



# Reforming a complicated income tax system: The political economy perspective

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## Abstract

In this paper we analyze the political economy of revenue-neutral income tax reforms when a government aims at cutting back deduction possibilities in exchange for lower tax rates (“tax-cut-cum-base-broadening”). We show that the individual decision whether to support or reject a reform proposal depends on how strongly the voter is affected by all available exemptions, even if the cut of only one single exemption is at stake. The voting outcome in the society depends on the joint distribution of the deductible characteristics. Due to implicit logrolling there are cases where only symmetrical tax reforms are possible, whereas for other properties of the joint distribution only asymmetric cuts of privileges are politically viable.

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## 1. Introduction

Many continental European countries have high income tax rates but extremely complicated rules about how to determine the individual tax base due to many parallel deduction possibilities (Elschner et al., 2003; OECD, 2001). It is frequently argued that this is harmful for the economy because of high information costs for understanding all relevant tax laws (Aaron et al., 1999), and because of problematic distributive effects, as

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typically only the rich hire expensive advisors who know all available legal possibilities to save taxes (Pechman, 1987). Many economists, international organizations and policy commentators therefore prefer a simpler income tax system with fewer exemptions, a wider tax base and lower tax rates (e.g. OECD, 2001). Although some European countries have recently taken steps to implement structural reforms of their income tax systems in this direction, it seems fair to say that there is still a great reluctance to adopt a *tax-cut-cum-base-broadening*. Presumably this is so because of political constraints. In rhetoric there is a broad consensus among policy makers that a simplification of the tax system is desirable but the opposition of voters who are negatively affected by abolition of deduction possibilities is seen as a major obstacle in the reform process.

It is therefore important to analyze the political economy of structural income tax reforms. This is the aim of this paper, which looks at reforms of a “complicated” income tax system, which we define as a system with more than one initial deduction possibility. The government wants to broaden the tax base in exchange for lower tax rates by cutting back or abolishing one, several or all available exemptions. Yet, any specific proposal must win the support of the majority of voters in order to be politically feasible. The main contribution of our analysis is to show how interdependence of tax exemptions influences the voting behavior of individuals and consequently voting outcomes in the society as a whole.

We show that the decision of a single voter whether to support or reject the isolated cut or abolition of *one* tax exemption crucially depends on how strongly he or she is affected by the other deduction possibilities, even though they play no role in the government’s reform proposal. To give a concrete example, consider a tax system with two initial deduction possibilities, the deductibility of commuting expenses and of nightwork income. Both are quite common exemptions in European income tax systems. Our analysis implies that the more a voter commutes, the more reluctant he or she is to support the isolated cut of the exemption of nightwork income. This can even lead to the paradoxical situation that some voters reject the cut of a tax exemption from which they nearly do not benefit. That is, voters can reject the abolition of the deductibility of nightwork income in exchange for lower tax rates even though they hardly ever work at night! On the other hand, individuals can also support the abolition of an exemption even though they are affected more than the average voter in the society. This interdependence has an important implication for tax reform. When the government is interested in the political chances of an isolated cut of the nightwork privilege, it is insufficient only to look at how much the voters work at night. To see the full picture, the government also needs to look at how much voters are affected by the other tax exemption, i.e. at how much people commute.

In the paper we will present a simple method for how the government can correctly address the political feasibility of any specific strategy to implement a *tax-cut-cum-base-broadening* in a system with two initial exemptions. Which reforms are politically feasible depends on the joint distribution of the two tax relevant characteristics across the voting population and implicit logrolling can arise as an important feature that shapes the voting outcome in a “complicated” income tax system. Lastly, the interdependence of the tax exemptions raises the question whether the single exemptions may contribute to their persistence, i.e. whether the existence of one deduction possibility per se lowers the political possibilities to cut back another one. This question is also analyzed below.

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