

Social Acceptability of Tax and Transfer Schemes

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Beveridge 2.0 Tax Justice Symposium
LSE, May 3, 2022.

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1. Introduction

- The standard efficiency-equity model to analyze tax and transfer issues, based on the rational self-interested individual, has dominated thinking on taxes and transfers since the work of Mirrlees (1971).
- Policy prescriptions from this model are not always accepted by society, even in situations where rational self-interested individuals should support them:
 - ✓ food subsidy reforms, which should be supported, or at least not opposed, if losers receive direct income compensations, are often rejected, sometimes leading to demonstrations and riots;
 - ✓ the same occurs with fuel tax changes to eliminate regressive subsidies or combat climate change.
- More generally, responses to policy prescriptions for tax and transfer reform can be strongly influenced by factors outside the standard model: perceptions of trust in government, behaviors guided by feelings of solidarity and reciprocity, ideas or visions of the world.
- We explore some issues that determine the social acceptability of tax and transfers schemes, including responses to proposals to reform individual components of these schemes, or to systemic reforms.

2. Rational Private Interests and Politics

- Identifying winners and losers from reforms may not be enough to sustain them, even if losers are compensated.
- Trust in government can be a critical factor:
 - ✓ Iran's, fuel subsidy reform required pre-deposit of compensations in households' bank accounts, which were activated only when the subsidies were removed;
 - ✓ Mexico's VAT reform in 2003 failed because the legal instrument to compensate low-income households was a presidential decree while the tax reform would be contained in a law; an asymmetry between a permanent tax increase and potentially transitory compensations;
 - ✓ Chile's income tax reform of 2014, on the other hand, was successful because citizens trusted President Bachelet to invest the proceeds to the intended purpose (education reform).
- Tax/subsidy reforms that are identical in their technical design can be accepted or rejected based on the political context: history of previous reforms in the country or government in power.
- Designing commitment mechanisms to ensure that compensations do take place can be central.
- Because of lack of trust, formal earmarking might make reforms palatable, and in some cases may be a sine qua non condition, contrary to the strictures of standard economic analysis.

3. Behavioral Economics and Tax Policy

- Large literature, with a number of reviews (eg Bernheim and Taubinsky, 2018).
- We illustrate with two recent papers on attitudes to carbon taxes, which capture many of the themes in the literature
- Douenne and Fabre (2022). Based on representative survey in France three months after the Gilets Jaunes protests in France.
 - Carbon tax with revenue distributed uniformly is rejected.
 - Net monetary losses are overestimated.
 - Characterize the policy as regressive.
 - Changing beliefs can increase support, but the effects of informational treatments are small.
 - “Indeed, the respondents that oppose the tax tend to discard positive information about it, which is consistent with distrust, uncertainty, or motivated reasoning.”
- Carattini, Carvalho and Frankhauser (2018). Review of literature on public attitudes to carbon taxation as a function of proposed use of the tax revenue.
 - Formal earmarking of revenues to address environmental concerns or redistribution directly tends to increase public acceptability of carbon taxes. Related to trust issue.
 - Greater (perceived) progressivity of redistribution of carbon tax revenues increases acceptability.
 - Compensation through cutting other taxes appears to be the least persuasive in changing attitudes to carbon taxation. Issue of trust. But also mental accounting: “...people do not make the link between a policy that is aimed at reducing greenhouse gas emissions and the desire to reduce taxes in a different area. They perceive these to be separate problems requiring separate solutions.”

4. Social Constraints to Fine Targeting

- Targeting transfers for poverty alleviation is often advocated in developing countries.
- But finely targeted transfers can create poverty traps; may be associated with a political economy that limits their amounts; may lend themselves to electoral/political manipulations; and may generate feelings of unfairness among those excluded.
- These issues go beyond the traditional concerns with information issues and proxy targeting techniques:
 - ✓ a sharp separation of the poor from the non-poor can isolate the former and limit the budgetary resources (“more for the poor is less for the poor” (Gelbach and Pritchett, 2002);
 - ✓ the results to fine targeting may not be understood by all, particularly in rural communities where the non-poor are not-too-dissimilar from the poor, leading to stress and tension (Adato, 2011).
- Targeting can sometimes conflate income levels with formal/informal status in the labor market. Transfers targeted on the double condition of being poor and informal can increase informality rates among poor workers (Garganta and Gasparini, 2015; Bosch and Schady, 2019).
- Fine targeting may create poverty traps if the transfer is high (Garganta et al., 2017).
- On the other hand, conditionality can make transfers to the poor acceptable to the middle class, in contrast to unconditional transfers, even if at the margin they have no impact on behavior (Fiszbein and Schady, 2009).
- These issues play out differently depending on cultural values, political context, and labor market institutions.

5. Ideas and Interests (1/2)

- Social protection systems in some developing countries, among them many in Latin America, rely on an “augmented” Bismarckian model (wage-based contributory health, pension and other programs bundled with minimum wages and stringent dismissal regulations). For many reasons, this model usually excludes more than 50% of the labor force.
- In response, governments have expanded coverage of social protection through introducing non-contributory health, pension and related programs, and targeted income transfers for the poor (usually in the form of a CCT). These responses have occurred gradually on a “scheme-by-scheme” basis.
- The resulting systems (a mix of contributory and non-contributory programs, CCTs, minimum wages and dismissal regulations) are very complex. On balance, they are not effective at protecting workers against risks, they redistribute little (and sometimes in the opposite direction), and they punish productivity (Levy and Cruces, 2021).
- The introduction of new schemes is often not matched with taxes (as opposed to the Bismarckian model). Households see little connection between taxes and benefits and are unwilling to pay the former. As a result, the tax burden is usually low compared with OECD countries, and so are the benefits. The result is a low tax, low quality of services equilibrium, with limited protection, little redistribution and undesirable incentives.
- A systemic reform towards universal social insurance would go a long way correcting the current situation. This reform is inextricably linked with tax reform, as the mix of labor and other taxes in financing social insurance would need to change, and the overall tax burden increased.

5. Ideas and Interests (2/2)

- Interests and ideas make these reforms very difficult. A small but powerful set of households benefit from the *status quo* (usually private workers in large firms and public sector workers). In parallel, many consider that the Bismarckian is redistributive, despite evidence to the contrary, under the belief that wage-based contributions redistribute income from (always rich) firms to (always poor) workers. These beliefs are used by higher-income households that oppose taxes.
- Trust, information and perceptions are then central elements of a systemic reform. At present, middle-income groups oppose tax reforms because they only perceive costs. They oppose eliminating generalized fuel subsidies because compensations are usually targeted at groups with lower incomes than theirs. They oppose tax increases because they perceive that they finance social protection programs that fail to address their needs. Under these perceptions, reforms are very difficult.
- An overall vision of the social protection system may change them. A proposal for a broad redesign might allow different groups to see what is in it for them and to understand that under systemic reform they can be winners. But they need to be presented with new ideas for them to consider that their interest might lie elsewhere.
- Systemic reform does not imply that everything needs to be reformed at the same time. But it does imply that an overall vision of the desired social protection system is required, even if individual reforms are carried out gradually.
- It is indispensable to have clarity about what needs to be done. Yes, interests are there; nothing new here, but ideas can be central.

6. Conclusions

- All societies rest on taxation, and the distribution of its burdens and benefits among households is central to their welfare. In modern societies, however, taxes cannot be imposed arbitrarily by emperors, pharaohs or kings; a broad majority of citizens needs to agree with them and be willing to pay them.
- The equity-efficiency framework often used by economists to analyze taxation, based on the rational individual carefully calculating costs and benefits, is incomplete because it pays little attention to the social acceptability of taxation. This is not to deny that individuals pursue their own self-interest, but it is to say that their attitudes towards taxation are more complex than that.
- Failure to consider the social acceptability of taxation can lead to the rejection of tax changes by individuals that, on the standard calculus, should support them. These failures can be very costly, and some countries are foregoing the benefits of reforms that could increase societal welfare.
- Understanding the social acceptability of tax and subsidy schemes is thus of the essence. The key point is to recognize that in addition to self-interest, individual behavior is also determined by culture and ideas.
- The interaction between these factors is complex because it depends on specific context, and because the ideas that individuals have about reforming taxes and subsidies may depend on whether they are put forth on a “scheme by scheme” basis or in a more systemic context.
- The challenge is to develop a richer framework, one that surely needs to pay central consideration to issues of efficiency and equity as usually understood, but that also incorporate the fact that these policies do not operate in a vacuum; they operate in countries with specific histories, cultures and political contexts.

Thank you.