[A Positive Theory of Tax Reform]

CFM-DP2015-26

Ethan Ilzetzki

Department of Economics, London School of Economics, Centre for Macroeconomics, Centre for Economic Performance and CEPR.

In an era of fiscal austerity, questions of tax reform have once again taken centre stage. In recent U.S. debates, both political parties expressed support for reform. During the debt crisis in Southern Europe, calls to reform the tax systems of Spain, Portugal, Italy, and Greece could be heard. Tax reform has been one of the most contentious issues facing the current Indian parliament. Why has the passage of reform been so difficult? Why do inefficient tax systems persist? Are there economic or political conditions that are particularly propitious for tax reform?

Most tax reforms involve changes not only to tax rates, but also to the tax base. In contrast, in most economic and political economy models of taxation the tax base as given, making it hard to make sense of the real-world political debates on tax reform. This paper proposes a new political economy theory of taxation where the tax base and statutory tax rates are separate dimensions of taxation. In the model, the tax base may be less than comprehensive because tax exemptions are allocated to special political interests. Exemptions of this sort map neatly into the types of tax exemptions existing the U.S. and other tax codes (e.g. mortgage interest deduction, employer provided health insurance). I then propose a lobbying model where special interests bid for tax exemptions.

A number of findings arise when studying these two dimensions of policy. First, tax reform is more likely to occur when the government faces larger revenue needs. Second, there is a tipping point (a critical tax base or critical level of public goods to be financed) that triggers tax reform. At such a reform moment, even special interests are willing to forgo their tax exemptions in favour of tax reform. While no special interest would unilaterally give up its exemption, special interests can be collectively better off if all exemptions are eliminated. Third, for this reason, large “big bang” tax reforms are more politically viable than small ones are. Finally, there are strategic complementarities in lobbying for tax exemptions. That is, a lobby’s willingness to pay for tax exemptions is increasing in the number of other special interests lobbying for tax exemption. This leads to multiple equilibria where there is little lobbying and an efficient tax system or much lobbying and multiple tax breaks.

Some of the model's predictions are studied using data on corporate tax base changes in 30 OECD countries from 1980-2004. The data shows that countries tend to broaden the tax base when public spending is high and/or the statutory corporate tax rate is high: as would be predicted by the model. Tax base increases are associated with cuts in tax rates, also consistent with the model.