

# Taxation as an Instrument of Public Policy

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# A Preview

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- ◆ Social Objectives of Taxation
- ◆ Some Principles in the Design of a System of Taxation
- ◆ Examples of the Possible Types of Taxes

# Social Objectives of Taxation

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- ◆ Raising revenue for the provision of public goods (e.g., maintenance of law and order, national defense)—Is there an “optimal” way for raising the net revenue (i.e., revenue collected less the costs of collection and enforcement) necessary to support a given level of public expenditure?
- ◆ The “optimum” should be defined taking into account other social objectives, e.g., public health, sustainability, and externalities.

# Some Principles in the Design of a System of Taxation—Fairness and Equity

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- ◆ Horizontal equity—individuals facing the same situation (e.g., same age, same number of dependents, and same income) should have the same tax liabilities.
- ◆ Vertical equity—individuals with the greater “ability to pay” should bear proportionally a higher tax burden—a “progressive” income tax (redistribution).
- ◆ Progressivity can also be justified on the basis of diminishing marginal utility of income—the loss of utility of one additional dollar of taxes is higher for a low-income individual than a high-income individual.
- ◆ General versus specific taxes/user fees
  - ◆ General tax revenue should be used to finance non-excludable public goods (e.g., national defense, environmental protection) and publicly provided goods with universal access (e.g., universal catastrophic health insurance).
  - ◆ Specific taxes/user fees should be used to finance excludable public goods and goods and services of exclusive benefit to specific individual users (e.g., automobile license fees, road tolls) in the absence of significant external effects.

# Some Principles in the Design of a System of Taxation—Neutrality

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- ◆ Taxation of both individual and corporate income should be neutral, absent a compelling justification—e.g., an individual income tax is not intended to change the relative preference between two goods of a consumer and the corporate income tax is not intended to change the relative value of the marginal productivity between two inputs.
- ◆ The tax treatment of cash dividends paid by listed public corporation in corporate taxation is not neutral in at least two aspects:
  - ◆ Corporate and non-corporate businesses are treated differentially—capital is taxed twice in a corporate business.
  - ◆ There is also a bias in favor of debt financing over equity financing.

# Some Principles in the Design of a System of Taxation—Efficiency

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- ◆ For a given level of net revenue, the taxes are optimally set so as to maximize social welfare.
- ◆ The system of taxation should minimize unintended distortions—the values of the marginal product of every resource should be equalized across all uses.

# Some Principles in the Design of a System of Taxation—Simplicity

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- ◆ A simple tax is easy to understand and thereby encourages compliance.
- ◆ A simple tax implies low transactions costs for both taxpayers and tax collectors alike, thus resulting in gains for both.
- ◆ A simple tax is also easy to enforce.
- ◆ It is best to avoid a proliferation of deductions—that is why a “flat tax,” or a “piecewise flat tax,” under which the marginal tax rate is (locally) constant, has a great deal of appeal.

# Some Principles in the Design of a System of Taxation—Universality

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- ◆ Everyone should have to pay some direct taxes (except those with either no or very low incomes). People who pay taxes are more likely to realize that any additional public expenditures will have to be financed through additional taxes, the burden of which they will have to share. Hence, the demands for larger social welfare payments and more social welfare programs and other forms of income “transfers” may be moderated.
- ◆ Paying taxes and filing annual tax returns should become a habit and taxpayers should be encouraged to begin doing so even if their incomes are low.



# Some Principles in the Design of a System of Taxation—Incentives

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- ◆ A 0% rate of taxation and a 100% rate of taxation both result in zero tax revenue.
- ◆ Based on worldwide experience, the maximum marginal tax rate should not be much higher than 35%. Otherwise the incentive to work and save, and the incentive for faithful voluntary compliance, will be reduced as the incentive to evade taxes is enhanced.
- ◆ One should always focus on the net tax revenue that can be collected taking into account the costs of collection and enforcement and the incentive effects.

# Individual Income Taxation

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- ◆ The standard optimal taxation literature is based on the assumption that the government has a knowledge of the distribution of the individual characteristics (including earnings ability) in the population but cannot observe these characteristics at the level of the individuals. The government therefore selects a tax schedule that gives tax as a function of the actual observed income, that maximizes the expected social welfare, defined as the sum of the individual utilities, subject to the given distribution of individual characteristics and a total revenue constraint.
- ◆ The question of tax integration: Should the taxes on different categories of income be integrated under a comprehensive income tax? (If progressivity is important, then there should be integration of different categories of income under a comprehensive income tax.)
- ◆ Progressivity also has the additional desirable property of facilitating automatic macroeconomic stabilization—the effective marginal tax rate rises as income rises, and falls as income falls.
- ◆ A flat tax or a piecewise flat tax? A piecewise flat tax is by definition more optimal than a flat tax with a single marginal rate because there are more instruments—the spirit of a flat tax is not so much the single rate but the elimination of deductions.
- ◆ A general consumption tax (this is different from the commodity specific retail sales tax which is also referred to as a consumption tax in China) as an alternative to an income tax—a consumption tax may be regarded as a means for promoting savings—the unconsumed income is eventually taxed when it is consumed over the life-cycle of the individual. In a country such as China, the saving rate is already high enough (perhaps even too high), weakening the justification for a general consumption tax. A general consumption tax in the form of a general retail sales tax is likely to be regressive.

# Tax Treatment of Owner-Occupied Residential Housing

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- ◆ The imputed income on owner-occupied residential housing is normally exempt from taxation.
- ◆ Given the exclusion of the imputed income on owner-occupied housing from taxable income, the costs of maintaining the owner-occupied residential housing, including interest payments on the mortgage and property taxes, should not be deductible against taxable income. The United States is the only major country in which mortgage interest payments on owner-occupied residential housing is deductible against income.
- ◆ Whether capital gains on the sale of owner-occupied residential housing should be taxed is a more subtle question—I am inclined to support a tax exemption on some form of capital gains from owner-occupied residential housing.

# Business Income Taxation

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- ◆ The value-added tax.
- ◆ Investment tax credit and accelerated depreciation.
- ◆ Development of the capital market:
  - ◆ Elimination of double taxation on corporate earnings.
  - ◆ Reduction of the rate of stamp duty on securities transactions.
  - ◆ Exemption of taxes on cash dividends up to a ceiling amount.

# Commodity Taxes

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- ◆ Differential commodity taxes can be used to achieve specific social objectives.
- ◆ The “sin” taxes—alcohol and tobacco taxes—can be used to promote and improve public health.
- ◆ The gasoline tax and the “gas guzzler” tax can be used to reduce environmental pollution, enhance sustainability and reduce dependence on oil imports.

# Commodity Taxes

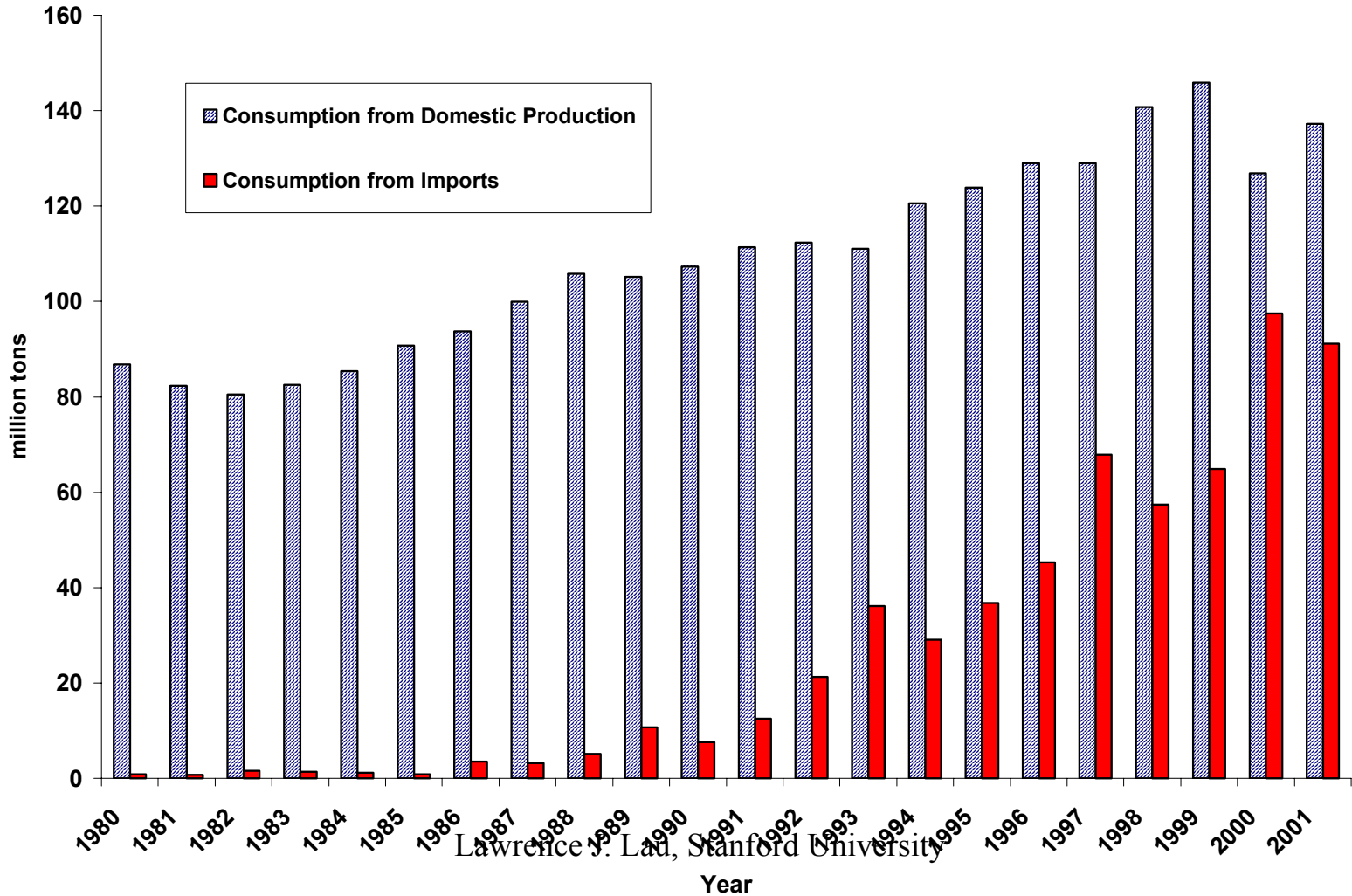
## The Gasoline Tax and the “Gas Guzzler” Tax

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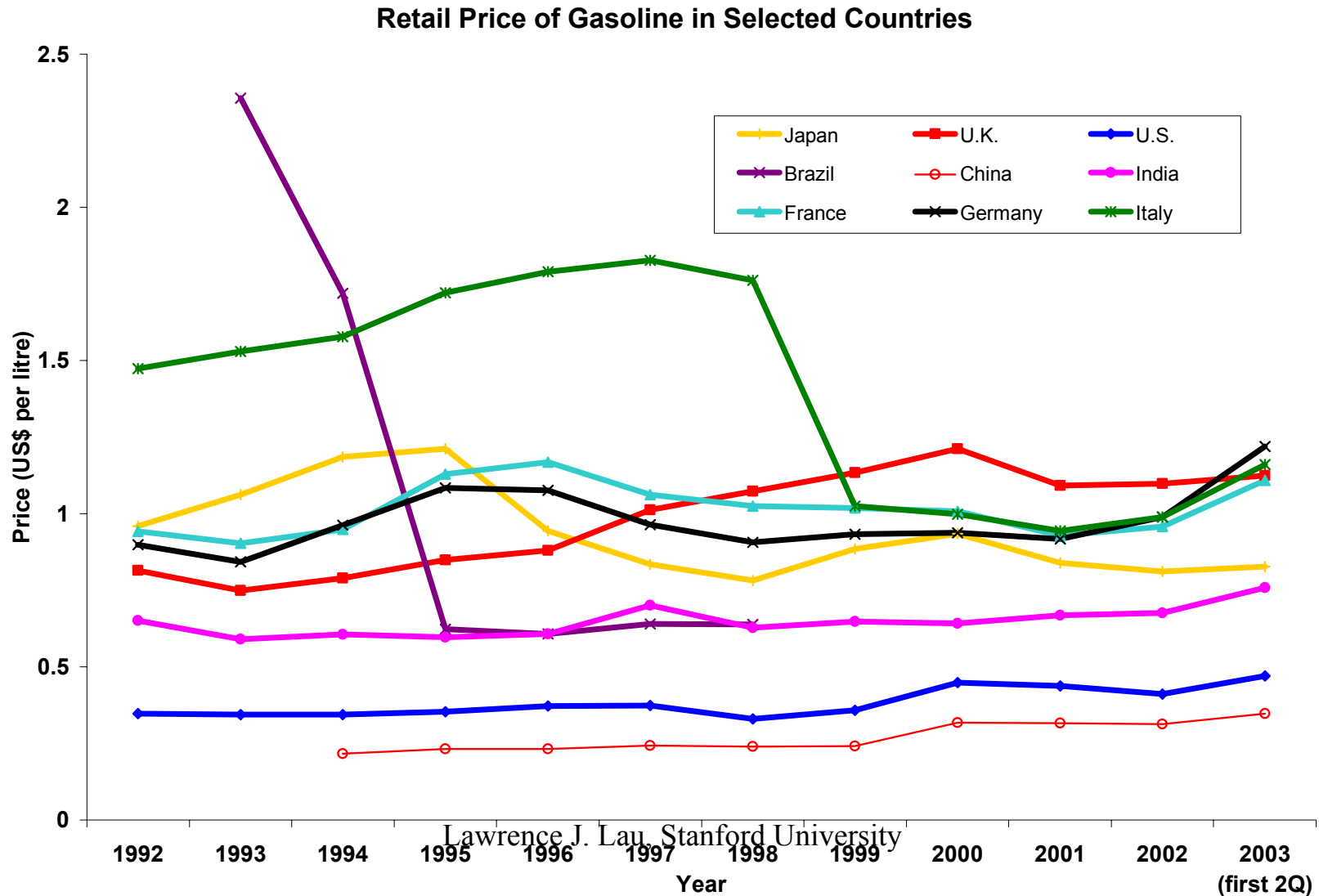
- ◆ Huge pent-up demand for new affordable automobiles—annual domestic demand now estimated to be 4 million units in 2003.
- ◆ In 2003/Q3, the retail sales of automobiles grew 77.5% YoY.
- ◆ Automobile assembly lines are now operating in 23 provinces, autonomous regions and municipalities.
- ◆ Such taxes as the gasoline tax and the “gas guzzler” tax are likely to be progressive in China because only high-income people are likely to have private automobiles.

# Oil Consumption in China

Petroleum Consumption in China



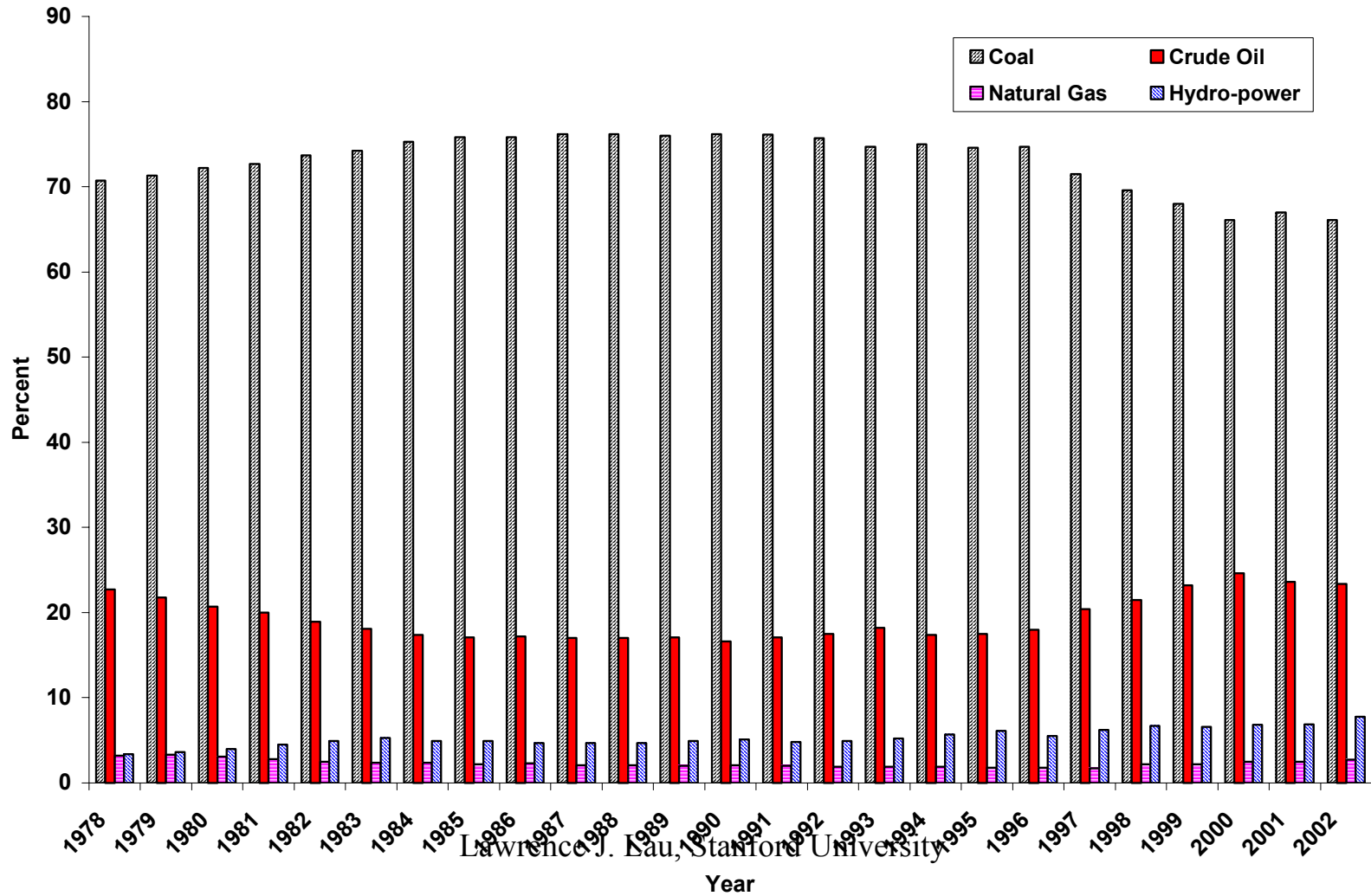
# Retail Prices of Gasoline in Selected Countries





# The Composition of Chinese Primary Energy Consumption

The Composition of Chinese Primary Energy Consumption



# The Development of the Great West: Reducing Regional Inequalities

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- ◆ Tax incentives can be provided to encourage investment and production in the low-income provinces and regions.

# An Export Tax as an Alternative to a Revaluation

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- ◆ An “export tax” is permitted under WTO rules.
- ◆ An export tax is better for China than a revaluation of the Yuan because while it increases the terms of trade in the same way as a revaluation, it does not lead to losses for holders of the U.S. dollars or U.S. dollar-denominated assets, e.g., the People’s Bank of China or other commercial banks and enterprises that may have to recognize the foreign exchange losses.
- ◆ It also does not generate windfall gains for the holders of the Renminbi and thus does not reward currency speculators or encourage continuing currency speculation.
- ◆ Moreover, an export tax can be easily lifted if and when the balance of payments conditions so warrant.

# An Export Tax as an Alternative to a Revaluation

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- ◆ An export tax has the same effects as the reduction in the rebate of the value-added tax in discouraging Chinese exports but it is much easier to implement and does not treat different industries discriminatorily. An uniform export tax is neutral in its effects across industries.
- ◆ An export tax is likely to encourage the migration of some export industries from the more prosperous regions to the less prosperous (lower-cost) regions
- ◆ An import subsidy also has the same effects on trade flows as a revaluation or an export tax. However, from a fiscal point of view, an export tax is better because it generates revenue whereas an import subsidy requires expenditure.
- ◆ The consideration of an export tax as an alternative to a revaluation by itself is likely to discourage currency speculators who can benefit from a revaluation but not from an increase in the export tax. The implications for Chinese exporters in terms of competitiveness are identical under either an export tax or an equivalent revaluation.

# General Equilibrium versus Partial Equilibrium Effects

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- ◆ “Ceteris paribus” versus “mutatis mutandus”—e.g., the “Laffer” curve.
- ◆ Cross-tax substitution—e.g., a reduction in the taxation of cash dividends may result in an increase in the cash dividends paid by corporations and hence an increase in individual income taxes paid; in addition, an increase in cash dividends may increase the demand for common stocks and hence increase stamp duties collected on securities transactions.

# Conclusion

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- ◆ A well-designed system of taxation can enhance economic growth and help to achieve important social objectives.