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Why Taxes Affect Economic Growth

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To those who struggle daily to succeed in business, it is well known that the rules of government and the customs of the community can influence the scope of economic activity. Certain communities permit trade on holy days; others do not. Some governments encourage exchange with suppliers and customers in other countries; others raise barriers that prohibit international transactions. Workers and business owners in some countries face taxes that burden entrepreneurship so greatly that innovation withers; in other countries, governments levy just enough tax to support the judicial and protective functions needed by those who risk physical property and personal labor to create new products.

What ordinary business people have understood for countless generations is now working its way back into mainstream economics and public policy. After a long and relatively barren period, economists are paying full attention to the crucial role played by civil and political institutions in shaping economic activity. Academic and policy economists now ask questions about the institutional setting for economic growth—questions that remind historians of problems that dominated the attention of early classical economists like Adam Smith, David Ricardo, and John Stuart Mill. What set of rules and policies will best ensure a country's prosperity? What set of institutional arrangements most promotes economic growth? The modern economist's question about economic growth should concern all citizens who care about their economic future: How can institutions and policies be changed so that high levels of economic well-being and output are achieved?

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Adam Smith, the 18th century Scottish philosopher and founder of modern economics, devoted the whole of his *Inquiry into the Nature and Causes of the Wealth of Nations* to a seemingly simple question: Why do some countries prosper

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while others do not?[2] For Smith and his many followers, the answer is obvious: All economic growth flourishes from the single root of creatively dividing labor in the production of desirable goods, and blossoms in a political environment that protects private property, free exchange, and the justly deserved fruits of labor. Countries will experience opulence and peace, Smith argues, once they create the institutions that encourage entrepreneurship and savings (the stock of capital upon which all production takes place). On the other hand, countries reap only poverty and despair when they discourage business and punish productive activities.

Today, experts and laymen alike differ on what is meant by economic growth and the nature of its mediating institutions. Is economic growth merely the expansion of an economy's size, or is it the extension of improved well-being to all of a country's citizens? Do a country's imperial designs executed in the name of economic growth count at all in answering the basic question of what constitutes growth? Or does growth in any meaningful sense occur only when peaceful domestic and international exchange leaves, as in David Ricardo's felicitous example, the English and the Portuguese both better off through trade in cloth and wine?[3] If the government compels upper-income citizens to transfer large portions of their income to their lower-income counterparts and thereby temporarily narrows the gap between the rich and the poor, does that narrowing constitute economic growth?

Similarly, if government policy puts labor behind and capital ahead in the struggle for income shares, or strips capital owners of their property in the name of improved welfare for labor, is that really growth? Indeed, does public policy play any role at all in the long-term growth of an economy, or does economic expansion really stem only from changes in population and technology that are not related to public policy?

Considering these difficult questions, many of which are raised by experts on economic growth, is it any wonder that non-experts, from oil tycoons to short-order cooks, wonder what to believe? Nearly everyone lives in the massive currents of the rise and tumble of great companies, and the ebb and flow of everyday working life. These are the economic rhythms that shape people's lives and punctuate their everyday work, and they leave precious little time for abstracting the big question from the minutiae of living.

Despite this seeming Babel on economic growth, the views of economists are steadily coalescing around key factors that must be present if a country wishes to experience economic growth rates higher than the rate of population growth. Throughout all of these factors, one finds tax policy playing a prominent, and often decisive, role.

- **Accumulate capital.** Increasing the stock of physical capital available for each worker in the economy is one of the best ways to increase per capita income.
- **Keep government small.** Government spending consumes scarce resources that could be used for productive investment and distorts the incentives faced by individuals and firms. State ownership of capital stock means that the output from those productive assets will be lower than if they were in private hands.
- **Open the economy to foreign trade and investment.** Leading economists of this new consensus on economic growth have uncovered many previously unknown gains from foreign trade and investment, including the faster and deeper diffusion of technology from abroad, an increase in competition that improves efficiency, and the more rapid accumulation of capital.

2. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Glasgow Edition, R. H. Campbell and A. S. Skinner, eds. (Oxford, UK: Oxford University Press, 1976); published originally in 1776.
3. David Ricardo, *On the Principles of Political Economy and Taxation*, Third Edition, Piero Sraffa, ed. (Cambridge, MA: Cambridge University Press, 1951); published originally in 1821. See especially Chapter 7, "On Foreign Trade," for Ricardo's discussion of how two economies can grow by trading commodities in which each has a comparative advantage.

- **Respect property rights and the rule of law.** Without adequate protection for property rights and a secure political environment, individuals and firms will face severe disincentives to invest and engage in productive activities.

- **Do not burden the productive sector with unnecessary government regulations and controls.** Regulations, mandates, and wage and price controls are a drag on economic growth. They raise the cost of producing goods and services and make innovation and invention more expensive. Government controls also increase the opportunities for gains from corruption and thus divert entrepreneurship from productive activities to nonproductive "rent-seeking" activities.

- **Invest in "human capital."** Education, which increases worker productivity, is very important to growth, according to many leading economists in this field. In this context, it is important that education systems operate primarily to educate students rather than to serve the ends of "social justice" or of powerful political groups.

The old theory of why economies grow generally held that public policies do not matter to long-term growth rates. Advocates of this view argued that economies can grow no faster than their rate of population change and growth in technology. Ultimately, in this view, the growth rates of all economies will converge to a rate equal to the replacement rate for the population—say 1 percent per year—and the rate of capital growth—say another 1 percent. Public policies intended to boost this rate of growth above 2 percent will have a short-term impact on growth rates, but all such impact will have diminishing returns over the long term.

Whereas the old growth theory predicted that establishing sound policies would lead only to a one-time boost in income (and therefore only a transitory increase in economic growth rates), the new approach to growth predicts increasing returns from sensible policies. This means that the benefits of instituting wise economic policies (and the costs of pursuing misguided policies) are much greater than was thought to be the case under the old theories that assumed decreasing returns. In these new growth models, introducing a "good" policy can create a virtuous circle of economic expansion that will feed on itself to bring about a permanent acceleration in the growth of the economy. Likewise, "bad" policies can mean permanently lower growth rates and cost society more than earlier economists had thought possible.[4]

In short, the new growth theory suggests that public policies do matter. In a recent essay on the reasons some countries enjoy better economic performance than others, the late Mancur Olson, one of this century's leading economic theorists, observes that "those countries with the best policies and institutions achieve most of their potential, while other countries achieve only a tiny fractions of their potential income." Olson further notes that

> the large differences in per capita income across countries cannot be explained by differences in access to the world's stock of productive knowledge or to its capital markets, by differences in the ratio of population to land or natural resources, or by differences in the quality of marketable human capital or personal culture.... The only remaining plausible explanation is that the great differences in the wealth of nations are mainly due to differences in

4. The literature of "new growth economics" is itself growing at increasing rates. A proper literature review would consume an enormous amount of space, but the reader should sample the pieces of this thinking. Robert J. Barro's new book, *Determinants of Economic Growth: A Cross-Country Empirical Study* (Cambridge, MA, and London, UK: The MIT Press, 1997), provides an accessible and mercifully brief summary of current research on economic growth. The seminal paper on increasing returns belongs to Paul Romer, "Increasing Returns and Long Run Growth," *Journal of Political Economy,* Vol. 94 (1986), pp. 1002–1037. A comprehensive treatment of the subject can be found in Barro and Xavier Sala-I-Martin, *Economic Growth* (New York, NY: McGraw-Hill, 1995).

> the quality of their institutions and economic policies.[5]

Tax policy stands at the center of our effort to get public policy right for economic growth. Tax policy mirrors our view of the role of government in everyday life and parallels the level of spending and the diversion of resources to the state. It reflects as well our opinions about the social worth of achievement and financial prudence and shapes our practice of the principle of equality before the law and equal access to due process. We know from our study of over 130 other countries that those with low tax rates on labor and capital relative to the average have adopted other public policies that promote growth: free trade, minimal restrictions on the import and export of capital and labor, rule of law, stable money, and light regulations on the use of one's private property in production.[6] We know as well that those countries with below-average tax rates on labor and capital have long-term growth rates that are about 0.6 of a percentage point higher than those countries at or above the average.

Numerous studies conducted over the past four years by The Heritage Foundation and by other think tanks with economic specializations show that reductions in tax rates on labor or capital—or both—lead to higher levels of economic activity. Tax policy changes that provide credits or deductions for some and not for others, however, have little effect on the overall level of economic growth, even though they may achieve greater equity in tax law. In fact, it is commonplace for economists to give low economic growth scores to tax policy proposals that reduce the tax burden on targeted classes of taxpayers. For example, the recently enacted child tax credit, although important for reversing the growing inequity in the code stemming from allowing the personal exemption for children to lag behind inflation and the exemptions for adults, hardly causes the standard economic models to stop for breath. Drop the taxes on capital gains or reduce marginal tax rates on ordinary taxable income, however, and these same economic models register significant increases in economic activity and long-term growth rates.

What explains this economic difference between rates and tax burden? The principal feature of an economic decision is the question that owners of labor and capital resources must answer when presented with opportunities for change: Will contributing more of my labor or more of my capital to an economic enterprise so improve my well-being that the benefits of doing more outweigh the costs? In other words, is the new opportunity less costly than staying put?

Answering this question affirmatively (that is, making a change) has everything to do with economic growth. An expanding economy generally means that new products and services are being produced that improve the well-being of people who participate in that economy. Economic growth rates that exceed the rate of population growth imply economic change that is making people better off. Thus, the individual decision to do more with his or her labor or capital is crucial to change. If contributing an additional hour of labor or dollar of capital means having to pay more taxes because that additional unit is taxed at a higher rate, then staying put may make good sense. Just reducing the total amount of taxes a person or business pays through deductions or credits may lower their overall costs. It can leave a person in the "stay-put" position, however, if working an additional hour still means that income from that hour will be taxed at a higher rate. In tax economics, it is the marginal unit or the next piece of the decision puzzle that really matters.

The importance of tax policy to economic growth is illustrated by exploring obvious tax

5. Mancur Olson, "Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Are Poor," *Journal of Economic Perspectives,* Vol. 10 (Spring 1996), p. 19.

6. See William W. Beach and Gareth G. Davis, "The Institutional Setting of Economic Growth," in Bryan T. Johnson, Kim R. Holmes, and Melanie Kirkpatrick, eds., *1998 Index of Economic Freedom* (Washington, DC: The Heritage Foundation and Dow-Jones & Company, Inc., 1997).

effects in the six characteristics of growing economies that new growth theorists have identified.

- **Accumulating capital.** Tax policy can affect the stock of physical capital directly. If taxes on the earnings of capital (interest, dividends, capital rents) rise too high, then the owners of capital will charge higher prices for the use of their capital. The usual result from an increase in the price of capital is greater use of human labor to do the "work" that machines previously performed or refusal by management to adopt the latest labor-saving technologies. In any event, the productivity of people falls, which reduces potential well-being and the rate of economic growth.

- **Keeping government small.** The sole purpose of a tax system should be to produce necessary income for government in as economically and socially neutral a fashion as possible. When the tax system is used as a tool for producing certain economic and social outcomes (such as universal home ownership, inexpensive access to education, redistribution of income to needy families) it becomes, perhaps by accident, the essential partner in expanding the scope and size of government. History never has seen a tax system employed for "purposes of the state" that did not engender a large and expensive bureaucracy. When government grows relative to the economy and the population, it diverts scarce resources from those activities in the private sector that could improve everyone's well-being. The growth of the economy inevitably falls below its potential.

- **Opening the economy to foreign trade and investment.** Tariffs and restrictions on trade and investment are, of course, the oldest forms of taxation known to government. Any foreign-produced product that must pay an entry fee in order to compete for sales in the United States starts from a disadvantaged position. If such a product is superior to one produced in the United States, then U.S. consumers are directly harmed by having to pay a higher-than-normal price for a superior product (one that makes them better off). If such border taxes and other trade restrictions become too high, they can shut off valuable investment and product sales in the United States. When investment falls and Americans lose access to new and superior technology, the economy suffers, and the growth rate falls below potential.

- **Respecting property rights and the rule of law.** History is full of taxing authorities that undermined the rule of law in their zeal for revenues. History also is filled with evidence that the rule of law and respect for property rights may be the most important prerequisites for economic growth. Certainly, when unexpected political change in a country leads to new rules and violations of property rights, economic activity quickly falters. Severely restricting the taxing authority's power over property and information about income is one of the most proved and certain ways of advancing economic growth.

- **Not burdening the productive sector with unnecessary government regulations and controls.** Another tax often overlooked is any regulation that adds to the cost of producing a good or service or prohibits a certain economic practice or behavior. Behavioral taxes actually may be more influential in shaping many decisions at the margin than income taxes. Certainly, any foreign company thinking about opening a factory in the United States must carefully assess the additional costs of operation that stem directly from our country's clean air and water regulations. Even though many Americans would not want to live without such regulations, they should recognize that these taxes on property use and economic behavior directly reduce economic activity and the rate of economic growth. To the extent that behavioral taxes reduce economic growth, they reduce economic well-being.

- **Investing in "human capital."** Clearly, any country that has instituted low-tax and -regulation policies, the rule of law, free trade, and stable money will benefit from a more edu-

> cated workforce. Too often, countries (including the United States) assume that universal education will lead to economic prosperity and that nothing need be done about the rights of people to keep the fruits of their labor, to open new businesses, to immigrate freely, or to enjoy objective laws that are evenly administered. Of course, recent history is replete with examples of huge investments made in educating poor people who remain stubbornly poor no matter how literate they become because they are not permitted to keep most of their income or build family wealth. Education really only adds to economic growth in a society in which the taxes levied on an individual's productive use of education are low and fair; otherwise, universal education is an enormous waste of a country's resources.

Getting tax policy right is a task that knows no particular season. This year's opportunity for redirecting tax policy down the seldom-trodden road to righteousness, however, happens at a time of unexpected, rather large budget surpluses. Clearly, surplus politics can be employed to advance pro-growth tax policy. Congress has the opportunity to perform two amazing tasks: begin the schedule leading to fundamental income tax reform and work toward payroll-tax relief through significant changes to Social Security's retirement program.

Doubtless, Congress will record many historic debates on these two policy fronts. The importance of this debate in the history of American public policy, however, hardly can be diminished. Our tax laws work against savings and investment, burden all taxpayers with rules that annually cost society billions of dollars in unnecessary compliance expenses, routinely shift the payment of taxes to low- and moderate-income households, and distort economic decision-making. Our defined-benefit, publicly funded retirement system causes low- and moderate-income workers permanently to lose thousands of dollars in potential retirement income. It totters dangerously on the brink of bankruptcy; indeed, it promises future workers a significantly lower standard of living than today as payroll taxes rise and retirement benefits fall in an effort to keep Social Security solvent. Moreover, the current and forecasted budget surpluses raise a fundamental issue in political philosophy: Once the revenue requirements of government have been determined in our constitutional system of representative decision-making, must tax revenues above the needs of government be returned to taxpayers immediately; or does the national legislature have an expansive authority to seize taxpayer income beyond the budget law it has enacted?

Members of Congress and, indeed, the general public may not see the important connection between how these questions are answered and future economic performance. If Congress gets policy right, then Americans are on the verge of unprecedented prosperity. If this opportunity is missed, Americans may find themselves the subject of endless academic essays diagnosing their failure to grab the chance for greater well-being when the fortunes of economic events offered it.

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