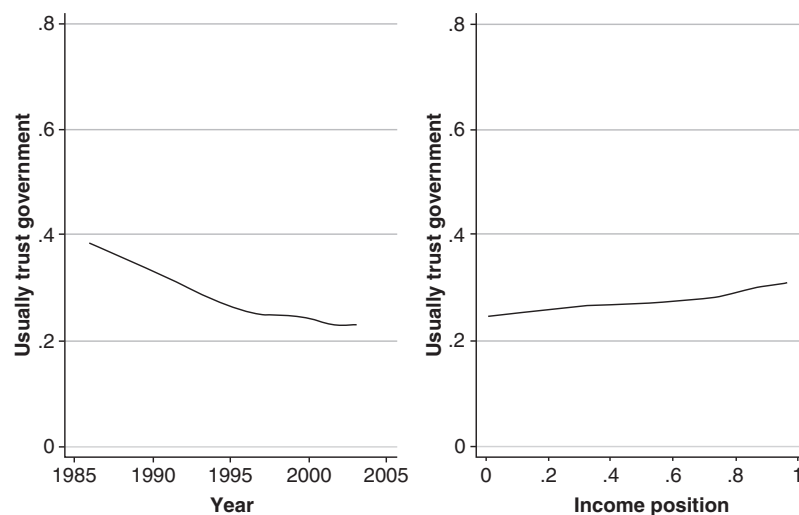


Figure 13.6. Trust in government (BSA, 1986–2004)

would like it to be funded on a progressive basis. It is also clear that preferences for redistribution decrease with income, as one might expect. However, it is also clear that preferences for redistribution have declined over the past twenty to thirty years.

We have already posited that declining levels of trust might explain why politicians have been reluctant to promise higher levels of public spending through increased levels of taxation, despite apparent public preference for such a policy. But we must ask other questions, such as why there were cuts in statutory marginal rates of income tax during the 1980s, a time when attitudes towards redistribution were at their most favourable. We attempt to answer this question through an examination of what we might expect politics to deliver, given different models of political economy. This involves consideration of the electoral system, party preferences, and the inherent multi-dimensionality of politics.

#### 13.4.2. What taxes does politics deliver?

The foregoing analysis on individual preferences could serve as precursor to a standard treatment of the optimum income tax literature. Dependence of individual utilities on tax schedules is precisely the information needed for a hypothetical benevolent dictator to choose the tax schedule maximizing social welfare conceived as an appropriate aggregate of those individual utilities. In a general setting observations follow about the optimum structure

of taxes and if we restrict ourselves to linear taxes we can compare optimum tax rates under different assumptions about the economy. Tuomala (1990), for instance, makes many comparisons of this type. Typically it seems true to say that optimum tax rates rise with the inequality of wages (as the case for redistributive correction becomes more pressing) and that optimum tax rates fall with responsiveness of labour supply to wages (as efficiency costs of redistribution become more acute).

The political economy literature seeks to investigate how tax rates arise from the political process. Since tax setting in democracies should be responsive to individual preferences it is not surprising that qualitative conclusions, at least of the simplest models, nonetheless have much in common with those regarding optimum tax setting.

### *Median voter models*

The canonical model of political representation that has dominated political economy for fifty years is the case of two parties competing by announcing election strategies that they will carry out if they win office. The most stylized version of this model has no role for post-election politics with announcements being carried out after the election and parties whose sole motivation is to win. This approach was applied most influentially to the political economy of tax policy in Meltzer and Richard (1981), building on earlier work by Foley (1967), Romer (1975), and Roberts (1977).

The approach focuses on the rate of income tax as a single dimension of conflict between citizens who differ in their pre-tax incomes, as outlined above, the proceeds of taxation being spent on goods and services or income transfers which accrue uniformly to the citizens. As long as preferences are appropriately 'single-peaked', then competition between two parties, each of which cares only about winning, will result in the tax rate being chosen to suit the voter with median income. One simplistic interpretation of this is that we should expect the middle classes to have most political weight in determining tax policy outcomes.

The level of taxation, and thus the amount of redistribution, chosen by the median voter is determined by two things: (i) the distance between the median and mean income, and (ii) the extent to which increases in income taxation reduce pre-tax labour earnings through distortion of labour supply. To the extent that the difference between median and mean income can be regarded as indicative of the degree of inequality—as it is, for example, for a lognormal distribution—then these determinants are strikingly similar, at least qualitatively, to those that would determine optimum tax rates.

Another key implication of the theory which bears emphasizing is that both parties who compete to offer tax packages will offer the same policy. This is characteristic of the Downsian class of models in which this is based. There are periods in the UK in which such policy convergence seems plausible and there are clearly some important issues of tax policy where this is the case. For example, Labour in 1997 was committed to maintaining the 40% top rate of tax introduced by the Conservative Party in 1988. Likewise the Conservative Party in 2007 indicated a commitment to maintain Labour's spending plans (even before knowing what they were). But as a general proposition, there are sufficient differences in policy between parties—even in two-party systems—to make this a questionable intellectual foundation for studying political economy issues. We will discuss this further below.

This approach is hard to take to the data directly. First, the kind of tax system that it describes does not correspond very well to what we see in reality. Second, measuring the extent to which pre-tax income distributions are right skewed across countries on a consistent basis over time is also difficult. Most empirical work has tended to look across countries where it is difficult to believe that factors determining income distribution are not correlated with those affecting political choice over tax rates so that causation from the former to the latter is extraordinarily difficult to isolate. Moreover, the basic institutional structure which is needed to yield the median voter prediction—two vote seeking parties in a majoritarian system—seems implausible for many countries.

In any case the popularity of the model was never matched by the success of its empirical prediction that more pre-tax inequality should go hand in hand with more income-targeted redistribution (Perotti (1996)), even if there are historical instances where such a description might fit. Consequently, a significant literature extends the basic framework in a number of directions. For example Snyder and Kramer (1988) investigated voting on a progressive income tax in the presence of an untaxed alternative economy, but found difficulties in showing the existence of equilibrium. Voting behaviour in a Meltzer–Richard model also changes in the presence of social divisions including religion (Scheve and Stasavage (2006)), moral values (Roemer (1998)), Benabou and Tirole (2006)), race (Alesina and Glaeser (2004)), and the quality of jobs (Austen-Smith and Wallerstein (2006)).

Extending the median voter model to contexts in which tax and public spending choice acquire multiple dimensions requires heavy and unreasonable restrictions on voter preferences, on the nature of choice or on the political process. Moene and Wallerstein (2001) consider choice over both tax

rates and targeting of benefits, demonstrating that equilibria may be found if one assumes issue-by-issue voting, for example, or party competition of a particularly restrictive kind. Bergstrom and Goodman (1973) discuss issues in public spending choice. However, existence of equilibrium is, in general, a challenging issue.

Hettich and Winer (1988, 1999) adopt a 'probabilistic voting' model to study tax policy. Here governments seek to maximize 'expected support' where the probability of any voter supporting them depends upon the difference between the value of benefits received and the costliness of taxes paid. More broadly we can interpret weight given to different voters' interest as reflecting 'relative political influence' (1988, p. 702), an idea underlying the treatment also in Georgiadis and Manning (2007). Models of this sort are notable for their explanation of income tax system complexity, with multiple brackets targeting particular constituencies being a prominent feature. While the ability to handle multidimensional issues in tax setting can be seen as an advantage, the extent to which this is achieved in this strand of literature by 'bypassing questions concerning the existence and stability of political equilibrium and the explicit derivation of government objective functions in a game-theoretic context' (Hettich and Winer (1988), p. 702) means important questions are left unresolved.

#### *Party preferences and swing voters: passively moving rightwards*

A weakness of the models considered so far is their treatment of parties as disinterested vote chasers. Iversen and Soskice (2006) show how recognizing parties as run by actors with specific interests can change conclusions. They present a model in which parties are tied to class interests, describing a world in which there are three classes but majoritarian political competition restricts the number of parties to two (according to Duverger's law). Median voters located in the middle class are forced to choose between parties representing coalitions of middle and lower class interests or middle and upper class interests. They vote for the latter because, uncertain about the class leanings of party leaders, they are more scared of lower class than upper class domination. The asymmetry arises because the middle class can ally with the lower class to defend itself against upper class expropriation but would stand alone defenceless against expropriation by the poor. There is an inherent tendency in their view for majoritarian systems, such as that of the UK, to deliver the median voter with less redistribution than they would prefer and less than would be delivered under alternative systems based on proportional representation.

Recognition that parties can represent particular interests, in some respects unconnected to issues of taxation, also opens up new perspectives on electoral competition over taxes. We can suppose that voters differ in their loyalties to the parties: some are more likely than others always to support the same party, while others can be persuaded by appropriately targeted policies. One useful way to think of this in a UK context is to maintain the idea that political competition is broadly organized between three main parties. These parties have core supporters who will be loyal to the parties under most circumstances. However, there are also groups of 'swing voters' who will vote for whichever party has a better policy stance on issues that it views to be salient. Some subset of these swing voters may view some kind of tax policy as being a salient issue. A party that has a large advantage over the other parties for non-tax reasons will find it less necessary to make tax promises that are designed to appeal to politically decisive voters. Such policies will be more important when there is a larger politically decisive group that is not loyal to one party.

Then there is the electoral system: we should also factor in that swing voters belong to Parliamentary constituencies. Some are safe in the sense that the outcome is determined by loyal voters while others are marginal in the sense of being potentially winnable by either main party. To win a majority in the House of Commons, electoral strategy will involve trying to appeal to swing voters in marginal seats. These will be the decisive voters in the sense that Meltzer and Richard cast the median voter as decisive, but the decisive voter will have to choose between alternatives proposed by the competing parties. These alternatives may or may not converge.

So are swing voters distinctive? BSA also collects data on party identification allowing us to separate out attitudes among those uncommitted to particular parties, who constitute about half of respondents, a proportion which has grown slightly over the period observed.<sup>34</sup> Figure 13.7 picks out attitudes on two of the dimensions discussed above. Generally speaking, trends in attitudes over time among both swing voters and party identifiers tend to move in very similar directions with attitudes of swing voters on most questions lying between Labour and Conservative identifiers in predictable ways. Attitudes to redistribution typify this, with swing voters less inclined to approve redistribution than either Labour or Liberal Democrat supporters but more so than the Conservatives and showing a time path of mean opinion very similar to that already seen for the overall population. Of all aspects

<sup>34</sup> Clearly, it would be interesting to analyse the opinions of uncommitted voters in marginal constituencies.

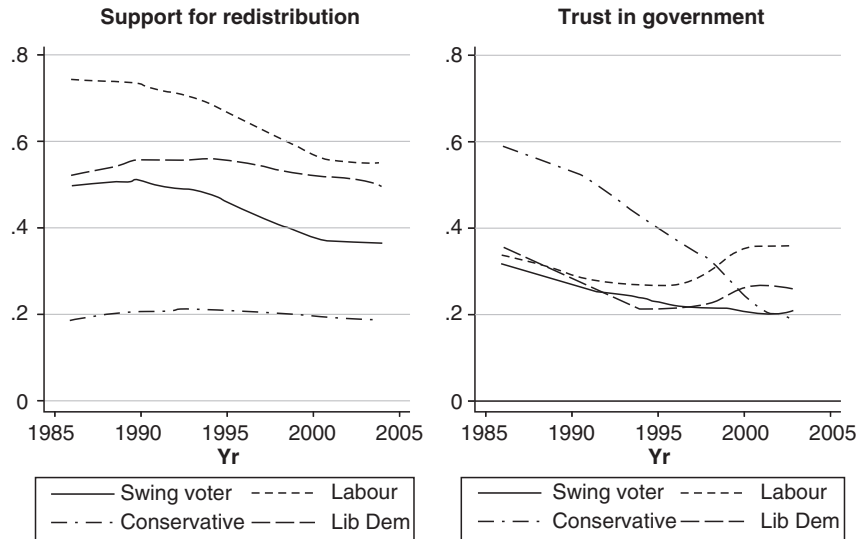


Figure 13.7. Opinions by party support (BSA, 1986–2004)

to attitudes considered above, the one exception to this rule, interestingly, is trust in government which is consistently weakest, and declining, among swing voters. Among committed voters, average trust in government appears to be driven largely by the identity of the party in power.

How will parties come up with their proposals in such a model? Parties will be reluctant to give election promises that compromise their core values if they can find something else that appeals to swing voters. As the electoral compromises reached will differ between parties we should not expect parties to converge on common tax policies and, even if voter opinions do not polarize, elites (parties) can, so the divergence between them may vary over time.

Table 13.3 summarizes each of the main parties' manifesto proposals on the basic and top rates of income tax at elections between 1979 and 2005. Where parties specified an exact value in their manifesto, we report this value; where they only give a preferred direction of change, we report whether this is less or more than the current value. If there is no evidence of a preference for change in either direction we report NC (for No Change).

Combining the information on party positions with the parties' shares of the votes allows us to construct a vote-weighted median position for each of the top and basic rates of tax by using weights equal to vote shares. If the tax issue in question were the sole issue on which voters decided then we could think of this as the position of the median voter. In practice, of course, there are many issues and the voter may have to make the best of

Table 13.3. Party position on income tax

	Actual	Labour	Lib Dem	Conservative	Other	Vote-weighted median
<b>1979 vote shares</b>		36.9	13.8	43.9	5.4	
Basic rate	33	NC	<33	<33		<33
Top rate	83	NC	50	<83		<83
<b>1983 vote shares</b>		27.6	25.4	42.4	4.6	
Basic rate	30	NC	NC	<30		30
Top rate	60	>60	>60	<60		>60
<b>1987 vote shares</b>		30.8	22.6	42.2	4.4	
Basic rate	27	29	NC	25		27
Top rate	60	>60	NC	<60		60
<b>1992 vote shares</b>		34.4	17.8	41.4	6.4	
Basic rate	25	25	>25	20		25
Top rate	40	50	>40	NC		>40
<b>1997 vote shares</b>		43.2	16.8	30.7	9.3	
Basic rate	23	23	24	20		23
Top rate	40	40	50	40		40
<b>2001 vote shares</b>		40.7	18.3	30.7	10.3	
Basic rate	22	22	23	<22		22
Top rate	40	40	50	<40		40
<b>2005 vote shares</b>		35.3	22.1	32.3	10.3	
Basic rate	22	22	22	NC		22
Top rate	40	40	50	NC		40

Source: Various manifestos 1979–2005, authors' calculations.

a bad job, choosing the most appealing of divergent party promises, so any such identification would be tenuous but the vote-weighted median remains an interesting indicator of where parties chose to stand on tax questions. So, for instance, in 1979, Labour proposed no change in the basic rate, but both the Conservative and Liberal parties favoured a cut. More than 50% of voters voted for the latter two parties, so the median voter in the pure tax policy dimension voted for a cut in the basic rate. Alternatively in 1992, the Labour party proposed a top rate of 50%, the Liberal Democrats a top rate higher than the current rate of 40% and the Conservatives proposed no change. Given that a majority of the population voted for either Labour or the Liberal Democrats, we know that the median voter in a pure tax policy dimension voted on this occasion for a rate higher than 40%.

What do we observe over time? First, it is worth noting that a non-median position has won the election on taxes quite a few times, something that is perhaps unsurprising under the UK's combination of three-party politics and plurality-based electoral system, demonstrating that the median voter is not necessarily the pivotal voter.



Secondly, one notes in Table 13.3 that the divergence in party tax proposals is also not constant over time. Although there has been policy divergence over the top rate in every election, disagreement over the basic rate was at its highest in the late 1980s and early 1990s, when tax policy was at its most salient as an electoral issue, but has declined since and more or less disappeared in the most recent election. There are circumstances under which this policy divergence or polarization advantages the right. In general how it affects the strengths of competing parties depends in a subtle way on how deadweight costs vary with tax rates.<sup>35</sup>

Thirdly, however, it is also the case that the median position has drifted rightwards over time so that parties in later years tend to compete in proposals centred around lower marginal tax rates. Moreover, the question of whom declining average tax proposals benefit is far clearer than that of whom declining polarization benefits: there seems to be good reason to think that they will be helpful to more left wing parties.<sup>36</sup> Finally, we note that Kim and Fording (1998, 2003) present evidence, based on expert analysis of party positions on taxing and spending, to suggest that the rightwards drift of the median that we observe in Britain since the 1970s has actually been OECD-wide.<sup>37</sup>

### 13.4.3. Summing up electoral interests and the representation problem

In summary, we have found some evidence of declining support for redistribution and social insurance, though on the whole attitudes towards redistribution, though declining, are still fairly positive and a majority of individuals favour higher top rates of tax. It is noteworthy that there is some evidence of a strong and ongoing decline in the number of people who place their

<sup>35</sup> In the linear-quadratic model, drawn from McCarty, Poole, and Rosenthal (2006) and discussed above, partisan advantage depends only upon the average tax rate offered. Polarization in tax proposals around an unchanging average offer polarizes party support in the sense that each party's supporters become more committed but doesn't lead anyone to switch sides. In a model where *marginal* deadweight costs were convex however, one would find greater polarization advantaging the right.

<sup>36</sup> If voters decide between competing tax proposals by balancing the redistributive gains (if below mean income) against deadweight costs (which harm everyone) and if marginal deadweight costs are increasing in tax rates whereas marginal redistributive gains or losses are not (as in the models of Bolton and Roland (1997) or McCarty, Poole, and Rosenthal (2006)) then differences in deadweight costs will assume more and more importance the higher is the average of the marginal tax rates offered by the parties, to the detriment of those proposing higher taxes.

<sup>37</sup> The Kim–Fording data also suggest two OECD-wide swings leftwards: an earlier one from 1950 to 1975 and recently from about 1990 to 2000. Their expert data is also consistent with our treatment of polarization in tax policy proposals, above.

trust in government, which may somewhat undermine support for taxation. It nonetheless seems difficult to claim that the trend towards lower statutory rates of income tax has been the result of a groundswell of support for such a policy.

Marginal tax rates proposed by the main parties at elections have evidently drifted downward in recent years and divergence between party proposals has recently declined markedly from a period of more intense competition over tax rates in the 1980s and early 1990s.

When we introduce the idea that voters are imperfectly informed about the tax system and party preferences, things naturally become more complicated, and we will discuss this more in Section 13.6. However, we speculate that the combination of a policy divergence from majority opinion and a lack of trust in politicians is a vicious circle, especially if voters are ill-informed about the tax system and true party preferences.

### 13.5. INTEREST GROUP POLITICS: A CASE OF POLICY PERSISTENCE AND DRIFT

Unlike the personal income tax, corporate taxation is not typically electorally salient. Perhaps the many who work for large corporations feel a (class) conflict with their employers or, as in the US, 'large corporations have not yet found any effective narrative for attacking corporate taxes' (Graetz and Shapiro (2005), p. 272). Perhaps corporate tax usually involves technical or complex aspects that elude public understanding.<sup>38</sup> Whatever the reason, the lack of an electoral connection opens the door to lobbying by special interests, often for closely targeted benefits. Nor does this happen just in the US:

[A contrast with Britain] is the apparently greater vulnerability of tax policymaking in America to lobbying by special interest groups . . . evident in the notoriously wide range of provisions favoring special groups that have typically characterized the US Tax Code . . . But British tax policy is not immune to special pleading; the 1997 Budget brought special tax breaks for the film industry. (Michael Keen, 'A British Perspective on Tax Policy in the United States', in Slemrod (1999), pp. 505–6.)

<sup>38</sup> When the costs of a policy, though small, are easy enough to observe, then mixing even small but well-financed or organized groups with extensive media coverage can result in mobilizing the otherwise unorganized. This gives the issue increased potential electoral salience: this is the essence of Graetz and Shapiro's (2005) account of the evolution of support for estate tax repeal in the US. In the UK, the case of fuel tax protests makes a similar point.

We analyse the case of Labour's R&D tax credit to reveal both the opportunities for and limits on lobbying by special interests for favourable tax treatment in the UK. The R&D tax credit purports to support a socially desirable goal: its origin was a government intent on promoting innovation, to some extent initially impressed by the way this was done elsewhere. Any benefits of increasing aggregate innovation or investment are imperceptible to voters but larger to those firms actively involved in research and development. However, this policy does not appear to be the direct result of lobbying by concentrated, organized interest groups. The effects of lobbying appear to be more subtle. Development of policy subsequent to its introduction reveals important political forces, including *ex post* lobbying and provision of information by the industry, with the programme drifting and growing beyond the original intent and justifications that were offered for it.

We use a blend of quantitative, documentary, and interview evidence<sup>39</sup> that focuses particularly on the political behaviour of large firms and the transition of the R&D credit (initially predominantly aimed at and economically justified for small firms) from an SME credit to a larger programme of large company credits. How it happened, why it happened, what the politics of various decisions were is the substance. Nevertheless, puzzles remain. For instance, will the policy prove to be politically unsustainable, however good the original intentions?<sup>40</sup>

Section 13.5.1 provides a stylized model of policy persistence as a result of *ex post* lobbying (the full technical detail of which is not crucial for non-technical readers) and Section 13.5.2 provides the case study of the R&D tax credit. Section 13.5.3 provides examples of interest-group politics outside corporation tax, the zero-rating of children's clothing in VAT, together with one where the 'unorganized' suddenly became very organized and very vocal—the fuel tax protests in 2001.

### 13.5.1. The political economy of interest groups

The standard interest-group explanation of policy is that groups representing net beneficiaries of a policy form to advocate and/or defend it.

<sup>39</sup> As stated in the Introduction, we conducted a number of interviews with individuals involved in the tax policy process over the past thirty years. These interviews are an important source of information for our case study of the R&D tax credit. Although these individuals are not named in the case study, we do indicate which quotes came from the same people and the nature of their involvement in the tax policy process.

<sup>40</sup> Should they take power, the Conservatives appear likely to propose a scheme whereby businesses would be willing to give up the credit in exchange for a lower rate of corporation tax, an exchange several executives we interviewed indicated they would be happy enough to make.

Concentrated, organized groups have an advantage over unorganized interests (Olson (1965)) and a disproportionate advantage in seeking policies whose benefits are concentrated and costs widely dispersed (Wilson (1989)) because it is unlikely that those bearing the costs will find it worthwhile or possible to organize collectively to oppose the policy. This is the usual explanation for the success of special interests in seeking trade protection and subsidies as well as favourable regulation and tax treatment, in Britain as well as elsewhere.<sup>41</sup>

However, Noll and Cohen (1983) pointed out over two decades ago that firms affected by a regulation also frequently adjust to become its greatest defenders, even if they were not originally advocates. So far the R&D credit is a textbook case: frequently changed, with its tax cost rapidly growing in the years since it was introduced. Moreover, its principal beneficiaries were not active proponents of the credit before it began, and though they are quick to claim that it doesn't make a significant difference to their investment decisions,<sup>42</sup> they continue to be willing to suggest further extensions to the credit.

There is a puzzle here, which is this: if an interest group had the capacity and incentives to lobby to maintain a subsidy, for instance, they presumably would have the capacity and incentives to lobby to introduce such subsidies, so the existence of such subsidies cannot be used to explain their persistence. Coate and Morris (1999) describe the political economy conventional wisdom that once an economic policy is introduced, it is hard to remove, even if its original rationale no longer applies or is invalid.<sup>43</sup> Asking how policy introduction alters incentives in the political process for maintaining the new status quo, they write:

[T]he mechanism by which the introduction of the policy alters incentives in the political process in favor of the new status quo . . . [is that when] an economic policy

<sup>41</sup> For instance, Person F (interview) noted how lobbying for a special regime for shipping to encourage and retain UK ship-owners became the Tonnage Tax in Finance Act 2000. 'This was a result of direct lobbying by the industry. It benefited Greek ship-owners based in London, who also benefit from the personal tax rules for those not domiciled in the UK, as they only pay tax on money they bring into the country. A long running review on domicile by the then Inland Revenue never came to any conclusion, in part because of the perceived economic damage to the UK if such non-domiciliaries were to leave the country. Similar arguments have also been used, and widely reported, to criticize proposed changes to the rules governing non-domiciliaries from 2008 onwards—another good example of focused lobbying, by a special interest group.'

<sup>42</sup> Of course, a credit that works at the margin of choice can have real effects even if decision-makers are unconscious of its effects.

<sup>43</sup> Here Coate and Morris note that the standard explanation, which they regard as inadequate, is that 'interest groups representing net beneficiaries form to defend policies' (footnote added to quotation).

is introduced, agents will often respond by undertaking actions in order to benefit from it . . . increas[ing] their willingness to pay for the policy in the future.

This extra willingness to pay will be translated into political pressure to retain the policy and this means it is more likely to be operative in the future. We present a simple dynamic model which . . . combines an agency style model of political competition of the type pioneered by Robert Barro (1973) and John Ferejohn (1986), with a lobbying model of the form made popular by the recent work of Gene M. Grossman and Helpman (1994) . . . to point out that policy persistence . . . can be Pareto dominated . . . because voters forgo support for policies which provide temporary efficiency benefits, anticipating that they will persist once they have been implemented. (Coate and Morris (1999), p. 1327.)

The model's equilibrium sequence has policy first created without the support of the affected interest (in our case, the large firms did not lobby for the creation of the R&D tax credit), but once the policy exists, affected interests lobby and politicians respond by maintaining the policy in every period, even after the rationale for the original policy has disappeared.

The model combines agency and lobbying in an optimizing framework with political implications.<sup>44</sup> Politicians value re-election to a point, but firms' contributions can persuade politicians to do other things than carry out voters' most-preferred policy. In equilibrium, policies are either never implemented, or, if implemented, they persist, even if dominated by sequences (in the public, or voters' interest) in which a policy is implemented and then removed. However, the latter does not arise in equilibrium as long as voters have partial control, because firms, even if they did not contribute to creating the policy, adjust their behaviour so as to become willing to contribute enough to persuade politicians to maintain policy. If there are synergies between policies, so that firms can contribute to other policies favoured by the government, the policy in question may even expand. That is how some policies that favour a sector but are costly to citizens at large persist, indeed, even grow.

### 13.5.2. Policy evolution: the R&D tax credit

Tax incentives can potentially increase innovation by attracting investment by new firms, either by convincing large multi-national enterprises (MNEs) looking to expand globally to invest R&D resources or by helping small firms to emerge and establish themselves as business entities. Alternatively,

<sup>44</sup> In particular it lacks parties as well as the uncertainty about the results of elections that might make the implementation of post-election policy unpredictable *ex ante*.

tax incentives can fuel greater innovation by leading existing investors to increase their level of spending. In any case, R&D tax incentives provide tax relief to research-intensive companies for undertaking R&D, defined for tax purposes as projects that '[seek] to achieve an advance in overall knowledge or capability in a field of science or technology, not a company's own state of knowledge or capability'.<sup>45</sup>

### *Origins*

Everyone seems to agree that the R&D tax credit was 'not something industry was lobbying for'.<sup>46</sup> New Labour came to power in 1997 with a Chancellor who believed that tax is a tool of social and economic policy.<sup>47</sup> His 1998 Budget speech announced that since '[e]ncouraging greater R&D investment is . . . crucial to higher productivity' the government would begin the consultations that by 1999 resulted in a small-company credit, seen as a measure 'to facilitate and directly influence the demand to innovate and undertake R&D' (p. 15). This measure was introduced in the 2000 Budget at an estimated cost of £100 million in 2001–02 and £150 million in 2002–03,<sup>48</sup> which compare with an initial cost estimate of £50 million per year.<sup>49</sup>

At the time, some believed there was observable evidence of an 'innovation deficit' in the UK. Griffith et al. (2006) show that in the 1990s affiliates of UK firms were disproportionately likely to place R&D in the US, in comparison with firms from Japan or Germany. Moreover, between 1987 and 1996 nearly half of the European Patent Office filings by the largest UK-based pharmaceutical firms were based on research conducted in the US, while 'for all other countries with major pharmaceutical industries . . . the large majority of patents came from the home country' (Gambardella et al. (2000), p. 42). Economic arguments for subsidizing R&D focus on externality issues associated with the inappropriability of technological spillover benefits from research and the inadequacy of other interventions, such as patenting legislation, fully to address the problem (see, for example, Griffith, Sandler, and Van Reenen (1996)).

At the same time it was also (and in many quarters continues to be) widely accepted that research supported the government's belief in the effectiveness of R&D tax credits (see Hall and Van Reenen (1999)), at least in the case

<sup>45</sup> As defined by HM Revenue and Customs in reference to DTI (now DBERR) Guidelines.

<sup>46</sup> Person F interview.

<sup>47</sup> Person C interview citing RedBook 7/97 sections 1.66–1.72 (HMT archive).

<sup>48</sup> See Budget 2000 Scorecard.

<sup>49</sup> Recollection of Person F (interview) confirmed by Person A (interview) and other decision participants.

of smaller firms that may be financially constrained and thus particularly unable to capture the economic returns that their research activities produce. Berger (1993) and Hall (1993) estimated that tax credits reducing the after-tax cost of R&D by 10% could increase R&D by 10–15%. Bloom, Griffith, and Van Reenen (2002) placed the long-run increase in R&D at 10% from a 10% reduction in costs, based on a study of several countries from 1979 to 1997, and noted that the benefits of such a tax credit increase from the short to the long run.<sup>50</sup>

Person A describes the sources of the R&D tax credit, including evidence surrounding the effectiveness of R&D tax credit in other countries:

The source of the RDTC was atypical, it came from productivity policy built on work done at IFS, then it found favour with some advisors, who believed the benefits. It looked like a logical step to improve innovation and creativity . . . but [some] doubted it would work in the world. There was a need to understand whether firms will change their behaviour, and it was not convincing that firms would do R&D just because it is a bit cheaper. Firms do R&D because they need it for their business, not because it is a little cheaper. There were both formal and informal discussions, informal mostly with those with large R&D, aerospace and pharma, aerospace self-selected as leaders of the discussion; also informal (led by CBI) discussions with smaller firms.

Apart from a host of technical issues, the government faced two core choices. One was whether the basis of credit should be new increments of R&D spending or the total volume of spending. The other was what size companies would be eligible, since ‘Increasing Innovation’, the Budget 2001 consultation, specifically concentrated on the economic analysis of ‘the difficulties that smaller companies have in accessing capital for R&D investment’ (p. 19),<sup>51</sup> but while that case can be made for small firms, it is less clear for big.

But the goal of the policy was innovation, and R&D was to be substantially increased: later a 40% increase came to be the public target. Of course, big firms do most of the R&D. The 1999 BERD Survey shows that of the £8+ billion in current, private R&D expenditure undertaken in the UK in 1999, SMEs<sup>52</sup> did maybe 10% (Dilnot et al. (2002)). The other 90%, done by non-SMEs, was an attractive target for a government determined to do something

<sup>50</sup> Griffith, Redding, and Van Reenen (2001) provided further support. However, note that firms do not perceive financing, high costs, or appropriability problems to be more significant barriers to innovation in the UK than in the US (Abramovsky, Griffith, Harrison (2005b)). See also comments in *Supporting Growth in Innovation*.

<sup>51</sup> It also noted that the UK goes further and allows companies to write off immediately all R&D capital expenditure, including plant and machinery and scientific buildings but excluding land and dwelling houses.

<sup>52</sup> Throughout this discussion, as in eligibility for the credit itself, the definition of small and medium sized enterprises (SMEs) as having less than 250 employees follows EU concepts.

to encourage innovation. Since their contemplated scale of change would require an unimaginable fourfold increase in SME R&D, it would have to be done by larger firms.

In 2000, EU countries established the Lisbon Agenda to make the EU ‘the most competitive and dynamic knowledge-driven economy by 2010’.<sup>53</sup> The Treasury’s consultation paper, ‘Increasing Innovation’, came out shortly after in 2001, committed to

Encouraging innovation ... a vital component of the Government’s strategy for improving the UK’s productivity performance and competitiveness ... The Government can help by ... giving business the platform from which to innovate. (p. x)

It proposed to extend the credit to larger firms, believing that of several available options, this one was ‘the most appropriate instrument for helping boost the demand of businesses to innovate and undertake R&D’ (p. 2) hoping to ‘bring about a step change in the level of R&D and innovation’ (p. 24).

Therefore, we see that the origins of the R&D tax credit seem to be a desire to raise levels of innovation and increase productivity. Moreover, the policy seems to have been based on evidence found in economic research. Its introduction was certainly not a case of industry lobbying for more generous tax treatment. We now move to discuss what informed the government’s choice of a volume-based credit, and the decision to extend the credit to larger firms.

#### *Volume versus incremental credits: an informed choice*

Originally the intent was to introduce the credit in incremental form: this had the strong support of the DTI and influential figures in government. The incremental form was modelled on the US tax credit, first introduced in July 1981 as part of the Economic Recovery Tax Act and later renewed in the Tax Reform Act of 1986.<sup>54</sup> The US tax credit is administered on the incremental basis, rewarding relative increases in, rather than absolute levels of, R&D spending.<sup>55</sup>

<sup>53</sup> <<http://www.euractive.com/en/agenda2004/lisbon-agenda/article-117510>>.

<sup>54</sup> TRA86 made the significant change of incorporating it into the General Business Credit and removing it as a separate statistical line item. See Bronwyn Hall, ‘Effectiveness of Research and Experimentation Tax Credits: Critical Literature Review and Research Design’, Report prepared for the Office of Technology Assessment, Congress of the United States, 15 June 1995, p. 4. Over the next ten years, it continued to be renewed on a short-term basis, mostly through yearly Omnibus Budget Reconciliation Acts.

<sup>55</sup> Although the US is not the only country to use this system—France, Japan, and Korea have also implemented incremental schemes—it is nevertheless noteworthy as a contrast to the volume-based



The incremental system has been argued to distort dynamic incentives because companies have to invest more and more in R&D each year just to receive the same, or less, credit. They thus have less incentive to invest early in large quantities in R&D, because doing so will simply raise the base from which the incremental credit is calculated in subsequent years. It appears to have been clear already (see Griffith, Redding, and Van Reenen (2001) commenting on the 1999 consultations) that it was doubtful that the credit (which was announced in incremental form) would be cost-effective in the short run, though it always was in the long run. The volume-based system is intended to reward companies that show a long commitment to R&D and innovation.

In the end, the government chose to introduce a volume-based system, on the basis of internal discussions and on the advice of industry. Interviewees frequently cited similar economic logic as described above for why the government made this choice. Below Person A describes some of the reasoning behind why the government eventually chose the volume-based system.

[Initially] HMT favoured an incremental credit over volume: in a simple model with one decision-maker, incremental looks better, but outside the one company model life is more complicated. The incremental approach takes away all the certainty with regard to the credit, where companies are linked they may take offsetting decisions by mistake. Business saw this as a problem too. Incremental had supporters, but not many in complex businesses.<sup>56</sup>

From Person D's point of view the R&D tax credit was born out of a broader agenda of putting the intellectual property tax regime right and agreed that industry certainly favoured the volume-based system:

[We] heard Gordon Brown say 'Innovations are key to a knowledge-based economy, therefore, we need to incentivize the creation of knowledge', so they decided to introduce the R&D tax credit. In June 1998 came the Budget 98 document 'Innovating for the Future'. The government consulted the Intellectual Property Institute and business to discuss the position regarding all types of protected intellectual property: copyright, patents trademarks, know-how, etc., in order to understand the tax treatment in each case. They found that the tax treatment was inconsistent,

systems of other countries, including the UK. Because of their incremental nature, tax credits bear only a fraction of their face value. This is because each time they increase their spending, the base that they must spend to earn the same amount of credit increases. Based on some simple calculations, (Brown (1984), p. 3) concludes that 'the incentive is not the \$25 face value of the credit, but just the value of getting \$25 now rather than later. Assuming an interest rate of 10 percent, the discounted value of the credit is not \$25, but only \$4.29.'

<sup>56</sup> Person A interview.











































































































































