

# ***Peculiar Institutions: A British Perspective on Tax Policy in the United States***

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## ***Abstract***

By both effect and example, tax policy in the United States has a huge impact on the rest of the world. This paper explores five features of the American tax system that seem, from a British and European perspective, to be both especially peculiar and potentially instructive. These are: the remarkably low overall level of taxation; the absence of a value added tax (or any other general national tax on consumption); the absence of any explicit interstate equalisation; the marginal subsidisation of low earnings under the Earned Income Tax Credit; and the fragmentation of power in policymaking, an important aspect of which is the role played by the Constitution.

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## **I. INTRODUCTION**

The tax policy pursued by the United States has powerful effects far beyond its borders. It has a direct impact on economic activity, and well-being, in other countries: changes in the tax treatment of savings or investment in the US, for example, can induce significant capital flows,<sup>1</sup> whilst ensuring and exploiting the

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<sup>1</sup>Sinn (1985) estimates, for example, that the encouragement to domestic investment in the Accelerated Cost Recovery System induced capital inflows to the US in the order of \$1 trillion (about seven times the current account deficit of the time).

availability to US multinationals of the foreign tax credit on their repatriated profits is a major concern for many countries in designing their corporate taxes. The US tax system is also widely looked to — rightly or wrongly — as an embodiment of best practice. This is true both of the broadest elements of tax strategy — as is evident in the widespread emulation of the base-broadening, rate-cutting strategy of the 1986 Tax Reform Act<sup>2</sup> — and in the most detailed matters of tax design. Many American practitioners clearly regard important features of the US tax system as undesirable or, at any rate, not necessarily to be universally recommended. Nevertheless, any country reviewing its tax structures or administration is sure to ask ‘how do they do it in America?’.

Now is an especially good time for British observers to ponder the US tax system. For the new Labour government elected in May 1997 shows signs of being strongly influenced by US tax policy. Gordon Brown’s first Budget had as its centrepiece a ‘welfare-to-work’ programme, with both label and spirit borrowed from the US. It also foreshadowed a new savings incentive, to be called the Individual Savings Account; the reference to Individual Retirement Accounts (IRAs) is clear, though the acronym will have to be changed! The Budget speech also referred explicitly to the possibility of introducing a scheme modelled on the Earned Income Tax Credit (EITC). And, not least, the possibility has also been raised of introducing a distinction between short- and long-term capital gains of the kind that was made in the US until 1986 and reintroduced there in 1990, but which has not been seen in the UK since 1971.

The American tax policy experience is also of increasing importance from a wider European perspective. For as the European Union evolves towards some as yet unknown form of federalism, the forms and features of federalism elsewhere acquire increasing importance as potential exemplars. The US is not the only model of federalism, of course; but it is a uniquely successful one, and is widely referred to in Europe. Experience with the states’ sales taxes, to give one small example, has strongly influenced discussion of the appropriate degree of indirect tax harmonisation in Europe. As European integration proceeds further, more fundamental lessons from the US will be looked for.

This paper explores a few key aspects of American tax policy. No attempt is made to describe the US system.<sup>3</sup> Nor is the purpose to draw lessons from one side of the Atlantic to carry over to the other (though there will be some of that). Rather, the object is to explore a handful of aspects of the American tax experience that, to British and European eyes, are liable to seem distinctly strange. To many American eyes, of course, they will look perfectly normal, and the oddity will be that anyone should find them strange. It is not, however, the oddity that

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<sup>2</sup>Few British observers could resist remarking, however, that this strategy was anticipated in the 1984 reform of corporation tax in the UK.

<sup>3</sup>An excellent account is in Stotsky and Sunley (1994).

ultimately matters, but whether these features reflect any useful diversity of experience.

There is no shortage of choice in constructing a list of features of US tax policy that are liable to intrigue British observers: it would include, for example, the use of a classical system of corporation tax, formula apportionment, the attempt to tax US citizens residing abroad, the alternative minimum taxes, the universality of tax returns, and what seems now to be the almost ubiquitous practice of phasing out the benefit of exemptions through high marginal rates over some interval. The focus here, however, is on just five peculiarities. These are not necessarily the most important; we do not discuss, in particular, key issues in the treatment of savings and investment, which are treated in the companion paper by Gale (this issue). Their selection is entirely eclectic: they are interesting, and perhaps instructive.

The five, dealt with in turn, are: the very low level of taxes in the US; the absence of a VAT (or any other general national tax on consumption); the absence of interstate equalisation; the marginal subsidisation of low earnings under the EITC; and the peculiarities of tax policymaking, not least the role of the Constitution.

## **II. WHY ARE TAXES IN THE US SO LOW?**

Many outside observers will have been shocked by President Clinton's announcement, in his 1996 State of the Union address, that 'The era of big government is over' — shocked because, by the standards of most advanced economies, the US has never had big government.

In 1995, taxes (at all levels of government, and including social security payments) accounted for about 28 per cent of GDP in the US.<sup>4</sup> The average in EU countries was nearly 15 points higher, at 42.5 per cent of GDP; for the UK, the ratio was 34 per cent. Indeed, on this measure — which, for familiar reasons, is a very imperfect indicator of the extent of government intervention (not capturing, for example, the extent of regulatory activities) — amongst all OECD countries, only Mexico and Turkey have smaller governments than does the US. While much of US politics apparently revolves around a perception that taxes are too high, the interesting question is surely the exact opposite: how come taxes in the US are so low?

A first hypothesis that might occur to the outsider, dimly aware of continual agonising over the seemingly perennial federal budget crisis, is that perhaps the US maintains public expenditures at levels comparable to those elsewhere by

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<sup>4</sup>Revenue statistics are from OECD (1996) except where indicated.

massive borrowing. But in fact the federal deficit<sup>5</sup> is now relatively modest: in 1996, a year of essentially full employment, it ran at 1.4 per cent of GDP.<sup>6</sup> This is well within the guidelines for fiscal probity in the Maastricht criteria for participation in the single European currency — the bench-mark by which Europeans now instinctively gauge such numbers — which require a deficit of no more than 3 per cent of GDP. Indeed, in July 1997, agreement was reached on a package to balance the federal budget by 2002. Deficits have certainly been run at higher levels than these since the early 1980s, resulting in a ratio of federal debt to GDP of 69 per cent in 1996. This is above the Maastricht figure of 60 per cent, and in that sense looks rather high. But it is by no means unprecedented even in the fiscal history of the US: the federal debt–GDP ratio is now at roughly the same level as in the mid-1950s.

Nevertheless, work on generational accounting tends to confirm that low taxes in the US reflect a marked propensity to postpone tax payments. It suggests that, irrespective of the current pattern of receipts and expenditures — open, to some degree, to manipulation by judicious relabelling of items — a comparison of the present values of taxes and benefits anticipated under current rules indicates that those currently alive in the US have made themselves promises — in terms, especially, of pension and health care — that can ultimately be met only by substantial future tax increases. Auerbach, Gokhale and Kotlikoff (1994), for example, estimate that the lifetime tax rate (the present value of taxes divided by the present value of lifetime incomes) on those born in 1991 was around 34 per cent on the rules then in place; but that the lifetime rate required on those born thereafter — in order to balance the books — was 71.1 per cent. Thus the low tax ratio in the US may well reflect a deferral of higher rates to the future. What is not so clear, however, is whether this deferral is any greater in the US than in other economies, many of which — such as Japan, with an equally low ratio of taxes to GDP — face even more marked demographic challenges.

A second potential explanation of small government in the US is by an assertion of exceptionalism: Americans traditionally dislike government. This is a nation, after all, whose dominant citizens were for centuries virtually self-selected by a deep-rooted fear of oppressive government; and in which the only significant home-grown terrorist movement is aimed at the federal government *per se*. There are traditions here from which both the Chicago and Virginia schools of economic analysis grew and now in themselves feed — schools which, for all their differences, share a profound mistrust of government. And there is, it seems, some survey evidence that Americans tend to be more hostile to government than other nations are.<sup>7</sup> But historic exceptionalism of this kind, however appealing, will not

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<sup>5</sup>All states other than Vermont have balanced budget rules, of some form, intended to ensure that current expenditures are not financed by borrowing. Thus we focus here on federal borrowing. (Including state borrowing, the ratios of deficit and debt to GDP in 1993 were around 5.3 and 84 per cent respectively.)

<sup>6</sup>*Economic Report of the President, 1997.*

<sup>7</sup>Steinmo (1993) refers to such evidence.

entirely do as an explanation of low taxes in the US. For the divergence of tax levels in the US from those in most of its natural comparator countries is relatively recent. In 1900, the ratio of government spending to GDP in the US was about 8 per cent, midway between the levels for the UK (10 per cent) and Germany (6 per cent).<sup>8</sup> As late as 1970, the tax ratio in the US (29.2 per cent) — though lower by then than that in the UK (36.9 per cent) — was almost exactly the same as that in the European OECD (30.7 per cent). Since then, the US and the UK have been almost unique amongst OECD members in maintaining broadly constant tax ratios, whilst others — including such old industrial nations as France and Germany, and even Japan — have very substantially increased taxes. Much of the most interesting divergence has thus occurred in the last 25 years.

But although the notion of a generalised distrust of government cannot in itself provide an entirely satisfactory explanation of small government in the US, there are persistent differences between the US and its natural comparators in the role perceived for government. Perhaps the most fundamental of these is the relatively low expenditure on social transfers (meaning pensions, welfare, unemployment and health). This is deep-seated: Lindert (1994, Table 1A) reports that, throughout the 50 years from 1880, the US spent a significantly smaller proportion of GDP on social transfers than did either Germany or the UK, and indeed finds a tendency for such transfers to have grown less in the US over the period than one would predict on the basis of demographic and other considerations: some sign, that is, of American exceptionalism in this regard. By 1990, social transfers stood at 12.2 per cent of GDP in the US compared with 16.2 per cent in UK and well over 20 per cent in other European countries.<sup>9</sup> Indeed, the divergence between tax-GDP ratios that we seek to understand arises very largely because the US did not participate in the further growth of social transfers over the last 30 years or so. Broadly then, to explain low taxes in the US, one has to explain relatively low programmatic redistribution there — or high redistribution elsewhere — especially since about 1970.

This, though, leads to a puzzle. One would expect one of the primary determinants of the extent of redistribution to be the extent of pre-tax inequality, with simple models predicting that greater inequality will lead to more redistribution. In an optimal tax context, greater inequality is likely to increase the weight placed on the equity gain from redistribution relative to the efficiency losses. In a voting context, greater inequality is usually expected to increase the gap between median and mean incomes, leading to more redistribution (because the loss to the median voter from an increase in the tax rate — which depends on his or her own income — is now reduced relative to his or her gain from the increased amount available for redistribution — which depends on mean

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<sup>8</sup>Peltzman, 1980, Table 1.

<sup>9</sup>Lindert, 1996, Table 1.

income).<sup>10</sup> Since the US is characterised by relatively high interpersonal income inequality, one might on both counts expect to observe more redistribution in the US than elsewhere: exactly the opposite, that is, of what we actually do seem to observe.

In fact, this is but one instance of a more general puzzle. For it seems to be an empirical regularity — first noted by Peltzman (1980) and recently confirmed by Persson (1995) — that greater pre-tax inequality actually seems to lead to *less* redistribution and *smaller* governments. Quite why this might be remains unclear. Lindert (1996), building on Peltzman's argument, explains it in terms of social affinity: greater inequality means less commonality of identity between middle and lower classes, weakening their ability and inclination to win redistribution towards themselves. Persson (1995) builds an alternative explanation on the notion that people care not only about the level of their own incomes but also about their incomes relative to those of others. For this creates an externality that leads people to work too hard — because they neglect the envy their earnings cause others — so that introducing a linear income tax in an economy with relatively little pre-tax inequality can make everyone better off: it mitigates the externality by discouraging effort, an effect that may lead even those who lose (a little) from the direct effect of redistribution to support it. This explanation is not entirely compelling: such preferences imply, for example, that the non-poor would actually gain by taking resources away from the poor and simply throwing them away. Thus the regularity, if such it is, remains mysterious. There may be other and more particular factors also at work in the US context. For instance, snapshot measures of income inequality may significantly overstate the inequality in lifetime incomes relative to that in other countries; and the ease and willingness with which labour moves across the US may reduce the need for social insurance.

This brings us to a third potential explanation of low taxes in the US, which is one of special interest in the nascent federal context of the EU: perhaps the low tax ratio reflects the constraints imposed by interstate tax competition. There is, of course, a strong vein in American federalism — dating back to the *Federalist Papers* and powerfully articulated by Brennan and Buchanan (1980) — that sees competition between the states as a key weapon in the armoury of checks on tyranny: through the mobility of people, capital and commodities, and the scope for yardstick competition in evaluating politicians, competition between the states places downward pressure on tax rates that provides the citizenry with some protection from grasping governments.

There is a sizeable empirical literature, stimulated by Oates (1985), addressed to the question of whether greater centralisation of tax powers is associated with larger government. This remains broadly inconclusive, but it is the case that among the OECD countries, and conditional on both the level of national income and the ratio of central to total taxes, the ratio of tax to GDP is significantly lower

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<sup>10</sup>A classic treatment of this is in Meltzer and Richard (1981), and a recent variant in Persson and Tabellini (1994).

in federal countries.<sup>11</sup> But the effect is slight — less than one percentage point of GDP. Moreover, both Canada and Switzerland have participated in the general increase in tax–GDP ratios since 1970, so that federalism itself does not seem to account for US experience.

Indeed, the conventional presumption that federalism is conducive to low tax rates is itself open to question. For although horizontal tax competition between the states may be expected to exert downward pressure on tax rates, recent work has emphasised that co-occupation of the same tax base by both federal and state levels of government may create a vertical tax externality that points in exactly the opposite direction.<sup>12</sup> For an increase in the tax rate levied by either level of government reduces the common tax base and so adversely affects the revenues of the other level. If this effect is not fully internalised — and it seems plausible to suppose that many states will neglect the loss that they impose on other states by raising their own tax rates and consequently reducing federal revenues and, hence, expenditures — the combined (federal plus state) tax rate on the shared tax base will wind up excessively high. Quite how real an issue this is for the US is unclear. On one hand, the extent of co-occupation is clearly considerable: over 97 per cent of the federal tax base is shared with the states.<sup>13</sup> On the other, it is also clear that the combined tax rates on many shared bases — such as cigarettes — are far from high by international standards.

It is conceivable, of course, that the operation of such vertical externalities means that taxes are higher than they should be in the US even though they are, at the same time, relatively low by international standards. That would be consistent, indeed, with much of the tenor of US politics.

### III. TAXING CONSUMPTION (OR NOT)

Probably the single most peculiar feature of the American tax system is the absence of a value added tax.<sup>14</sup> All other major countries apart from Australia (which is thinking of introducing one) — and pretty well all minor countries too — now have a VAT (in substance, if not always in name). Indeed, indirect taxes in general are extraordinarily low in the US. There are general sales taxes at state and local levels,<sup>15</sup> of course, but these are light: the average statutory rate is about 5 per cent, and sales tax revenues took only about 2.2 per cent of GDP in 1992, compared with 7.4 per cent in the European OECD. Excises, too, are very low,

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<sup>11</sup>This result is in Keen (1996). The federal countries are taken in this exercise to be Australia, Canada, Switzerland and the US; the centralisation of tax powers in Austria and Germany is so great that these countries are regarded, for this purpose, as unitary.

<sup>12</sup>See, for example, Dahlby (1996), Flowers (1988) and Keen and Kotsogiannis (1996).

<sup>13</sup>Keen, 1996.

<sup>14</sup>The lonely exception being business transfer tax in Michigan, which is essentially a subtraction form of VAT.

<sup>15</sup>Sales taxes are deployed by 45 states, the District of Columbia and 6,000 local governments.

taking 2.1 per cent of GDP rather than 4.7 per cent. Low indirect taxes clearly go a very long way towards accounting for the relatively low tax ratio in the US.

It is thus no surprise that the possibility of a greater role for explicit consumption taxes has been widely discussed in the US. What is surprising is the normal context of such discussions. Surely the obvious way of dealing with the long-term budget crisis was — is — by introducing a general federal consumption tax of some form. Indeed, an early response to the deficits of the depression years of the 1930s was to propose a national sales tax. But all such proposals have failed. Instead, the context in which radical movements towards consumption taxation are most usually discussed — which, as Auerbach and Slemrod (1997) observe, has remained strikingly disjoint from the budget crisis discussions — is that of fundamental tax reform. Indeed, the very term ‘fundamental tax reform’, as used in the US, seems now to be virtually synonymous with the question of whether it would be desirable to shift towards some form of general consumption tax.

Ten years after the 1986 Tax Reform Act (TRA86), it seems that fundamental tax reform is returning to the political agenda (an excellent account of the issues and options being provided by the contributions in Aaron and Gale (1996b)). It is striking, indeed, how rapidly many of the central features of TRA86 began to unravel. TRA86 was the paradigmatic move towards comprehensive income taxation, with capital gains (albeit only nominal) taxed as other income and significant measures of base-broadening and rate reduction. Yet preferential tax treatment of capital gains did not take long to re-emerge — the top rates of personal tax on income and capital gains are now 39.6 and 20 per cent — and nor did the special pleading for such breaks as the tuition credits. Perhaps even more striking is that the response to these difficulties has been to return to essentially the same policy agenda as in the 1980s, with the alternative strategy most widely canvassed again being the replacement of (personal and corporate) income taxes by some form of consumption tax: the class of options, that is, that so spectacularly lost the political battle (though perhaps not the intellectual one) against the comprehensive income tax.

Consumption taxes come in many forms, and, to the occasional observer of US tax policy debates, the variety of proposals and labels is bewildering. Box 1 provides a brief primer.<sup>16</sup> These schemes differ in many important matters of structure and administration, and each can be reshaped in many ways. Of the many issues that they raise, we focus on just two.

#### BOX 1

#### **A Quick Tour of Consumption Tax Strategies Proposed for the US**

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<sup>16</sup>See Aaron and Gale (1996a) and Auerbach (1996) for more detail.



- The *flat tax* (originated by Hall and Rabushka (1983), advocated by former presidential candidate Steve Forbes and now associated with Representative Armey and Senator Shelby). This combines a cash-flow tax on firms — wages and intermediate purchases (including investment) being deductible — and a tax on wage income (levied at the personal level), both charged at the same rate but with an exemption limit for the latter. For those with earnings above the exemption, this is equivalent to an origin-basis VAT combined with a poll subsidy; for all others, the subsidy is reduced or zero.
- A *general sales tax* of some form, the two candidates being:
  - \* A *VAT*. It seems generally taken that this would be on a destination basis. But there is no consensus as to whether it would be implemented by the invoice method (as is assumed, for example, by Slemrod (1996)) — often referred to as the ‘European’ method, though it is the norm more generally — or by the subtraction method (as proposed by Representative Gibbons, and currently operated by Japan and Belarus). McLure (1987) provides an elegant account of these design issues.
  - \* A *national retail sales tax (RST)*, akin to the current state RSTs but with a wider base (including, in particular, services). Experience with these state sales taxes is not entirely encouraging: Slemrod (1996), for example, sees significant administrative difficulty in levying such a tax at the rates required (and see also Mikesell (1997) and Murray (1997)).
- The *unlimited savings allowance (USA)* scheme combines a uniform VAT with a progressive personal consumption tax (of the kind popularised in a UK context — without such a clever acronym — by Kay and King (1978)). Credits are available for payroll taxes, and there are provisions for the limited relief of consumption financed by previous savings.

The first is implicit in what has already been said: how is it that the US has resisted the charms of VAT, which have so beguiled tax policymakers in almost every other country of the world?

The bar-room explanation most commonly given seems to be that, simply put, Republicans oppose a VAT because they think it would prove a money machine for inherently untrustworthy governments, and Democrats oppose it because they think it would prove regressive. Neither view is compelling.

Compared in the usual way — with people ranked by their current incomes — a uniform VAT certainly looks regressive compared with the present income tax.<sup>17</sup> But, of course, that is not the only comparison of interest, either conceptually or as a guide to practical policy. Conceptually, it is well known that, when viewed from a perspective of lifetime welfare, a proportional tax on consumption may be more

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<sup>17</sup>Gale, Houser and Scholz, 1996.

equitable — both horizontally (taking the same present value of revenue from those with the same lifetime opportunities) and vertically — than one on annual income: for the level of consumption that any individual chooses, given all they know about their own circumstances and prospects, may be a better indicator of their economic well-being than is their current income. Movement to a VAT might also have broadly progressive asset price effects.<sup>18</sup> In practice, however, it is surely hard to conceive of a wholesale replacement of the current income tax by a sales tax applied at a uniform rate to all commodities. There would doubtless be pressures for rate differentiation — which, of course, has its cost in terms of simplicity and, perhaps, efficiency — of the kind that have led in the UK to the zero-rating and exempting of many sensitive items (amounting to well over 40 per cent of consumer expenditure). A VAT might also be accompanied by compensating income transfers, as is the Canadian goods and services tax (GST): Feenberg, Mitrusi and Poterba (1997) show that such measures can also substantially affect the progressivity effects of shifting to a general sales tax.

The money-machine concern seems even less well placed. One can perhaps concoct an argument for restricting untrustworthy politicians to inefficient instruments as a way of increasing the political cost to them of increasing taxes. But surely it would be better to impose constitutional limitations — of a kind that, as discussed later, US policymakers put such faith in — on overall levels of expenditure, whilst enabling this to be financed in the most efficient way?

Even taken on its own terms, moreover, there is a sense in which the money-machine fear is ultimately unconvincing. For a uniform VAT is equivalent, to anyone born after its introduction, to the combination of a wage tax and an inheritance tax.<sup>19</sup> And the federal government already has both of those instruments at its disposal. In the long run, a uniform VAT thus adds nothing to the federal government's power to tax. In the shorter term, things are different. For those alive at the time of its introduction, a uniform VAT is equivalent to a tax on their future and current earnings — again, an instrument already available — plus one on the financial assets they have built up under the previous tax regime. The federal government already has devices by which it might, in principle, impose capital levies; but nothing quite as powerful as this. Perhaps, then, the money-machine concern is best seen as another aspect of the standard transition problem that arises in moving to any form of consumption tax, not just a VAT: concern at the prospect of substantial intergenerational redistribution through an implicit levy on the initial wealth of current generations. At which point, of course, the argument is again essentially one of equity.

A quite different but perhaps no less fundamental obstacle to the adoption of a federal VAT is the issue of how this would relate to the pre-existing retail sales

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<sup>18</sup>Gentry and Hubbard, 1996.

<sup>19</sup>For simplicity, the arguments in this paragraph abstract from capital market imperfections, intergenerational linkages and administrative issues.

taxes (RSTs) of the states. This has two aspects. One is the political issue of states' rights, general sales taxation having previously been the preserve — *de facto*, not as a constitutional right — of the states. The other is technical: how does one best combine a federal VAT with continuing state sales taxation?

On this latter, one possibility is to superimpose a federal VAT on existing state RSTs. The bases and administration of the two taxes would likely be so different, however, (services, for example, would be within the VAT net but are effectively excluded from the state RSTs) that this would be a very cumbersome structure. And converting the states to VATs which are then simply piggybacked on the federal VAT has its own problems. The key issue here is the treatment of interstate sales, the difficulty being to eliminate any risk of strategic tax-setting by the states — seeking to advantage themselves at the expense of others — while securing the VAT chain (and maintaining the identical administrative treatment of inter- and intra-state sales) by avoiding, if possible, the zero-rating of out-of-state sales. These same issues currently arise in several federal contexts, not least in the EU; for the traditional VAT, whose appeal is very largely the ease with which it handles international transactions, has difficulty reconciling the aspirations to both a preservation of sovereignty at lower levels of government and seamless economic integration between them that is a hallmark of federal systems.

There is, though, one form of VAT that goes a long way towards reconciling these objectives. This is the 'VIVAT', proposed in a European context by Keen and Smith (1996). Though the problems in Europe are very different, this scheme also seems to provide a natural structure for the US. Its key feature is that there would be two distinct rates of tax for any item, depending on the identity of the purchaser: one rate for purchases by VAT-registered traders (at, say, 10 per cent), another for sales to final consumers (at, say, 13 per cent).<sup>20</sup> This, in turn, is equivalent to the combination of a VAT of the usual kind levied at 10 per cent (on all transactions) and an RST (albeit with a broader — better — base than state RSTs at present) of 3 per cent. The obvious strategy in the US setting is then to allocate the former component to the federal government and the latter to the states. The state RSTs would thus be replaced by a tax charged by all VAT-registered traders on all sales to those not so registered. Interstate transactions on intermediate goods would bear tax only at the federal rate, while the states would retain full discretion on the rate applied to final sales (receiving the revenue corresponding to any excess of that rate over the federal rate). In this way, the state sales taxes are integrated into a coherent national VAT structure, with no need for restrictions on states' sovereignty in tax-setting or for any reallocation of tax revenues across states. Thus existing state RSTs can be combined with a federal VAT in such a way that the only structural changes required of the states look like improvements.

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<sup>20</sup>VIVAT works best on an invoice basis, it being necessary to distinguish sales by the identity of the purchaser.

A second set of questions is prompted by the observation that the principal item on the menu of fundamental tax reform — offered in various dishes — is exactly the same as 20 years ago: consumption taxation. What have we — or should we have — learned since the time of the US Treasury's *Blueprints*<sup>21</sup> and the Meade Committee (1978) report?

The balance of the arguments made for consumption taxation has certainly changed. One of the merits especially emphasised in the 1970s was the ease of dealing with inflation. This is no longer to the fore. Now the emphasis is much more on simplification — the TRA86 strategy being seen as less than a complete success in this regard<sup>22</sup> — and, especially for academic writers, the desire to exclude from tax the return to savings. Of course, in many respects — such as the deductibility of pension savings placed in Individual Retirement Accounts — the US system already offers consumption tax treatment. The question is whether to move to such a system explicitly and thoroughly.

On this issue, it seems to bear emphasising, again, that the theoretical case for a pure consumption tax is not overwhelming. The limitations are familiar to many of those most active in the US debate (many of whom have indeed helped develop them) but seem all too often to be at risk of being forgotten. For one thing we should surely have learnt over the last 20 years is that the optimal rate of tax on capital income in an economy like that of the US is almost certainly not zero. The well-known results of Chamley (1986) and Lucas (1990), with optimally zero rates, may seem to say otherwise. But these rely on a dynastic view of intergenerational relationships that is increasingly mistrusted as a useful approximation to reality — and outside of which the optimal tax treatment of capital turns sensitively on issues of preference structure and debt policy (see, for example, King (1980)). They also side-step a profound time consistency issue by supposing governments are able credibly to commit to zero taxation of capital. Nor, contrary to an impression sometimes given, is the optimality of a zero rate on capital income a corollary of the Diamond–Mirrlees (1971) theorem on production efficiency.<sup>23</sup> For a small economy that is unable to monitor its residents' income from investments abroad, it may indeed be optimal not to tax the return to saving; but that hardly seems to be the position of the US.

Whilst sole reliance on consumption taxation is thus unlikely to be fully optimal for the US, the same is also true of a comprehensive income tax; indeed, there seem to be no known circumstances in which — as a matter of principle rather than a requirement to control avoidance — it is optimal to tax labour and capital income at the same rate. But rather than focus on the two extremes of consumption and comprehensive income taxation — or, indeed, on the uneasy

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<sup>21</sup>Bradford et al. (1984), originally published in 1977.

<sup>22</sup>See Auerbach and Slemrod (1997).

<sup>23</sup>Production efficiency requires, in a competitive world, that there be no tax wedge between the producer prices faced by different enterprises. Capital income taxes operate on a quite different wedge, between consumer and producer prices (of deferred consumption).

hybrids of the two that have emerged in the US and elsewhere — perhaps one should explicitly consider the possibility that these two kinds of income might optimally be taxed at different non-zero rates.

One such scheme — arguably the most important innovation in tax policy since TRA86 — is that developed in the Nordic countries since the start of the 1990s (and very nicely described in Sørensen (1994 and 1997)). The archetypal Nordic scheme comprises a flat (and low) personal rate on capital income (at the same rate as that on corporate income) plus a progressive tax on labour income. Put differently, this is essentially the Hall–Rabushka tax except that the tax on wage income may take a general non-linear form and a flat tax is levied on even the normal return to capital. Here, then, is a scheme that provides a third alternative to the consumption and comprehensive income tax options that have so dominated the fundamental tax reform debate in the US and elsewhere for the last 20 years. Such a system could have helped deal with many of the concerns that the TRA86 attempted to address, such as the inter-asset variation in effective marginal tax rates and — something a pure Nordic system would eliminate but a progressive tax on capital income intrinsically invites — the arbitrage possibilities and distortions arising from interpersonal variation in marginal tax rates on capital income.<sup>24</sup> Whether the approach has much to offer the US now is not immediately clear: obviously, the Nordic system reflects the particular experience of being a small player in increasingly globalised world markets. But perhaps the US is evolving towards some such system, with a differential opening up between the progressive taxation of labour income and the taxation of capital income — assuming one can choose to take it as capital gains, when preferable — at a lower and fairly flat rate. Perhaps an explicit recognition of this, along Nordic lines, would help the task of simplification.

A last observation on the consumption tax debate: in pondering a wholesale move to consumption taxation, it is natural for the US to look for examples to follow elsewhere in the world and to be discouraged by their absence. It may, then, be worth bearing in mind that one of the principal reasons others have rejected the consumption tax route is their view that the US Treasury would not regard a cash-flow tax as eligible for foreign tax credits. A country that adopted the Hall–Rabushka tax, for example, would find that US multinationals might well be unable to claim foreign tax credits on repatriating their profits to the US. For many countries, indeed, this is enough to immediately preclude movement to cash-flow taxation.<sup>25</sup> It would be a shame if the world were to find itself locked into an inefficient equilibrium, with the US discouraged by an absence of successful experiments in consumption taxation elsewhere that in itself reflects US policy.

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<sup>24</sup> Arbitrage gains will be available, for example, if there are ways in which individuals facing high marginal rates of tax can deduct interest payments made to those with low marginal rates. See Gordon and Slemrod (1986).

<sup>25</sup> McLure (1997), for example, cites this as a sufficient reason for Kazakhstan not to have adopted cash-flow taxation.

#### IV. FEDERALISM WITHOUT EQUALISATION

All men may be created equal, but the states of the Union have surely been very differently endowed by their creator. The same is true, of course, of very many federations. Others, however, respond to these differences in a way that the US does not: by arranging explicitly equalising transfers between the states. In Canada — the most obvious comparator for the US — the principle of equalisation is written into the Constitution, and such payments amount to about 15 per cent of the revenues that recipient provinces derive from their own sources. Switzerland, too, implements explicit equalisation: about 13 per cent of federal tax revenues is redistributed across the cantons in accordance with population and fiscal capacity. Australia, India and Germany also operate explicit equalisation across the second-tier jurisdictions. The US stands alone amongst the federations of the advanced economies<sup>26</sup> in its failure to equalise across the states.<sup>27</sup> For a Europe that appears to be advancing towards some form of federal structure, and in which the prospect of monetary union has raised questions as to the potential for a new and enhanced role for interjurisdictional transfers, this further peculiarity of the American experience is of special interest. How is this absence of equalisation to be explained?

There are broadly three purposes that might be served by an equalisation system (by which we mean one of unconditional horizontal transfers across the states): horizontal redistribution, insurance in the face of state-specific shocks and the correction of market distortions. Does none of these call for explicit equalisation in the US?

The immediately relevant dimension of redistribution here is not between persons — national views on this are presumably dealt with through the federal tax–transfer system — but between state governments. And the rationale for this is presumably a view that, irrespective, to some degree, of their own resources, states should be able to afford similar levels of public provision of key goods and services. This is made explicit in Section 36 of the Canadian Constitution, which envisages equalisation payments sufficient ‘... to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public service at reasonably comparable levels of taxation’. Viewed in this light, equalisation is essentially a matter of ensuring horizontal equity across the nation, with a belief in the legitimacy of this seen as a key part — to some, almost a definition — of nationhood. Note, too, that this view of equalisation as facilitating the public provision of some key goods comes very close to a rationale for conditional grants, so that line between equalising payments and conditional grants

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<sup>26</sup>There is no explicit equalisation in Russia or (though not formally a federation) China, though, of course, one does not usually think of these as natural comparators for the US.

<sup>27</sup>President Nixon did propose a thoroughgoing system of revenue-sharing that would have had a strong equalising component. In the event, however, only relatively minor schemes of this kind were introduced. There is now no general revenue-sharing at the federal level.

can become blurred. Interestingly, litigation in a number of states — following the decision of the California Supreme Court in the *Serrano* case in 1976 — has enjoined quite considerable equalisation of spending on education *within* states. No such imperative has emerged for equalisation across the states themselves.

Is there, then, any less need for interstate redistribution of this kind in the US than elsewhere? Interstate income inequality does seem lower in the US than in some natural comparator federations, though not dramatically so:<sup>28</sup> in 1991, the coefficient of variation of gross state product per capita was about 0.22 in the US, compared with 0.28 in Canada and 0.24 in Switzerland. Australia, however, implements an equalisation system despite apparently much lower interstate inequality (with a coefficient of variation in 1995–96 of around 0.12).<sup>29</sup>

Or perhaps significant redistribution does in fact occur between the states of the US, but it is simply not labelled equalisation?<sup>30</sup>

The question this raises is whether, in fact if not in name, federal transfers to the states tend to favour the poorer amongst them. From their purposes and structure, one might suspect that they would. Well over half of all federal grants to the states in 1994, for example, were for Medicaid and family benefits, and so might be expected to benefit most the most distressed states; moreover, the rate at which the federal government matches these state expenditures decreases with the state's per capita income. Other items supported by grant — highway improvements, for instance — can presumably also be targeted, *de facto*, to poorer regions. Is it then the case that states whose gross state product per capita is low tend to receive more federal aid per capita? The answer is a firm 'no': in 1993, states' receipts of federal grants-in-aid per capita — taken in the widest sense, so including payments related to Medicaid, Aid for Families with Dependent Children (AFDC), roads, education and so on — were essentially unrelated to their gross state product per capita.<sup>31</sup> Part of the explanation may lie

<sup>28</sup>A fuller comparison, of course, would need to allow for possible interstate differences in the cost of service provision.

<sup>29</sup>Figures are calculated from US Bureau of the Census (1995, Tables 27 and 703), *CANSIM* of Statistics Canada, Ruding Committee (1992, Table 9B.2) for Switzerland in 1989 and the Australian Bureau of Statistics Time Series Service ([gopher://gopher.statistics.gov.au](http://gopher://gopher.statistics.gov.au)).

<sup>30</sup>Indeed, there is no entirely clean economic distinction between equalisation payments — in the sense of unconditional horizontal transfers — and conditional grants: the same pattern of transfers may be represented in many different ways, with different 'equalisation' components. This reflects the familiar point that a conditional block grant that is smaller than the amount that the recipient state would otherwise spend on the item concerned is, in principle, equivalent to an unconditional grant of the same amount. The 'flypaper effect' — the feature that grants do not seem as fungible in practice as this argument implies (for reasons that remain unclear: see Hines and Thaler (1995)) — diminishes the force of the argument, but the point remains: the concept of an equalisation payment is not well defined.

<sup>31</sup>One finds, for instance, the regression line

$$\frac{G}{POP} = 0.53 + 12.31 \frac{GSP}{POP} - 0.063 POP \quad ; \quad R^2 = 0.07, N = 49$$

(0.24) (14.57) (0.56)

in the importance of matching grants: poorer states can afford only lower target levels of expenditure — lower benefit levels for AFDC, for example — and so may end up attracting no more federal support despite, perhaps, facing a more generous matching rate.

One might take a wider view of the potential role of the federal government in redistributing across the states by also taking into account federal taxes and benefits (such as social security (meaning pensions)) that the federal government pays directly to individuals. The progressivity of these will mean that average state incomes are more equal after their operation than before. They do not directly redistribute between state governments, of course, but they do, in a broad sense, equalise their tax bases. Looking at the combined effects of taxes, transfers and grants, Bayoumi and Masson (1995) find the net impact of the federal government to be progressive: a \$1 increase in average state income leads to a reduction of about 22 cents in net receipts from the federal government. Somewhat higher figures have been found (using slightly different methodologies) by Sala-i-Martin and Sachs (1992) and MacDougall Committee (1977): 35–44 and 25 cents in the dollar respectively. This implicit equalisation does look rather low compared with that found in other federations: the analogous figure has been put at 30–39 cents for Canada<sup>32</sup> and at 35 cents for the UK and Germany.

Though the reconciliation of these various results is not entirely clear, it seems that there is very little (if any) interstate redistribution through the full set of grants-in-aid, but that — in terms of the interstate distribution of net incomes — the progressivity of federal taxes and transfers more than compensates. The full extent of implicit interstate redistribution in the US, though not high, is far from zero.

The second potential role of equalisation is as a source of insurance of the states. Of course, the kind of interstate redistribution just discussed can itself be thought of, to some degree, as a form of social insurance — behind the veil of ignorance as to how the states will be endowed, all might wish to mutually insure each other — but here we have in mind a role in stabilising shorter-term macroeconomic disturbances. The focus thus shifts from equalisation across the cross-section of states to the smoothing of each state's income or consumption over time. Asdrubali, Sørensen and Yosha (1996) estimate that the extent of federal smoothing is fairly substantial (around 13 cents in the dollar) and perhaps even greater than in Canada,<sup>33</sup> but that other devices — investing in or borrowing

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where  $G$  denotes federal grants-in-aid in 1993 (\$ million),  $GSP$  gross state product in 1991 — the most recent year available — (\$ billion) and  $POP$  population in 1993 (million) and the figures in parentheses are White standard errors. Alaska is excluded, being a clear outlier; inclusion results in a strongly significant positive coefficient on per capita  $GSP$  — that is, a strongly perverse distributional effect. The data are from US Bureau of the Census (1995, Tables 27 ( $POP$  being column 10), 418 ( $G$  being column 6) and 703 ( $GSP$  being column 10)).

<sup>32</sup>Bayoumi and Masson (1995) and MacDougall Committee (1977).

<sup>33</sup>Bayoumi and Masson (1995), who look instead at the stabilisation of state incomes net of federal taxes and transfers, also find a more significant effect than in Canada.



from other states — are qualitatively more significant. Moreover, although smoothing of state consumption remains incomplete, it seems that there is little scope for a beneficial expansion of the federal insurance role, much of this remaining risk being undiversifiable within the US. It may also be that the considerable mobility of workers across the states in itself provides a means of insurance that reduces the need for financial transfers.

This brings us to the third argument for equalisation payments: as a response to inefficiencies in location decisions. These arise from the likely fiscal externalities that migrants will impose on pre-existing residents through, in particular, congestion effects that drive up the per capita cost of providing public services. Judicious transfers to (so discouraging emigration from) states offering relatively low net fiscal benefits — which one would expect to be the poorer ones — may, for this reason, prove beneficial to both recipient and donor. But despite significant and systematic internal migration in the US, this efficiency consideration has received far less attention in the US than it has, most notably, in Canada. Why?

Three potential explanations come particularly to mind. First, it may simply be that the efficiency gains to be had are small, as Watson (1986) argues to have been the case for Canada. Second, whilst the potential for Pareto improvement suggests that beneficial transfers might emerge voluntarily,<sup>34</sup> perhaps the constitutional prohibition on states making agreements amongst themselves without congressional approval has prevented the emergence of the agreements between subsets of states that would be required; it is hard, however, to detect signs of any very great suppressed pressures. Third, perhaps the US recognised earlier than others that equalisation schemes can also create efficiency losses by encouraging game-playing by the states. Smart and Bird (1996) provide an intriguing account of this in the Canadian context. For the equalisation formula used there partially insulates each province against the main revenue cost of raising its tax rate, since any induced contraction in its tax base — an increase in tobacco taxes reducing expenditure on cigarettes, say — is, in effect, regarded as increasing its neediness and so entitling it to greater equalisation receipts. The consequence is clear: receiving provinces are encouraged to set excessively high tax rates. It may be that such efficiency losses from equalisation are sufficiently high that it is best not attempted.

American federalism is strong, at least in the sense — perhaps the only one that ultimately matters — of there being no significant regional separatist movement. It would be too much to conclude that this is because of, rather than despite, the absence of explicit equalisation: not least, the experience of a civil war fought to rule out secession doubtless still leaves its mark. Certainly, though, equalisation has not gone hand in hand with national unity in, for example, Canada or Yugoslavia: the resentment of the haves has been all too clear. One can, it seems,

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<sup>34</sup>As shown by Myers (1990).

go a long way towards explaining the absence of an interstate equalisation system without invoking any American exceptionalism.

## V. WHAT ROLE FOR THE EARNED INCOME TAX CREDIT?

The Earned Income Tax Credit (EITC) seems to be widely reckoned a success. Certainly, it has grown substantially since its birth in 1975, to the point at which in 1997 it is expected to cost the federal government about \$27 billion (which is about 2 per cent of total federal receipts).<sup>35</sup> The EITC has been described as the ‘cornerstone of the Clinton administration’s welfare reform agenda’,<sup>36</sup> with its growth projected to continue. This perceived success has not been lost on the new British Chancellor, who indicated in his first Budget speech that the government would ‘consider at an early stage the advantages of introducing a new in-work tax credit for low-paid workers. [This] would draw upon the successful experience of the Earned Income Tax Credit, which helps reduce in-work poverty and now helps 19 million low paid workers’.<sup>37</sup> US experience with the EITC is thus currently of special interest to British observers.

The EITC is a refundable credit against the federal income tax. An interesting and distinctive feature is that, at low levels of earnings, the amount of the credit increases with income, so that the scheme acts as a marginal earnings subsidy: that is, the effective marginal rate of tax on earned income is *negative* at low earnings. In 1996, for example, the credit rate for a taxpayer with two children was 40 per cent, up to an annual earnings level of \$8,890: within this ‘phase-in’ range, earning an additional dollar actually brought \$1.40 into the house.<sup>38</sup> Above this earnings ceiling, the amount payable (\$3,556 in the running example) remains constant until another ceiling is reached and the benefit starts to be phased out (at a rate of 21.06 per cent).

It is not the idea of a refundable tax credit that is novel from the British perspective — a scheme of this kind was discussed in a 1972 Green Paper (HMSO, 1972) — but rather the notion of a marginal subsidy on earnings.<sup>39</sup> Our concern here will not be to judge the success or failure of the EITC itself — which requires placing it in the wider context of a complex tax–transfer system (of which more later) and evaluating, *inter alia*, both its labour-supply effects and the potential for fraud that has been a continuing concern.<sup>40</sup> Rather, we address here a

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<sup>35</sup>*Analytical Perspectives: The Budget of the US Government Fiscal Year 1997*, Tables 3-1 and 5-6.

<sup>36</sup>Dickert, Houser and Scholz, 1995, p. 42.

<sup>37</sup> Budget speech, line 133.

<sup>38</sup>The scheme was initially restricted to taxpayers with children, but was extended to those without in 1993.

<sup>39</sup>The closest UK relative to the EITC — family credit — operates by bringing earned income up towards some target level that depends on family composition, and thus implies a strictly positive marginal tax rate. See Walker and Wiseman (this issue) for an intriguing direct comparison between the EITC and family credit.

<sup>40</sup>On these, see, in particular, Dickert, Houser and Scholz (1995), Scholz (1994 and 1996) and Whitehouse (1996).

question of deeper principle that the structure of the EITC raises: what role, if any, do marginal earnings subsidies have in optimal tax–transfer schemes?

The answer is not as simple as it might seem. For consider the lowest-earning individual in the US, and suppose this person's earnings lie in a range over which a marginal subsidy applies. Imagine, now, a reform that reduces the marginal subsidy rate on this person whilst leaving her net income unchanged at her initial level of earnings. This reform will certainly leave this lowest earner no less happy: for she can achieve exactly the same combination of leisure and consumption as before simply by working exactly as hard as before, so that if she chooses to change her behaviour it can only be because doing so makes her even happier. Moreover, the government will find that its net revenue rises: for, since the individual faces a higher marginal tax rate than before, any change in her effort will be in the direction of working less; and since earnings are being subsidised, this will reduce the government's outlays. Starting from any situation in which the earnings of the poorest are subsidised at the margin, one can thus reduce that subsidy in such a way that both the welfare of the poorest earner and the government's revenues are increased. The conclusion to which this argument points — that schemes that act as marginal earnings subsidies cannot possibly be optimal — is a direct implication of the seemingly innocuous and little-remarked result in Mirrlees (1971) that the optimal marginal tax rate is always somewhere between zero and one.

Does this then mean that there is no good argument for a marginal earnings subsidy?

One potential rationale comes from supposing that policymakers care not about the welfare of the poor — which will reflect, amongst other things, the number of hours they work — but only about their disposable incomes. In practice, discussions of poverty do, indeed, focus on incomes rather than, for example, the possibility that the poor may be holding multiple jobs to secure those incomes. If no significance is attached to the number of hours worked, then reducing a pre-existing marginal earnings subsidy in the way described above is no longer an unambiguously sensible thing to do: for recall that one of the consequences of such a reduction is to induce the poorest worker to work less hard, and so to earn a lower income. With such a non-welfarist emphasis on income, encouraging the poorest to earn more by subsidising their earnings is indeed optimal.<sup>41</sup>

A very different line of argument<sup>42</sup> rests on the existence of involuntary unemployment, which is assumed away in the (standard) conceptual frameworks

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<sup>41</sup>This result, established by Kanbur, Keen and Tuomala (1994), requires that it be optimal for all to work. Altruism defined over the consumption of the poor has similar implications, as is shown by Oswald (1983): it is optimal to subsidise earnings, and hence consumption, because, when making their labour-supply decisions, the poor neglect the benefit that their consumption conveys on others — an argument, interestingly, that runs almost exactly counter to that of Persson (1995) discussed above.

<sup>42</sup>There are others that, for brevity, we do not develop here. Complementarities between skilled and unskilled labour, for example, may create a case for subsidising the earnings of the unskilled: see Allen (1982). In an

used above. For, by subsidising wages, one may hope to both expand employment and increase the net wage of those in work. Moreover, if the employment response is sufficiently great, the revenue cost of the wage subsidy may be more than offset by the reduced cost of supporting the unemployed; even the unemployed could then be made better off by increasing the level of benefit paid to them. And firms, too, should surely be better off, since one would expect them to be able to share in the financial benefit of the subsidy. In a context of involuntary unemployment, subsidising earnings thus holds some prospect of a Pareto improvement, with all — the unemployed who find work, the unemployed who stay unemployed, those employed throughout, employers and the Treasury — benefiting.

The precise impact of an earnings subsidy will depend on the cause of unemployment. A brief appendix considers the case in which it emerges from efficient bargaining between unions (which care about both wages and employment) and profit-maximising firms. The analysis confirms the possibility of a Pareto improvement but emphasises that this is by no means assured. An earnings subsidy in this model certainly reduces unemployment and increases profits. The government's revenues increase, as one would expect, only if the expansion of employment is sufficiently large and/or the unemployment benefit saved on each person moved into work is sufficiently high. Perhaps surprisingly, however, it emerges that the net wage received by the employed (inclusive of the subsidy) may quite plausibly actually *fall* as the earnings subsidy is increased: the intuition, it seems, is that a subsidy makes it more attractive for the union — acting in the interests of all its members, not just the employed — to accept offers involving low gross wages (and high employment) because these no longer imply such low consumption for those in work.

Though clearly model-specific, this result serves to draw attention to one key aspect of the EITC that seems to have been little studied: the extent to which it reduces the gross wage paid by employers rather than increases the net wage received by employees. The conventional assumption on this incidence issue — in both the theoretical optimal literature referred to above and such empirical studies of the effects of the EITC on labour supply as that of Dickert, Houser and Scholz (1995) — is that the net wage to the worker rises by the full amount of the subsidy. In practice, of course, one would typically expect — as the result above emphasises — that at least part of the benefit will be taken by employers. Indeed, such a reduction in the gross wage has a key role to play in generating the expansionary effect on employment that seems to be a central part of the subsidy's rationale. Any assessment of the impact of an EITC must take some view on this incidence issue. Theory indicates some of the factors likely to be important: in the efficient bargaining framework mentioned above, for example, the increase in the

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efficiency wage setting, to give another example, it may be better to support the low-paid by means of a wage subsidy than by a lump-sum transfer: for while the effect of the latter is to reduce the net income of the poor (Ravallion, 1984), the effect of the former, it can be shown, is to increase it.

net wage brought about by an increase in the subsidy rate is greater the higher is the replacement ratio (workers then having a more attractive outside option) and the less elastic is the demand for labour<sup>43</sup> (employers then being willing to pay more to prevent workers taking the option of unemployment).<sup>44</sup> Here, as in many other areas of tax policy, our empirical knowledge on key questions of incidence lags far behind both theory and the empirical study of lesser but more tractable problems.

In practice, the EITC operates in a world far more complex than that of any of the models referred to above. In particular, its effect and hence potential rationale are further and profoundly affected by its likely interaction with other instruments of policy. Two such linkages stand out.

The first is that with a minimum wage. Unlike the US, the UK has never had a national minimum wage. The incoming Labour government, of course, has a manifesto commitment to introduce one. And there may then be merit in seeking to mitigate the potentially adverse employment effects of a minimum wage by an accompanying earnings subsidy. Or, put differently, the presence of a minimum wage may limit the extent to which the benefits of an earnings subsidy can be reaped by employers in the form of a reduced wage.

The second set of interactions are those with other taxes and means-tested benefits, which tend to raise marginal tax rates on the poor. Holtzblatt, McCubbin and Gillette (1994) report that, in 1993, the marginal subsidy received by those in the phase-in range of the EITC — about 3.5 million filers — was large enough to offset income and payroll taxes, the average marginal rate for this group being – 21.3 per cent. But those also receiving food stamps and AFDC<sup>45</sup> would be very likely to face positive marginal rates overall.<sup>46</sup> Moreover, most recipients of EITC — about 90 per cent<sup>47</sup> — are not in the phase-in range. In practice, the main effect of the EITC seems to be to imply low effective marginal rates at the lower reaches of the earnings distribution, not negative ones. The observation is simple, but fundamental, and perhaps has lessons for the UK: if the important structural feature of the EITC in practice is not the negative marginal rate that it carries in itself but rather the effect it has in reducing the effective wedge between net and gross real wages of the poorest workers, perhaps it would not be as radical an addition to the armoury of instruments currently deployed in the UK as it might at

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<sup>43</sup>Or, rather, the reciprocal of the elasticity of the marginal product of labour, which is the elasticity of labour demand in the competitive case.

<sup>44</sup>An overall assessment of the incidence of the EITC would also need to take account of the effect of the ranges in which the subsidy is constant and then phased out; this lends a progressivity to the tax structure that one might expect to encourage employment and depress net wages (there then being some advantage to having several low-paid workers rather than a few high-paid ones): see Koskela and Vilmunen (1996).

<sup>45</sup>The eligibility links between these and the EITC are complex.

<sup>46</sup>See Dickert, Houser and Scholz (1995).

<sup>47</sup>Holtzblatt, McCubbin and Gillette, 1994, Table 1.

first seem. The real issue it highlights, it seems, is the choice between delivering benefits through the tax system or the welfare system.

## VI. SECRETS, LOBBIES AND CONSTITUTIONS

Some of the most striking differences between tax policy in the US and the UK are in the way in which it is made.

To the outsider, the most obvious contrast is in the degree of consultation in the formation of tax policy. In the US, major tax policy initiatives are developed, marketed, analysed and negotiated at great and doubtless often tedious length. In the UK, they are commonly announced in the annual Budget speech of the Chancellor of the Exchequer as, in effect, *fait accompli*. The classic example of this is the 1984 corporation tax reform. Though there had been a Green Paper on the topic a couple of years previously (HMSO, 1982), this did not consider the option actually adopted and nor indeed was there any expectation, when the Chancellor rose to make his speech, that he would have anything much to say about corporation tax. This continued Budget secrecy — which now results in the Chancellor going into a silent purdah for two months before the Budget, in the fear that he might say something interesting — is, of course, widely criticised. There have been some signs of greater openness in recent years (Higson, 1995). And certainly many major structural reforms are discussed in advance. The windfall tax that the new Labour government has imposed on privatised utilities, for example, was a manifesto commitment and had been widely discussed; and the reference to the EITC in the 1997 Budget speech will doubtless stimulate analysis. Less happy — for the openness, if not the effectiveness, with which policy is conducted — is the apparent practice of occasionally leaking measures under consideration to the media, allowing the government to market test its ideas without having to enter into any intellectual debate and whilst also distancing itself from any adverse political reaction. This was the case, for example, of the decision in the 1997 Budget to withdraw imputation credits from non-taxpaying pension funds: this was widely anticipated in the financial press, but of course could not be discussed by any in authority because of Budget secrecy. When in opposition, the Labour Party promised to ‘... open up the secretive budget process’.<sup>48</sup> In office, its first Budget contained significant surprises — a cut in the rate of corporation tax, for instance, and an increase in investment allowances — that smacked of furtive business as usual. More promising is the new government’s commitment to setting out its options in a ‘Green Budget’ to be issued in the autumn preceding the March Budget. Embraced enthusiastically, this could prove one of the most significant institutional reforms of an administration intent, it says, on modernising the apparatus of government.

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<sup>48</sup>Andrew Smith MP, then Shadow Chief Secretary to the Treasury. I owe this quotation to Michael Devereux and Malcolm Gammie.

The ability of British governments to proceed as they have reflects the vast power that the executive enjoys relative to the legislature and the judiciary. A government with a majority in the House of Commons can do pretty much what it wants in terms of tax policy. Thus it is that, with rare exceptions — usually on quite technical issues, such as the troublesome matter of the tax treatment of dividends paid from overseas income — the measures announced in the Chancellor's Budget speech find their way into the Finance Act. In the US, in contrast, taxing powers are fragmented between the executive (equipped with a presidential veto), the legislature (home of the tax-writing committees) and the judiciary (guardian of the Constitution). This fragmentation underpins the widespread consultation on tax matters in the US just discussed. It has other consequences too.

One is the apparently greater vulnerability of tax policymaking in America to lobbying by special interest groups. Making campaign contributions to key figures on congressional committees is a very direct way of exerting influence on tax policy in the US. There are no such natural targets in the UK. This is partly because of tighter rules on campaign financing, though there are other means of rewarding helpful politicians: contributing to their party, for instance, or holding out the prospect of future employment. But the great concentration of tax-making power in the UK means that there are rather few politicians worth influencing; and those who are have so much power in setting tax policy that the political damage they would suffer from appearing to have been influenced would be much greater. Perhaps, too, the greater ability of parties in power to deliver tax favours (or disfavours) in the UK enables them to extract their rents in return for fewer favours. In any event, the apparently greater vulnerability of the US tax system to lobbying is evident in the notoriously wide range of provisions favouring special groups that have typically characterised the US tax code, and which has been the particular target of reformers: Aaron and Gale (1996a) report that deductions, allowances and credits in the US reduce the personal income tax base by about 50 per cent. The UK tax code is generally reckoned to be cleaner, with the UK Treasury in particular having traditionally fought hard against special provisions. But British tax policy is not immune to special pleading: the 1997 Budget brought special tax breaks for the film industry, for example, just a few paragraphs after the Chancellor had stressed that '[t]he route to success is not for the government to pick winners ...'.<sup>49</sup> A second consequence of fragmentation in the US — clearly related to the lobbying issue just raised — is the greater complexity of the US system. This is true both on the tax side, as just discussed, and on the spending side: Barfield (1981, p. 9) quotes the example of there being four different federal water and sewer grant programmes, corresponding to the four separate committees of Congress. Joe Pechman, in contrast, once asked a senior UK Treasury official

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<sup>49</sup>Budget speech, line 81.

why Tax Bills in the UK are so much less complicated than those in the US, to be told it is because 'we are bullying Parliament'.<sup>50</sup>

A third consequence is a greater difficulty of bringing about significant tax reform in the US, there being more constituencies to carry along. Perhaps the ease with which a British government — indeed, a few people within it — can bring about major tax reform will be looked on with envy by would-be tax reformers in the US, all too aware of the thin line between checks and balances on the one hand and gridlock on the other. But consider the poll tax.

A final and fundamental aspect of fragmentation is the pivotal role played by the Constitution, which has shaped US tax policy throughout the nation's history and continues to be a focal point for discussion: in April 1997, for example, a balanced budget amendment failed in Senate by one vote. The UK, of course, has no written Constitution. While the case is sometimes made for acquiring one, this is rarely, if ever, with issues of tax policy in mind.

In the US, the notion of gaining credibility by writing restrictions into the Constitution is deeply ingrained. From the UK perspective, there does seem to be scope for some scepticism on the ultimate effectiveness of constitutional restrictions. The Canadian Constitution, for instance, restricts the provinces to the use of direct taxation; but this has not stopped them deploying provincial sales taxes that look, to all but a few smart lawyers, pretty indirect. It is clear, too, that ill-judged, outdated or unclear constitutional restrictions can prove extremely costly. Fiscal structures in Australia, for example, currently face upheaval at the prospect of a court decision that may interpret the phrase 'duties of excise' in the Constitution in such a way that the states become empowered to levy a general sales tax, which it had previously been assumed they could not do. And was it really worth waiting nearly 20 years for the Sixteenth Amendment to permit federal income taxation? Nor do constitutional restrictions seem necessary for governments to build strong reputations for responsibility in tax-setting. British governments have implemented retrospective 'windfall' taxes on capital twice in 16 years<sup>51</sup> without, it seems, encountering serious credibility problems.

Constitutional restrictions have thus played little role in British national tax policymaking. But the potential reshaping of intergovernmental relations in the coming years — relative to the EU and also, perhaps, in terms of devolution within the UK — means that this may change. The EU currently places few restrictions on member states' tax policies. There are minimum rates of indirect taxation, but these were very largely non-binding at the time of their introduction. In any event, the likelihood of tight constraints being imposed by the Union is powerfully limited by the veto that each government currently enjoys over all European tax proposals. Probably the most important constraint yet imposed by membership of the Union is that the necessary conditions for membership include

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<sup>50</sup>Quoted in Steinmo (1993, p. 145).

<sup>51</sup>On banks in 1981, and now on utilities.



implementation of a VAT: this was certainly the proximate reason for its adoption in the UK. Over the coming years, however, it may be that tighter rules will come to be written to deal with a perceived risk of tax competition, and as the Union expands, the requirement of unanimity on tax matters is likely to come under increasing strain. Within the UK, too, it is interesting that the Scottish Parliament (forthcoming) has been endowed with tax powers that are strictly proscribed: it may raise or lower the basic rate of income tax applied by up to three percentage points. But the still more significant constitutional innovation would come if the UK were to join the single currency. For this would entail commitment to maintaining a budget deficit of no more than 3 per cent of GDP, with fines levied, under the terms of the stability pact, if this target is missed. It may be that the UK will have something approaching a balanced budget amendment before the US does.

## **VII. CONCLUDING REMARKS**

The US tax system is a construct of awesome power and complexity. This discussion has done scant justice to either attribute (or to the daunting volume of research in the area). The peculiarities considered here have not been fully explained, nor have their implications been fully understood. The closer one looks, the more clearly there emerge unresolved issues of politics and federalism. As Gale (this issue) remarks, for example, it is not entirely clear why the tax base seems to be so much cleaner in the UK than in the US. Nor do we fully understand how vertical relationships in federal structures are likely to affect tax levels and structures. What is certain is that the UK and other European countries will continue to look to the US for guidance on the organisation of federal structures, and that — in this and other areas — US experience will continue to stimulate and puzzle outsiders. (One immediate puzzle, for example, is that fiscal federalism has not been a much more central issue for American tax economists.) History teaches us, of course, that Britons who take an interest in American tax affairs are liable to end unhappily; but both sides, one hopes, can acquire some wisdom in the process.

### **APPENDIX: THE EFFECTS OF SUBSIDISING EARNINGS IN A MODEL OF EFFICIENT BARGAINS**

We consider a bargain between a union and a firm. The firm seeks to maximise its profits,  $\Pi \equiv F(L) - wL$ , where  $F(\cdot)$  is a strictly concave production function (the output price being taken as fixed, perhaps on international markets),  $L$  denotes labour employed and  $w$  the gross wage. The union has a utilitarian objective function  $Lu[(1+s)w] + [N-L]u(b)$ , where  $s$  is the rate of the earnings subsidy,  $b$  the unemployment benefit,  $N$  the fixed number of workers and, for simplicity, we

henceforth assume linear utility,  $u(x) = x$ . We consider a generalised Nash bargain with the union having ‘power’  $\beta$ , and take the union’s threat point to be for all workers to take unemployment benefit whilst the threat payoff of the firm is zero. The bargain thus maximises

$$(1) \quad L^\beta [(1+s)w - b]^\beta [F(L) - wL]^{1-\beta}.$$

Maximising with respect to  $w$  and  $L$ , one finds, after some manipulation, that

$$(2) \quad F'(L) = \frac{b}{1+s}$$

$$(3) \quad w = (1-\beta) \frac{b}{1+s} + \beta \frac{F(L)}{L},$$

from which the comparative statics of interest follow. First, differentiating equation (2) gives

$$(4) \quad \frac{dL}{ds} = \frac{EL}{1+s} > 0$$

where  $E \equiv -F'/LF'' > 0$ . Using equation (3) to write equilibrium profits as

$$\Pi = (1-\beta) \left( F(L) - \frac{bL}{1+s} \right),$$

one finds, using equation (3), that

$$(5) \quad \frac{d\Pi}{ds} = (1-\beta) \frac{bL}{(1+s)^2} > 0.$$

Expenditure on unemployment benefit and subsidy combined being  $C \equiv b(N-L) + swL$ , differentiation and evaluation at  $s = 0$  shows, using equation (4), that a small subsidy will reduce expenditure if and only if  $w < bE$ .

Consider next the effect on the net wage,  $w_n \equiv (1+s)w$ . From equation (3),  $w_n = (1-\beta)b + \beta(1+s)(F/L)$ , so that, from equation (4),

$$(6) \quad \frac{dw_n}{ds} = \beta \left[ \frac{F}{L} + \left( F' - \frac{F}{L} \right) E \right],$$

which (by concavity of  $F$ ) is positive for  $E$  sufficiently small and is negative for  $E$  sufficiently large.

It remains to show that it is possible for a small subsidy to increase employment, profits, the net wage and government revenues. The first two of these, we have just seen, are assured. For the last two, we confine ourselves to giving a simple example in which a small subsidy leaves the net wage unchanged but reduces the government's expenditure. Consider, then, the Cobb–Douglas case,  $F(L) = L^\alpha$ , with  $\alpha \in (0,1)$ . From equation (6), it is readily seen that — strikingly — the net wage is then independent of the subsidy rate. Using equations (2) and (3), the condition for a small subsidy to reduce expenditure can be written

$$E > 1 - \beta + \beta \left( \frac{F}{F'L} \right)$$

which is readily verified to hold if, for example,  $\alpha = 1/2$ .

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