Taxes, growth and social welfare

Diaro Expansión (Spain)

José Emilio Boscá / Rafael Doménech / Javier Ferri

11 Sep 2017

As Oliver Wendell Holmes Jr. stated in 1904, and as appears inscribed on the façade of the US Internal Revenue Service Building, “taxes are what we pay for a civilized society”. However, it is difficult to answer the question of whether we pay too much or too little without taking into account what we receive in return. In a democracy, the level of public spending depends on social preferences and priorities, so taxes are collected to finance the spending policies chosen and to ensure the sustainability of the public accounts in the medium and long term. Yet the tax structure also has important repercussions on the variables that determine social welfare, such as private consumption, leisure time, inequality or life expectancy. Thus, the objective is to aspire to a tax system that improves the welfare of society, ensuring the volume of public revenue needed to finance spending policies with a structure that generates as few distortions as possible.

The problem is that it is difficult to determine optimal tax levels. Firstly, the relationship between fiscal pressure and social welfare is not linear. An insufficient level of taxation, which makes it impossible to finance an adequate volume of public goods and services, can be as damaging to social welfare as taxes set so high that they end up distorting GDP or employment. The key is to find the equilibrium between more income with which to finance public spending that can generate welfare, and fewer distortions and costs, which can harm private activity. Secondly, the relationship between fiscal pressure and welfare depends on the efficiency with which public administrations transform taxes into goods and services that are useful for society. It is not surprising that economies in which the public sector better manages its resources are more likely to increase in size and to accept higher levels of fiscal pressure. Finally, taxes and spending policies affect social welfare through multiple channels and pathways, rendering inadequate many measures the effects of which have not been properly evaluated.

In a recent study (http://goo.gl/rd6Cdc) we contributed to this debate by trying to answer three questions. Firstly, how does the tax burden and its structure in Spain compare with the more advanced European economies in the welfare rankings? By using the implicit tax rates (i.e. the actual collection of each tax against its tax base), Spain has been characterised in the last two decades by a low taxation on consumption (9.4 percentage points lower than the average), high social security contributions (3.7 percentage points above the average), lower taxation on labour income once social security contributions were excluded (10.2 percentage points below the average) and taxation on capital which is similar to the European average.

Secondly, does public revenue increase or decrease when tax rates increase? The answer is not obvious, since it depends on whether the increase of the tax rates can overcome the negative effect on the tax bases. The increase of the tax can be so high and can so reduce the taxable income bases that the amount collected ends up falling. When this happens it is said that the summit of the Laffer curve has been crossed. Finally, the third issue has to do with quantifying the distorting effects of increases in tax rates on aggregate production and employment.

Our results indicate that the tax rates in Spain are in the section with a positive slope on the Laffer curve:

moderate increases in rates increase public revenues, albeit with decreasing effect and with a collection capacity that varies with the tax rate. Although the tax rate on capital that would maximise public revenues is close to 60 percent, the maximum tax revenue improvement would be only 6 percentage points as it would cause a fall in GDP of almost 20 points. For the tax rate on labour income (including social security contributions), its maximum level would be 57 percent. In this case, public revenues would increase by 29 percent, but at the expense of a drop in GDP of 31 percentage points and in employment of 29 points. The greatest tax collection capacity comes from indirect taxes, in addition with the least distorting effect on GDP and employment.

In short, within certain limits, increases in tax rates in Spain generate higher public revenues, but there are no free lunches: they do so at the expense of negative effects on activity, employment and welfare if they are not accompanied by significant increases in the efficiency of public spending, as other more advanced economies have managed to achieve. Beyond the improvements in the fight against fraud and in the pedagogy on taxation, which are without a doubt necessary, with such results it is not surprising that, according to CIS surveys, approximately two-thirds of respondents think that Spanish society benefits little from what it pays in taxes and declare themselves in favour of not increasing them.

BBVA | Research

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.