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Tax reform : toward a simpler, more pro-growth tax regime

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Tax Reform:

Toward a Simpler, More Pro-Growth Tax Regime

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Abstract:

This paper proposes that tax reform should take the direction of focusing on economic rent as the tax base. Since personal incomes that are very high typically carries a large component of economic rent, even very high marginal tax rates may not have much adverse effect on effort provided that the tax bands are wide enough so that, say, 90% of the working population will enjoy very low marginal tax rates. From this perspective, the author proposes to abolish the profits tax altogether, but to treat dividends and capital gains (net of inflationary gains) the same as labor income.

1. Introduction

Lawrence Summers wrote an article: “How to fix costly and unjust US tax system” recently in the Financial Times. He started his article referring to the concerns over raising revenue, fairness, excessive complexity, and the adverse effects of such complex tax rules on the economy.

In a highly globalized environment, with tax arbitrage, tax havens, and developments in information technology making transactions on the internet increasingly popular, tax revenues from corporate income tax are dwindling even without the various allowances introduced by politicians favoring particular industries and particular activities. Raising revenues from the profits tax is posing an increasingly daunting task; and tax evasion is distorting activities and causing deadweight loss for society. In order not to lose the tax base altogether, and in part in order to boost economic activities, most countries have been aggressively cutting the tax rate. For example, despite proclamation to adhere to fiscal austerity, UK Finance minister George Osborne announced he would cut the corporation tax rate another percentage point to 20 per cent by April 2015, down from 28 per cent when the government came to power.[1] Moreover, penalties for tax avoidance by big corporations are now rare, and David Gauke, the government’s tax minister, “is able to declare without a hint of a blush” that such leniency “is as important to tax competitiveness as the tax we set”.[2] The latest report by the World Bank and PWC[3], Paying Taxes 2013: the Global Pictures, observed that “On average across the eight years of the study the cost of tax, the Total Tax Rate has fallen by almost 1% for *each* year (for a total of 8% decline); the time to comply has fallen by 54 hours (seven days); and the number of payments has fallen by 6.5.”

The report showcased one company in the United States that paid a corporate income tax rate of 27.6%, comprising both local and federal taxes; 10% in labor taxes; and 9.1% in other taxes, adding up to a total of 46.7%. It needs 87 hours for complying with the corporate income tax, 55 hours for complying with the labor taxes, and 33 hours with all other taxes.

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[1] Financial Times, March 20, 2013.

[2] The penalties levied by HMRC against large companies had dropped to 0.01 per cent of the tax they under-declared on their tax returns. See the Book Review by Jonathan Ford in Financial Times, March 22, 2013.

[3] World Bank Group and PWC(2012): Paying Taxes 2013: The Global Picture, November 21. http://www.doingbusiness.org/reports/thematic-reports/paying-taxes

For the world as a whole, in 2011 the corporate income tax rate averaged 16.2%, labor taxes averaged 16.2%, and other taxes averaged 12.3%, for a combined total tax rate of 44.7%, which is the effective total tax rate borne by companies.

Most tax reforms are taking the form of lowering the corporate income tax rate, and simplifying the tax filing system. This is what drives the decline in the tax rate, compliance time, and number of payments already noted above. However, companies as well as individuals continue to seek tax shelters. President Obama was said to have cited Ugland House, a building in the Cayman Islands, and official home to 18,000 companies, as symptomatic of the problem of tax dodging.[4] In a recent book, Brooks, a former tax inspector at Her Majesty's Revenue & Customs, demonstrated that even the UK has become a tax haven for multinational corporations, which are lured to register in the UK as non-domcile corporations for a small fee and then will enjoy tax-free status on incomes earned overseas.

2. Taxing Economic Rent More and Taxing Effort Less

There is actually a relatively simple way to reform the tax system, and economists know that all along. This is the principle that taxing economic rent is superior to taxing economic behavior. Taxing pure economic rent should cause no deadweight loss at all, but taxing effort will always cause efficiency loss. Unfortunately, almost every form of tax will translate into some form of tax on effort. Still, it is possible to distinguish what and when a tax is more likely to tax rent than to tax effort. Herein lies the key to tax reform that I am proposing in this paper.

Henry George has been credited with the discovery that taxing pure land rent is not only efficient but also adequate in meeting all worthy local government expenses.[5] But isolating pure land rent from the result of human effort, in particular the effort of the owner in the form of improvements, is not easy. Yet the principle of taxing economic rent being superior to taxing anything else remains valid, and has indeed been endorsed by many notable economists, particularly Joseph Stiglitz. Other Nobel Laureates endorsing taxes on economic rent include James Mirrlees, James Buchanan, William Vickrey, Milton Friedman, Paul Samuelson, and Herbert Simon.[6]

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[4] See the story by Charles W. Eliot in the Economist, Feb 16th 2013. http://www.economist.com/news/leaders/21571873-how-stop-companies-and-people-dodging-tax-delaware-well-grand-cayman-missing-20

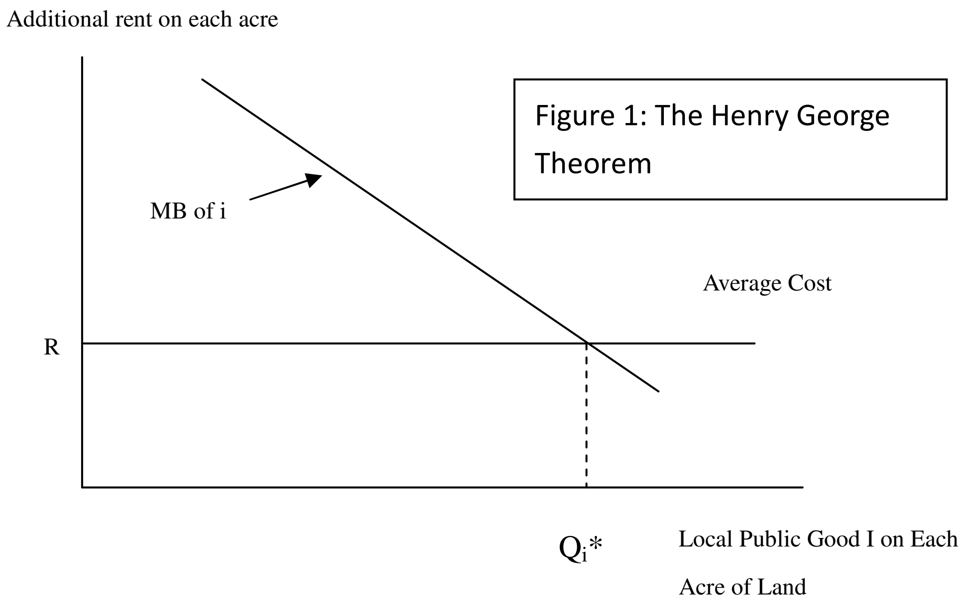
[5] See Stiglitz(1977)

[6] See: http://centralresearchgroup.org/notable-advocates-and-endorsers-of-taxing-economic-rent/notable-other-figures-present-and-past-who-endorsed-taxing-rents/nobel-prize-winners-in-economics-who-endor

The Henry George Theorem can be easily proven graphically as follows. The only assumption that is needed is that the production of local public goods is subject to constant returns to scale. This is the same assumption made by Stiglitz in his mathematical proof.

Referring to Figure 1, given constant returns to scale, any local public good i has a constant average cost of production that is also equal to the marginal cost. If it brings benefits to the local community as depicted by the Marginal Benefit line MB, the optimal production of local public good i should be Q_i*. Since the total benefits are under the MB curve, residents who live there and enjoy the local public goods can pay an additional rent equal to R times Q_i*, and still derive a net benefit depicted by the triangle above the AC line.

To the extent that the government is spending the money for a good cause that brings benefits bigger than the costs, land rent is created, and the cost of the local public good can be paid, still allowing a net gain to the residents. There is NO NEED to capture the entire rent for tax, so that the local population will enjoy net benefits from the local public goods despite the tax.



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This logic applies to all local public goods for any i, provided constant returns to scale is assumed.

The beauty of taxing land rent is that it can allow substantial lowering in the tax rates for such taxes as the salaries tax, the profits tax, and the sales tax. Hong Kong is reputed to be one of the lowest tax regimes in the world. Out of the 3.5 million people in the workforce, 3.1 million either do not pay any salaries tax (about 2.2 million) or pay very little tax that amount to just 4.3% of total salaries tax intake. Hong Kong's current top marginal tax rate is only 17%, and taxpayers will never have to pay more than 15% of their gross incomes under a "standard tax rate" arrangement.

A recent study from Organisation for Economic Co-operation and Development concluded that property taxes offer the best way of collecting revenue. On the other hand, "corporate income taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes, with recurrent taxes on immovable property being the least harmful."(OECD, 2010)

While personal income taxes often represents a tax on effort and is indeed harmful to incentives, we may argue that typically incomes beyond a certain range often represent economic rent, so that a tax structure with low marginal tax rates that apply to most workers through progressive tax rates and wide tax bands will generally preserve the incentive to work and will bring relatively little economic distortions. For example, author J.K.Rowling collects huge royalties each year from her Harry Potter series and other books, and an accomplished world-class soccer player or basket player makes in a week more than the average worker in a year.

It is submitted that the personal economic rent that some people are enjoying can often be traced to their past effort. For example, author Ms Rowling and the Korean singer and entertainer Psy, who made history with his Gangnam Style video shattering all download/viewing records, had made a huge effort and had both endured many setbacks before becoming famous. All the superstars that we can name got their status with hard work. But still they are all enjoying huge economic rent. Because of the huge divide between "making it" and "not making it" it is unlikely that taxing this economic rent—even up to 50%, will dminish the effort of would-be superstars, since the reality is that only a handful of those who try very hard will in the end make it to stardom.

Sometimes, economic rent is associated with some offices. A notable example is

Joseph Yam, who was a civil servant in the Monetary Affairs Branch of the colonial government in Hong Kong. He was instrumental in setting up the Hong Kong Monetary Authority. After transferring to the Hong Kong Monetary Authority to serve as its first Chief Executive, his earning jumped several times. Still another example is Mr Kwong Ki-chi, who was a civil servant and who enjoyed a fourfold jump in income transferring to the Hong Kong Exchanges and Clearing Ltd to serve as its Chief Executive. It is unlikely that a tax that reduces the take home pay but still leaves the pay substantially higher before their transfers would deter their taking up the positions.

3. Taxing Land Rent

Land rent is not only a good source to raise revenue to finance the production of local public goods, it is also a good starting point for a redistribution policy that will correct some of the excesses of the market economy, especially in a globalized world.

Hong Kong is certainly one of the mature economies with the highest degree of income inequality, if it is not at the very top. Its Gini coefficient has been steadily rising, reaching 0.533 in 2006, and further advancing to 0.537 in 2011.

The Gini coefficient for the world has risen from 0.372 to 0.39 from 1998 to 2007 according to the CIA. Among all countries, China's Gini coefficient appeared to rise the fastest, from 0.415 in 2007 to 0.48 in 2009.[7] The CIA's figures often, but do not always, tally with official figures. In particular, the People's Daily On-line reported that "the index has …retreated gradually since hitting a peak of 0.491 in 2008, dropping to 0.49 in 2009, 0.481 in 2010 and 0.477 in 2011," quoting Ma Jiantang, director of the National Bureau of Statistics.

Under the forces of globalization, competition for very scarce resources boosts economic rent; while competition for work among a globalized labor force depresses wages. In Hong Kong, a highly globalized city, rent for prime sites has exploded in recent years. A 2012 CBRE report says that "Hong Kong is the world's most expensive shopping destination as significant inbound tourist flows and continued increases in domestic wealth fuels occupier demand from international fashion and luxury retailers."[8] A retail space in Causeway Bay that had rented for HK$0.83 million per month, after being vacated by the existing tenant, was listed at 2.5 million per month.[9]

[7] https://www.cia.gov/library/publications/the-world-factbook/rankorder/2172rank.html
[8] http://www.cbre.com/EN/aboutus/MediaCentre/2012/Pages/071212.aspx
[9] See Mingpao, February 20 2013.

Mingpao reported four cases of retail spaces in Causeway Bay being re-rented or re-let at new rents representing increases ranging from 83% to 185%.

The increased rents do not arise from nowhere. The increased rents are actually created by hard work, and by enterprising businessmen putting the rented spaces to productive uses. But with the rent increases, such hard work and enterprise are reduced to earning only normal profit, while the landlord collects all the earnings beyond normal wage and normal profit for rent. Taxing the rent, and redistributing part of the proceeds thus collected, will not affect efficiency, but will enhance fairness. Since efficiency dictates that each factor be assigned to whoever is prepared to pay the highest price, it does not make economic sense to interfere with the pricing of factors of production. If some activities are deemed to carry value beyond commercial value, instead of interfering with the pricing of the scarce land, perhaps they should be subsidized, with the subsidies reflecting the non-commercial social value.

Moreover, taxing rent at least allows profits tax and salaries tax to be reduced, and that is good for economic efficiency.

4. Abolishing Corporate Incomes Tax and Rationalizing Capital Gains Tax

A recent letter to the editor at Financial Times from George Osborne, Pierre Moscovici and Wolfgang Schäuble, the ministers of finance for UK, France, and Germany respectively submitted that “the international corporate tax system is increasingly outdated” and “has allowed some large multinational companies to avoid paying their fair share in tax.” They noted that “International tax standards have struggled to keep pace with our changing economy. This has allowed some multinational companies to restructure their business to minimise the amount of tax they pay, shifting the taxation of their profits away from the jurisdictions where they are being generated, so that they pay less tax than smaller, less international companies.” One glaring example is the tax avoidance tactics used by Apple Inc. This leading IT company has five subsidiaries in Ireland. Of these only two pay Irish profits tax. The other three do not pay any tax at all, because Ireland levies tax based on the location of the management and operations. A subsidiary such as Apple Operations International is registered in Ireland but there are no operations in Ireland; so it does not have to pay taxes. On the other hand America levies taxes based on the location of the incorporation of the company. Since the company is not incorporated on American soil, the IRS cannot levy tax on this subsidiary, which however had booked a profit of

20 billion dollars from 2009 to 2012. The subsidiary merely collects the dividend payouts from Apple operations elsewhere.

According to Tim Cook the CEO of Apple Inc. Apple Inc. had paid 6 billiion dollars of profits tax to the US Government, and subsidiaries in Ireland had funded much of Apple's R&D. He claims that the company had done nothing wrong, because the tax avoidance was lawful and was necessary because the American tax system was outdated. The tax savings had driven American employment and productivity.[10]

All this underscores the huge social cost and the ineffectiveness of the tax effort on the corporate income tax. The joint letter from the finance ministers cited an OECD report(2013) *Addressing Base Erosion and Profit Shifting* to note that "the practices that some multinational enterprises use to reduce their tax liabilities have become more aggressive over the past decade. Some multinationals are exploiting the transfer pricing or treaty rules to shift profits to places with no or low taxation, allowing them to pay as little as 5 per cent in corporate taxes while smaller businesses are paying up to 30 per cent. This distorts competition, giving larger companies an advantage over smaller, more domestic companies." The ministers vowed to take concerted action to ensure a competitive tax system that supports businesses, but where everyone pays their fair share. But this is going to increase enforcement cost, compliance cost, and may lead to other distortions.

A good question is: if the corporate income tax is so costly to collect and may even be counter-productive, why not abolish the corporate income tax altogether. Not collecting the corporate income tax does not mean that the tax base is lost. Indeed, in the final analysis, only *people* can feel and can bear tax burdens; and it is people who benefit from the services funded by government revenues. If shares gain in prices, there will be capital gains available for taxing. If dividends are paid, there will be dividends available for taxing. If payments in the form of salaries, bonuses, and perks are paid, these too are available for taxing. If earnings are retained for investment purposes, not taxing retained earnings should be good for investment and indirectly good for society.

Traditionally, one objection against taxing dividends is that profits are already taxed. Taxing dividends would be tantamount to double taxing. If the corporate income tax is abolished altogether, there should be no objection against taxing dividends on this

10 http://www.bloomberg.com/news/2013-05-21/apple-ceo-cook-rebuts-9-billion-tax-avoidance-claim.html

ground. Since shares are registered under owners' names or nominees, and nominees have an incentive to report incomes that accrue to the true owners, tax evasion from dividend income is almost impossible.

Given today's technology, it should be simple to transfer all records of dividend payouts to individuals to the tax authorities, which should have no difficulty in running a consolidated dividend income statement for each taxpayer. Admittedly, not all countries are technological ready to do this. But where the technology is available the reform should greatly improve efficiency and simplify compliance.

In America, capital gains are presently taxed at different rates depending on whether the gains have been achieved within or beyond one year of holding of the asset. The tax rate on long-term gains was reduced in 1997 from 28% to 20% and further from 20% to 15% in 2003. For those whose effective marginal tax rate is less than 15%, the tax rate on capital gains was cut from 10% to 5%. The American Enterprise Institute has always argued for repealing the capital gains tax, in part on the ground that it represents double tax, which makes some sense if corporate profits are already taxed, and in part on the ground that abolishing the tax would stimulate economic growth.[11] But abolishing the corporate incomes tax is a more direct way of stimulating economic growth, and would render the double tax argument against the capital gains tax invalid.

To avoid taxing illusory capital gains, we need only offer for each asset an annual inflationary allowance. Such an allowance is not at all complicated, since the CPI is available monthly and, unlike national income accounting statistics, is seldom revised. All that needs to be done is to work out the inflation rate between the time an asset is acquired and the time that asset is disposed. If it is A% then only gains beyond A% is taxable.

One might argue that, if capital gains are taxable, shouldn't capital losses be shared by the government? While it does make sense to allow capital losses to offset gains, making the government share losses is problematic, as this may lead to reckless decisions that count on the government to share losses.

[11] See:
http://www.american.com/archive/2009/august/capital-gains-tax-an-argument-for-repeal

To summarize, if the corporate income tax is abolished, realized capital gains should be taxable like all other personal incomes, the only condition being that inflationary gains must be exempt from taxes.

5. The Necessity of Taxing both Income and Consumption

Traditionally, economists tend to favor consumption tax over income tax, not because consumption tax does not tax effort, but because the income tax without exempting returns from investment may represent taxing effort twice—when it is first earned, and when earnings are generated from savings invested. In other words, an income tax taxes both savings and consumption.[12]

It may be thought that there should be no need to tax both income and consumption. As was mentioned above, traditional economic analysis tends to favor consumption tax rather than income tax, for the fact that the latter amounts to taxing both consumption and savings. However, taxing incomes will allow taxing the extraordinary earnings that some people make, which a tax on consumption is likely to miss. Taxing incomes alone, on the other hand, may miss all the incomes earned in the underground economy, and ends up disproportionately encouraging activities to go underground. Taxing both consumption and incomes will allow tax rates to be lower, especially for the ordinary people, and lower tax rates will minimize distortions on incentives.

It should be noted that in practice, those who make really extraordinary levels of incomes typically make those incomes not so much because of effort but because they enjoy economic rent, which may be associated with their personal characteristics or personal backgrounds, or with the office that they hold. These economic rents have typically been pushed to astronomical levels under the forces of globalization, which has given rise to the resentment among those who set out to occupy the Wall Street and those who protest against globalization. There are plenty of examples that may lend support to this observation. Some examples will be offered in the next section.

Since the incomes that these individuals earn are much higher than what they can spend, a tax on consumption alone cannot effectively tax the economic rent that they

[12] See Mankiw's explanation in his blog:
http://gregmankiw.blogspot.hk/2006/06/consumption-vs-income-taxation.html

enjoy. So a consumption tax without a parallel income tax will grossly miss both the ability to pay and the benefit principles in tax. Violation of the benefit principle of a tax regime based on the consumption tax alone is grounded on the fact that these people are benefiting from globalization, often at the expense of others.

6. Conclusions

Readers will know that the proposal to tax corporate profits at zero rate and to maintain a progressive income tax system is just one variant of the “dual income tax” system pioneered by the Nordic countries and discussed in Bird and Zolt(2010), in which these authors referred to “the dual income tax systems in Finland, Norway, and Sweden” which “provide for a progressive income tax rate schedule applicable to labor income and a flat tax rate on capital income.”(p.185). They further noted that among these countries “The tax rate on capital income is at or near the lowest positive rate for labor income and the highest marginal tax rate on labor income is about 15–25% higher than the tax rate on capital income.” Our proposal herein is personal incomes—whether earned as labor income, capital gains, or dividends, should be subject to progressive tax rates, while the profits of corporations that only fuel job creation and growth should be tax free.

One key difference in the approach taken in this paper from the traditional approach is that whereas the traditional approach tries to encourage savings by taxing capital gains at lower rate and to encourage investment by firms by offering various tax incentives that would lower the tax burden on corporations, we recommend abolishing the corporate profits tax altogether, and to treat capital gains like ordinary incomes while effectively reducing the personal income tax rates for most people.

Abolishing the corporate profits tax will simplify the tax system significantly and will kick-start investment incentives by firms. As long as profits are reinvested, capital gains will be created in the shares of the companies, offering an alternative tax base that is clean and non-distortionary. If dividends are paid out, personal incomes will be boosted, and they will be taxed at the personal income tax rates. Taxing dividend incomes that accrue to persons should not be difficult because dividend payouts are all registered. Dividends paid to other corporations will not be taxed.

One central hypothesis underlying this paper is that typically, beyond a certain point, personal incomes comprise mainly economic rent of one kind or another. It is therefore possible to raise the marginal tax rates to higher than conventional levels without affecting incentives and without undermining economic efficiency. Thus it is recommended that tax bands are widened so that 90% of the workforce will enjoy lower top marginal tax rates. Marginal rates at the very high end can go up to 50% without really taking a toll on economic efficiency.

While dividends will be reported as personal incomes, only capital gains in excess of a allowance each year will count as personal incomes. That allowance will take care of inflation gains which are not real gains, as well as providing an added incentive for savings, given that savings is valued.

Retaining a sales or consumption tax will help lower the tax rates on incomes, further boost savings, and allow earnings in the underground economy to be taxed. Such a tax can go along with an annual refund for each citizen that effectively untax spendings for maintaining a basic living standard.

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