Taxation

Lectures 13 and 14

Connolly and Munro (1999): Chp 10

Stiglitz (2000): Chp 17

Griffiths and Wall (2007): Chp 19

Outline

- Purpose of Taxation

- Desirable Features of a Tax System

- Classification of Taxes

- Composition of the Tax Burden

- Taxation Issues and Reforms

- Incidence of Taxation

Purpose of Taxation

- Finance public services

- Re-distributive tool

- Reflect values of society by altering choices
  - eg support female labour market participation

- Trend towards ↑ individual choice and freedom
  - ↓ state involvement
  - ↓ personal income taxes
  - ↓ corporate taxes

Desirable Features of a Tax System

- 1. Efficiency
  - Pareto efficiency: P = MC

    …but a wedge between P and MC ie efficiency loss
  - Lump-sum taxes cause least harm

- 2. Equity
  - Horizontal equity: equal treatment of equals
  - Vertical equity: ability to pay

- 3. Simplicity and low administrative cost
  - Special tax treatment
  - Differential rates
  - Tax-raising bodies

Classification of Taxation

- Method of collection
  - Direct
  - Indirect

- The tax base: taxable pay
  - Income tax
  - Capital tax
  - Expenditure (consumption) tax

- Tax rate
  - Specific tax
  - *Ad valorem* tax

The Tax Burden I: UK Trends

- Tax burden ↑ over time

- Are taxes too high in the UK?

Fiscal Year	Tax (% of GDP)
1964-65	30.00
1973-74	33.75
1978-79	33.30
1980-81	35.80
1985-86	38.10
1990-91	35.90
1995-96	34.80
2000-01	37.20
2004-05	36.20

Net Taxes plus Social Security Contributions (% of nominal GDP)

The Tax Burden II: an International Comparison

- Continental Europe v Anglo-Saxon economies

- Rich v emerging economies

- Scope for future ↑ tax?

Country	2007
France	44.7
Italy	43.0
Germany	40.4
Britain	**37.7**
Australia	29.5
Japan	28.2
US	28.0
India	18.9
China	16.4

Tax take (% GDP)

OECD Classification of Taxation I:
UK Sources of Tax Revenue as at 2007

- 1000: taxes on income and capital: **37.8%**
  - Individuals: 28.7%
  - Companies 9.1%

- 2000: social security contributions: **22%**

- 3000: employer's payroll or manpower taxes

- 4000: taxes on property: 12%

- 5000: taxes on goods & services: **28.1%**
  - Consumption: 17%
  - Excise: 8.5%

- 6000: other taxes

OECD Classification of Taxation II:
A Comparison of Tax Revenue Sources

Country	Income & Capital	Social Security	Goods & Services
France	23.4	40.2	24.1
Italy	34.2	30.8	28.7
Germany	30.9	40.8	26.2
Britain	37.7	22.0	28.1
Australia	59.2	0	25.4
Japan	35.4	36.6	18.6
US	48.3	24.5	15.6
India	47.7	0.2	34.1
China	28.4	0	64.9

Taxation Issues

- Incentives
  - to work and save
  - Poverty trap; unemployment trap

- Hypothecation
  - Link financing and use of public services

- MNEs and transfer pricing
  - Double tax treaties

- Tax avoidance and tax evasion

Incentives I: a Flat Tax

Average tax rate on taxpayers' total income	Flat tax rate on taxed income	Allowances and deductions	Losers – millions (net number)	Tax revenue lost
18	23	Unchanged	27	Nil
15	20	Personal allowances raised by £2,500	8	£10bn
13	18	Unchanged	None	£20bn

Incentives II: the Poverty Trap

	April 2005			
	(£ pw)	**(£ pw)**	**(£ pw)**	**(£ pw)**
Gross earnings[†]	150	200	250	300
Plus Child benefit	28.40	28.40	28.40	28.40
Child tax credit	75.46	75.46	75.46	75.46
Working tax credit	55.88	37.38	18.88	0.38
Housing benefit	5.08	–	–	–
Council tax benefit	4.98	1.98	–	–
Less				
Income tax	7.47	18.47	29.47	40.47
National insurance	6.16	11.66	17.16	22.66
Net income	**306.17**	**313.09**	**326.11**	**341.11**

*For a married man with two children under 11 with weekly Local Authority rent of £56.82 and Council tax of £20.90.
[†]30 hours per week at the minimum wage (April 2005) was £145.50.
Source: Adapted from the Tax/Benefit Model Tables (April 2005).

Incentives III: the Unemployment Trap

In work	£ pw	Out of work	£ pw
Gross earnings	150	Jobseekers' allowance	163.61
Child benefit	28.40	Child benefit	28.40
Child tax credit	75.46	Housing benefit	56.82
Working tax credit	55.88	Council tax benefit	20.90
Housing benefit	5.08	Meals and welfare	7.57
Council tax benefit	4.98		
Less			
Income tax	7.47		
National insurance	6.16		
Net income	306.17	Net income	277.30

Replacement ratio $\dfrac{277.30}{306.17} = 90.6\%$

*For a married man with two children under 11 with weekly Local Authority rent of £56.82 and Council tax of £20.90.
Unemployed married couple with one earner previously working more than 30 hours a week.
Source: Adapted from Tax/Benefit Model Tables (April 2005).

Taxation Reforms

- A simplified tax system

- A shift towards indirect taxation

- Local taxation

- Savings schemes

- Welfare Policies

Burden of Taxation and Tax Incidence

- The tax burden: true economic weight of a tax
  - $Y^d = Y - t$; P and W adjustment

- Incidence of tax: who actually pays?

- Effects of imposing a tax
  - ↓W: tax is shifted backward (to a FOP eg labour)
  - ↑P: tax is shifted forward (to the consumer)

- Employer portion of social security
  - Mostly shifted backwards

- Corporate income tax
  - $\downarrow N^d \rightarrow \downarrow W$: tax is borne by workers
  - ↑P: tax is borne by consumer

Summary

- **Desirable Features of a Tax System**
  - Minimise efficiency losses
  - Equity goals

- **Composition of UK tax burden**
  - Shift from direct to indirect taxes

- **Taxation Reforms**
  - A simplified tax system
  - Efficiency and incentives
  - Equity and welfare policies