

PROGRESSIVITY IN TAX DESIGN



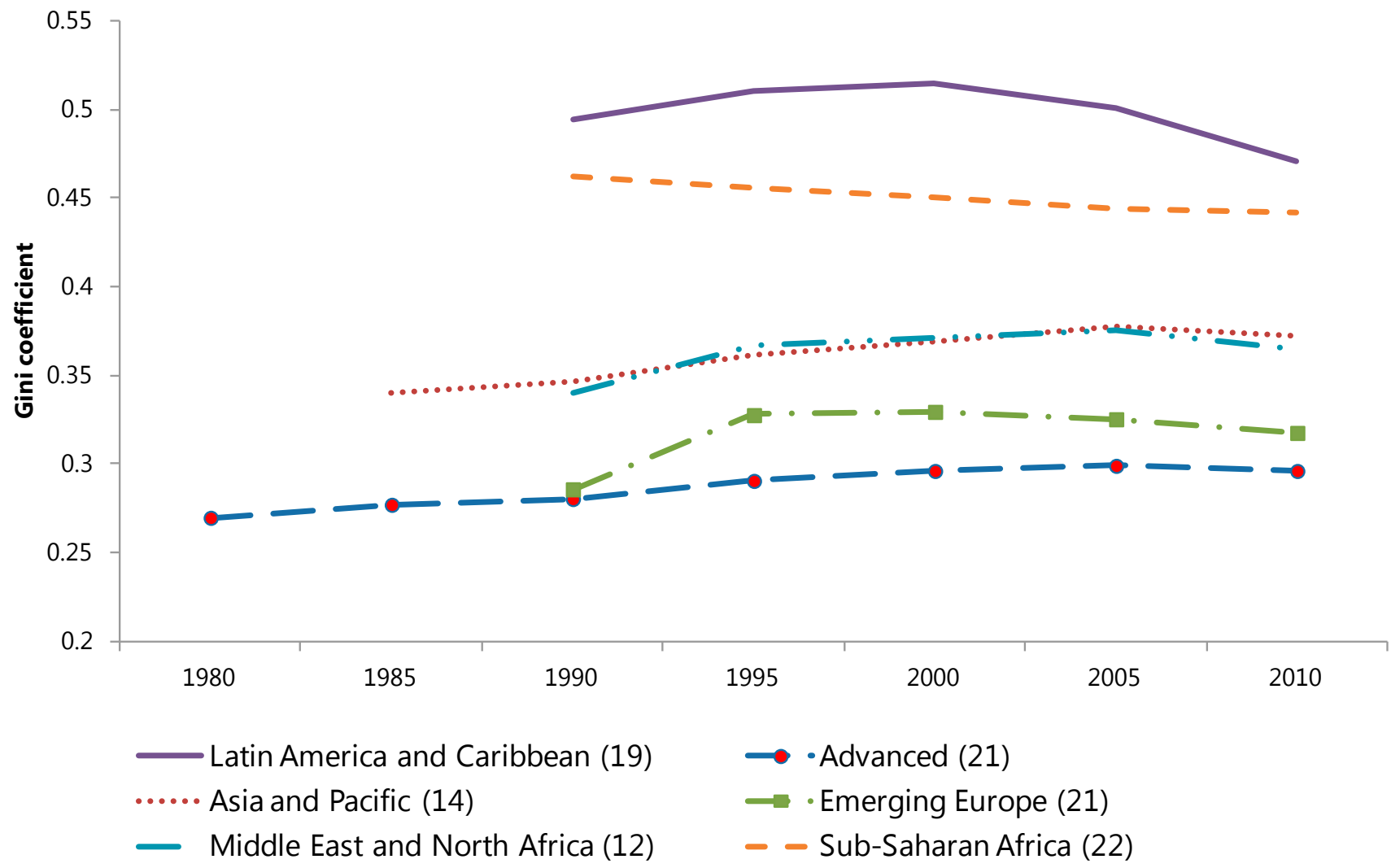
Michael Keen

International Monetary Fund

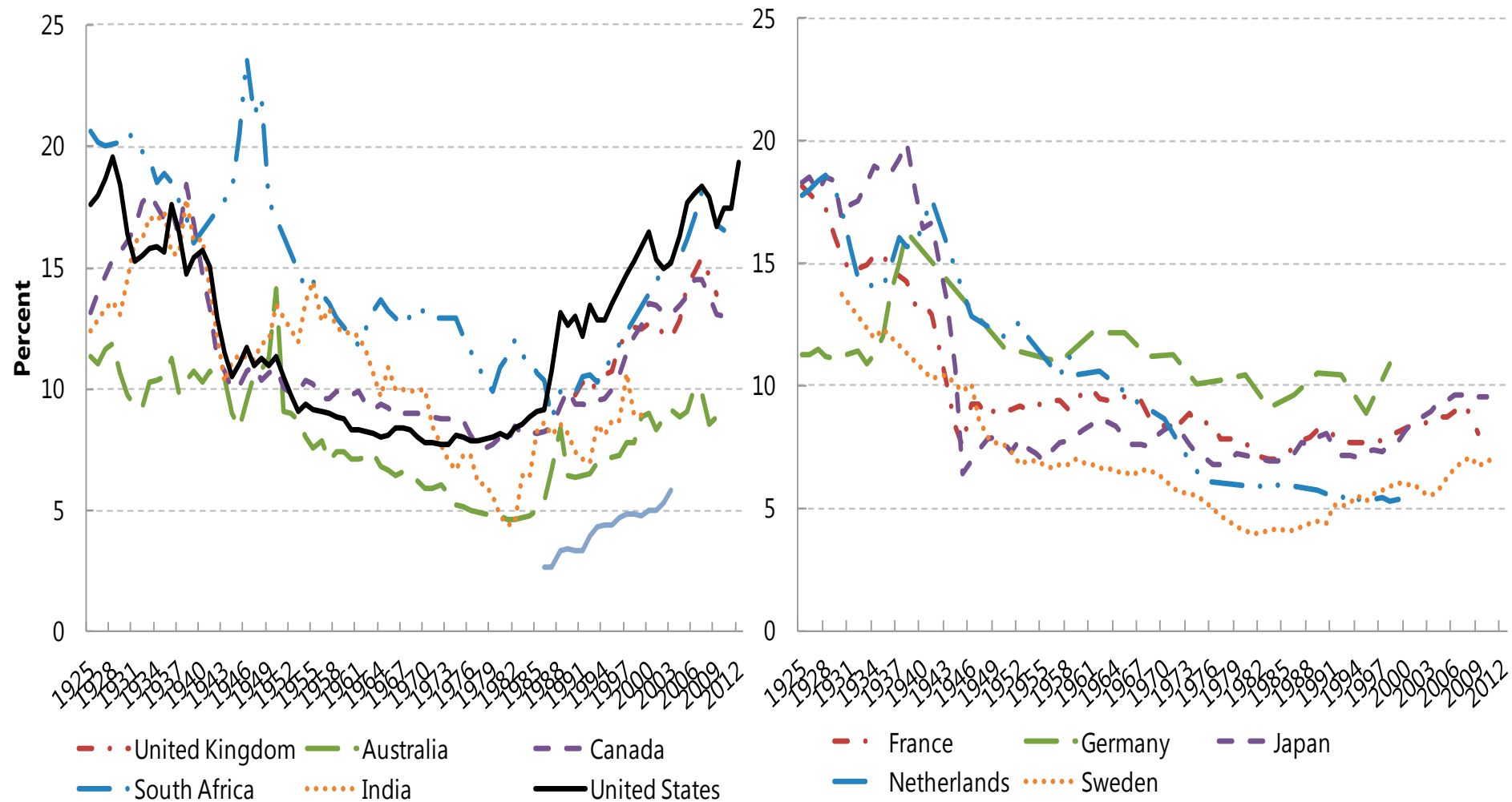
The 5th IMF-Japan High-Level Tax Conference for Asian
Countries Tokyo, April 21, 2014

CONTEXT

Inequality has been increasing...



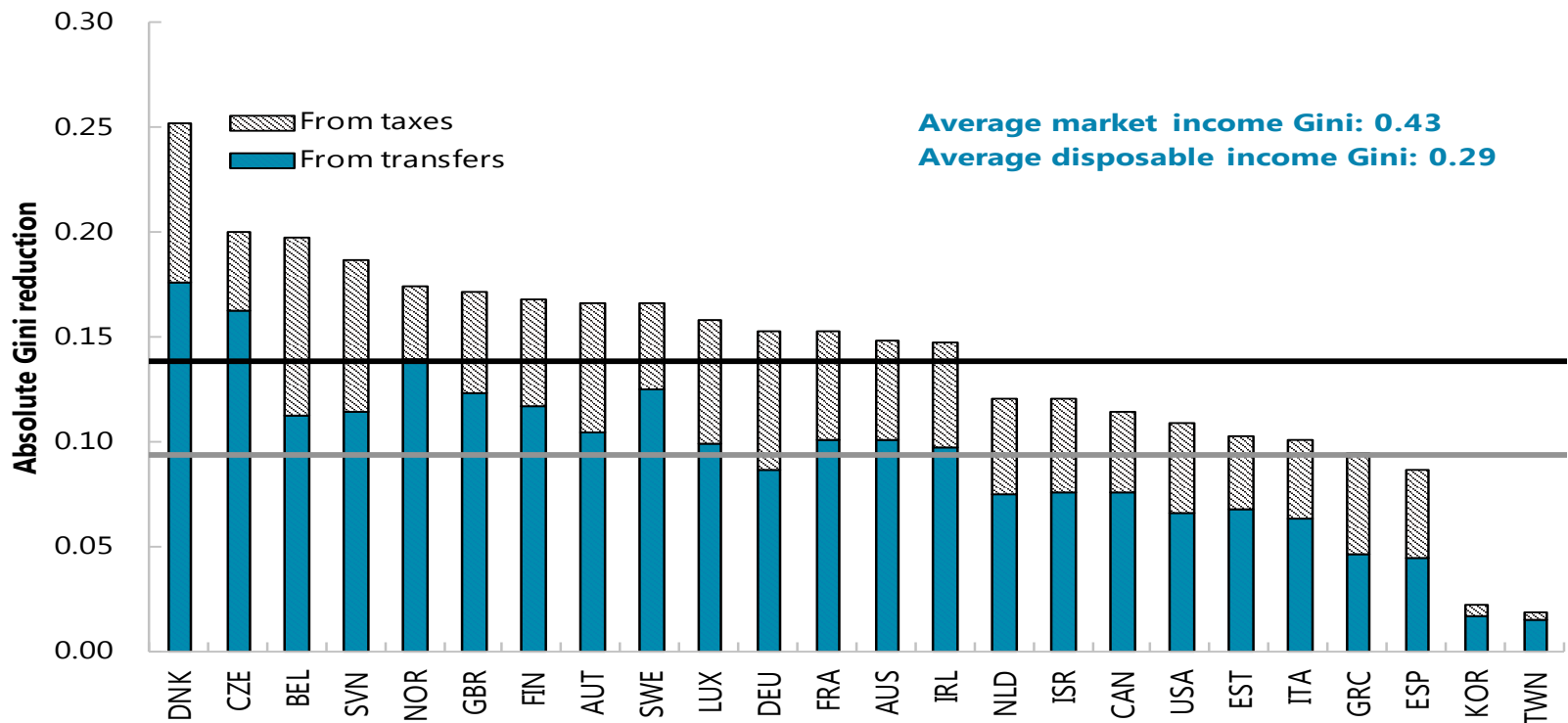
..notably at the very top



—especially in Anglo-Saxon countries

What role for taxation?

- Most redistribution is through spending, for advanced...



...and likely true for developing too

To bear in mind...

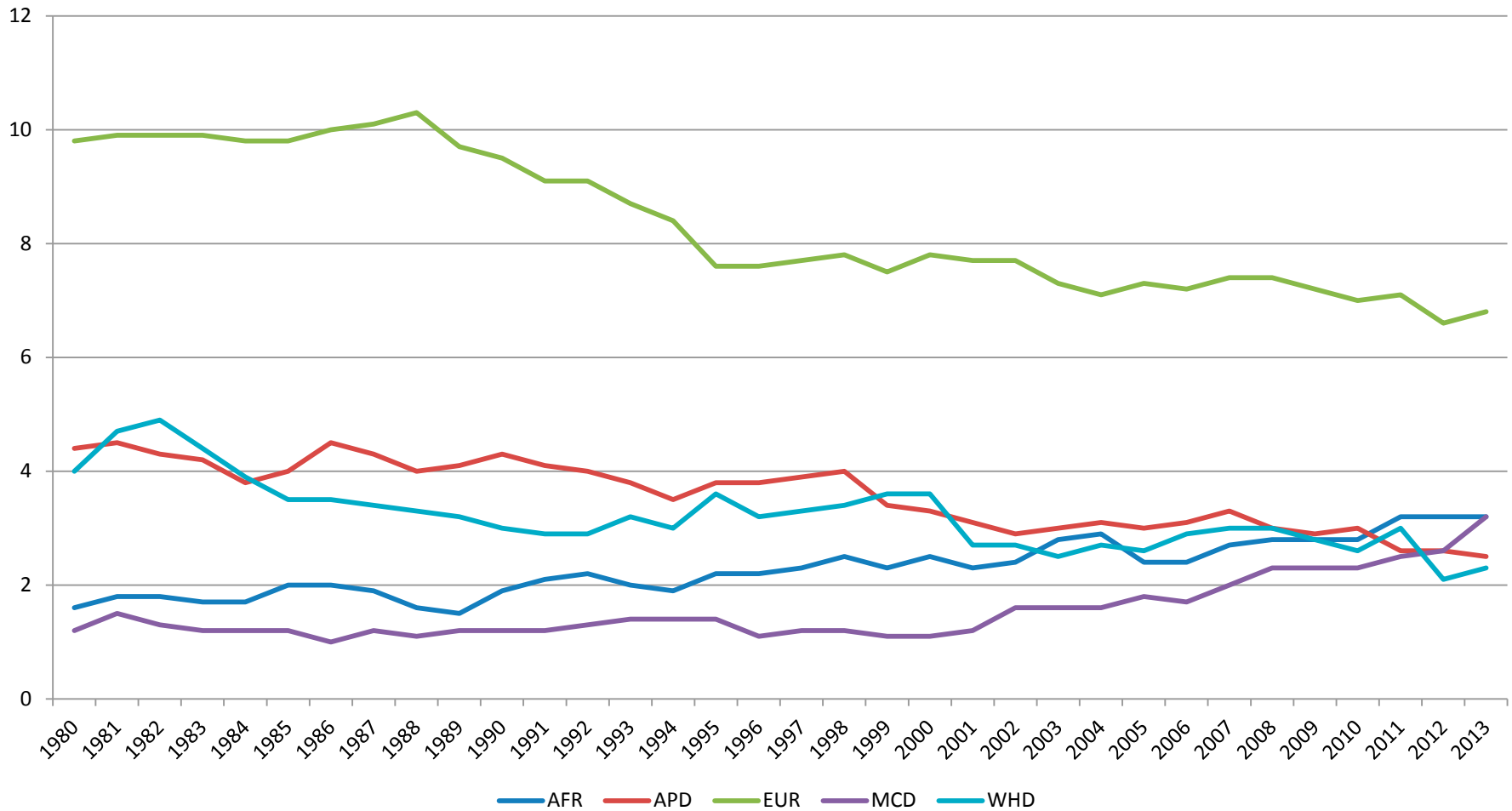
Will focus on instruments most directly related to progressivity, but

- Governments have their own equity views
- All taxes matter for fairness
- ‘Progressivity’ can refer to impact on either:
 - Distribution of after-tax income
 - Distribution of tax payments

E.g. \$1 paid only by richest person is very progressive in latter sense, but not in former

PERSONAL INCOME TAX (PIT)

A modest share of GDP



...which limits its redistributive effect

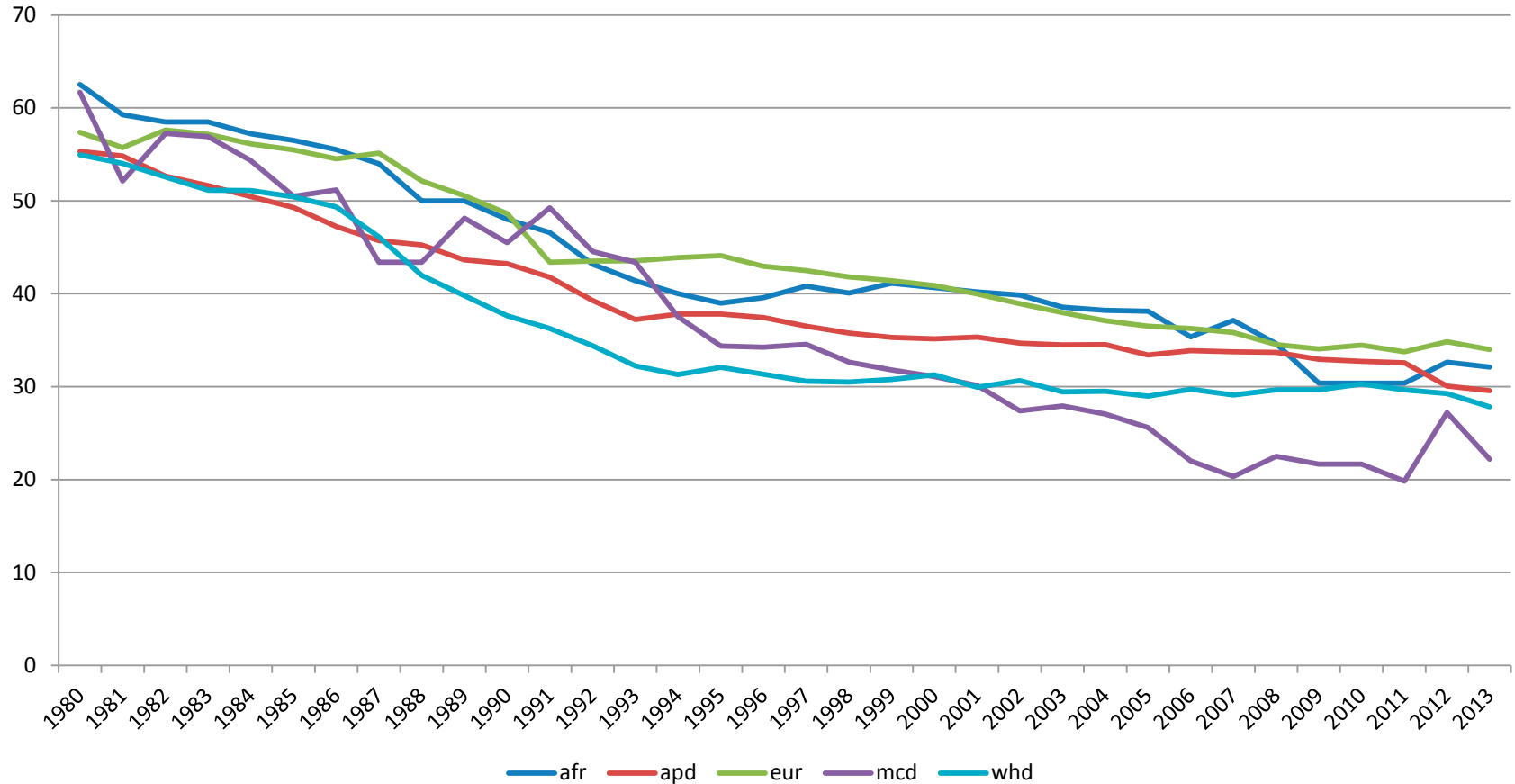
ALTERNATIVE PIT MODELS

- 'Global'
 - Apply schedule to sum of income of all kinds
- Dual
 - Flat rate on all capital income (= lowest rate on labor)
- 'Flat tax'
 - Single positive marginal rate on labor income

(Not really a distinct category, but much attention since Russian 2001 reform)

RATE STRUCTURE

- Much (too much?) interest in top rate



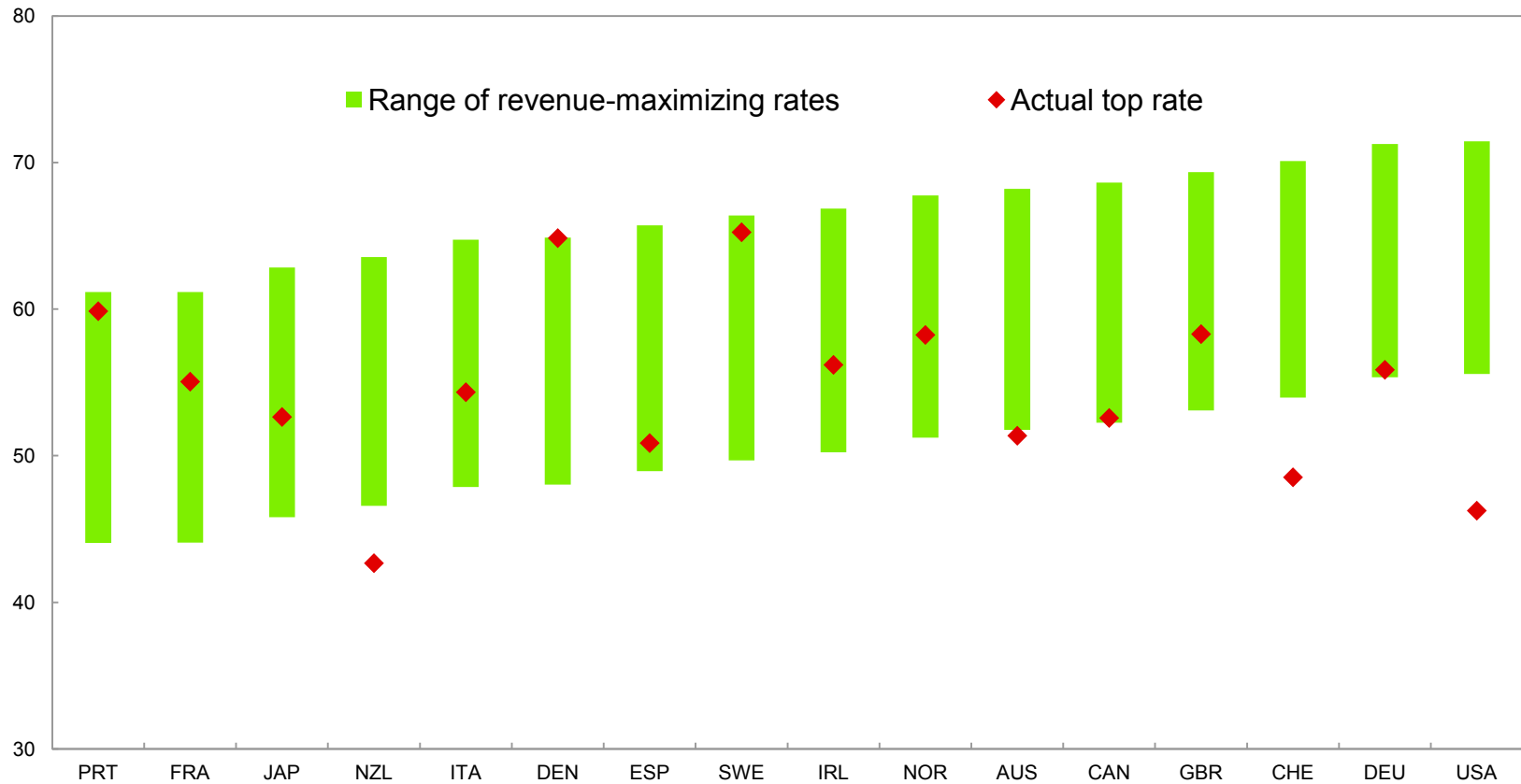
- Downward trend—but surprisingly little variation

The optimal rate balances...

- Revenue gain from higher top marginal rate
- against
- Discouragement of effort
 - Impact on evasion/avoidance
 - Both captured by ‘elasticity of taxable income’ (ETI)
 - Welfare loss of those affected

For advanced economies..

Revenue maximizing rate:



Where capacity is less well developed?

- Might expect ETI to be higher
 - E.g. strong compliance improvement from cutting top rate (30% to 13%) in Russia
 - (but not enough to make it self-financing!)

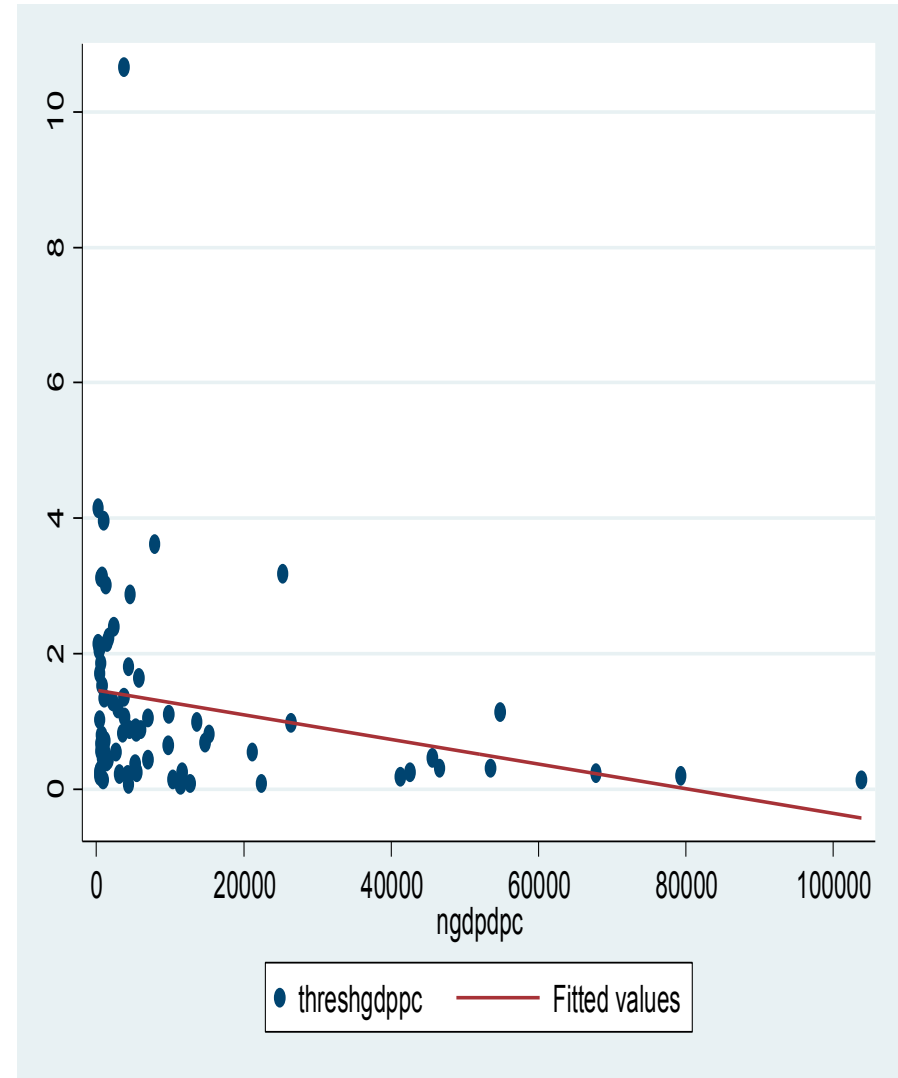
Hence optimal top rate to be lower

- But not entirely clear
 - Because issue is marginal effect, not level
- Much to be learned!

THRESHOLD

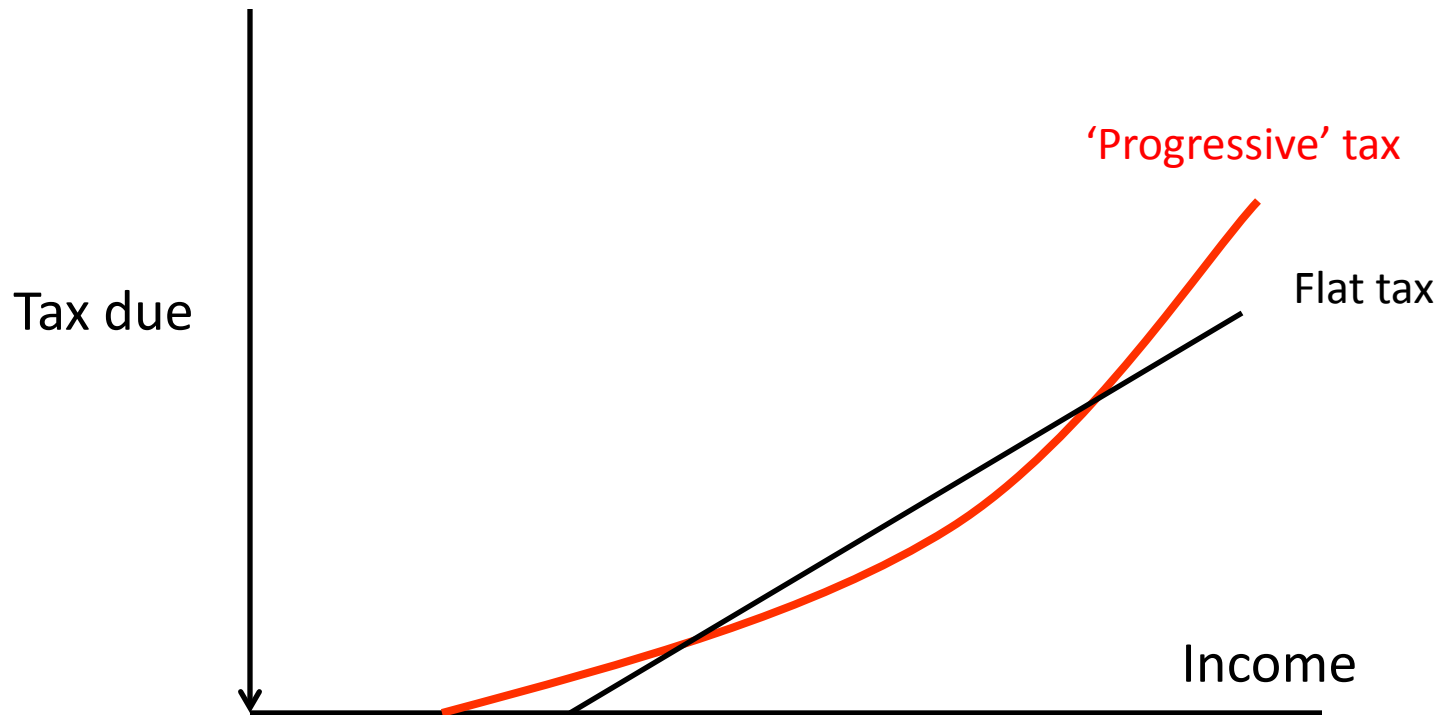
A key parameter

- Choices vary widely...
- ..with only weak tendency to decrease (as would recommend?) at higher income levels



To illustrate significance...

Several flat taxes had higher thresholds:



So 'winners' were at top AND towards bottom

BASE EROSION

- Special provisions favoring better off...
 - Mortgage interest relief, deductions for health, charitable contributions
- ...commonly undermine progressivity
 - And are often ineffective

To limit them, as well as setting caps:

- Replace deductions by credits at basic rate: same value for everyone

TAXING CAPITAL INCOME

Progressivity alone might call for relatively heavy taxation

—though how large a redistributive effect?

But potentially high efficiency costs:

- Distortion to savings, hence growth effects
- High international mobility

Dual income taxation?

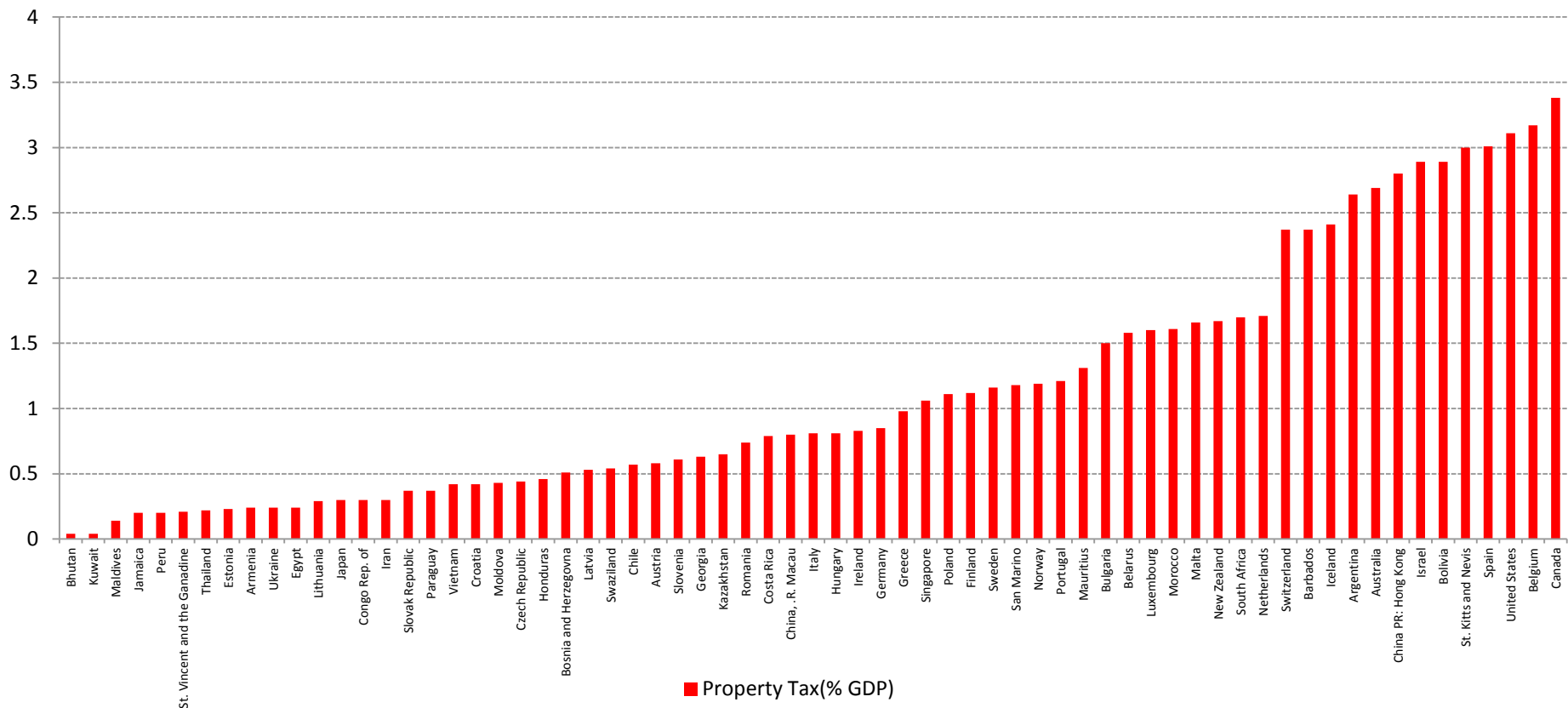
- Pioneered by Nordics—where equity a concern
 - Increasingly popular, if not always under that name
- ‘Achilles heel’ is need to distinguish capital from labor income for small and closely held firms
 - But their treatment is highly problematic in lower income economies anyway....
- And can facilitate more uniform treatment different forms of capital income

OTHER TAXES

Recurrent real estate taxes attractive

- Wealthy hold much of their wealth in real estate
- Immobile

Scope in many countries to do more:



Wealth taxes?

- Wealth is much more unequally distributed than income
- Wealth taxes have rarely been effective, and have been dying—but now a change?
- Becoming more feasible?
 - Combine real estate tax with (lower rate) on financial assets?
 - (A)EOI a game-changer?

Inheritance and gift taxes?

To address intergenerational transmission of inequality

- Practical challenges less than for wealth taxes?
 - Since can draw on legal framework for inheritance
- ...But may still be considerable
 - Often riddled with exemptions, like wealth taxes
- How distortionary?
 - Depends on motive of giver

CONCLUDING

- Tax systems seem to have been becoming less progressive over last twenty years or so
 - Reflecting politics and globalization
- Effective tax progressivity in many countries likely to have been low
 - A mistake to introduce PIT in same form as advanced economies?
- But are the mood and possibilities—now changing?