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Tax Design and Redistribution

Most economists agree on the broad criteria that are important for evaluating tax policy. Good tax policy should be efficient, equitable and simple (or rather, "administrable"). The task of describing the overall desirable structure of the tax system is not easy, because tax policy can serve many different purposes. It is obviously there to simply collect revenue, but it also plays a key redistributive role, it is often used to incentivise particular types of behaviour (e.g., R&D, addressing externalities or implementing paternalistic objectives) and it may play a role in macroeconomic stabilisation. In this short note, I will provide a brief overview of the redistributive role.

There are two broad ways of thinking about how tax policy might interact with redistribution. One is to focus on taxation alone and postulate that it should be progressive on its own. This is an approach that is familiar to public finance economists: the idea is to tax and transfer based on ability to pay, possibly as one integrated system, where the bottom of the distribution faces negative tax liability. It is also the line of thinking that naturally fits with direct interest in reducing inequality (rather than simply increasing welfare – a subtle distinction that assigns independent value to equality over direct individual/utilitarian well-being), because it motivates the focus on taxation of the rich, perhaps pushing beyond what otherwise might be considered efficient.

The alternative is to separate taxation and redistribution, with social assistance and insurance spending financed using tax revenue, but with less of a focus on the distributional aspects of how revenue is collected.

Obviously, real tax systems have elements of both, with income taxation adding progressivity to the tax side and the safety net financed out of many sources of revenue. As Figure 1 shows, the explicitly redistributional income tax and, to some extent, corporate tax amount for an important but far from dominant chunk of revenue in the countries of the Organisation for Economic Co-operation and Development (OECD), with Spain close to the average and the United States relying on them more despite its smaller overall revenue take. In contrast, instruments that are on their own flat or mildly regressive – chiefly excise tax, sales or valued-added tax (VAT), and payroll tax – account for the majority of the revenue for the average OECD country, with Spain again close to the mean and the United States deviating from it greatly. Finally, inheritance, estate and wealth taxes are very progressive and attention-grabbing but play a trivial role in terms of their revenue take.

Somewhat paradoxically, countries that do a lot to redistribute rely less (or, in proportion to revenue, much less) on progressive tax instruments than the United States, while financing their spending in part regressively. In particular, VAT – which does not even exist in the United States – collects over 9% of gross domestic product (GDP) in revenue in Denmark, New Zealand, Sweden and Finland.

As Figure 2, replicated from Blanchet et al. (2022), shows, this translates into a less progressive overall tax system in high-income European countries than in the United States, reflecting the important role in Europe of somewhat regressive indirect taxation and effective income tax rates that are already fairly high on the low end of the distribution (and overall flatter than in the United States).

What I take from these observations is that successful redistributive systems involve (1) a large tax take that is (2) used to spend very progressively but (3) overall financed in a reasonably flat manner using taxes that hit the middle class with only moderate progressivity at the top.

I believe that this reflects the pragmatic choice driven by the fundamental characteristics of different sources of taxation. Each tax instrument has its problems, but VAT and payroll taxes are collected by relying on businesses – predominantly large ones – and tax bases that largely reflect transactions with redundant flows of information that lend themselves

to effective information reporting: wages and business-to-business sales. This makes them efficient and administrable. Individual income taxation works well when it goes after labour earnings, but starts having practical problems when it extends to businesses, capital income, rents, and – even more so – wealth. Observing and taxing these additional sources of resources is important when one wants to redistribute through the tax system and tailor tax liability to the "ability to pay", but this is precisely where practical issues related to timing, realisation and location of income, assignment to ultimate owners, valuation and liquidity start to bite, because in most cases extending the tax system in this direction requires going beyond arm's-length observable market transactions. Moderate progressivity of income taxation is one response to dealing with the real-world consequences of problems with measuring, tracing and taxing income comprehensively.

Firms loom large in any tax system. A corporate tax without integration with individual income taxation is a rough attempt at progressivity (because equity owners tend to be wealthier), but it does so without closely interacting with income taxes paid by the ultimate owners. A potentially more progressive solution is to tax business income as individual income – what is known as the "pass-through" approach in the United States (see Kopczuk and Zwick, 2020, for more discussion). That solution, however, is problematic when dealing with publicly traded firms or firms that have foreign or institutional owners, so that – in practice – the profits of large corporations need to be taxed through entity-level taxation in a way that is only loosely tied to individual incomes.

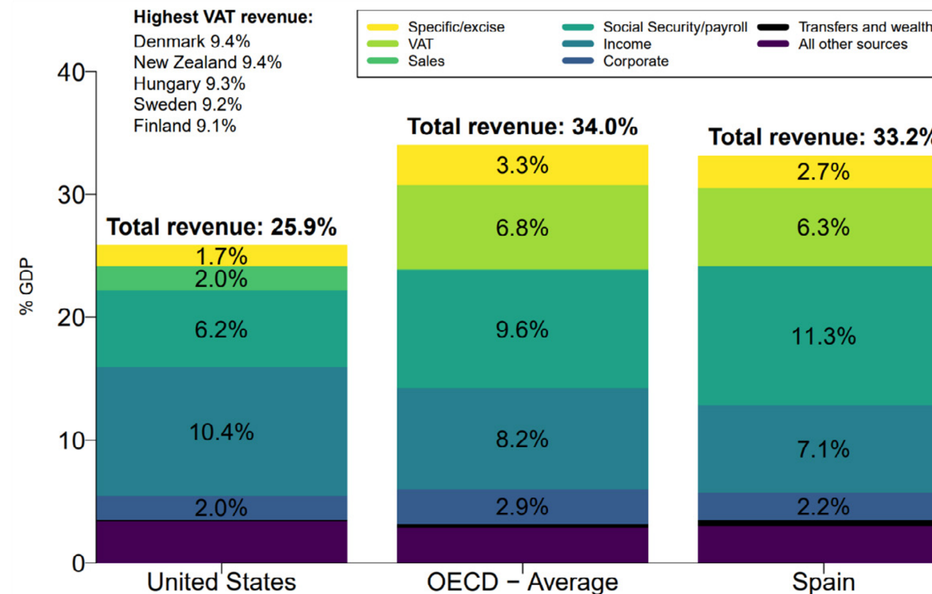
A broad alternative to that is to implement progressive individual taxation of consumption rather than income, perhaps along the lines of Bradford's (1986) famous X-tax proposal. Such an approach has some administrative advantages and efficiency benefits related to eliminating saving distortions, but has not yet been implemented anywhere at a large scale.

A different direction is to focus on alternative metrics of ability to pay, such as wealth or transfers. Saez and Zucman (2019) advocate a progressive top-focused variant of such a tax. My view, expressed more extensively in Kopczuk (2019), is that such proposals have problems. Wealth taxation – especially when it is not just about the very top – reflects a mix of past consumption and saving decisions with corresponding inequities and distortions. Perhaps more importantly in practice, wealth taxes tend to struggle with observability, valuation and liquidity of assets, in particular in the case of the class that is key for progressivity: private business. They also often run into political problems when expanding the base to owner-occupied housing. Practical approaches to dealing with these issues involve exemption or preferential treatment of hard-to-tax or unpopular components of the base, leading to a system that introduces cross-asset distortions and inequities while raising little revenue due to the narrow base (see Alstadsæter et al, 2022, for a discussion and evidence in the Norwegian case). Finally, wealth tax is a cousin of capital income taxation that shifts the focus toward principal and away from returns (and, especially, away from rents/extraordinary returns), raising additional efficiency and equity concerns.

Does this mean that wealth taxation should not be used? Economic theory does suggest that wealth tax is desirable when it is one-time, immediate and unexpected, because it resembles lump-sum taxation. It is a hard task to credibly implement such a tax, but historically solutions resembling this idea have occasionally been used to finance wars or tax ill-gotten gains. Such situations do seem like the best case for it.

This is but a quick overview of the main themes related to the role of tax policy in the design of a redistributive tax

Figure 1: Sources of revenue in Spain, the United States and OECD as a share of GDP



system. Countries that have large and generous safety nets collect their revenue in ways that are not extremely progressive, but rather correspond to a fairly large and reasonably flat share of overall income effectively taxed throughout the distribution. I believe that this reflects the general administrative difficulty of implementing aggressive taxation based on ability to pay. Nevertheless, if the primary objective is safety net and well-being rather than just focusing on metrics of inequality, those practical choices that combine large but not extremely progressive tax take with very progressive spending are capable of delivering that objective.

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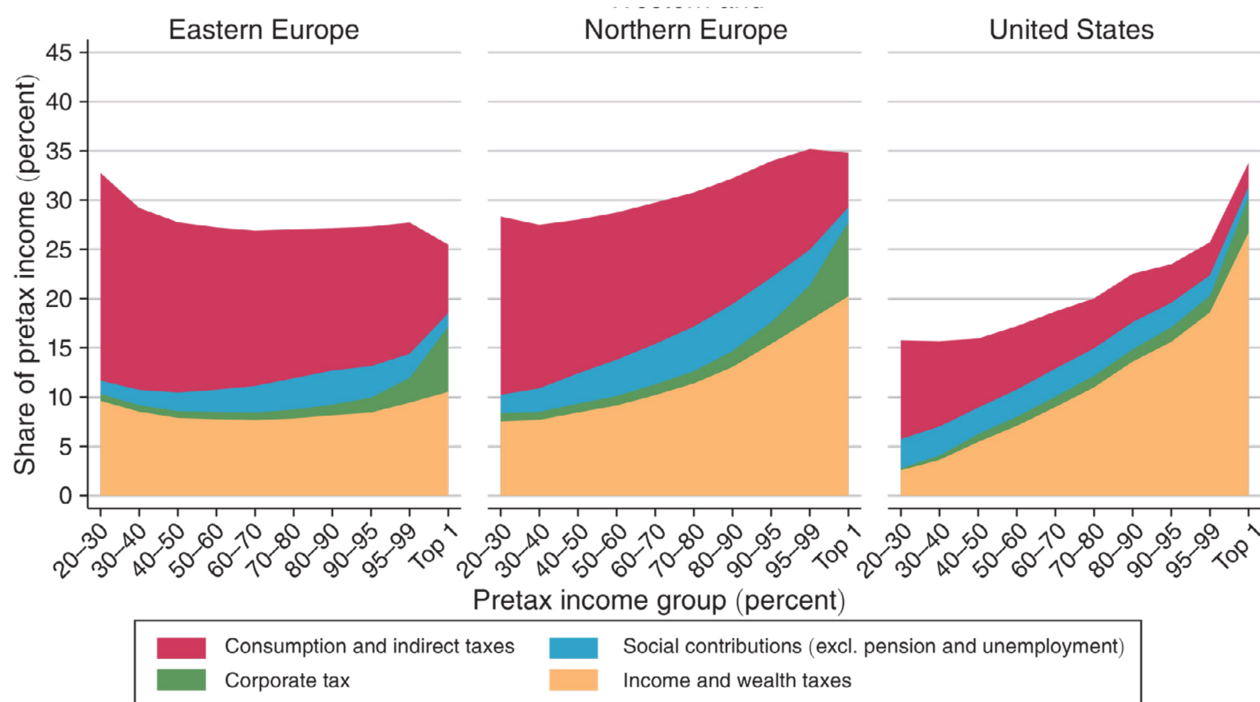
Figure 2: Distribution of taxes in Europe and the United States (Blanchet et al., 2022)



Source: OECD, Revenue Statistics for 2019, retrieved from https://stats.oecd.org/Index.aspx?DataSetCode=REV