Tax Design

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Fundamentals of tax design

- Relying heavily on the Mirrlees Review (Institute for Fiscal Studies)

- Key concerns are the effect of tax system on:
  - Distribution
  - Efficiency

Adam Smith's Four Principles of Taxation

(i) The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities

(ii) The tax which the individual is bound to pay ought to be certain and not arbitrary.

(iii) Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.

(iv) Every tax ought to be so contrived as to take out of the pockets as little as possible, over and above that which it brings into the public treasury of the state.

Further principles. Conditional on distributional outcome:

- the negative effects of the tax system on welfare and economic efficiency should be minimized;

- administration and compliance costs—all things equal, a system that costs less to operate is preferable;

- fairness other than in the distributional sense—for example, fairness of procedure, avoidance of discrimination, and fairness with respect to legitimate expectations;

- transparency—a tax system that people can understand is preferable to one that taxes by 'stealth'.

Further …

- Simple, neutral, and stable tax systems are more likely to achieve these outcomes than are complex, non-neutral, and frequently changing systems.
- A good tax system will not just limit negative effects on efficiency. It will also promote economic welfare by dealing with externalities which arise when one person or organization does not take account of the effects of their actions on others (e.g. tax on carrier bags)
- Taxes should be viewed from a lifetime perspective – not just a snapshot of the last year's income. Income varies dramatically over the lifetime.

What is the basic unit of account?

- We need to be clear whether we are looking at the effect of taxes on *individuals* or on *households*

- Income tax paid by individuals. Tax credits paid to households. Council tax paid by households.

The Burden of Taxation

- Who bears the economic cost of a tax? Not always the person on whom it is levied – the statutory bearer. Income taxes remitted by firms but paid for (at least in part) by employees.

- Other examples where burden does not always fall on statutory bearer – alcohol duties, stamp duties

- Taxes impose losses on consumers and producers – losses almost always greater than the revenue they raise – this is known as *deadweight loss*

How do taxes change behaviour?

- Increase in income tax – some will work more hours to maintain their income. Others will conclude that work has become less attractive than leisure and reduce their hours of work. This is the effect usually thought to dominate.
- Effects differ between different types of worker. Older workers may retire, young may migrate, some may withdraw from the labour market, other just reduce their hours
- Other taxes can affect willingness to work e.g. on consumption
- Tax system should take these responses into account
- Taxes may have long-run effects – e.g. the development of more fuel-efficient cars

Do **all** taxes cause economic distortions and reduce welfare?

- When a rent arises, taxing it should not alter behaviour, since only the excess income over the next-best use is taxed. Rent is most often associated with the return to land. Land derives its value from its location and this makes the return to owning land attractive to tax, because the owner cannot move it elsewhere.
- The supply of property, and especially land, is not very responsive to its price, which means that it can be taxed without significantly distorting people's behaviour.

Other Issues

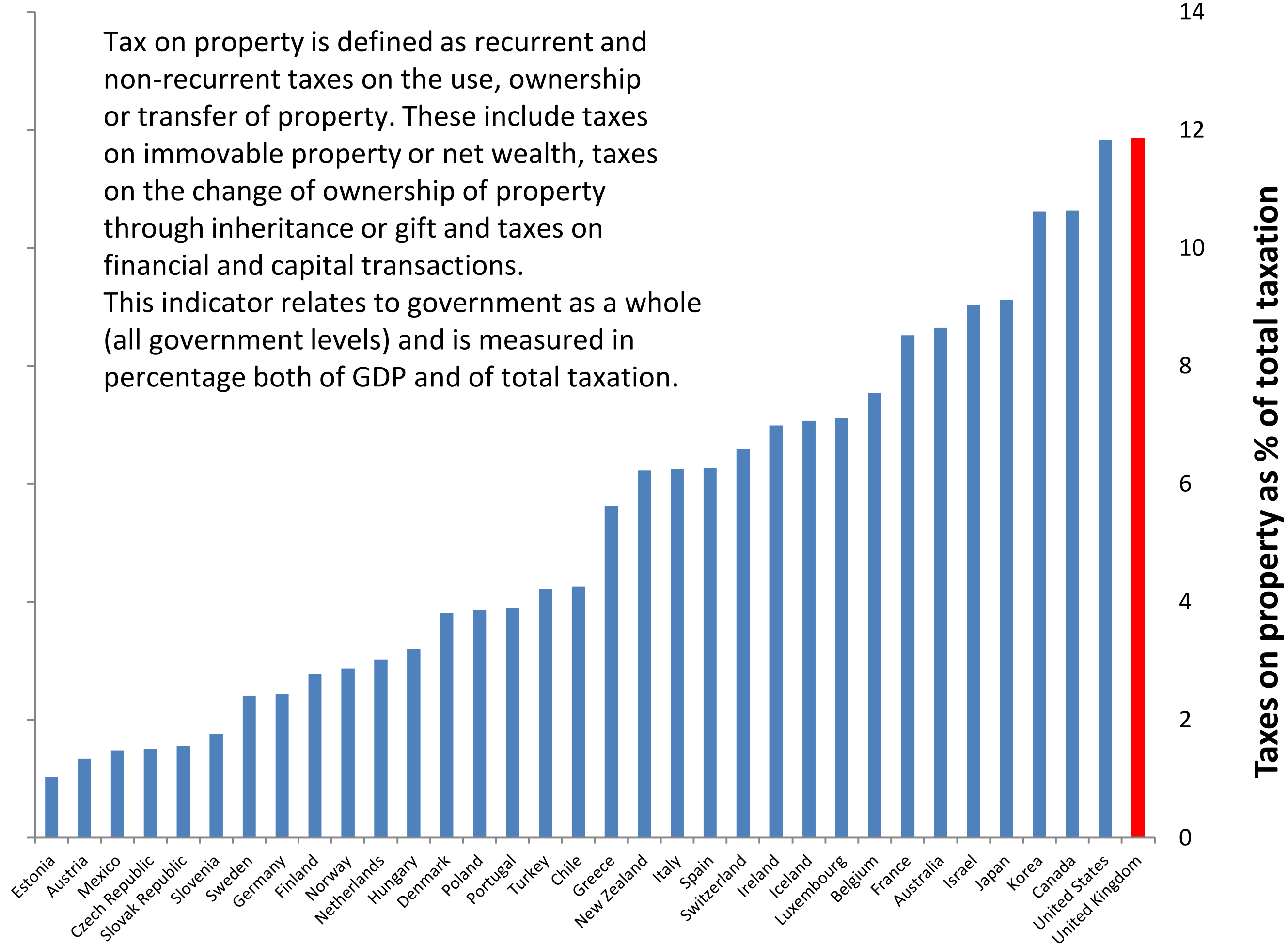
- Distributional fairness - the tax system should treat similar people in similar ways. This is called horizontal equity by economists.
- A neutral tax system—one that taxes similar activities similarly—avoids giving people encouragement to shift from high- to low-taxed activities in a way that is economically costly.
- How should we think about balancing efficiency loss against equity?
- Neutrality, simplicity, and stability – guide to design of a successful tax system
- It is the redistributive impact of the system as a whole which needs to be measured and judged. Not every tax needs to be progressive.

Taxing Property - Principles

- **Land, whether used for business or residential property, can be taxed at an** arbitrarily high rate on economic efficiency grounds.
- **Business property is an input into the production process and, on**
- efficiency grounds, should not be taxed.
- **Owner-occupied housing combines the features of an investment and a** consumption good, and we should consider its taxation from both these points of view.
- **Rental housing is an investment good from the point of view of the owner** and a consumption good from the view of the renter.
- Overall, there is a presumption in favour of taxing it at a similar level to owner-occupied housing.

Property Taxation – OECD Statistics

Tax on property is defined as recurrent and non-recurrent taxes on the use, ownership or transfer of property. These include taxes on immovable property or net wealth, taxes on the change of ownership of property through inheritance or gift and taxes on financial and capital transactions.
This indicator relates to government as a whole (all government levels) and is measured in percentage both of GDP and of total taxation.



Taxing Land

- The economic case for taxing land itself is strong
- Taxing land ownership is equivalent to taxing an economic rent—to do so does not discourage any desirable activity.
- Land is not a produced input; its supply is fixed and cannot be affected by the introduction of a tax (?)
- With the same amount of land available, people would not be willing to pay any more for it than before, so (the present value of) a land value tax (LVT) would be reflected one-for-one in a lower price of land: the classic example of tax capitalization. Owners of land on the day such a tax is announced would suffer a windfall loss as the value of their asset was reduced.
- But this windfall loss is the only effect of the tax: the incentive to buy, develop, or use land would not change. Economic activity that was previously worthwhile remains worthwhile.

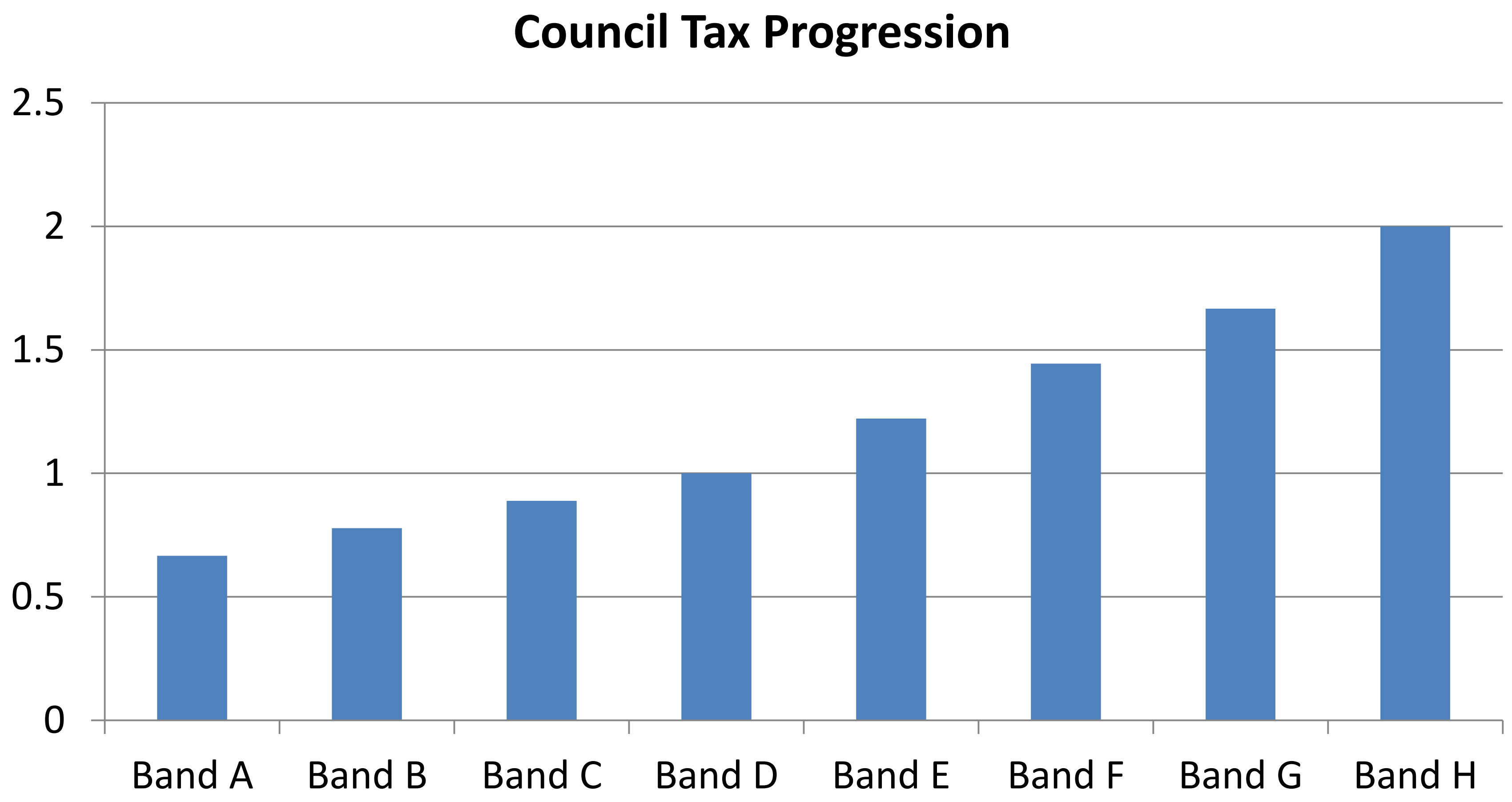
Who said this?

- “Roads are made, streets are made, services are improved, electric light turns night into day, water is brought from reservoirs a hundred miles off in the mountains — and all the while the landlord sits still. Every one of those improvements is effected by the labour and cost of other people and the taxpayers. To not one of those improvements does the land monopolist, as a land monopolist, contribute, and yet by every one of them the value of his land is enhanced. He renders no service to the community, he contributes nothing to the general welfare, he contributes nothing to the process from which his own enrichment is derived. “

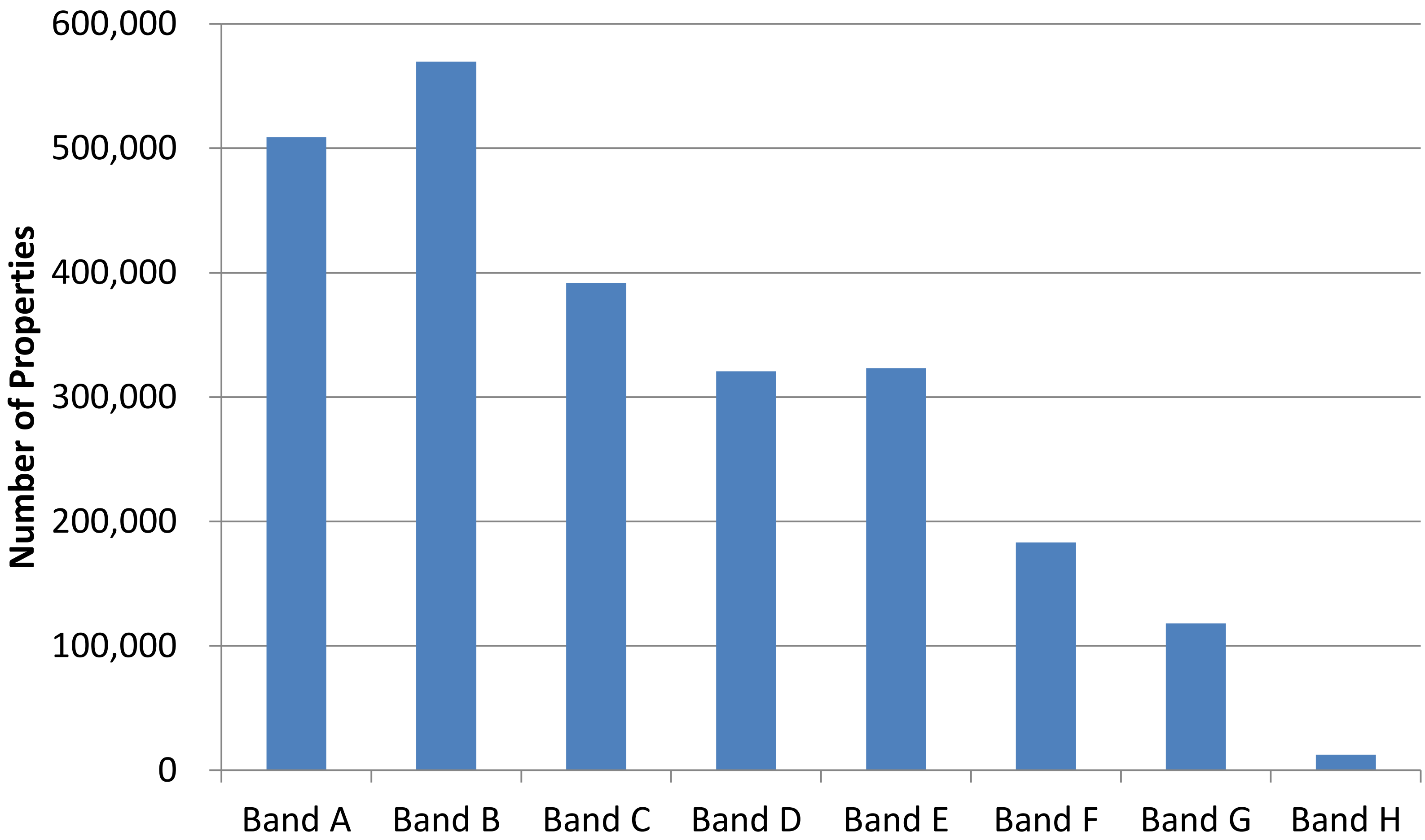
Taxing Housing

- A house sits on land, the value of which we might want to tax because the land is completely fixed and the return to it is an economic rent. But the house also provides services that are consumed by the occupier—just as a fridge or a car does. One could argue that the value of this consumption should be subject to VAT.
- The house is also a valuable asset, whose value rises and fluctuates like those of stocks and shares. So we might see homeownership as a form of saving that should be taxed consistently with other savings

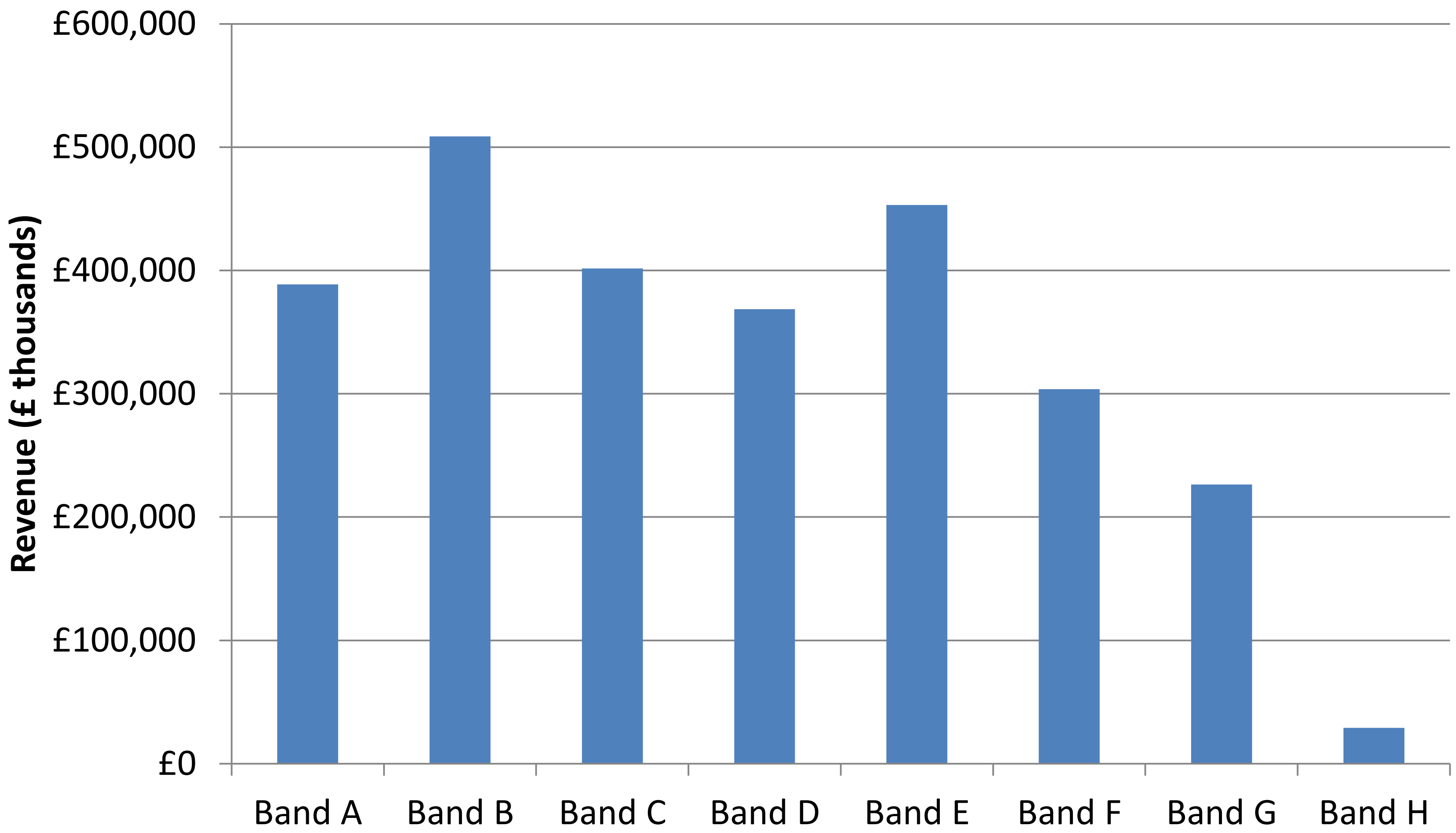
Council Tax Band Ratios



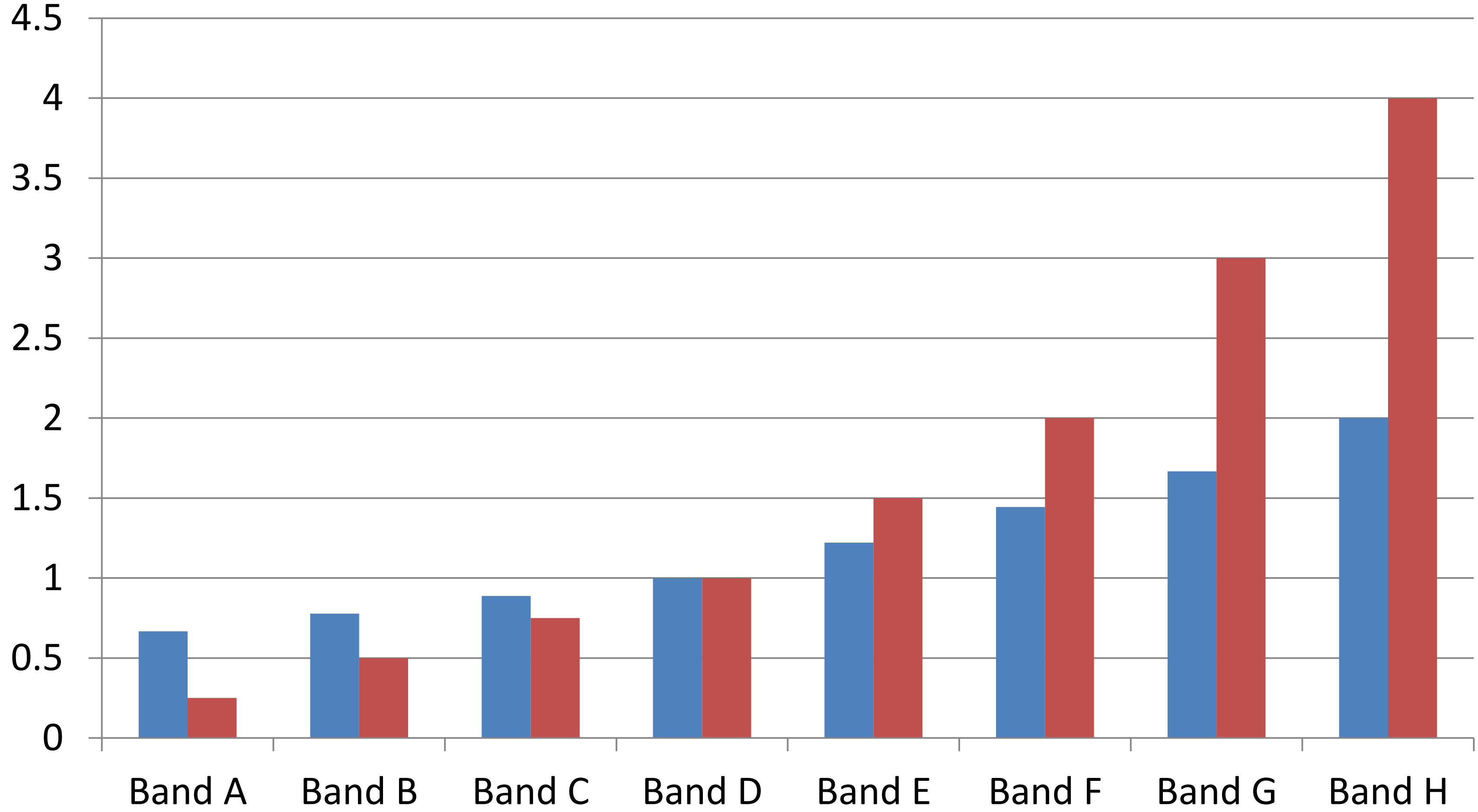
Properties by Council Tax Band in Scotland 2014



Council Tax Revenue by Council Tax Band 2014



A Revenue Neutral? Change to Council Tax Banding



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