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The optimum income taxation

Obama finds foreign a tax rate that is both fair and efficient

By Richard W. Rahn
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What is the maximum income-tax rate that anyone should be expected to pay? Some questions are never settled, in part because people often ignore the theoretical and empirical evidence, and history that can help answer the question. The question of what an optimum income-tax rate would look like is one of those questions. Political demagogues shout: "It is only fair that the rich pay more."

Back in 1971, a Scottish economist by the name of James A. Mirrlees wrote a groundbreaking paper, in which he attempted to answer the question of what an optimum income-tax regime would look like if one desired to reduce inequalities while at the same time not discouraging work and economic growth. Up to the time of Mr. Mirrlees' work, no one had been able to figure out the optimum trade-off between equality and efficiency. Mr. Mirrlees was awarded the Nobel Prize in economics in 1996 for his work, and was knighted in 1998.

Mr. Mirrlees had been an adviser to the British Labor Party, which supported the high tax rates in effect at that time. He did a careful analysis of the variation of people's skills and the effect tax rates had on their incentives to earn. Much to his surprise, he found the optimum tax rate on high earners was about 20 percent, not the 83 percent in effect at that time. He also determined that 20 percent should be the optimum rate for everyone, thus giving rise to the idea of the flat tax (which now has been adopted by several-dozen countries). In his 1971 paper, Mr. Mirrlees concluded, "I must confess that I had expected the rigorous analysis of income taxation in the utilitarian manner to provide an argument for high tax rates. It has not done so."

In the decades since, there has been much additional theoretical work to support Mr. Mirrlees' conclusions; but, perhaps, more importantly, there have been the actual outcomes in many of the flat- or very low-rate countries, which have greatly outperformed the high-rate countries. Even though Mr. Mirrlees is highly regarded by most economic professionals, his work has all but been ignored by those on the political left (including many in the media), because his conclusions are not politically convenient.

In the United States, there has been almost no relation between maximum individual tax rates and tax revenues as a percentage of gross domestic product (GDP). For example, individual-tax revenues have averaged about 7.9 percent of GDP for the past half-century, whether the maximum rate was 28 percent (after Ronald Reagan's reform in the late 1980s), 70 percent

(during the Jimmy Carter era in 1978), or 39.6 percent (when Bill Clinton was president in 1995, and also in 2013 under President Obama). All of this only goes to show that higher maximum individual income-tax rates (despite the conventional wisdom and the endless faulty estimates from the government tax-revenue forecasters) are no more likely to produce greater revenue as a share of GDP than lower rates. High rates do, however, have the clear disadvantage of causing more tax evasion, lower job creation and slower economic growth.

Many economists view the corporate tax as one of the worst possible taxes, even though it appeals to politicians because they can claim they are taxing the "evil" corporation. Anyone who thinks about it for a minute realizes that only people pay taxes and, therefore, the corporate tax must be paid for by a corporation's workers in lower wages, by its customers in higher prices, and by its investors in lower returns. The United States now has the highest corporate-tax rate in the world among major countries (35 percent plus state corporate taxes), which is causing many corporations to move elsewhere. The Obama Treasury Department is trying to penalize corporations to keep them from moving, making them even more noncompetitive.

The Canadians and British, who have more rational economic leadership than the United States, have taken the constructive approach to global corporate-tax competition by reducing the maximum rate to 15 percent in Canada and 20 percent in the United Kingdom. As a result, they have a surge of corporations moving to their countries, and their corporate-tax revenues are a higher percentage of GDP than they are in the United States. The average international corporate rate is now about 22 percent; the Irish charge only 12.5 percent, and a number of countries have even lower rates.

The Republicans are promising tax reform. Recently, Sens. Marco Rubio of Florida and Mike Lee of Utah made a constructive proposal, particularly on the business investment and saving side. They were constrained by the potential revenue loss number as projected by the static-minded congressional tax-revenue estimators. However, they and others should be bolder as were Reagan and his ally, Jack Kemp.

At a minimum, the maximum individual tax rate should be brought down to 28 percent and, ideally, to 20 percent. The corporate-tax rate should be reduced to a minimum of 20 percent and, ideally, to 14 percent, which is the optimum corporate rate, according to the highly regarded, dynamic-thinking economists at the nonpartisan Tax Foundation. Real tax reform can never take place if those in Congress allow themselves to be chained down by the zero-sum static thinkers.

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