Lectures 9 to 12

CHAPTER 4 PUBLIC FINANCE FOR PUBLIC GOODS

4.1 Taxation

• This raises issues on top of others associated with public goods (see later, e.g. preference revelation and bureaucratic obstruction)

• Covered already in EC2020

Efficiency (4.1A)
**Excess Burden**

- Direct (e.g. income taxes) vs indirect taxes (VAT or excise duties)
- Excess burden of an income tax (Fig. 4.1 done on board)
- Depends on slopes of S curves: if inelastic little effect
- Ignores income effect, which could increase labour supply
- Taxes imposed on labour market to fund public goods market
- Indirect taxes (Fig. 4.4 done on board): depends on slope of D curves
- Value added tax: operation, not affected by ownership structure, hard to evade.
- VAT exemptions: decrease base, which means higher rates to generate same tax revenue.
- Higher the VAT rate, the greater the chance of adverse effects (see later)
• VAT concessions very attractive politically, especially coming up to elections
• Indirect taxes and fiscal federalism: US example (covered a little in EC3030)
• Excise or specific taxes; to alter behaviour or just an ‘easy’ revenue source? If former, big decrease in D desirable, but does not apply to cigarettes and alcohol.
• Also cross-border shopping possibility.

Other Costs of Taxes
• Compliance/emotional costs for taxpayers: shock of official letters plus time needed to complete forms.
• Administration; revenue collecting costs.
• Wealth tax story.
Taxes with no excess burden (the ‘holy grail’!)

• Lump sum taxes: zero elasticity of supply or demand. Hence very good for revenue with few behavioural consequences
• Property taxes on improved and unimproved land. Henry George ‘story’
• Poll tax and Mrs Thatcher ‘downfall’. See footnotes 15 and 16.
• Household charge Ireland
• Taxes an issue for a long time!
It's a new idea where you plunder them just a little bit on a regular basis - it's called "taxation."
Measurement of the excess burden

- Cannot be measured at individual level
- Aggregate level and diversity of estimates. Surveys give conflicting outcomes.
- Taxes impact on other markets: for example, increased corporation tax leads to increased price, decreased demand, and decreased wages and hence income taxes.
- Labour markets: choice to work or not, rather than vary hours
- Or to enter black market.
- Or to emigrate: high-income people very mobile and can leave country easily. One result of globalisation and hence need for co-ordinated tax policies?
Tax Revenue and the Laffer Curve (4.1B)

- Tax revenue = tax rate x tax base = \( t \cdot (w \cdot L) \)
- \( t \) increase, implies \( w \cdot L \) (total hours worked per year) decreases and possibly total tax revenue declines

Napkin ‘science’

- Laffer curve
- Varies by individual; aggregate estimates
- Laffer curve for investment taxes also (e.g. corporation tax in Ireland)
• Political sensitivity of curve and can be ‘manipulated’ for political gain
• Long run v short run (large differences)

Incidence or Who Pays Tax? (4.1C)

Who Pays the Tax?
Theoretical and Empirical Considerations of Tax Incidence

• Horizontal v vertical equity
• Benefit v ability to pay principle
• Legal v effective incidence: can be big difference
• Political emphasis on former
• Fiscal illusion: e.g. company tax and who pays (if don’t really know who pays a ‘good’ tax politically? Also excise duties same applies.)
• Direct v indirect tax debate. Income taxes v TV licence or water charges. Latter very visible and hence more resistance? Also purpose much more explicit and hence subject to scrutiny.
• Economy wide effects: dentist and sugar example. Increase tax on sugar, implies more healthy teeth, implies decreased demand for dentists.
• Skipping 1.D, taxes on international trade (e.g. French tax on beer but not wine issue)

4.2 Tax Evasion and the Shadow Economy
Tax evasion as free riding (applies to all taxes, especially income tax and VAT)

Public Policies
• Not paying own taxes v keeping other’s tax payment
• Expected value penalty = probability of detection x penalty level
• Limits to increasing level of penalty: because of danger of wrong conviction
• Tax amnesties: brings people into net but upsets honest taxpayers. Tax due plus interest: latter let off sometimes

Why do people evade?
• Absence of guilt or shame: could have latter without former. Being caught the issue rather than any moral concern.
• Social norm: taxes not widely accepted, e.g. poll tax in UK, water charges in Ireland
• Expressive behaviour and shame: e.g. lists of names in paper. Funeral collection ‘story’.
• Level of risk aversion and degree of shame.

Opportunities for Evasion
Self-employed v PAYE sector
Services in kind: dentist and lawyer friends. Evasion or avoidance? DIY work then?
Smuggling and indirect taxes: arises from higher prices across borders
Multinationals and transfer pricing (the ‘double’ Irish)

Illegal immigrants
Exploited by employers

Tax avoidance v evasion
Task of tax accountants/lawyers to maximise former. But divide line often not clear.

Behaviour of tax authorities (4.2B)
Tax collector should be unpopular! Benjamin Franklin quote, p. 283.
Implies less evasion and less fear of ‘capture’

- Presumptive taxation: tax according to presumed ability to pay. See article on Italian tax case.
- Corrupt tax officials: influenced by level of penalties

Shadow Economy (4.2C and 4.2D)

- No taxes paid at all
- Also often welfare fraud, money laundering, drugs, etc
• Size of ‘black’ economy? Use electricity consumption or .....?
• 66% of GDP in Georgia, 23% Italy, 9% Switzerland, 8% USA. Greece, Spain? Very difficult to measure accurately, not surprisingly!
• High where governments corrupt
• People must be ‘invisible’ and hence cannot be seen to be successful. So avoid driving a BMW!
• Consequence of high taxes?

4.3 Government Borrowing
• Deferred taxation
• Fine if benefits into future (arises in case of state investment)
• Should be equal payment, through deferred taxation in this case
• Default: avoid paying altogether!
• Benefits only today but place burden on future generations: they will be richer?
• Ricardian equivalence: bond v taxation same impact.
• Must be paid back with interest either by you or your offspring
• Hence private saving increases to pay future taxes, and no macro impact of borrowing
• Who knows benefits to future generations?
• Fiscal illusion: benefits now costs later
• Same applying to future pension liabilities of state?
• Attractive for government: Ireland in 1980s, Greece in 2000s. But huge long-term costs
• Constitutional constraint on borrowing: recent German proposal (see later lectures, Chapter 10.
• Budget surplus or savings: will it be squandered?