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The Scope for Progressive Tax Reform in the OECD Countries: A Macroeconomic Perspective[1]

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Over the past decades, the redistributive effect of the tax system in most OECD countries has been substantially and deliberately weakened by tax policies which reduce the tax burden on wealth. Personal and corporate income tax rates have been massively reduced and special provisions privilege capital income. At the same time, rich individuals and corporations have increasingly used legal and illegal tax evasion by shifting income or profits to low tax countries. If this trend continues, the disparities in income distribution will continue to rise. In the long run the financing of the welfare state will be seriously threatened.

However the budgetary stress experienced since the Great Recession, together with substantial increases in disparities in the distribution of income and wealth, have put progressive tax reforms back on the agenda in many OECD countries. There are some signs that the downward trend in redistributive taxation may be coming to a halt (Godar/Paetz/Truger, 2014). A number of international institutions have also commented in a more or less progressive way on how to achieve fiscal consolidation through a socially acceptable tax reform.

More scope for redistribution than often claimed by the mainstream microeconomic perspective

Despite these encouraging signs, a comprehensive systemic policy change is not underway. The standard mainstream argument – which still seems to be highly effective, politically – countered such change with calls for a serious trade-off between equity and efficiency. The dominant view is that higher taxes on upper personal incomes, corporate income and wealth are detrimental to growth and employment, and increase tax avoidance (OECD, 2012: 39).

However, careful scrutiny of this microeconomic neoclassical mainstream wisdom shows that the case against more progressive taxation is substantially weaker than claimed (Godar, Paetz and Truger, 2014). Even within the mainstream approaches, from both a theoretical and an empirical perspective, the negative effects on growth and employment and the erosion of the tax base may not be large.

What is more, factors other than taxation (the cyclical condition of the economy, infrastructure investment, research and development expenditures, and the educational system as provider of a qualified workforce) turn out to be much more important for growth and employment. If those factors can be enhanced by government expenditures financed through progressive taxation, then the overall economic effect may well be positive.

Therefore the alleged trade-off between progressive taxation and growth and employment need not be very important even from a neoclassical microeconomic perspective (see Atkinson, 2015). However, the problem remains that, within neoclassical microeconomic tax theory, proponents of progressive taxation are always defensive of the standard assumption that progressive taxation is detrimental to growth and employment. However from a more Keynesian macroeconomic perspective – which gained considerable influence after the failure of mainstream economics and the great Great Recession - taxation can be seen as systematically conducive to growth and employment both in the short and long term.

The macroeconomic perspective: progressive taxation for higher growth and employment

The macroeconomic perspective focusses on the potentially positive effects of progressive taxation on aggregate demand. The first channel is the effect on private consumption, which mainly depends on current disposable income. One can thus derive a negative relationship between private consumption and the degree of inequality in personal income distribution. The marginal propensity to consume tends to decrease as disposable income increases at the household level. Therefore redistribution from households with lower incomes to households with higher incomes usually results in decreased consumption and an increase in savings. Therefore, a tax correction of disparities in income distribution would strengthen private consumption and hence increase growth and employment.

Taxation which changes the functional income distribution - the distribution of national income between labour and capital – may also produce positive effects. Redistribution from capitalists to workers can be conducive to growth because the propensity to consume out of profit tends to be lower than the propensity to consume out of labour income.

Accordingly, a more progressive taxation of personal income as well as higher taxes on corporate profits should be growth enhancing.

A second channel uses additional tax revenue to finance additional government spending. Following the standard textbook example, this policy should be expansionary because usually the multiplier of additional government spending can be assumed to be higher than the negative revenue multiplier – a result that is broadly confirmed by most empirical multiplier estimates (Gechert 2015). Since the multiplier for government spending on investment and consumption is most probably larger than the multiplier

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for tax cuts and transfers for low and middle income households, the expansionary effect would most likely be stronger than the effect of revenue-neutral redistribution within the tax system.

At this time, such a policy of redistribution may well be the only way for the Eurozone to comply with the European Fiscal Rules without increasing the macroeconomic imbalances that have come to be seen, by many observers, as a root cause of the global financial and economic crisis of 2008 and 2009 and also the Euro crisis. In Europe, the countries with large current account surpluses are to reduce these surpluses to allow external rebalancing within the Eurozone. Macroeconomically, this can be achieved either by allowing higher public deficits or by reducing the huge surpluses in the private sector. If the fiscal architecture precludes higher deficits, then the only way is reducing private sector surpluses, that is, lowering savings of private households or corporations, or increasing corporations' investment (see Godar, Paetz and Truger, 2015; Hein and Truger, 2014).

As argued above, progressive redistribution policies could be used to correct the sectoral balances. A revenue-neutral tax reform which increases the tax burden on high incomes, wealth and corporate profits and reduces the tax burden on low and middle incomes would reduce the private sector surplus via the expected reduction of the savings rate. If redistribution leads to higher private consumption, it can be associated with increasing demand and increased profit expectations by firms, which will lead them to strengthen their real investment and hence reduce the surplus of the corporate sector. The increase in domestic demand would partially improve government budget balance and also reduce current account surpluses.

If at least part of the revenue gained from a progressive tax reform was used to expand public investment, transfers and purchases of goods and services, one could expect stronger domestic growth due to higher expenditure-side multipliers, which should also lead to a correspondingly stronger correction of sectoral balances.

Conclusions for national tax policies

On the international level, the widespread consensus on the need to combat tax evasion and limit tax avoidance as well as introduce a financial transaction tax should be used to implement such reforms in the most ambitious way possible (OECD 2013a and 2013b).

However national tax policies should seek a substantially higher level of redistributive taxation even without international coordination, and independently of the success of international measures. The scope for redistributive tax policies on the national level has been shown to be considerably larger than claimed by the dominant mainstream view. Therefore national tax policies need not restrict their efforts to the faint-hearted measures proposed by many influential international institutions such as broadening the tax base and increasing taxation of residential property while avoiding excessively negative distributional consequences of increasing consumption taxes.

Instead, for many national governments there is substantial leeway to increase top personal income tax rates, corporate income tax and taxation of capital income in general. National governments should use this leeway, because it would increase revenues for essential public purposes and decrease inequality while at the same time encouraging progressive reforms on the international level.

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