Inequality and the narrowing tax base

Too reliant on the few

Taxes are best raised on a broad base, but in many countries it is worryingly narrow

"I LIKE to pay taxes," said Oliver Wendell Holmes. "With them I buy civilisation." Most people recognise that taxes pay for public services, but few are as keen to stump up for them as Justice Holmes was. High income taxes tend to discourage effort and entrepreneurship, while encouraging all manner of activity to avoid them. That is why a basic principle of good tax policy has long been to charge a low rate over a broad base.

It is a target which many countries miss, and the gap is growing. Income taxes—one of the main sources of tax revenue across the rich world—are increasingly paid by a small minority of the most affluent. In Britain, employment has risen by 1.3m in the past five years, but the number of taxpayers has fallen by 2.2m. More than 40% of American households pay no income tax. In contrast, the most highly paid 1% of workers in Britain pay 28% of all income tax, while in America it is 46%. In 1979 those shares were 11% and 18% respectively. Corporate income taxes show the same concentration. In Britain just 830 firms pay almost half of all corporation tax. Five American industries account for 81% of the country's corporate tax revenue, but just a third of its companies.

This narrowing of the tax base is partly the natural consequence of widening inequality. Since an ever bigger share of overall income goes to the highest earners, and since income taxes are progressive (with a higher rate levied at higher income), it is inevitable—and appropriate—that the most affluent should pay a growing share of the overall tax take. Well-intentioned efforts to encourage work among poorer folk have also concentrated the pool of taxpayers. America's Earned Income Tax Credit (EITC), which tops up the earnings of the least-skilled, is one of its biggest poverty-fighting schemes. Thanks to the EITC, millions get a cheque from Uncle Sam rather than paying income tax. Much of the drop in the number of British taxpayers is also thanks to generous new exemptions for low earners.

Unfortunately, the narrowing of the tax base, both personal and corporate, also reflects two failures of tax policy. The first is the proliferation of exemptions and deductions that go far beyond reasonable poverty-fighting policies. America is the most egregious offender. Its income tax (which contributes a bigger share of overall revenue than in other rich countries) is riddled with myriad deductions, from medical insurance to mortgage interest, which collectively cost a whopping 7% of GDP and mean that income tax is levied on a much narrower base than it could be. Other rich countries, from Italy to Australia, also have too many unnecessary deductions.

The second problem, which applies most to corporate income taxes, is that tax rules have failed to keep up with the reality of the 21st-century economy. A web of arcane bilateral tax treaties allows clever companies to shift their profits from high-tax to low-tax jurisdictions, whether by registering patents or setting up intra-company loans. A firm's tax bills depend more on what industry it is in and how clever its accountants are than its profitability. America, with the highest marginal rate, has the biggest distortions.

Better simpler and better together

These failures need to be fixed. A narrow tax base is economically and politically risky, particularly if the logic for who pays taxes seems capricious. Governments across the rich world, but particularly in America, should aggressively prune deductions. And they should work together to reach international agreement on how firms should book their profits. This week's blueprint from the OECD is a good start (see article). As with trade, a multilateral approach to tax treaties is far better than bilateral deals. That way, more countries have a better chance of raising the taxes that help build civilisation.