

Research paper on how effective is taxation as an influence on economic behavior

[Economics](#)



Taxes are in direct relation with the macro-economic operation of the state, in which, the revenue generated by the state is invested to ensure the smooth running of the administration; it also directly affects the micro-economic behavior of consumers/individuals/citizens as well as numerous public goods and services. Every action or policy pertaining to economic structure has a benefit or a drawback (Agliardi, 2001). People are influenced by incentives: will a particular product or a service satisfy their demand? How will it bring private benefits to them? Does the use of that particular product or a service has an overall positive/negative social cost? If the product in discussion adequately addresses their demand in an apt price, they'll buy it whereas if it doesn't, whether in terms of quality or price, they'll start looking for alternatives. Likewise, if the cost of a business rises, it'll search for ways to cover up the cost and it may do so by increasing the price of the finished goods. As price and cost effect consumers/businesses and households, the tax, in a very similar manner, influences the decisions and behavior of these stakeholders. For instance the taxation can cause a rise in the prices of the goods. The corporate or property tax imposed on private businesses will raise the cost of their production. Private firms operate in order to maximize their profits; therefore to cover up this cost and maintain their profits, they'll put the burden of the tax on the consumers by raising the prices of the products. This rise in the price of the product will cause the overall/aggregate demand to fall, hence resulting in lower profits. The amount or the rate of taxes reinforces the idea of reallocation factors of production within the operating firm. It causes them to re-consider what, how and for whom to produce in order to efficiently operate and maintain high

profits. State often uses different tax policies to attract and control firms at their will. Some countries, offer tax holidays/low tax rates to MNC's (Multinational Corporations) as an incentive to invest in their countries. A tax holiday is method of exemption from taxes for particular period of time. Multinational corporations tend to relocate their location to countries with low tax rates in order to keep the cost low and profits high. So, it's not only the state that has the power to influence the actions of firms through their taxations policy, the taxation policy can have adverse effects on the economic structure of a country if it is not properly monitored. Similarly, if the production from a firm is causing massive pollution which results in increase in Social costs, the state may impose higher tax rates on them in order to cover up the environmental cost caused by the production from the firm. The state also has the power to cease the production or fine them heavily (Arrow and Lind, 2014).

There are several types of tax policies and tax rates. For instance, there are three major tax systems in most of the countries in the world. It is progressive, regressive or constant. Progressive tax rate involves individuals with a higher income to pay a higher tax rate, while regressive tax rate is totally opposite. Countries with constant tax rates, as the name suggests, the tax rate is constant for all individuals. Whatever the tax rate or the system, taxes have direct effect on how individuals spend, save, borrow and involve themselves in entrepreneurial activity. (1) Now most of the studies revolve around Marginal tax rates or MRT. MRT refers to the tax rate that applies to the next dollar/pound earned. Because it directly impacts the next dollar/pound earned, it tells how much an individual is left with to spend. So

while deciding, whether to work extra hours learn a new skill through different workshops or get more education on a certain area of work, MTR is a crucial determinant. If the MTR is high, the level of productivity of an individual will be lower as well where as if MTR is low, the individual may decide to work more in order earn more because he is left with much to spend after tax reductions. This encourages him to spend more and save less. The aggregate demand increases and the economic structure improve. However a low MRT can have detrimental effects on the economy of a state. A lower MRT would mean a continual rise in the price of products and services, hence increased rate of inflation. This increased rate of inflation may cause individuals to save more and spend less and the lower circulation of money within the economy may put the economy in a recession.

Recession will cause firms to fire their employees to keep their costs lower and cover up losses. So, the state has to be very careful while deciding tax rates. It has to be fluctuated to meet the needs of the economy and keep it running (Fama and French, 1998).

The studies of European scholars Padovano and Emma Galli show us the effects of MRT on the economic growth. The studies associated a high MRT with chronic detrimental economic growth. Their follow up study in 2002 found that an increase of 10 percent points in marginal tax rates decreased the annual rate of economic growth by 0. 23 percentage points. Another study done by Eric Engen and Jonathan Skinner in 1996 inspected more than twenty studies, studying the tax rates and economic growth in United States and other countries. In conclusion, from their review, and it said ‘ a major tax reform reducing all marginal rates by 5 percentage points, and average tax

rates by 2-5 percentage points, is predicted to increase in long-term growth rates by between 0.2 and 0.3 percentage points (Fama and French, 1998). Moving on, taxes also severely affect labor supply. As mentioned earlier, the progressive nature of the tax rates can determine the decisions of individuals pertaining to their work. A high tax rate leaves an individual much less to spend hence it demotivates him to work harder. It directly affects his/her production capacity. A high tax rate may cause an individual to not to enter the labor market altogether. High taxes reduce work effort. This phenomenon is supported by several academic studies that show the relation between lower working hours and an overall participation the workforce. A study conducted by Prescott in 2004 showed that the role of marginal tax rates in accounting for changing in hours worked and the employment income for the working age population in the G-7 countries in for the time frame of 1970 to 1974 and 1993 to 1996. The author observed the direct relation between the differences in hours worked and marginal tax rate in United States and several European countries. Lower Marginal tax rates in United States showed that the working population worked 50% more than the civilians of Germany and France. Another study conducted in 2003 by Emanuela Cardia scrutinized the impact of changes in labor-tax rates on worked hours across numerous countries, including Canada and the United States. A decrease of 10 percentage points was observed in marginal tax rates increased the weekly hours worked by between 4.5% in Germany and 18% in the United States. While in Canada the weekly hours increased by 9.9 percent. Coming to a more recent study done Ziliak and Kniesner on the basis of United States tax reforms of the 1980s and 1990s illustrate the

impact of income taxes on labor supply as a whole. A 10 percent increase in the wages caused an increase in the working hours by 3 percent. It was also estimated that the efficiency cost of an additional dollar of tax in the regimes before to the reforms was 16 percent and 21 percent (Schanz and Schanz, 2011).

The chart above illustrates the varying relation between percentage of employed workers and percentage of wage and salary workers between 1930 and 2010.

As mentioned earlier, the tax rates set by the state define and affect the investment brought into that economy. High tax rates mean low after-tax rate of return on investment and thus it reduces the amount of money the business has reinvest in the capital. Investment is crucial for any growing economy, however and high MTR reduces an investor's willingness to invest into that economy. This has many negative consequences on the economic structure of the state. Firstly, it results in a decreased productivity of workers. The people who are willing to work don't have space and latitude to work which leaves them jobless, hence unemployment increases. Likewise, the resources aren't used and the total output of the economy is reduced, which, at the end of the day, lowers the living standards of the general population. Unemployment, uncertainty and lack of invest means less money in circulation which means people spend less, which results in lower living standards. This relationship is demonstrated by a study conducted by Robert Hall and Dale W. Jorgenson, the results of which were presented in American Economic Review. The study calculated the effects of changing tax policy on investment behavior for three major tax revisions after the Second World

War the results pointed towards the conclusion that the tax policy was very successful in changing the level and timing of investment expenditures. It also found that tax policy had important effects on the composition of the investment (Wasylenko, 1999).

Tax rates have a direct and an indirect influence on savings of a person. The higher the tax rate, the more an individual is inclined to save and the less he is inclined to spend. So, the theory is that the more tax one must pay on an additional dollar of income, the greater incentive one has to reduce the portion of the dollar that is subjected to tax. A study done by Cherie O'Neil and Rodney Thompson, analyzed the impact of the Tax Reform Act on 1986 on the IRAs. The variables that affected the decision to contribute to an IRA depended on the Individual's MTR, the filing status of taxpayer, the presence of interest income and the geographical location. Some specific results showed a decrease of one percentage point in the MTR was associated with a 0.5% to 1% decrease in the chances of participation (Fama and French, 1998).

Tax policies and systems can have a significant effect on the entrepreneurship and risk taking ability existing within the country. An Entrepreneurship is a skill defined and marked with words like innovation, creativity, business startups and growth enhancing activities. Taxes can either encourage or deter such activities. For instance, if a state imposes high taxes on new businesses, the new businesses will fail to cope up with cost and go bankrupt. The increase ration and chances of bankruptcy will discourage people from entering the market and risking their investment into something that has low chance of surviving and/or a low return. High tax

rates on income would also leave less room for people to save adequate amount of money to invest into the business in the first place. The legal cost of starting up the business could be very high as well. While on the other hand, in order to encourage domestic production or to make market more competitive, a state will reduce its tax rates for the new businesses giving them room and aid to grow into larger businesses. This leniency by the state in the form of low tax rates will encourage/attract investors to invest more into the market and the market will grow larger with numerous benefits for the state. Using tax returns of sole proprietors before and after the US Tax Reform Act of 1986, Robert Carroll, with empirical evidence, concluded that personal income taxes exert a significant influence on the probability of hiring workers. Another paper in the series illustrated an increase in a sole proprietors' tax price increased the size of her/his business. The tax price was raised by 10% and it increased the revenues by 8.4%. It was also concluded that a decrease in the marginal tax rate applied on a sole trader from 50 percent to 33 percent would lead to an increase in receipts of about 28 percent (Wasylenko, 1999).

Conclusively, the empirical data and research in the field of economics show the indication that tax rates do indeed influence the behavior of individuals, businesses and the state. The activities and the process of working, saving, borrowing, investing and entrepreneurship is impacted by taxation in many different forms. To say that the high tax rates stunts or makes economic growth dilatory in the long run wouldn't be so incorrect; whereas lower tax rates will boost economic activity by encouraging, motivating and attracting workers, investors and entrepreneurs likewise. Taxation is one such concept

in the field of economics that can be used to study both macro-economic affects as well as micro-economic effects. Taxation is a pillar that keeps the state in operation and controls many variables within the economy. The chronic effects of taxation on an economy can be detrimental or beneficial depending on the circumstances and policy adopted by the state. In this regard, this tool should be used carefully to tap into the full economic potential of the state, which not only maximizes private benefits but also shoulders social benefits.

References

- Agliardi, E. (2001). Taxation and investment decisions: a real options approach. *Australian Economic Papers*, 40(1), pp. 44--55.
- Arrow, K. and Lind, R. (2014). Uncertainty and the Evaluation of Public Investment Decisions. *Journal of Natural Resources Policy Research*, [online] 6(1), pp. 29-44. Available at: [http://dx. doi. org/10. 1080/19390459. 2014. 867640](http://dx.doi.org/10.1080/19390459.2014.867640) [Accessed 26 Oct. 2014].
- Fama, E. and French, K. (1998). Taxes, Financing Decisions, and Firm Value. *J Finance*, [online] 53(3), pp. 819-843. Available at: [http://dx. doi. org/10. 1111/0022-1082. 00036](http://dx.doi.org/10.1111/0022-1082.00036) [Accessed 26 Oct. 2014].
- Schanz, D. and Schanz, S. (2011). *Business taxation and financial decisions*. Heidelberg: Springer.
- Wasylenko, M. (1999). Taxation and economic development: The state of the economic literature. *PUBLIC ADMINISTRATION AND PUBLIC POLICY*, 72, pp. 309--328.