Proposed changes to the personal income tax system

Economics, Tax

Abstract

This paper proposes some changes that can be made to the personal income tax/benefit system in the UK. The paper also provides justifications for the changes. The change proposed is that measures should be taken to reduce the marginal tax rate as it results in disincentives to work thus leading to a decline in economic growth.

1. Introduction

Personal income tax represents the tax that individuals pay on their personal income. It is an important source of government revenue and contributes to economic growth. There have been increasing debates on the proper structure of personal taxes and benefits in the United Kingdom. While some favour tax increases, some favour tax deductions. For example, the Conservatives believe that government expenditure needs to drop so as to help reduce the budget deficit (The Telegraph, 2011). On the contrary, the Labour party believes that cutting spending could harm economic recovery and result in slow economic growth (The Telegraph, 2011). The objective of this paper is to analyse the impact of a change in the current personal tax/benefits system. The researcher assumes the position of the Chancellor of the Exchequer and presents an analysis of how one change in the system can help to improve economic growth in the United Kingdom. The rest of the paper is organised as follows: section 2 presents some theoretical and empirical literature on personal income taxes and benefits and their impact on economic growth. Section 3 presents one change to the personal income tax/benefits system and analyses the impact of this change on economic growth by using the theoretical and empirical analysis presented in section 2; and section 4 provides some conclusions and recommendations.

2. Theoretical and Empirical Framework

The government is responsible for the provision of public services such ashealthcare, defense, transport infrastructure, education, etc. Personal income tax represents one of the major sources of government revenue. For example, personal income tax accounts for the highest source of revenue for the General Fund in South Carolina (S. C Department of Commerce, 2010). In particular, personal income tax accounted for 46. 6% of revenues in Fiscal Year (FY) 2009-2010 (SC Department of Commerce, 2010).

Despite its importance as a source of revenue, the manner in which the tax is structured in terms of tax bases and rates can affect economic growth through its impact on incentives to supply labour and work. Personal income tax has an impact on economic growth. Personal income tax has a potential to influence economic growth through its effect on human capital investments, labour supply and work effort (Hanson, 2012). Human capital investment depends on whether the government is using flat or progressive taxation. Education is unaffected by flat income taxes. This is because, the state shares equally in the foregone earnings and future return from education (Trostel, 1993). On the contrary, progressive income taxes have the potential to discourage investment in education. This is because taxes saved while in school are paid on future earnings to education (Heckman et al., 1998).

In addition to affecting investment in education, tax structure also affects work effort. Ehrenberg (1990) and Prendergast (1996) argue that compensation schemes play an important role in determining the amount of effort that people put into their jobs. These studies observe a positive link between wages and work effort. The aforesaid indicates that an increase in taxes lowers net wages thus increasing production costs and

]]#.,. efficiency. It has also been observed that high taxes on high income-earners result in a reduction in work effort rather than a reduction in the number of hours worked (Gruber and Saez, 2002). The foregoing therefore suggests that high taxes lead to low productivity.

Taxation of personal income also affects entrepreneurial activity, which in turn affects economic growth. Entrepreneurship enhances economic growth through the creation of new ideas and promotion of technological change (ADB, 2000; Olu, 2009). The impact of personal income tax on entrepreneurial activity is not clear cut. It depends on the tax on entrepreneurial activity. In countries here personal income tax is taxed at a higher rate than entrepreneurial income, more people are encouraged to engage in entrepreneurial activity (Hanson, 2012). However, when entrepreneurial income is taxed at a higher rate than personal income, then, entrepreneurial activity is low.

In general, economic theory suggests that there is a negative relationship between taxes and economic growth. This is because, taxes result in an increase in the cost of economic activity (Hanson, 2012) Personal income taxes in particular create disincentive to work or earn higher (Poulson and Kaplan, 2008). Individuals often engage in activities that will minimise the tax burden. As people substitute activities that are to be taxed at a lower rate for activities taxed at a higher rate, individuals engage in less productive activity thereby resulting in lower tax revenue and lower growth in GDP. (Poulson and Kaplan, 2008). The foregoing suggests that the personal income tax system must be designed in such a way that will results in higher tax revenue for the state and low tax burdens for individuals.

3. Proposed Changes to Personal Income Tax in the U. K

The major change that needs to be made to the personal income tax system in the UK is the marginal rate of tax. The marginal tax rate is defined as the rate on the last pound of income earned. The marginal tax rate is different from the average or effective rate, which represents the total tax paid as a percentage of total income earned (Koester and Roger, 1989).

The marginal rate of tax in the UK currently stands at 40% of income above ? 50, 000. In addition, in 2013, plans were announced to scrap child benefits for people earning between ? 50, 000 and ? 60, 000. The effect of this change is expected to increase the marginal tax rate to approximately 51%. In addition, people who have three or more children will suffer even higher marginal tax rates of about 65% (Chapman, 2013).

In addition, austerity measures implemented in 2011 were expected to take more households into the 40% tax bracket (Clark, 2011). Nearly 1million people were expected to see their tax rates skyrocket following the implementation of austerity measures in the spring of 2011. Tax rates were expected to rise to approximately 83%. Citing the Institute of Fiscal Studies (IFS) Clark (2011) observes that the changes were expected to drag 750, 000 people into the 40% tax band. In addition, cuts on tax credits were expected to increase the marginal tax rates of 175, 000 working parents to more than 70%. This will result in an average or effective tax rate of 83% for Middle income earners (Clark, 2011).

As the Chancellor of the Exchequer, I will implement policies that will result in a decline in the marginal tax rate. This can be done by reinstating child benefits for people who earn between ? 50, 000 and ? 60, 000. I focus solely on the marginal tax rate because a high marginal tax rate has devastating consequences on the economy.

According to economic theory, marginal tax rates are very important because of their impact on people’s incentives to earn additional income (Gwartney and Lawson, 2006). An increase in marginal tax rates reduces the incentives of individuals to earn more. High marginal tax rates affect the economy in a number of ways. Marginal tax rates discourage people from putting in more effort to work. In order words, marginal tax rates result in negative attitude to work. This is because; taxes reduce the marginal revenue that one is permitted to take home. People respond to marginal tax rates in a variety of ways. For example, individuals with a working spouse may decide to drop out of work altogether. Some may decide to work few hours per week while others may decide to take lengthy vacations, retire earlier. Marginal tax rates also force people to migrate to states or countries with low marginal rates. These factors have devastating consequences on economic performance (Gwartney and Lawson, 2006). As the Chancellor, I will take reasonable steps to keep marginal rates down in the UK as this may force some people to relocate to countries with more competitive tax rates.

Another impact of high marginal tax rates is that they reduce the incentives of people to invest in both physical and human capital (Gwartney and Lawson, 2006). High marginal tax rates in the UK will result in a decline in foreign investment and an increase in the outflow of investment capital from the U. K. High tax rates will make it difficult for people to invest in their education and skill development. This is because investors in human capital find it difficult to capture a sustainable share of the return from their investment in education and skill development. High marginal tax rates in the UK will therefore make it difficult for people to invest in developing their skills which can result to shortage of necessary skills and thus to a decline in economic performance.

Empirical evidence suggests that an increase in personal income tax and a reduction in property and consumption taxes have negative effects on economic growth (Acosta-Ormaechea and Jiae Yoo , 2012). In order to ensure that the UK economy is not plunged into another recession, it is important that marginal rates of tax remain low so that people can be motivated to work hard to build the economy. High marginal rates can only lead to low productivity. In addition, high marginal rates can cause people to engage in tax avoidance and evasion schemes. The overall impact will be a reduction in the amount of revenue that the government can collect from taxes.

4. Summary and Conclusions

This paper has proposed plans to reduce marginal tax rates in the U. K. The paper observes that the U. K has one of the highest marginal tax rates. This places the country at a less competitive position as more people with desirable skills will be forced to leave the country to countries that are more tax competitive. In addition, high marginal tax rates will result in low supply of labour and poor work effort, which will result in an overall decline in productivity. It is therefore important to keep the marginal tax rate down to ensure that economy maintains a positive trend.

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