

TIM HARFORD

THE UNDERCOVER ECONOMIST

Why a tax cut just isn't fair on teenagers

Alistair Darling did something rather strange recently, to baffling applause from his own backbenchers, and cries of “bribery” from the opposition: he announced a tax on teenagers.

Darling's plan – for those who missed it – is to cut income taxes temporarily for all but the most prosperous taxpayers. The apparent windfall is £120 a head. A similar plan is already in place in the US, where a temporary “tax rebate” began to arrive in the bank accounts of a grateful nation about a month ago.

But there is no such thing as a free lunch: since neither the UK nor US governments plans to alter its spending plans, these tax holidays will be funded by government borrowing – borrowing that must eventually be repaid. That will require taxes to go up in the future, or not to fall when they otherwise might.

Who should celebrate? Not the typical taxpayer, that is for sure. The tax cut makes no difference to her. If she – assume she is British – had wanted an extra £120 right now, she could already have it in her pocket, either by withdrawing it from savings or by borrowing the money. If she did that, of course, she would later have to repay £120 plus interest. But that is exactly what Darling's successor as chancellor will require of her. To look at it another way, the rational taxpayer should save the £120 windfall now, keeping it to pay the higher taxes that are surely on the horizon.

But whichever way you look at it, the US and UK governments are handing their citizens borrowed cash – and the citizens themselves are liable for the debt. If my bank manager arranged a surprise loan in my name and handed me the cash, I might feel pampered or put-upon depending on whether I was planning to take out the loan myself anyway. Either way, I doubt I would feel any richer.

Of course, some people should count themselves wealthier after the tax cut. Anyone expecting to die without making a bequest should be pleased: if the Grim Reaper knocks on the door before the taxman does, he can spend the tax rebate now and leave the bill for some other sucker.

Who will be the fall guy? We don't know for sure, because we can't say who a future government will tax. But an obvious candidate would be today's teenagers, very few of whom are paying income tax right now, but most of whom will pay it in the next few years. Their best hope is that their grandparents add the tax windfall to their bequests rather than blowing the money on a weekend in the sun.

The idea that a debt-funded tax cut makes little difference to anybody is called “Ricardian equivalence”, after David Ricardo, one of the founders of modern economics. The equivalence is between government taxes and government borrowing. However government spending is funded, it generates a bill that will fall due sooner or later. Far-sighted taxpayers will immediately take note.

Clearly, there are reasons for some taxpayers to care whether taxes arrive today or later on with interest. Even so, these tax gimmicks matter much less than we might think. It is current government spending, not current government taxation, that is the real measure of a government's size.

Empirical economists are still arguing over whether Ricardian equivalence holds good, but one study by Matthew Shapiro and Joel Slemrod concluded that most US citizens used a 2001 tax windfall to pay off their debts, leaving more money available to pay future taxes – Ricardian equivalence in action.

That suggests that as consumers and taxpayers, we aren't fooled by fiscal sleight of hand. Are we fooled as voters? Alistair Darling obviously hopes so.

<http://timharford.com>