Public Issues

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Nº 914 - April 24, 2009

ISSN 0717-1528

Taxes: When less is more

During the month of April, more than 2.3 million taxpayers filed their tax returns over the income received during 2008. An important number of people apply for a refund of those taxes paid in excess, while the rest must pay a significant sum of money given the steepness of our personal tax scale which –on its top range- reaches up to 40%. Undoubtedly, such scale ranks Chile as one of the countries with the highest marginal income tax rates.

In spite of the distortions generated by Chile's personal tax structure, there have been no improvements introduced during the last years; not realizing that several countries have already began to move in the correct direction.

During the last 20 years and particularly during the last 5, corporate and personal tax rates around the world have dropped more rapidly than during the last 100 years.

The example of Bulgaria[1]

Bulgaria dropped its corporate tax to 10% in 2007 and its personal income tax rate to 10% also, in January 2008. This example of having a "flat tax" caused a reversal of the flight of qualified workers to other countries because of the high rate that existed previously. Similarly, the corporate tax also stimulated new domestic as well as foreign investments.

Such increased economic activity generated greater tax flows, reason why there is not only additional employment; but also, a healthier fiscal condition. This phenomenon was precisely what triggered Arthur Laffer's stidy, which determined that with lower tax rates it is possible to generate greater tax returns than to those obtained with high taxes.

The example of the United States

The United States approved 2 tax reductions during the Regan Administration (one in 1981 and the other in 1986) which dropped the maximum marginal rate over personal income tax from 70% to 28%. Reagan also controlled the 2-digit inflation that had stymied the US economy during the decade of the 1970's. Such policies exerted a gravitational pull over more than US$ 5 billion foreign investment capital that came into the country from 1982 to 2007.

This tax advantage for the US forced other nations to cut their own tax rates as well or else face a loss of competitiveness. In fact, when Reagan reduced taxes in America, that also implied a reduction for the entire world and, currently, President Obama is also proposing tax cuts to combat the recession.

Maximum tax rates on personal income

País	1980 (%)	2007 (%)	cambio (puntos porcentuales)
Reino Unido	83	40	-43
Portugal	84	42	-42
Noruega	75	40	-35
Estados Unidos	**73**	**39**	**-34**
Suecia	87	56	-31
Italia	72	43	-29
México	55	28	-27
Bélgica	76	50	-26
Nueva Zelandia	62	39	-23
España	66	43	-23
Canadá	64	44	-20
Alemania	65	45	-20
Holanda	72	52	-20
Irlanda	60	42	-18
Finlandia	68	51	-17
Australia	62	49	-13
Austria	62	50	-12
Francia	60	48	-12
Dinamarca	66	59	-7
Suiza	38	34	-4
Promedio	68	45	-23

Source: Organization for Economic Cooperation & Development (OECD) Tax Database. Table 1.4, in: http//www.oecd.org/document/60/0, 3343,en_2649_34533_1942460_I_I_I_I00.html; World Tax Database, in: http://www.bus.umich.edu/ otpr/ otpr/ introduction.htm.

During the last 20 years and particularly during the last 5, corporate and personal tax rates around the world have dropped more rapidly than during the last 100 years, such as it may be observed in tables 1 and 2. The average personal income tax rate in industrialized countries in 1980 was 68%. This rate dropped to 50% in 1995 and stands at 45% today. This means that average tax rates over personal income on the upper end of the income scale have dropped by more than one-third. On the corporate income tax side, the tax drop impulse is even more pronounced. The average tax rate in industrialized nations has dropped by half, from 45% to 25% ever since the beginning of the Reagan Administration.

The example of Europe

In 2007, Germany, under Angela Merkel, reduced corporate taxes by nearly 9 percentage points. In this manner, Germany, which started out in this century with a corporate income tax rate of more than 50%, has now reduced that rate to somewhat less than 30%. Merkel's arguments are very similar to Reagan's when she says that the objective of such tax reductions consists in boosting "Germany's attractiveness as a destination of international investment".

Spain has also reduced its taxes. Measures have been implemented to reform taxes –both during the José María Aznar administration as during the leadership of the Socialist, José Luis Rodríguez Zapatero. The maximum tax rate over personal income was reduced from 56% to 43%, while the corporate tax rate dropped from 35% to 30%. Additionally, equity taxes were abolished in 2008.

Sweden completely abolished taxes over real estate properties. In his promise of "abolishing equity taxes", Prime Minister Fredrik Reinfelt, stated: "We expect to promote the desire to invest in Sweden and create a situation so that new and expansive companies may generate more jobs". Toward the end of the year 2008, Sweden also announced a plan to reduce its corporate income tax rate by 1 additional percentage point (down to 24%), thereby leaving Sweden's corporate taxes 11 points below the current US rate.

The impact on workers

The study prepared in 2006 by two academicians; Kevin Hassett and Aparna Mathur, of the American Enterprise Institute (AEI) shows that the corporate tax burden falls in great measure on workers by way of lower salaries.

In a study carried out in 72 countries, it was discovered that production salaries were negatively correlated with high corporate taxes. In effect, the Laffer Curve suggests that nations would increase their economic production and competitive structure in the global race for capital if they were to reduce corporate tax rates even further. Alan Reynolds, a Cato (formerly Hudson) Institute economist, confirmed this correlation: those countries that reduce their tax rates overtake noticeably those that do not. Reynolds calls "supply side economies" those countries that reduced their tax rates and "demand side economies" those countries that increased their taxes during the decade of the 1990's. Supply side countries whose tax rates dropped on the average from 61% to 34% exhibited economic growth rates 3 times greater than demand side countries.

In conclusion

The supply side idea behind the Laffer Curve; namely, that high tax rates hamper economic growth and may even reduce income, generated significant controversy during quite some time among politicians and even among trained economists.

Nowadays, however, nations all over the planet are increasingly adopting the idea. Seemingly, in those countries that reduce taxes, such lower taxes become a decisive component of the capitalization process in the globalization of financial markets.

[1] The country cases depicted in this report were developed by Stephen Moore in the 2009 Economic Freedom Index prepared by the Heritage Foundation.