

# Syllabus for ECON7008 Economics of Tax Policy

**Term:** Spring 2011

**Course lecturer:** Dr. Antoine BOZIO

**Office hour:** Tuesday 4pm-5pm (Drayton House room G05)

**EMAIL:** antoine\_b(at)ifs.org.uk (please mention ECON7008 in the subject)

## 1 Practical information

**Lecture's room:** Archaeology LT

**Course timetable:** There will be 20 hours of lectures, on Tuesday 2-4pm from Jan 11th to March 22nd with a break Feb 15th.

**Course website:** see Moodle page

## 2 Objectives

The course aims to provide students with an understanding of the economics of taxation. Both theoretical and applied economic tools will be used to analyse various issues of tax policy. As great emphasis will be put on bridging the gap between theory and applied cases, students will be asked both to formalise tax issues and to discuss in plain English the complexity of real life taxation.

At the end of the course, students should:

- have a knowledge of the structure of taxation in at least one country (UK will be described primarily but examples from Europe and the US will also be mentioned);
- be familiar with basic economic concepts and methods relating to taxation, including tax incidence and excess burden;
- have an understanding of some of the key behavioural effects of taxes, including those on consumer spending, labour supply, saving and investment;
- have an understanding of the main normative analysis of taxation (optimal commodity taxation, optimal labour income taxation)
- be able to analyse, using relevant economic concepts and methods, a number of issues in tax policy, such as the relative merits of different forms of income taxation, environmental taxation or other tax reforms.

### 3 Tutorials

**Teaching assistants:**

- Antoine GOUJARD (LSE), A.J.Goujard(at)lse.ac.uk
- Andres OTERO (UCL), a.otero(at)ucl.ac.uk

There are four tutorials to this course. They will begin a month after the start of the term (early February).

**Required coursework:**

1. All students should prepare written answers to the short-answer questions in advance of each class, and be prepared to discuss these answers during the class.
2. In addition, students should submit two pieces of written work for marking during the course of the term. The submitted work should take the form of one set of short answer questions and one essay, chosen from the essay titles. The essay should be on a different topic from the short-answer question set submitted for marking.

A document on the web page of the course will detail the short-answer questions and the list of essay titles available for students to choose.

The deadlines for these two pieces of work are as follows:

- Short-answer questions for marking should be submitted by noon on the Friday before the relevant class.
- The essay should be submitted, at the latest, by noon on the Friday before the final tutorial class of term.

Coursework for marking should be submitted through Moodle in electronic format or by placing the work (with a departmental coursework cover sheet) in your tutorial class teacher's pigeonhole (mailbox) in the basement of Drayton House.

Coursework for marking should be submitted by the deadlines given in this document. Note that although the coursework grades do not count in the final assessment, the coursework is compulsory. The Department of Economics rules regarding coursework submission and class attendance apply. In particular, students should note that if they do not complete the coursework requirements, and do not attend the classes, they may not be permitted to proceed to the examination.

## 4 Assessment

The course will be assessed by a two-hour written examination in term 3. This will consist of two parts, each accounting for half the total marks available for the examination, and you should divide your time accordingly. You will be required to answer four short questions from a choice of six in Part A, and one longer essay-type question from a choice of four in Part B.

Part 1 consists of questions requiring short, specific answers. These questions may, for example, ask you to define or explain a particular concept, explain a diagram or equation, interpret some data, or give a brief answer in response to a specific question. The questions in part 1 will relate closely to the lecture material, and if you have attended the lectures, and read the textbook readings covering the lecture material, you should be in a position to answer all of the questions on this part of the paper. You should expect to devote no more than an hour to Part 1.

You can achieve full marks for Part 1 by giving a precise, clearly-explained answer to the questions set. You will not gain extra marks for material other than that needed to answer the question. Vague or imprecise answers, inadequately-captioned diagrams or graphs, and inadequate explanations for your answers will, however, be penalised heavily.

Part 2 will consist of four questions, from which you should answer one. These questions will require longer answers, in which you will be expected to draw on the lecture material and your wider reading. You will be expected to demonstrate your ability to set out a logical, well-organised answer, drawing as appropriate on both economic theory and practical “real-world” knowledge. **Ability to write clearly in a structured way is an integral part of the exercise.** A document outlining the requirements for a good essay will be posted on the course web-page and should be taken seriously.

You should not expect the questions in part 2 simply to ask you to reproduce material from the lectures. You need to be able to contribute your own “added value” over and above the lecture material, in the form of your independent reading and thinking about the issues raised in the course.

A “sample” paper is provided on the web page of the course as a guide to the format of the paper and the likely style of the questions.

## 5 Textbooks and other general references

There is not one single textbook perfectly suited for this course. Most undergraduate textbooks cover a broader subject than what is envisioned in this class while textbooks on the economics of taxation tend to be too advanced.

### 5.1 Main references

The main book we will rely on is Gruber (2007). All the examples and debates are very topical although they focus largely on the US. The book deals with public policy in general but part IV of the book is closer to this course. In addition, references will be made to the Mirrlees Review which has been conducted under the aegis of the Institute for Fiscal Studies with the aim to explain to a wide audience how best to design a tax system given our current knowledge. The review has led to two volumes. The first one is a collection of reviews on each of the taxation issues one can encounter while the second presents the thoughts of the editors on how best to reform the UK tax system. All the chapters of the two volumes are available on IFS website ([www.ifs.org.uk/mirrleesReview](http://www.ifs.org.uk/mirrleesReview)).

Gruber, J. (2007), *Public Finance and Public Policy*, Worth Publishers 2nd ed [G2007].

Mirrlees et al. (2010), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press [MR2010].

Mirrlees et al. (2011), *Tax By Design: The Mirrlees Review*, Oxford University Press, *forthcoming* [MR2011].

### 5.2 Other references

Recently published, Kaplow (2008) presents an integrated view of tax policy very akin to the approach taken in this course. Another very good reference is Stiglitz (1999), especially parts V and VI. In many instances it can be used instead of Gruber (2007). Kay and King (1990) is dated but very good non technical presentation of the issues in taxation in the UK context. A very good advanced textbook on the economics of taxation is Atkinson and Stiglitz (1980), but unfortunately it is only available in libraries. Salanié (2003) is a good short technical and more modern alternative and Myles (1995) offers a more detailed presentation of the theory of public economics.

Kaplow, L. (2008), *The Theory of Taxation and Public Economics*, Princeton University Press [K2008].

Stiglitz, J. (1999), *Economics of the Public Sector*, W.W. Norton & Company 3rd ed. [S1999].

Kay, J. and King, M. (1990), *The British Tax System*, Oxford University Press 5th ed [KK1990].

Atkinson, A. and Stiglitz, J. (1980), *Public Economics*, McGraw-Hill [AS1980].

Salanié, B. (2003), *The Economics of Taxation*, MIT Press [S2003].

Myles, G. (1995), *Public Economics*, Cambridge University Press [M1995].

A very good source of information about UK tax policies is the website from the Institute for Fiscal Studies (IFS) ([www.ifs.org.uk](http://www.ifs.org.uk)) in particular the page on Fiscal Facts with its detailed description of parameters of tax schedules. A good survey presenting an overview of the UK tax system can be found on the Mirrlees Review website (Adam, Browne and Heady 2010). For an institutional description of tax system in the OECD, one should consult Messere et al (2009).

Adam, S., Browne, J. and Heady, C. (2010), "Taxation in the UK" in MR2010.

Messere, de Kam, and Heady (2002), *Tax Policy. Theory and Practice in OECD countries*, Oxford University Press.

## 6 Course outline and references

This course has been designed to address tax policies issues by linking theoretical and practical considerations, positive and normative analysis. The first four lectures of the course are mostly concerned with presenting the institutional background for tax policies and the basic concepts of the analysis. The rest of the lectures deal with specific issues in tax policy.

The only reference which are required readings are the textbook chapters. The other references are recommended to prepare essays or the final exam. There are presented by order of difficulty.

### 1. *Tax policy: objectives and methods*

This lecture will define tax policy and its objectives, before describing the framework and the methods used in public economics. It will cover a brief overview of the history of taxes as well as describing current practices around the globe in the level and structure of taxes. It will present key concepts necessary to analyze tax policy such as the tax base, the tax schedule, the average and marginal tax rate or the progressivity of a tax. Finally it will present the economics of tax policy, with its positive and normative approaches, drawing on the concepts from social justice and political philosophy.

*Textbooks:* chap. 1 and 18 of G2007.

*To go further:*

Adam, S., Browne, J. and Heady, C. (2010), “Taxation in the UK” in MR2010.

Kaplow, L. (1995), “A Fundamental Objection to Tax Equity Norms: A Call for Utilitarianism”, *National Tax Journal*, Vol. 48, No. 4, pp. 497-514.

Sen, A. K. (1998), “The Possibility of Social Choice”, *Nobel Lecture*.

### 2. *Efficiency: What is the cost of taxation?*

This lecture will present the concept of efficiency in the economics of taxation, detailing the various costs of taxation, i.e. administrative costs, compliance costs and distortion costs. It will insist on the central issue of the *deadweight loss* or *excess burden*, and on the difficulty of measuring these social costs of taxation.

*Textbooks:* chap. 2 and 20-1 of G2007.

*To go further:*

Shaw, J., Slemrod, J. and Whiting, J. (2010), “Administration and compliance”, (part I) in MR2010.

Hines, J. (1999), “Three Sides of Harberger Triangles”, *Journal of Economic Perspectives*, Vol. 13, No. 2, pp. 167-188.

Auerbach, A. (1985), “The Theory of Excess Burden and Optimal Taxation” in *Handbook of Public Economics*, vol 3., Auerbach, A. and Feldstein, M. (eds.), sections 2-4.

### ***3. Tax incidence: Who pays taxes?***

Tax incidence is the most basic concept in economics of taxation but one of the most ignored by the general public. The individuals who end up paying a tax are rarely those who formally have to pay this tax. We will approach tax incidence first in the simple case of competitive markets and then with the cases of imperfect markets. General equilibrium effects will be distinguished from the partial equilibrium analysis. Examples from the empirical literature will help give sense to the theoretical analyses.

*Textbooks:* chap. 19 and section 24.3 of G2007.

*To go further:*

Chap. 1 in KK1990.

Lecture 6 of AS1980: “Tax Incidence - Simple Competitive Equilibrium Model”.

### ***4. Tax design: the structure of taxation***

This lecture will present the debate about the structure of taxation, whether to tax consumption or income, to use indirect or direct taxation, or which tax base to select. We will discuss equivalence results between apparently very different systems and show that this old debate is intimately linked with the tax treatment of savings. We will also argue that tax questions are best dealt by considering the tax system in its entirety and not separately, as different instruments can be used for different objectives.

*Textbooks:* chap. 25 of G2007.

*To go further:*

Heady, C. (1993), “Optimal Taxation as a Guide to Tax Policy: A Survey”, *Fiscal Studies*, Vol. 14, No. 1, pp. 15-41.

Auerbach, A. (2006), “The Choice between Income and Consumption Taxes: A Primer” NBER working paper 12307.

### ***5. Labour earnings taxation***

This important lecture will address the design of labour income taxation. Normative analysis of the design of income taxes will be presented along various studies of the impact of taxation on labour supply and taxable income. These analyses will serve to discuss the design of redistribution policies. At the upper end of the income distribution lies the debate about the efficiency cost of high marginal tax rates and the recent reforms in many countries toward less progressive income taxation. At the other end lies the debate about poverty or employment traps created by tax and benefit systems and the various remedies that have been tried out in developed countries.

*Textbooks:* chap. 17 and 21 of G2007.

*To go further:*

Moffitt, R. (2003), “The Negative Income Tax and the Evolution of U.S. Welfare Policy”, *Journal of Economic Perspectives*, Vol. 17, No. 3, pp. 119-140

Goolsbee, A. (1999), “Evidence on the High-Income Laffer Curve from Six Decades of Tax Reform”, *Brookings Papers on Economic Activity*, Vol. 1999, No. 2, pp 1-64.

## **6. Taxation of goods and services**

This lecture will present the foundations of optimal commodity taxation with the seminal work of Ramsey (1927) and the subsequent development when both equity and efficiency issues are incorporated. This largely theoretical presentation will lead to the discussion of the best design of indirect taxation in practice, and we will focus on the case of VAT in the EU.

*Textbooks:* chap. 4 of M1995.

*To go further:*

Crawford, I., Keen, M. and Smith, S. (2010), “Value-added tax and excise”, in MR2010.

Keen, M. (2007), “VAT attacks”, *IMF Working paper*, WP/07/142.

Lecture 12 of AS1980: “The Structure of Indirect Taxation”.

## **7. Taxation of capital income**

Taxation of savings is a crucial issue for tax policy as the level of savings can have a dramatic impact on the long-term growth of an economy. We will present the theoretical implications of taxation in the context of an intertemporal model of consumption and the empirical evidence on the sensitivity of savings to after-tax interest rate returns. Then we will shed some light on alternative models of savings and study the particular case of property taxation.

*Textbooks:* chap. 22 and 23 of G2007.

*To go further:*

Boadway, R. and Wildasin, D. (1994), “Taxation and Savings: A Survey”, *Fiscal Studies*, Vol. 15, No. 3, pp. 19-63.

Zodrow, G. (2001), “The Property Tax as a Capital Tax: A Room with Three Views”, *National Tax Journal*, Vol. 54, No. 1, pp. 139-156.

Mossin, J. (1968), “Taxation and Risk-Taking: An Expected utility Approach”, *Economica*, Vol. 35, No. 137, pp. 74-82.

## **8. Corrective taxation**

We will discuss the use of taxation to correct for externalities, using the cases of environmental taxation and sin taxes. We will compare the use of taxation for environmental issues relative to other economic instruments (regulation, emission trading schemes), describe the idea behind Pigovian taxes and finally present attempts to introduce these type of taxes. We will then address the special treatment of alcohol, tobacco and other sin taxes. Are these taxes justified by efficiency grounds, paternalistic views or are they supposed to correct for externalities?

*Textbooks:* chap. 5 and 6 of G2007.

*To go further:*

Gruber, J. (2008): “Commentary: Sin Taxes” in MR2010.

Nordhaus, W. (2007), “A Review of the Stern Review on the Economics of Climate Change”, *Journal of Economic Literature*, Vol. 45, pp.686-702.

Sunstein, C. and Thaler, R. (2003), “Libertarian Paternalism is not an oxymoron”, AEI-Brookings Joint Center for Regulatory Studies Working Paper No. 03-2.

## ***9. Taxation of wealth transfers***

Taxation of transfers is a highly contentious subject. We will review the theoretical arguments in favor or against transfer taxation and discuss the empirical evidence available. We will discuss more precisely the administrative issues that pertain to the possibility of transfer taxation, distinguishing the cases of property and business transfers.

*Textbooks:* Section 23.3 of G2007.

*To go further:*

Kopczuck, W. (2010), “Economics of Estate Taxation: A Brief Review of the Theory and Evidence”, mimeo Columbia University.

Holtz-Eakin, D., Joulfaian D. and Rosen, H. (1993), “The Carnegie conjecture: some empirical evidence”, *Quarterly Journal of Economics*, Vol. 108, No. 2., pp. 413-435.