Journal of Public Economics 164 (2018) 197–210

Contents lists available at ScienceDirect

Journal of Public Economics

journal homepage: www.elsevier.com/locate/jpube

Tax reform and the political economy of the tax base☆

Ethan Ilzetzki*

Department of Economics, London School of Economics, United Kingdom
Centre for Macroeconomics, United Kingdom
CEPR, United Kingdom

ARTICLE INFO

Article history:
Received 19 July 2017
Received in revised form 26 March 2018
Accepted 12 June 2018
Available online xxxx

JEL classification:
D72
D78
H26

Keywords:
Tax reform
Tax base
Political economy
Lobbying

ABSTRACT

This paper studies the political prospects for reform in a model where the tax base and statutory rate are separate instruments of tax policy. The model suggests that large changes in the tax code may be easier to enact than marginal reforms. The tax base faces a tipping point where even the beneficiaries from tax exemptions support reform. At this tipping point, tax reform is Pareto improving. Politically feasible tax reform occurs when fiscal needs are large, but may nonetheless involve reductions in marginal tax rates. There is strategic complementarity in lobbying for tax exemptions, resulting in multiple equilibria. The model's main predictions are consistent with recent tax reforms in OECD countries.

1. Introduction

The politics of tax reform are taking center stage once again, just as public debts are mounting worldwide. Congress passed a substantial change to the U.S. tax code in December 2017; calls for tax reform have also emerged in Spain, Portugal, Italy, and Greece following the debt crisis in Southern Europe. Tax reform was a centerpiece of the legislative agenda of the current Indian parliament. Frequently, tax reform involves changes not only in tax rates, but also in the tax base. Proposals eliminating exemptions or closing loopholes involve a change in the tax base. Indeed, expanding the tax base was central to the most successful reforms in recent history. For example, the landmark 1986 U.S. tax reform eliminated exemptions to both corporate and personal taxes.

Reviewing the history of any major tax reform, one sees immediately that broadening the tax base, while often economically desirable, is also politically contentious. (See Birnbaum and Murray, 1987 on the politics of the U.S. Tax Reform Act of 1986). An interest group that was powerful enough to secure a tax exemption is sure to resist attempts to eliminate this exemption when reform is on the table. This paper explores the political determinants of the tax base. To this end, I propose a model where a government meets its revenue needs through a choice of not only the tax rate, but also the tax base. These two policy dimensions appear important in actual reforms and are central to the discussion in this paper. This framework allows us to evaluate individuals' preferences for tax exemptions and the tradeoff between the two policy dimensions. In the model, all agents and goods are identical ex-ante and there is no economic rationale for tax exemptions. A broader tax base is more efficient, as it removes a wedge between the prices of taxed- and tax-exempt goods. However, in political equilibrium, certain goods may nevertheless be exempt from taxation. The rents from tax exemptions are large and concentrated, while their costs are diffuse. Therefore, a special

☆ This paper was previously titled "A Positive Theory of Tax Reform". I thank the Centre for Macroeconomics for their financial support. I also thank the editor, Wojciech Kopczuk, an annonymous referee, Manuel Amador, Levon Barseghyan, Tim Besley, Michael Boskin, Fabio Canova, Francesco Caselli, Georgy Egorov, Camilo Garcia-Jimeno, Alessandro Gavazza, Maitreesh Ghatak, Mike Golosov, Wouter den Hann, David Hemous, James Hines, Henrik Kleven, Patrick Kehoe, Roger Lagonof, Gilat Levi, Ben Moll, Torsten Persson, Ronny Razin, James Robinson, Florian Scheuer, Holger Sieg, Joel Slemrod, Ugo Troiano, and the participants in numerous seminars and conferences for their useful comments. Luca Metelli and Lisa Windsteiger provided outstanding research assistance. Many thanks to Laura Kawano and Joel Slemrod (Kawano and Slemrod, 2012) for sharing their data on the corporate tax base.
* LSE, Houghton Street, London WC2A 2AE, United Kingdom.
E-mail address: e.ilzetzki@lse.ac.uk.

https://doi.org/10.1016/j.jpubeco.2018.06.005
0047-2727/

interest may attempt to secure a tax break despite the inefficiency it creates. This phenomenon is familiar from our understanding of special interest politics. (See Grossman and Helpman, 2002).

The novelty here is the study of the budgetary and general equilibrium implications of the inefficient policies that result and their political repercussions. While a tax exemption increases the *relative* demand for a good, the resulting inefficiencies reduce *aggregate* demand. The model yields a simple expression that quantifies the general equilibrium losses borne directly by the beneficiaries of tax exemptions. When inefficiencies in the tax code reach a critical point, special interests themselves are willing to forgo their tax breaks in favor of tax reform: the elimination of *all* tax exemptions. Importantly, no (small) special interest would forgo its tax break in isolation. The rents from a single exemption are large, but the budgetary and general equilibrium gains from its elimination are negligible. At the same time, a broad coalition of special interests may agree collectively to give up their tax breaks for tax reform. I derive the (minimum) coalition size that would collectively forgo its tax exemptions for the enactment of tax reform. I show that the size of this coalition is decreasing in the government's fiscal needs. Hence, the scope for tax reform is greater when the government wishes to raise more revenues.

The economic framework outlined in Section 3 yields a number of results that inform the political analysis that follows. First, there always exists a tax base breadth, below which a coalition of all special interests would collectively forgo their tax exemptions in favor of full reform–the elimination of all tax breaks. As the tax base narrows, the private benefits of tax exemptions grow roughly linearly, while dead-weight losses grow exponentially. Hence, there is always a tipping point where the private cost of an unreformed tax system outweighs its benefits, even to the very beneficiaries of tax exemptions. Second, the minimal size of this reform coalition is decreasing in public good needs. As fiscal strain increases, a smaller number of special interests needs to be persuaded to forgo their tax breaks and prospects for tax reform are greater. Third, tax exemptions are strategic complements: the private benefits of a tax exemption are increasing in the total number of allocated exemptions.

Turning to politics, I study normative (Section 4) and positive (Section 5) implications of this economic framework. The main normative result is that a reform-minded policymaker, constrained by the need to compensate losers from reform, should opt for large, "big bang", reforms rather than gradual changes in the tax base. This follows from the complementarity of private benefits from tax exemptions. Eliminating an individual, or small set, of exemptions is very costly when the tax base is narrow, but less so when the tax base is broadened in one fell swoop. At the extreme, the general equilibrium gains from a big bang reform are sufficient to fully compensate losers and a large reform is Pareto improving. This is of course a limiting case: real world reforms typically have losers alongside winners. But this result emphasizes that both the benefits to winners are larger and the cost to each individual loser is smaller when a more ambitious reform is envisaged.

The positive analysis considers equilibrium policy in a standard lobbying model (following Grossman and Helpman, 2002, chapter 7). Results are robust to a variety of collective choice frameworks, but lobbying captures succinctly the conflict between special- and general-interests, central to the politics of tax reform. The main positive prediction is that tax reform is more likely when fiscal pressures are greater. Further, I extend the lobbying model to allow endogenous entry into lobbying. Given the strategic complementarity in tax exemptions, endogenous entry leads to multiple equilibria. If many citizens join the special interest group (SIG), the SIG vies for many tax exemptions. This increases the private value of each individual exemption, validating citizens' choice to join the SIG. On the other hand, if few citizens join the SIG, the value of tax exemptions is small and citizens have a smaller incentive to organize.

A large literature studies the political forces shaping tax policy.[1] Homing in on the tax base is motivated by the prominence of the tax base in major tax reforms in recent decades. Broadening the tax base was one of the main objectives of the Tax Reform Act of 1986 in the United States. Value-Added-Tax reforms in Canada and Sweden, both enacted in 1991, involved significant expansions of the tax base. Corporate tax reforms in the United Kingdom in 1984 and in Germany in 2000 similarly involved substantial broadening of the base. Existing theories of the political economy of taxation typically take the tax base as exogenous and usually as comprehensive. The large normative literature building on Mirrlees (1971) has individuals each taxed at a distinct rate and it is difficult to distinguish the tax base from the continuum of statutory rates. Given the prominence of the tax base in reform proposals, a model that makes this distinction explicit leads to new insights on the politics of taxation.[2]

The economic framework builds on models of tax enforcement, following Yitzhaki (1979), Wilson (1989), and Slemrod and Kopczuk (2002). I abstract from enforcement and focus on the political, rather than administrative, constraints to expanding the tax base. I augment existing models with endogenous production and explicit attention to the distributional implications of a narrow tax base. The latter extension creates special interests seeking preferential tax treatment. The former creates general equilibrium costs of a narrow tax base. Importantly, the focus of this article is on the politics rather than merely the economics of the tax base.

The paper also relates to the literature on the politics of economic reform[3] and more generally to the large literature on the role of special interest politics, the nexus between political and economic power, and public choice mechanisms. A common thread in this literature is the tension between particularistic interests and overall economic efficiency. A similar tension is present in this paper as well, but it differs in its general equilibrium setting. General equilibrium allows us to compare the individual losses with the general equilibrium gains from base-broadening tax reforms. This provides new insights, such as complementarity in special interests' lobbying incentives. Base-broadening tax reforms are just one instance of policy reform albeit one where we can cast light on the persistence of inefficient policy more generally. Illustrating these general points through the lens of tax policy has a number of advantages. First, the dead-weight losses of inefficient tax policies are readily assessed in a familiar public finance context, as are the benefits of tax provisions targeted to special interests. Second, tax exemptions are a popular vehicle for targeting special interests in practice. The Congressional Budget Office (CBO, 2013) estimates that the United States Treasury forgoes over one third of potential individual income tax revenues through "tax expenditures". This sum is similar in magnitude to all discretionary spending in the U.S.[4] Given the sums involved, it is of independent interest to understand the politics of tax exemptions.[5]

The remainder of the paper is organized as follows. In the following section, I describe a number of tax reforms in recent history. This narrative highlights the importance of the tax base in tax reforms and relates these reforms to the theory that follows. Appendix A.2

1 See Alt et al. (2009) and Persson and Tabellini (2002) for comprehensive literature reviews.

2 There is also a long tradition in public economics that assumes that the tax system can only be altered on the margin due to political constraints. See Dixit (1975), Feldstein (1976), and more recently Golosov et al. (2014). Here, I allow for reforms of any magnitude.

3 See Acemoglu and Robinson (2000), Alesina and Drazen (1991); Fernandez and Rodrik (1991); and Jain and Mukand (2003). For a recent contribution in the context of tax policy, see Scheuer and Wolitzky (2016) .

4 GAO estimates: http://www.gao.gov/key_issues/tax_expenditures/issue_summary

5 Tax expenditures are not uniquely a U.S. phenomenon. Tax expenditures in Australia and Italy are estimated at 8% of GDP, 6% in the U.K., and 4% in Spain, for example. Source: Tyson (2014).