Tax After Coronavirus (TACs) : Tax and redistributing i...

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As was discussed in the introduction to this section on Tax and Society within the Tax After Coronavirus (TACs) project, tax has at least six roles to play in any society. Redistributing income and wealth is one of those roles. This section explores that issue.

Redistributing income and wealth

Although most economic theory suggests that markets should distribute both income and wealth fairly within a society, the reality is that the assumptions made to achieve that theoretical result do not always reflect what happens in the real economy. In particular, in most economies existing wealth or social opportunities provide unequal access to markets for some, and denial of access to others, whilst monopolies, opacity and corruption all distort the allocation of economic rewards. The result is that some earn more than their fair share, and others less, whilst wealth becomes unevenly distributed within a society. This would not matter greatly if there was no, overall, consequence for the well-being of a society if this happens, but that is not the case. As economic theory suggests, and as all the world's major international economic organisations, including the International Monetary Fund, the World Bank and the Organisation for Economic Cooperation and Development recognise, too great a level of income and wealth inequality within a jurisdiction can be significantly harmful to its economic well-being.

There are good economic reasons why this is the case. With regard to income it is because the spending patterns of those with different levels of income vary considerably. For example, those on very low incomes tend to spend all of any additional income that they might earn precisely because they have unmet needs and wants. They also, very commonly, spend that additional income on consumption. This means that if they earn additional income it circulates back into the economy very quickly. They have what is called a high marginal propensity to consume.

In contrast, if the wealthiest in a society receive additional income they very often save it because they have few or no additional consumer spending that they need to undertake. They have a low marginal propensity to consume. Alternatively, if they do spend, they might buy items with either a long-term benefit, such as property, or items that reflect their social status e.g. artwork, antiques and other such items, which very often add very little overall value to the level of current economic activity in a country.

The result is that if all the benefits of growth go to those with low incomes this tends to have a very immediate impact on overall well-being because their additional income is rapidly recirculated into the economy, having an immediate knock-on (or multiplier) effect for others, whereas if the benefits of that growth go to those with high incomes the impact might be quite hard to see. The multiplier effect of their additional income is low. The consequence is that countries with relatively low levels of income diversity tend to see overall higher levels of growth when compared to those with higher levels of income inequality.

This is also true of countries with relatively low levels of wealth inequality. In this case this is because those with high levels of wealth tend to be very risk averse and overall do not invest in new risk-based or entrepreneurial activity: they do, instead, tends to invest in existing businesses, land and buildings or other stores of value which may suit their purpose of preserving existing wealth but which do not stimulate new economic activity in the economy as a whole.

In contrast, those with lower levels of wealth tend to have greater risk appetites, and so are inclined to invest in new business activities that are more likely to encourage economic growth, new employment opportunities, and higher wages. Economies with lower levels of wealth diversity do, then, tend to have higher appetites for risk taking. As a result they also tend to have higher rates of growth.

If a government does, then, wish to stimulate economic growth within its jurisdiction it is likely that it will wish to limit the diversity of incomes and wealth within that country to help stimulate this outcome, and by far the best way to do this is to use progressive taxation systems. A progressive tax is one that overall charges higher rates of tax on a person as their income or wealth rises. This increase is not just in absolute terms but also as a proportion of that income or wealth. In many countries this is a significant objective of tax policy as a consequence.