From Optimal Tax Theory to Tax Policy

Retrospective and Prospective Views

Munich Lectures in Economics

Robin Boadway

CES

From Optimal Tax Theory to Tax Policy

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In cooperation with the council of the Center for Economic Studies of the University of Munich

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Series Foreword

Every year the CES council awards a prize to an internationally renowned and innovative economist for outstanding contributions to economic research. The scholar is honored with the title "Distinguished CES Fellow" and is invited to give the "Munich Lectures in Economics."

The lectures are held at the Center for Economic Studies of the University of Munich. They introduce areas of recent or potential interest to a wide audience in a nontechnical way and combine theoretical depth with policy relevance.

Hans-Werner Sinn
Professor of Economics and Public Finance
Director of CES
University of Munich

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1 Introduction

Mirrlees' lecture was on optimal taxation, a branch of public finance that had conquered the academic world and, so far, has been largely ignored by the real world. Enormous intellectual resources have gone into it and, literally, thousands of papers have been written analyzing all possible ramifications of the theory. The problem is that no tax reform that I know of has ever applied it. The statistical or informational requirements are just beyond what countries can produce and the political requirements are beyond what governments want to live with. Thus, in terms of concrete results, optimal taxation theory must be considered a highly unproductive activity. Its recommendations often conflict with what governments want to do or what taxpayers expect them to do.

—Tanzi (2008), pp. 116–17, speaking about a plenary lecture given by the Nobel Laureate James Mirrlees at the 1997 Congress of the International Institute of Public Finance in Kyoto, Japan.

The choice of a tax (and transfer) system is one of the most important economic decisions governments take. In OECD countries, total tax revenues absorb in the order of half of national income. In developing countries, the proportions are somewhat smaller, but that is mainly due to the lesser importance of transfers as a source of government expenditures to be financed. The proportion of goods and services diverted by taxation from the private sector in developing economies is substantial.

Many things inform the choice of a tax system, including politics, public opinion, bureaucratic influence, administrative complexities, information technology, and ideas drawn from theoretical considerations. These lectures focus mainly on the role of scientific ideas as means of informing and influencing tax policy design. Those of us who are public economics scholars study the effect that the tax system has on economic outcomes, and formulate models of optimal tax-transfer systems based on normative principles that reflect efficiency and equity considerations. We use that analysis to form views about the optimal design or reform of actual tax systems in economies that are much more complicated than our models. We hope that our views will have some influence on real-world policy choices. These lectures review what normative analysis has taught us about optimal tax policy, how tax policy choices reflect those views, and what outstanding issues exist that optimal tax analysis must address in the future.

Despite the judgment about the relevance of optimal taxation expressed above by Tanzi (2008), and despite his considerable and important contribution to tax policy around the world, one can make a strong case that there is an important symbiosis between ideas drawn from normative tax analysis and tax policies actually enacted. Tax policy must necessarily be informed by *some* ideas and principles, and it is inconceivable that normative optimal tax analysis does not play an important role. The connection is not a direct one. Instead, it is rather subtle. Ideas germinated by normative tax analysis have always informed policy prescription by tax policy specialists and tax commissions. Some of these ideas challenge the way in which tax-transfer systems are designed and propose alternatives. Recent examples include the near-universal worldwide adoption of the value-added tax, the use of refundable tax credits, and various reforms of business tax systems. Other ideas provide normative rationales for features that already exist in tax systems and seem worth keeping, an example being the tax treatment of retirement savings and human capital investment. Even where specific proposals do not emerge from the theory, the latter provides a manner of looking at the policy problem that informs policy makers. A prime example of this is the lesson from optimal income tax theory that asymmetric information is an important constraint on policy. Many policy proposals are conditioned on alleviating information constraints, such as monitoring transfer recipients, addressing tax compliance and basing taxes on what can be observed.

The ideas of normative analysis are disseminated in many ways: through scholarly articles, informed debate, university curricula, the bureaucracy, and the media. Over time decision makers are subject to all these influences and take them on. In turn they persuade the public and tax reforms are enacted. Although much of my discussion will be devoted to exploring what we have learned from normative tax-transfer policy analysis, I will indicate several key areas where, contrary to Tanzi's views, practice has been heavily influenced by optimal tax principles. While there is undoubtedly some truth in Tanzi's allegation that policy makers cannot directly use the results of optimal tax analysis, that misinterprets the role of such analysis. Given that it is based on abstract and often unrealistic models, normative analysis cannot be expected to yield implementable results. Rather, normative analysis serves to inform policy analysis at a different level. It uncovers some basic ideas that inform the policy process, and it provides a way of thinking about normative policy issues that allow policy advisors and policy makers to frame complicated issues in meaningful ways. No doubt, Tanzi's remark was intended to be provocative and cautionary. My guess is that he might underestimate the extent to which even his own ideas have been affected by ideas that originated in the optimal taxation literature, even simple ones like the role of demand elasticities as considerations in tax design. Part of the intent of this book is to take stock of the most important of these ideas.

Optimal tax analysis has been evolving for the past half century, although the seminal works appeared some three decades earlier.[1] Over that period the analysis has grown exponentially, with some significant innovations along the way, especially those by Diamond and Mirrlees (1971), Mirrlees (1971), Atkinson and Stiglitz (1976), Stern (1982), and Stiglitz (1982).[2] The analysis has gone through a long period of refinement of the seminal approach, and in recent years has begun to be confronted with new theoretical challenges as a result of the findings in diverse areas such as behavioral and experimental economics, political economy, social choice, happiness economics, and dynamic macroeconomic analysis. Part of my purpose here will be to review the evolution of optimal tax analysis and how it might adopt to these new paradigms.

Tax systems around the world have also evolved over the past half century, with many broad trends spreading from country to country. Similarities have come to outweigh differences. There has been widespread adoption of value-added tax (VAT) systems, in many cases

1. Modern optimal tax analysis can be thought of as originating with Samuelson's 1951 memorandum to the US Treasury, reprinted as Samuelson (1986). It was essentially a restatement of Ramsey's (1927) seminal paper on optimal commodity taxation. See, however, also Dupuit (1844), Boiteux (1956, 1971), and Hotelling (1932).

2. There are various surveys available, all focusing on specific aspects of the theory. See, for example, Atkinson and Stiglitz (1980), Stiglitz (1987), Myles (1995), Boadway and Keen (2000), Auerbach and Hines (2002), Salanié (2003), Golosov, Tsyvinski, and Werning (2007), and Kaplow (2008). A recent paper by Sørensen (2002) has surveyed some of the main policy lessons from optimal tax theory.

replacing highly differentiated systems of sales, excise, and trade taxes. VATs tend to be broad-based, including almost all goods and services, and with one main tax rate, albeit with some exceptions. Besides the VAT, two other broad-based taxes are commonly used: income and payroll taxation. Income taxes and transfers are the main vehicle for addressing redistributive objectives, and do so through progressive rate structures. However, rate structures have become flatter over time. There has been experimentation in some countries with virtually fully flat rate structures, and in others with schedular rate structures with different structures applying to different sources of income. The common model is the dual income tax originating in the Nordic countries, in which a progressive rate structure is applied to earnings and transfers, and a flat rate to capital income. Some important forms of asset income are sheltered from income tax, either for policy reasons or for reasons of administrative convenience, and this is so even in dual income tax systems. Particularly important in this regard are savings for retirement, owner-occupied housing and human capital investments. These provisions have likely served to reduce progressivity even more, as has the gradual demise of wealth and wealth transfer (inheritance/bequest) taxation (Cremer and Pestieau 2006b).

This tendency for the income tax system to become less progressive has been countered at the bottom end of the income distribution by various forms of refundable tax credits, which are relatively recent innovations. These may apply, for example, to low-income families, especially those with children, and to low-income working persons. Transfers to those who are not employed for whatever reason tend to be done by stand-alone systems that are proactively administered rather than being based on self-reporting as in income tax systems. As well, much, or even most, redistribution to low-income persons is achieved by in-kind transfers and social insurance. Other tendencies in tax policy have included some interesting experiments in business taxation (e.g., rent tax systems, like the so-called Allowance for Corporate Equity [ACE], which allows firms to deduct as costs not only interest and depreciation but also costs of equity finance), some enhancement of environmental taxation, and greater use of user fees.

Major policy reforms have sometimes drawn on commissions or panels established by governments or independent policy research institutes. Some examples of these in the Anglo-Saxon world include the Royal Commission on the Taxation of Profits and Income of 1955 in the United Kingdom, the Royal Commission on Taxation of 1966 in Canada, the US Treasury's Blueprints for Basic Tax Reform in 1977, the Meade Report of 1978 in the United Kingdom, the Technical Committee on Business Taxation (1997) in Canada, the President's Advisory Panel on Federal Tax Reform in 2005 in the United States, the Henry Review of 2010 on Australia's Future Tax System, and the 2011 Mirrlees Committee Report in the United Kingdom on Reforming the Tax System for the 21st Century. These various reports typically involved public economics scholars, and served the indispensable purpose of drawing on state-of-the-art thinking about tax policy to make policy recommendations.

The study of public economics has always been a heterogeneous endeavor involving many methodological approaches. These have included normative theoretical analysis, empirical analysis, computable general equilibrium analysis, and other forms of quantitative modeling, public choice, and historical or institutional approaches. In recent years there has been a shift in focus, and some new challenges have arisen. Empirical analysis has taken a more prominent role, owing partly to advances in computational technology and data availability. Political economy has become prominent and has evolved considerably in both theoretical advances and empirical implementation. Implications of game theory have driven many innovations in public economic analysis, such as the understanding of the implications of the inability of governments to commit. Dynamic public economic approaches pursued especially by macroeconomists have led to new insights and challenges.

There are two areas that pose particularly difficult challenges for normative public economics since they go to the heart of some of the most basic principles. One of these involves the implications of recent findings in behavioral economics. Standard assumptions about the rationality of individual decision-making have been called into question by experimental, neurological, and field evidence. Some decisions are simply too complicated to be made without spending excessive time becoming informed. Even if well informed, decisions may be made irrationally because of too much weight being put on immediate payoffs to the neglect of longer term ones. Moreover decisions may be based on motives other than self-interest. All these problems call into question the individualistic basis of standard normative analysis, and invite considerations of whether government is justified in interfering with decisions voluntarily made by individuals.

The other area involves the normative basis for interpersonal comparisons, which are necessary for virtually all normative policy recommendations. The standard methodological approach is to base normative decisions on the welfare levels attained by members of society and to propose some social welfare function as a vehicle for aggregating those welfare levels. This aggregation becomes troublesome in principle when persons have different preferences, and when interdependent utility functions apply. The literature on social choice has offered some possible ways out of this problem, but much work remains to be done to make these suggestions implementable for policy purposes. These challenges are ones that must be dealt with by future normative analysis.

Given these developments in the theory and practice of tax policy, and especially the recent emphasis of new ideas in public economic theory, it is an opportune time to take stock of the role that optimal tax theory has played in establishing the principles underlying tax reform in the past and in assessing the challenges that lie ahead. In the following chapter I begin with an overview of the evolution of optimal tax theory, the main lessons we have learned for tax policy, and the challenges that lie ahead. I then turn in subsequent chapters to a more detailed discussion of the policy lessons from optimal tax theory, and then to the issues that must be resolved.

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