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Designing a more efficient and fairer tax system

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“In this world, nothing can be said to be certain, except death and taxes,” Benjamin Franklin had once famously said. The founding father of the United States was convinced, some 200 years ago, of the importance of tax design on modern economies. Today, as more politicians and governments struggle to address fiscal deficits and income inequality through taxation, it has never been more important to get tax structures right.

In a lecture jointly organised by Singapore Management University’s (SMU) School of Economics and Civil Service College Singapore, Richard Blundell, professor of economics at University College London and research director at the Institute for Fiscal Studies, spoke on the potential of a coherent tax reform based on characteristics of a fair and economically efficient tax system. He highlighted the proposals for reform, focusing on the role of empirical evidence and economic theory in the formulation of recommendations, drawing on the findings of the Mirrlees Review.

Published in 2010, the Mirrlees Review is a specially commissioned two-part publication that studies and gathers expert opinions on tax design in the United Kingdom. Blundell was a member of the review’s editorial team, together with Sir James Mirrlees, the 1996 Nobel Prize winner for economics, who was also chairman of the panel.

Principled taxation

A first principle employed in the review was to treat the tax system as a complete system. For example, the marginal tax rate is a sum of all additional taxes paid for an increase in income by $1, and not just a consideration of only one form of tax, such as income tax. As an outcome of this approach, Blundell said: “Particular taxes need not be green or progressive for the whole system to be green and progressive.”

Another principle is that of neutrality, where taxes should not discriminate between similar activities. An example of this is the capital gains tax, which typically is taxed at a preferential rate compared to income tax. If an employee can have the choice between getting his income through shares or by a paycheck, he would be able to benefit from this preferential tax rate, which presumably is unintended by the tax authorities.

The principle of progressivity was also considered, i.e. if the more well off pays more taxes than the less well off.

The UK’s current tax system, Blundell noted, not only defies these principles, but also does not work as a system. “There is a lack of joining up between welfare benefits, personal taxes and corporate taxes,” he said.

“It is also not neutral where it should be, with a corporate tax system that favours debt over equity since interest payments on debt are tax deductible,” he added. Where it should deviate from neutrality, for instance, to discourage certain harmful activities, it is not well designed, with a mass of different tax rates on carbon and a failure to price congestion properly.

It also does not achieve progressivity efficiently, with zero and reduced rated value-added tax (VAT) as a weak means of redistribution. The end result is a combination of taxes and benefits that might unnecessarily “damage” work incentives.

Aligning proposals to principles

By examining the key margins of adjustment to tax reform, measuring effective tax rates, studying the importance of information in terms of its complexity and salience, looking at the evidence from the magnitude of the responses, and examining the implications for tax design, the review panel arrived at some broad proposals.

To treat the system as a whole, the Mirrlees Review suggested that a single integrated welfare benefit be put in place, with less aggressive means-testing, and to align tax rates across employment and profits.

Moving towards a more neutral tax system, the review proposed widening the VAT base by not taxing the normal ‘return to capital’ while imposing a consistent tax on greenhouse gas emissions and congestion, a zero rate on VAT for childcare and special treatment for pensions. As for achieving progressivity, the review noted that the constraints imposed by responses to incentives must be taken into account.

Blundell looked at both the ‘extensive’ and ‘intensive’ margins of labour supply for key margins of adjustment; ‘extensive’ for when a taxpayer would stop working altogether, and ‘intensive’ when a taxpayer reduces work when confronted with a new tax. Examining data from, the UK, US and France, he noted that both margins matter and matter in different ways depending on the age and demographic groups of the taxpayers.

“Mirrlees’ Nobel prize winning idea is to relate responses to tax rates,” he said. Taxes generally reduce labour supply, especially for low wage earners who might decide not to work, but instead, collect unemployment welfare cheques. The level of responsiveness, measured in terms of elasticity, also suggested that women whose youngest child was of school age and those aged over 55 were especially sensitive to tax changes.

Using an equation based on the Pareto distribution, it was found that the revenue maximising tax rate for the top one per cent of income earners in the UK was 56 per cent. However, there are limitations as this is a group that often employs highly sophisticated means to avoid taxes. Base reforms are thus necessary.

Instituting anti-avoidance measures such as domicile rules would circumvent the shifting of wealth offshore. Equalising tax treatment of income derived from employment, self-employment and running a company would take away the incentives to convert labour income into dividend income or capital gains, which currently enjoys lower rates. This reduces the need to rely on anti-avoidance measures.

Shaping behaviours

The review’s study of consumer behaviour suggested that exceptions to a uniform VAT rate might help broaden the base of taxpayers. For example, a zero rated VAT for childcare would encourage mothers to join or remain in the labour force. Blundell observed: “VAT is a regressive tax if you do not do any kind of compensation.” It increases the costs of living for the lower income groups.

There is currently no VAT on financial and housing services and food in the UK. Zero VAT on certain classes on goods can act as a subsidy for the rich. While the poor might spend a higher percentage of their income on food, the rich spends more in absolute terms. Hence, a compensation mechanism could help remove this distortion.

Blundell believes the welfare gains reaped from removing such distortions could be sizeable, estimating it to be about 1.5 per cent of consumption using a Quadratic Almost Ideal Demand System(QUAIDS)model. He recommended that consumption of financial services be taxed, but noted that the standard VAT mechanism might not be suitable. There are alternatives such as cash-flow taxes or financial activities taxes. Further study will be required to find the most practical option, he said.

For housing services in the UK, Blundell suggested taxing the annual consumption of housing by reforming council taxes based on current valuations, as opposed to 1991 values. This will add a dimension of proportionality to the current values, remove the current discount for single occupancy, and help capture tax revenues. The additional tax revenues could then be used to replace present stamp duties. Similarly, having a congestion charge or a national road pricing could reap huge welfare benefits, instead of using ‘blunt’ fuel and vehicle excise duties.

Blundell does advocate taxes on savings and investment returns, but only for the amount in excess of the “normal” return. This would then treat capital gains in a similar way to other forms of income. When this is integrated with corporate taxation, it would provide neutrality between debt and equity. Differential tax treatments of incorporated and unincorporated firms should also be removed.

A tax system that favours debt and discourages savings and investments may exacerbate excesses in consumption and borrowing – trends that may partly explain the 2008 financial crisis. Blundell concluded that the Mirrlees Review charts a possible direction for tax reforms and challenges governments to rethink their designs.