Higher taxes can lower inequality without denting economic growth

A new study by the IMF finds no strong correlation between lower taxes and higher growth

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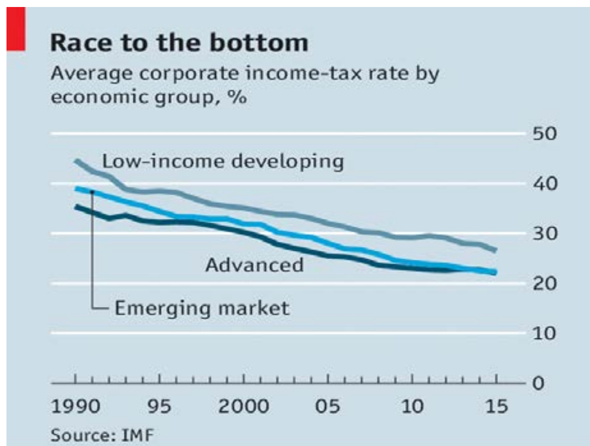
Inequality is one of the big political issues of the 21st century, with many commentators citing it as a significant factor behind the rise of populism. After all, nothing could be more indicative of the triumph of the common man than the elevation of a property billionaire to the American presidency.

A new IMF report looks at how fiscal policy can help tackle inequality. In advanced economies, taxation already has an impact. The Gini coefficient (a standard measure of income inequality) is around a third lower after taxes and transfers than it is before them. But whereas such policies offset around 60% of the change in market inequality between 1985 and 1995, they have had barely any impact since.

That is because of a change in policy direction. Across the West, taxes on higher incomes have generally fallen. This could be for a number of reasons, the IMF says. The tax take from high earners could have become more "elastic" (ie, sensitive to rate changes); in a mobile world, the elite will move countries to reduce their tax bills. But there is no sign that elasticity has increased in recent decades. A second possibility, easily dismissed, is that the share of income taken by the rich might have fallen; it has, of course, increased. A third option is that society reached a consensus that tax rates needed to be cut to help the rich. In fact, surveys show that people are more in favour of redistributive policies than they were in the 1980s.

Another reason that governments might have driven down top tax rates could be to create greater incentives to invest, thereby boosting economic growth. That certainly seems to be the rationale behind the cuts being proposed by President Donald Trump.

But the IMF, after analysing tax rates in OECD countries between 1981 and 2016, found no strong relationship between how progressive a tax system is and economic growth. Indeed the study adds that for countries wanting to redistribute wealth, there may be "scope for increasing the progressivity of income taxation without significantly hurting growth".



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The latter sentence will be seized on by politicians on the left. But the argument works better in some places than in others. The IMF reckons that the optimal tax rate on higher incomes, assuming the aim is revenue maximisation, is 44%. Britain's highest rate is already 45%. So the IMF study does not really provide much ammunition for Jeremy Corbyn, the leader of the Labour Party, the main opposition, who wants to raise it to 50%. It is a better argument, perhaps, for Bernie Sanders, the Democrat, since the top American tax rate, before any Trump cuts, is only 39.6%.

Even here, a note of caution is needed. Companies are inclined to move in search of more favourable tax treatment—hence the success of Ireland in attracting business with its 12.5% corporate-tax rate, and the row about "inversions" where American companies move overseas to lower-tax jurisdictions. In response, countries have steadily lowered corporate-tax rates; since 1990 the average rate in advanced economies has fallen by more than 13 percentage points (see chart).

Many rich individuals can choose to shift the way they report their income to take advantage of lower corporate-tax rates. So it is difficult to push up the tax rate on individual incomes while simultaneously lowering the corporate rate. As the IMF report drily remarks: "International tax co-ordination could potentially address this problem but has proved very difficult to implement." So are there other ways to reduce inequality via the tax system? Another option discussed by the IMF is taxing property, which is an immovable asset. Inheritance taxes are another possibility, although they are costly to administer, and no G7 country raises more than 1% of GDP through this route.

Given the political clout of the rich, it seems unlikely that an international consensus on reducing inequality through higher taxes is going to emerge. In the absence of such a consensus, few governments will take the risk of raising their own rates unilaterally. Step forward, however, a future Corbyn government, which plans to increase the tax rate on companies as well as on individuals—all in the context of Brexit, when companies might in any case be reconsidering their decision to invest in Britain. It will be an economic experiment closely watched by other countries, suggesting a new national slogan: "Britain—we try policies so you don't have to."