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Role of Income Tax in Accelerating Economic Growth

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Abstract: *This essay investigates the long-term effects of individual income tax adjustments on economic growth. The design and funding of a tax reform are essential to achieving economic growth. Tax rate reductions may encourage people to work, save, and invest, but if they are not accompanied by swift spending cuts, they will likely lead to an increase in the federal budget deficit, which will eventually lead to a decrease in national saving and an increase in interest rates. Numerous estimates suggest that the impact on growth is either insignificant or adverse. Base-widening measures can lessen the impact of tax rate reductions on budget deficits, but they also have a less impact on investment, savings, and labour supply, which has a smaller direct impact on economic growth. However, they also redistribute resources between sectors to maximise their economic value, leading to greater efficiency and perhaps a larger economy as a whole. According to the findings, not all tax measures will have the same impact on economic growth. The size of the economy will be impacted more favourably in the long run by reforms that increase incentives, remove existing subsidies, limit windfall gains, prevent deficit financing, but may also lead to trade-offs between equity and efficiency*.

Keywords: budget, income tax, reforms, and economic growth

I. INTRODUCTION

The effect of proposed changes to the personal income tax system on the size of the economy overall has long been of interest to policymakers and economists. The income tax system was the subject of a significant reform proposed by Representative Dave Camp (R-MI) earlier this year that would lower rates, significantly cut tax code subsidies, and maintain revenue- and distributional neutrality (Committee on Ways and Means 2014).

The effect of tax adjustments on economic growth is examined in this article. This expansion may involve an increase in the annual growth rate, a one-time boost in the size of the economy that does not affect future growth rates but places the economy on a higher growth trajectory, or both. We focus on two types of tax changes: individual income tax rate reductions and "income tax reform." In contrast to the short-term phenomenon, commonly referred to as "economic growth," wherein an increase in aggregate demand in a slow economy can enhance GDP and enable real GDP to align with potential GDP, we place a strong emphasis on the supply side of the economy and the long term.

The importance of the concerns raised arises from the income tax's significant contribution to revenue collection, its impact on how after-tax income is distributed, and its effects on a variety of economic activity. Its relevance is only increased by recent weak economic performance, doubts about the pace of long-term economic growth, and worry about the federal government's long-term budgetary health.

There is no question that tax policy can influence economic decisions, but we demonstrate that it is not necessarily obvious, ex ante, that tax rate reductions will eventually lead to a larger economy. While the rate cuts would boost the after-tax returns from working, saving, and investing, they would also boost the after-tax income people now receive, lowering their need to work, save, and invest. Through so-called substitution effects, the first effect often boosts economic activity, whereas the second effect typically depresses it through so-called income effects. Furthermore, tax cuts will increase government borrowing if they are not offset by spending reductions, which will further restrict long-term growth. The historical data and simulation studies support the idea that tax reductions that are not promptly accompanied by spending cuts will have little overall impact on economic growth. On the other hand, raising output through quick cuts in nonproductive spending will offset tax rate reductions.

A. lowered income tax rates

Through income and substitution implications, income tax rate reductions have an impact on how people and businesses behave. Lower tax rates boost the after-tax advantage of earning a living, saving money, and investing, which boosts the size of the economy. These higher after-tax gains lead to more work effort, more savings, and more investment due to substitution effects. Tax reductions' "intended" impact on the size of the economy is this. A further benefit of pure rate reductions is that they lessen the impact of current tax distortions and cause a shift in the composition of economic activity away from currently tax-favored industries like healthcare and real estate, improving efficiency (even if the level of economic activity stays the same). Pure rate decreases, however, may also have favourable income (or wealth) effects, lowering the need for work, saving, and investing.

For instance, incorporating all of these advantages would result in a general decrease in income tax rates. It boosts the marginal return to employment and expands the labour pool through the substitution effect. It changes the composition of economic activity by reducing the value of current tax incentives. Additionally, it raises a household's after-tax income at all levels of the labour supply, which has the financial impact of lowering the labour supply. The final outcome's impact on the labour supply is uncertain. Reductions in tax rates have similar effects on saving and other activities.

The effectiveness of a particular tax cut will depend on the original tax rate. For instance, if the initial tax rate, let's suppose it is 90%, the after-tax wage doubles from 10% to 20% of the pre-tax wage with a 10% reduction in taxes. However, if the initial tax rate is 20%, the same 10-percentage-point tax cut only results in an eighth rise in after-tax pay, from 80% to 90% of the pre-tax pay. Although the effects on income would be the same in both cases, the substitution effect on labour supply and saving would be greater at higher tax rates, thus a tax cut's net increase in labour supply would be greater (or a tax increase's net decrease would be less in absolute terms) at higher tax rates. Additionally, the efficiency gains from cutting tax rates are greater when tax rates are already high since the economic cost of the tax rises with the square of the tax rate.

B. Fiscal Reform

As was previously said, tax reform comprises lowering income tax rates as well as attempting to broaden the tax base by limiting the use of tax expenditures and other factors that limit the base.

Widening the tax base tends to raise the average effective marginal tax rates on labour supply, savings, and investment by eliminating preferential treatment for particular categories of income or consumption. Due to the fact that a lower tax rate increases incentives to work, for example, while expanding the tax base reduces these incentives, a revenue-neutral tax reform will have a smaller average substitution effect than a tax rate cut, and a truly revenue-neutral reform should have no average income effect at all.

Increasing the base has a side effect that should support economic expansion. In particular, it would reduce the amount of resources allocated to the sectors and industries that already have beneficial tax status. A system with a lower rate and a larger base would encourage the transfer of capital out of tax-favored industries and into those with higher pre-tax returns. A greater economy would arise from the reallocation.

C. Financing

Tax hikes affect the economy via adjustments to federal budgets, in addition to their effects on private agents. Because the reformed system would produce the same amount of revenue as the old system, there would be no financing implications if the change was revenue-neutral.

However, every tax cut must be offset by a combination of future spending reductions, tax hikes, and borrowing to close the difference between spending and revenue. Despite the fact that they were not explicitly included in the initial tax cut legislation, the related, essential policy changes must be made if the government is to stay within its budgetary constraints. The financing of a tax cut must be taken into account when estimating the impact of the tax cut itself because fiscally unsustainable policies cannot be maintained indefinitely.

D. Additional government agencies

Federal tax cuts can inspire responses from other governmental institutions, in addition to the central bank, state governments, and foreign governments. For instance, the Joint Committee on Taxation (2014) looked into how various Federal Reserve Board policies may affect how Representative Camp's proposed tax reforms would affect economic growth.

Foreign nations' potential responses are frequently ignored. For instance, tax cuts in the United States that promote foreign capital inflows may motivate other countries to adopt similar tax cuts to attract or retain foreign capital. The net impact of income tax reductions on economic growth will be less than it would otherwise be, depending on how other countries react.

II. CONCLUSION

Economic activity can be impacted by both changes in revenue volume and tax structure, albeit not all tax changes have the same or even advantageous effects on long-term growth. The claim that lowering income taxes encourages economic growth has been made so often that it is sometimes taken for granted. But theory, data, and simulation studies offer a different and more nuanced story. By strengthening the incentives to work, save, and invest, tax reductions have the potential to boost economic growth. However, they can have an impact on income, reducing the need for productive economic effort, and they may subsidise existing capital, giving asset owners windfall returns and reducing the incentives for new activity. Furthermore, tax reductions taken on their own (i.e., without spending cutbacks) sometimes result in a rise in the federal budget deficit. In addition to reducing national saving, American capital stock, future national revenue, and interest rates, the growing national deficit will also have a negative impact on investment by raising the cost of borrowing. The net impact of the tax cut on economic growth is therefore theoretically uncertain and is reliant on the tax cut's design as well as the timing and manner of its funding.

The results of numerous empirical studies that have attempted to quantify the aforementioned effects in various ways and using diverse models have usually been consistent. Long-term tax cuts accompanied by bigger deficits are anticipated to lower the national income over time rather than increase it. However, the computer models show that lowering income tax rates while also cutting spending may benefit economic growth. However, big tax reductions in American contemporary history (in 1964, 1981, and 2001/2003) were followed by increases in federal spending, not decreases. The claim that lowering income taxes encourages economic growth has been made so often that it is sometimes taken for granted. Although more complicated than the consequences of tax cuts, the effects of income tax reform—revenue- and distributionally-neutral base-expanding, rate-reducing reforms—build on them. Rate reductions have the same effects as previously mentioned. By enlarging the base in a way that is revenue neutral, the impact of rate cuts on budget deficits will be negated. Additionally, it will lessen how the rate cuts will affect the labour supply, savings, investments, and other factors by reducing the effective marginal tax rates.

Expanding the base will, however, have an additional effect. By lessening the degree to which the tax code subsidises alternative sources and uses of income, expanding the base will reallocate resources to their highest-value economic use, resulting in an expansion of the economy and a more effective allocation of resources. These effects can theoretically and in simulations be significant, especially for drastic policy changes like eliminating all personal exemptions and deductions and implementing a flat tax rate. Due in part to the fact that there has only been one significant tax reform in the past 50 years, there aren't many empirical studies of broad-based income tax change in the United States. According to a strong theoretical premise and considerable simulation data, increasing the tax base and lowering tax rates can improve long-term performance. However, as it generates the same amount of income from the same people as before, the purpose is not that it boosts labour supply, saving, or investment; rather, by eliminating targeted subsidies, it leads to a more efficient distribution of resources across economic sectors.

The size of the economy will be affected more favourably by reforms that boost incentives, eliminate existing subsidies, limit windfall gains, prevent deficit financing, although they may occasionally force trade-offs between equity and efficiency. These findings emphasise the potential advantages and drawbacks of income tax reform for long-term economic expansion.

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