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Corporate Tax Centre - Vern Krishna discusses how important different revenue and rates are to taxation, including three different tax rates: marginal, average, and effective.

The Three Rs of Taxation

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The Three Rs of Taxation

Vern Krishna

Governments worldwide crave more revenues to support their spending addictions and seek to prevent tax leakage through tax evasion. Taxpayers want a fair system of taxation within which they will inevitably seek to maximize their returns on earnings and investments. In this international tug of war between governments and taxpayers, we need to understand the three Rs of taxation: rate, rate and rate.

A tax system should raise sufficient revenue to finance government operations. A good tax system, however, is also concerned with the manner in which we collect the revenue. It should be neutral and efficient, fair and equitable, certain, administratively simple, and easy to comply with. These are often conflicting goals, and all the more so if we use tax law to implement economic, social and political objectives. Thus, tax law is a compromise of competing values.

To be sure, we levy income taxes to generate sufficient revenues for public spending, be it for war, economic development or social spending. In concept, the amount of revenue that a tax system raises is a simple mathematical function:

$$\text{Revenue} = \text{Tax Base} \times \text{Tax Rate}$$

These are the only two variables that directly determine the amount of revenue that a tax system can raise. The interplay between these two variables, however, is complex and influences the manner in which we achieve other non-revenue objectives. The size and character of the tax base and tax rates affect the fairness of the system, economic efficiency, certainty, and the costs of compliance.

The size of the tax base also has an effect on other aspects of the tax system. A system with a broad base is usually more certain and simpler than a system with a narrowly constrained base. This is because a broad-based system requires fewer lines of demarcation between classifications of income, expenditures and exclusions than a narrowly based system. For example, a system that taxes all forms of gains, regardless of from where they derive, requires fewer rules than a system that distinguishes between different sources of economic gains, each with its own rules.

We can generate the same amount of revenue from a broadly based system as we can from a narrow base by adjusting tax rates. The trade-off between the two, however, affects the economic efficiency of the system and its complexity, which in turn affects the cost of compliance and tax administration.

The second element in determining revenue is the tax rate that one applies to the tax base. All other things being equal (and they rarely are), the higher the tax rate, the greater the revenue collected from the tax base. Thus, ignoring behavioral responses to tax rates, a rate of 40 percent will in theory produce a greater amount of revenue than a tax rate of 20 percent. However, there are many economists who maintain that a reduction in tax rates stimulates economic growth and enhances revenues, which, in turn, leads to additional tax collections.

There are three different tax rates: marginal, average, and effective. The marginal tax rate is the level of tax that applies on the top dollar of taxable income. Hence, as marginal rates rise, the total tax payable increases by a rate that is more than proportional to the increase in income.

For example, an individual who earns $30,000 taxable income will pay basic federal tax at a federal marginal rate of 15 percent. In contrast, an individual who earns taxable income of $150,000 will pay at a federal marginal rate of 29 percent.

We obtain the “average rate” of tax by dividing the total tax payable by the tax base. The average rate reflects the weighted average of all of the marginal tax rates. For example, if Jane earns taxable income of $30,000, her average federal tax rate of an individual is $4,500 or 15 percent. In this case, the average and the marginal rates are equal because only one marginal rate (15 percent) applies to all of the income. If Harry earns taxable income of $140,000, his total tax is $30,145, which makes his average rate of tax 22 percent—that is, 7 percent lower than his federal marginal rate of 29 percent.

The “effective rate” of tax is the most meaningful rate of tax for taxpayers. It is the total tax payable divided by *net income* before exclusions and exemptions. In the above example, assume that Harry who has taxable income of $140,000 earned $60,000 of capital gains in the year. By excluding one-half of the capital gains from taxable income, Harry has, in effect, reduced his taxable income by $30,000. The individual’s effective tax rate is the actual tax payable of $30,145 divided by his “real” net economic income of $170,000. Thus, the effective tax rate is only18 percent.

When we make international comparisons, marginal and average rates of tax are not helpful because they do not take into account the differences in calculating the taxable base to which one applies the actual rate. For example, assume that Country A taxes net income at 40 percent whereas Country B taxes net income at 35 percent. On the surface, it appears that Country A has higher tax rates. If, however, Country A allows generous deductions, (for example, mortgage interest and property tax deductions) in computing income, that Country B does not permit, the effective rate of tax in Country A may actually be lower than in Country B.

The particular tax rate we use depends upon the underlying purpose of the analysis. Marginal rates are useful in tax planning because they pinpoint the amount of savings on the top dollar of income. Average rates tell us our overall tax bill. Effective rates are the most meaningful because they tell us what we are actually paying on all income and the amount of tax leakage for governments.

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