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Income tax policy: is a single rate tax optimum for long-term economic growth?

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Abstract

Purpose – The purpose of this paper is to show an optimum income tax policy, given that the government must raise sufficient tax revenue to fund public goods and services as well as income transfer programmes. The paper examines the different types of taxes and then suggests a policy that is efficient, equitable, easy to administer and leads to a higher level of economic growth.

Design/methodology/approach – A literature review has been done to find all scholarly work that relates to income tax policy and its effect on economic growth. Results from endogenous growth models have been utilised to determine both the significance and the magnitude of income tax policy's effect on the growth rate of real GDP.

Findings – After examining the benefits of each type of taxation and reviewing the principles of capitalism, a proportionate (single rate) tax of 12 per cent on all income would be approximately revenue neutral in the USA, and would add to the growth of real GDP, thereby improving the standard of living.

Research limitations/implications – The paper concentrates on income tax policy in the USA. While it is believed that the conclusions apply to virtually all market-based economies, cultural differences in some countries may result in a modification of the conclusion to fit the society.

Practical implications – In the USA today, the majority of people favour changing the current income tax code. The debate is about what to change and how to change it. This debate is also important to developing nations who try to set an income tax policy that reaches the goals while encouraging growth.

Originality/value – While the literature shows varying studies concerning the impact of tax policy, there is a gap when searching for an optimum policy. Many scholars have made suggestions but none of them seem to be optimal. This topic is of particular interest in the USA and the rest of the developed and non-developed world, since the recent performance of GDP growth has been very slow and in many instances negative. Most countries have tried combinations of monetary and fiscal policies to encourage growth, but none seem to be working effectively. The solution may be to change income tax policy. The proposal for an optimum income tax policy is new and different from any that has been suggested as yet.

Keywords Tax policy, Economic growth, Flat rate tax, Progressive tax

Paper type Research paper

Introduction

A most difficult question facing societies who choose to implement a market economy as the basis for their economic system deals with the manner in which tax revenue will be collected. While there are a number of different philosophies concerning how taxes should be levied and who should bear the burden of taxation, no comprehensive view has become dominant.

The effect of this is that there are numerous taxes paid by everyone to all levels of government. In the USA, federal income tax policy has become so complex and distorted that there seems to be a general feeling that government has become extremely inefficient and unfair with respect to raising tax revenue. The purpose of this paper is to attempt to examine the current tax structure of the federal government

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in general and specifically the complex issues of fairness and equity, and suggest a federal income tax policy that meets the criteria of equity, efficiency and ease of administration while creating no market distortions.

Historical perspective

In the USA, except for a brief period during and just after the Civil War (1860s), income taxes were deemed by the Supreme Court to be unconstitutional. In 1913, the constitution was amended to allow the federal government to place taxes on income. Prior to 1913, most government revenue was in the form of duties and tariffs. Although the initial tax rates were slightly progressive and modest (1-7 per cent), eventually both the progressivity and the rates increased to a maximum marginal rate of 92 per cent. The maximum rate has been reduced and increased several times in the past 80 years, so that the maximum rate is 36 per cent today.

If tax revenue is to be raised by income taxes, three points must be addressed. First, what type of tax shall be imposed? (Noting that the type will be defined by the changes in the tax rate with respect to changes in income). Second, how will the tax base be defined? Finally, what will be the rate of taxation?

Since 1913, the federal income tax has changed from slightly progressive to very progressive, with the rate of progressivity also changing. As mentioned, the rate has changed from 1 per cent to a maximum marginal rate of 92 per cent and reduced to a maximum marginal rate of 36 per cent. The definition of the tax base has also changed considerably, with income used for certain expenditures excluded from the tax base.

Methods and principles of taxation

According to Hyman (2008), taxes are classified based on the change in the tax rate, with respect to income, as income increases. A progressive tax is one in which the tax rate increases as income increases. The logic seems to be that individuals should be taxed based on some notion of the “ability to pay”. Progressive taxes insure that as income increases, individuals pay disproportionately more taxes. The burden of taxation is therefore placed on the upper income earners. Why this seems to conform to some notion of fairness is questionable. Bittker (1969) notes that there are a surprisingly large number of scholars who believe that progression seems to be instinctively correct. Blum and Kalven (1953) concluded that it is difficult to justify progression in taxes based on some concept or notion of benefit, diminishing utility, sacrifice, ability to pay or economic stability. Rather, the case only has strong appeal when progression is viewed as a means of reducing income inequality.

The second type of taxation is a regressive tax. Here the tax rate declines as income increases. There is very little logic to support regression unless a “lump sum for benefit received” position is adopted. In this instance an individual would pay a fixed dollar amount to receive a service. As an individual’s income increased, this lump sum would be a smaller percent of total income, thus making the tax regressive.

Because the average propensity to consume falls as income increases, any tax placed on consumption, is regressive. These include sales tax, excise tax, turnover tax and value-added tax, for instance. The greatest burdens of taxation are placed on the lowest income earners.

There is, however, one argument for taxing consumption which will ultimately be rejected herein, but does, none the less, have merit. That is, consumption is really a better gauge to use to measure ability to pay than income (Hyman, 2008). This also means that income applied to savings would be free of taxation.

A true proportional tax is one where the tax rate stays constant at all levels of income. Here each individual would increase his tax liability proportionately, as income increases. Each individual would pay exactly the same amount from each dollar of taxable income earned, no matter how many or how few.

In 2011, The US Office of Management and Budget reported that 47.4 per cent of federal government revenue came from progressive income taxes, 35.5 per cent came from regressive social insurance taxes, 7.9 per cent from corporate income taxes, which are progressive to the firm, but if they result in higher prices for goods and services to the public, could be arguably regressive. The balance comes from various taxes.

The question concerning the type of tax to levy is then dependent upon which type of taxation is deemed to be fair and equitable by the majority. Mill (1894) argued that fair and equitable could be found by examining equal sacrifice. Based on diminishing marginal utility, equal sacrifice would occur with very progressive tax rates.

Others have offered similar arguments, including Feldstein (1976), who said that to achieve equity in taxation, post tax utility should be equalized using progressive taxes.

There are three criteria for evaluating taxation (Hyman, 2008). First, policies should be equitable, both horizontally and vertically, so that individuals with the same income pay the same amount of taxes and that increases in tax rates conform to some notion of fairness. Second, taxes should be efficient, thereby causing only minimal efficiency losses in the private sector. Third, taxes should be relatively easy to administer. And, of course, the policy must raise sufficient revenue.

A progressive tax, like the current federal income tax, may not conform to any of these criteria. There is no horizontal equity since actual tax liability depends on the mixture of consumption and savings an individual undertakes and how the tax law treats the deductibility of those choices. For instance, if two individuals have the same income, but one owns his mortgaged home while the other chooses to rent his home, the actual tax liability could vary greatly.

On the issue of vertical equity, even those who favour progressivity will note that the actual tax liability of high-income earners may be much lower than it appears if those individuals dispose of their income in a tax-favourable manner or earn their income as a capital gain rather than ordinary income. As a result the current federal income tax system may be less progressive than believed and actual tax rates may not really increase significantly as income increases.

On the issue of efficiency, the current progressive federal income tax may again fail to meet the criteria. With progressive taxes, a natural occurrence would be to exclude from taxation certain portions of disposition of income. This tends to artificially raise some prices (home prices) and artificially lower some others (rents). Further, many investment decisions are made not primarily for the potential return in response to supply and demand conditions in a specific market, but rather for favourable tax treatment. This distortion decreases efficiency.

Finally, the current federal income tax is a tremendous nightmare to administer (more than three million words in the current tax code) and invites fraudulent behaviour. Therefore, it appears, the current system seems to fail all three of the criteria for evaluating taxation.

Function of taxation

Ignoring for the moment the use of discretionary fiscal policy, a free market interpretation for the purpose of taxation should be to fairly and equitably raise enough revenue to exactly match the current level of government expenditures. Beyond that, many learned economists have argued that tax policy should serve no other function. Indeed some argue that this use of discretionary fiscal policy to offset economic fluctuations is ineffective. Feldstein (1976) for instance, notes that overall taxing and spending policies have "no significant effect on the course of nominal income, inflation, deflation or on cyclical fluctuations".

While raising revenue, the levying of taxes should be configured so that no undue burden is placed on any individuals. It is then the belief that any tax placed on consumption, which is regressive with respect to total income, is therefore not consistent with the basic principles discussed herein and should not be considered.

Distribution of income

Considering that the means of production are privately owned and that the owners are free to transact any asset in accordance with their desire to seek economic gain, the income generated from these assets should reflect the value of the contribution. Similarly, all inputs into the economy receive income in accordance with the value of their contribution.

Many economists would argue that the resulting distribution of income is indeed "fair and just", because as Gregory and Stuart (1995), for instance, noted, factor owners receive a reward equal to the factor's marginal contribution to the economy's output. Because it is assumed that individuals are motivated primarily (although not necessarily entirely) by self-interest, the granting of rewards according to marginal productivity encourages improvements in the productivity of the resources. This benefits not only the owner, but also the entire society. Altering of this distribution by the government reduces incentives and is therefore viewed as counter-productive, noting, of course, that in a compassionate society some redistribution of income will occur. It is critical, however, that the federal tax system be configured so as to have minimal impact on the prices in the markets, which ultimately determine the income distribution. And that any and all redistribution of income be accomplished in a fair and equitable manner. Again we will note that the current progressive federal income tax system seems to be inefficient because of the market distortions created.

Tax rates and economic growth

Before specifically addressing the issues of efficiency, equity, fairness and ease of administration, an examination of changes in tax rates as it relates to economic growth should be undertaken. Endogenous growth models are the most widely used and most current. There are a number of scholars who have examined this issue and all reached a similar conclusion.

Karras (1999) found that when utilising an endogenous growth model, changes in the tax rate will alter real growth permanently. He utilised data from 11 Organization of Economic Cooperation and Development (OECD) economies from 1960 to 1992. The findings suggest that a higher tax rate permanently reduces the level of output.

A similar study was done by Padovano and Galli (2001). They used data from 23 OECD countries from 1950 to 1990 and an endogenous growth model. Using panel regression, their econometric estimations found that the effective marginal income tax rate was negatively correlated with economic growth and was robust to the considerations of other growth determinants.

Poulson and Kaplan (2008) similarly employed an endogenous growth model. Their data were compiled from each state in the USA. Their analysis revealed a significant negative impact of higher marginal tax rates on economic growth.

Cassau and Lansing (2004) studied the growth effects of shifting from a progressive income tax system to a single rate system. This study essentially examined the effect of a constant marginal tax rate. They too found that this shift from progressive to proportional tax policy would add to long-term economic growth.

A proposal

Consistent with the results previously mentioned, the lowest tax rate should result in the highest economic growth. So a logical proposal would be for individuals, the current progressive federal income tax could be replaced by a single rate (proportional) tax of 12 per cent on all income earned above a livable minimum, with no deductions. Income would be defined as all compensation for labour, rental income, interest income, previously untaxed pension payments, dividend income, proprietor's income and the gain on the sale of an asset in the period the gain is realised.

With reference to businesses organised as separate legal entities (corporations, LLC), a single rate tax of 12 per cent on all income, deducting only explicit costs from revenue to define income (an annual depreciation expense should not be included in expenses, further discussion follows).

This proposal will conform to all criteria used to evaluate taxation. First, it will be equitable. Horizontally, all individuals (adjusting only for the number of dependents) with similar incomes would pay exactly the same amount of taxes regardless of how they freely chose to dispose of that income. Vertically, this proposal would also be equitable. Taxes would be levied proportionately to the ability to pay. The current progressive system raises rates disproportionately as income increases.

For example, suppose we examine the tax liability for individuals who are married, the head of a household and have two children. Suppose further that we estimate a livable minimum (maybe the poverty rate is a good approximation) of $30,000 per year. Table I shows the actual tax liability for five similar individuals with different incomes.

This example shows the most vertically equitable method of taxation. Above a livable minimum, every individual will pay $0.12 of every dollar earned to federal income tax, which means the other $0.88 will go directly to the income earner, regardless of how much total income is received. The highest income earners will pay the most tax dollars, but the increases in tax liability will be proportional.

On the issue of efficiency, this proposal would be extremely efficient in that, by allowing no deductions, all purchasing decisions would be made by free choice so that

Table I. Tax liability for five individuals with different incomes

Person	Gross income	Livable minimum	Taxable income	Tax liability
1	30,000	30,000	0	0
2	50,000	30,000	20,000	2,400
3	200,000	30,000	170,000	20,400
4	500,000	30,000	470,000	56,400
5	1,000,000	30,000	970,000	116,400

the resulting price and quantity represent true free market equilibrium. This method would further eliminate any disincentives to produce more, work more and earn more. In addition, it would tend to increase capital formation and improve the personal savings rate. It would not discourage consumption, nor place an undue burden on the lower classes as would be the case with taxes on consumption.

Third, it would be extremely easy to administer. An individual would simply sum all relevant income for the time period, subtract what would be defined as a livable minimum and multiply the balance by 12 per cent. There would be no complicated tax forms, no cumbersome record keeping systems and no concern about determining what income will be liable for taxation. Further, because the marginal tax rate would be low, it would discourage dishonesty and fraud. It is also believed that taxpayers would not "feel" so badly concerning tax payments.

This tax policy would utilise the Simons (1938) definition of comprehensive income with the exception that only capital gains that have been realised would be taxable. Simons noted that income is an indicator of "the exercise of control over the use of society's scarce resource". Therefore income is a good measure of an individual's power to purchase goods and services, and so provides the fairest base for taxation.

The justification

Initially, it was noted that three points must be addressed concerning tax revenue philosophy. The first point considers the type of tax. For reasons discussed herein concerning the distortions and counter-productivity of a progressive tax code, the notion of a progressive tax as being fundamentally consistent with the principles of capitalism seems illogical. Further a regressive tax places undue burdens on the people who can least afford to have these burdens. Again we will note that any tax placed solely on consumption will result in regressivity, no matter how it is presented. Hall and Rabushka (1985) and others have argued to exclude from taxation, income that is devoted to saving and investment, thereby leaving only consumption to be taxed. This argument results in an essentially a regressive tax.

Hall and Rabushka (1995) further argued that the consumption tax is proper because it is "the embodiment of the principle that people should be taxed on what they take out, not what they put in". However, what individuals initially take out of the economy is income. Eventually all of it goes back in, whether in the form of consumption or future consumption (saving). This argument would suggest that if an extremely high-income earner chose to save the vast majority of that income, he could be virtually free of taxes for that period. Further, if the ability to pay criteria is at least considered, then an individual's tax liability should be based on his total income regardless of his decisions concerning the disposition of that income as consumption or saving.

The other argument presented, which also applies to the concept of taxing dividend income of individuals, is that an attempt should be made to avoid double taxation at any level. Hall and Rabushka (1985) said that if saving is taxed and then the income earned from this saving is taxed again, the result is a double taxation. Similarly if a corporation pays dividends from after-tax income, and an individual's dividend income is taxed on the personal level, this again is a double taxation. However, is it not true that virtually all income earned is received from revenue that has already been taxed? When a good or service is provided, the consumer pays for that transaction with after-tax dollars. The provider of the service then receives these after-tax dollars from the consumer, and is taxed on them. Further, when the provider uses the after-tax dollars to purchase other goods and services, the next provider is taxed on dollars that have already been taxed, perhaps a number of times. The key here is that when new income is earned by a different legal entity, it should be taxed in that period, regardless of how that income is disposed in the future.

This proposal includes the taxation of dividends with the reason being that dividends are transferred from one legal entity (a corporation) to another legal entity (a stockholder). Using the same logic as above, the dividend income becomes new income to the separate legal entity (the stockholder) and should therefore be included in the tax base. Business owners may choose to avoid this situation by organising the business as an LLC, a sole proprietor or a partnership. Thereby, business income is taxed only once, since the business is not a separate legal entity, and is not liable for taxes. In reality, business owners may not do this because they desire the liability protection (although an LLC provides that), ease in the ability to raise new capital that a corporation offers, ease of transfer of ownership and other advantages offered by establishing the business as legally separate. The bottom line is that if these advantages are desired, the price is taxation of dividends as new income to the individual.

It is, therefore, concluded that a proportional tax on all new income by each legally definable entity (individuals and/or corporations) regardless of how that income is earned or how it is disposed, is optimal for the economy. Further, addressing the second point concerning the definition of the tax base, this proposal utilises total income earned regardless of the manner in which earnings occurred and regardless of how that income is disposed. The third point concerns the rate. By allowing a broad tax base with minimal forgiveness of initial income, the rate will be kept low. The 12 per cent rate is approximately revenue neutral. The idea is to construct a base that allows the rate to be as low as possible, without placing any undue burdens.

One final note to this proposal deals with the method by which depreciation expense is computed by business. Hall and Rabushka (1985) argued that the full cost of any fixed asset should be taken in the year in which it is purchased. This may result in the business having a negative taxable income for the period. In that case no tax would be due in that period and the negative tax liability can be carried forward with no time limit. Then when the asset is sold, the full proceeds are taken as income and are therefore taxable. This proposal agrees with this concept for business.

While business will deduct investments made towards the production of goods or services, individuals may not. That is to say if an individual invests in a business, the investment is made with after-tax income, while a business will invest with before-tax income. The difference is that business' investment is directly into their activities while an individual's investment is made into a business. Therefore, the individual's investment is indirect and should be made from after-tax dollars. This is consistent with the concept of new income being created and liable for taxation when an exchange occurs between two separate legal entities.

Conclusion

Given that no method of taxation will be deemed fair by every individual, this proposal probably represents the "least unfair" method of taxation. The goal of tax policy should be to raise enough revenue to pay for the federal government's spending requirements, in a manner that is consistent with the basic principles of capitalism and meets the criteria of being equitable, efficient and easy to administer. This includes, of course, configuring a tax system that causes minimal market distortions.

This proposal meets the criteria of both horizontal and vertical equity, and is supported by the principle that all individuals and corporations (separate legal entities) should bear the tax liability in a manner that is "proportional to the ability to pay". Therefore, tax liability is incurred on all new income, no matter how that income is earned nor in what manner that income is so disposed. The vertical equity issue is further supported by allowing an individual to earn a livable minimum amount of income before any tax liability is due. The livable amount is determined by the number of dependents and the status as head of a household.

This proposal meets the criteria of efficiency, since it has virtually no impact on any specific decisions regarding the earning or use of income. Further, it restores the incentives to increase the value of the output of every individual and business. It will increase capital formation by eliminating over-taxation of successful individuals whose high incomes become the basis for new capital. It does not discourage consumption, nor place an undue burden on the lower classes that would be seen with any tax on consumption.

Finally, this revenue neutral proposal would be extremely easy to administer and, because of the very low rate, would discourage dishonestly and fraud. The tax form would be only a few lines. Once income for the period is totalled, only a livable deduction depending on household and dependents status would be allowed. Then the 12 per cent rate is applied.

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