MORE TAX CUTS?

The Truth About Taxes and Economic Growth

Interview with Joel Slemrod

Judging by the political scene in Washington, one would think that low taxes were the main source of economic growth in the United States and around the world. Even most Democrats dare not demand that President Bush's tax cuts be rescinded. But this leading tax expert, a political centrist, argues that there is no compelling evidence that high taxes impede economic growth.

Q There is a widespread belief among the public that low taxes generally mean rapid economic growth. The evidence does not seem to support that conviction.

A. That is right. There are many different kinds of evidence one might look at. One place to start is to look across countries to see if there is a clear relationship between how much taxes—say, as a fraction of gross domestic product—a country collects and its economic performance. If you look at the relationship

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between that tax ratio and the level of prosperity, measured by GDP per capita, there is no supportive evidence for the claim that low taxes guarantee prosperity. In fact, if you just plot out the points, you will find a clear, positive correlation between high tax rates and prosperity, and that is because developed countries are the ones with the high tax ratios.

Q In other words, when you say "a positive correlation," you mean that high tax rates tend to be associated with high levels of GDP per capita?

A. It is the developed countries that, for whatever reason, take more taxes per dollar of income from their citizens. Now, I would not interpret that evidence to necessarily mean that high taxes (and high government spending) cause prosperity, but it is a troubling fact that the people who say low taxes are the key to prosperity must confront. In fact, the positive correlation is probably largely due to factors, such as education level, that vary across countries and are connected with prosperity as well as facilitate the collection of taxes. So that positive correlation between prosperity and the tax ratio is not necessarily causal in either direction.

Q What do you mean by "facilitate tax collection"?

A. Take the income tax. It is very difficult, maybe impossible, to implement an income tax when many people are not literate and when most small and medium-size businesses do not keep books. Modern taxes such as an income tax are very difficult to implement in countries with low education levels.

Q Let us talk about growth rates. It is not merely a mat-

ter of looking at one point and comparing GDP to the proportion of taxes in an economy. There also does not seem to be a correlation with growth rates, as you point out in your research.

A. Another way to look at cross-country evidence is to look at the association between tax ratios and, not the level of prosperity, but the growth rate of prosperity. There have been a large number of studies about this concept in the last twenty years. Robert Barro of Harvard had an influential study several years back claiming to find that, while holding other determinants of growth constant, low tax rates and low government spending were associated with higher growth. However, there have been several studies since then showing that those empirical findings do not hold up to reasonable changes in the econometric approach he used and the data he studied.

Q In lay language, what does that mean?

A. It means that there are other reasonable ways to try to look at the association between tax ratios and growth rates and that these studies failed to find the relationship that Barro found. So his conclusion is by no means an undisputed empirical finding. Also, it is one that does not jump out by making scatter plots of points. If you look at growth rates on the y-axis and tax ratios on the x-axis, you will not notice a clear negative relationship between the two. It is only by doing more sophisticated econometric analysis that one can even have a chance of coaxing out a relationship between the two.

Q. And yet your studies and those of others suggest there is no relationship between low taxes and high growth or high taxes and slower growth rates?

A. Yes. Here, as I said, the evidence is mixed. Barro finds that there is such a relationship, and others uncover one, but many studies find that there is no such relationship. So the evidence is not at all clear.

Q It seems on the face of it, at least in theoretical terms, that low taxes should lead to more rapid growth—it diverts less money from the private sector.

A. There is no question that simple economic theory suggests that taxes have disincentive effects on labor supply, on saving, on investment, on innovation. If people in the private sector get to keep fewer of the rewards from their effort, they'll just do less. The theory is quite clear that taxes—in particular, progressive taxes—should have some negative economic effect due to these disincentives. What is in dispute is the magnitude of these disincentive effects. There is a large body of literature about each of these behaviors and just how much of a disincentive effect higher taxes have.

Q Some people argue that the tax system provides particularly large disincentives for the wealthy to work hard, to invest aggressively—in fact, a disincentive to entrepreneurialism in general. Does the evidence support that?

A. First, it is key that theory says marginal tax rates, and not average tax rates, will have disincentive effects. That is important because it raises the question of a trade-off between the disincentive effects of taxation and the equity effect. Raising a given amount of revenue in a progressive way tends to require higher marginal tax rates. Some people argue that this effect creates disincentives that impede growth. So there is this essential trade-off that policy must confront. Let me put that aside and answer your question, which is, what does the evidence say about the magnitude of these behaviors. How much do high marginal rates truly affect behavior? In terms of how they affect labor supply—the hours people work—the evidence suggests that the aggregate response is fairly low.

Q That is to say, people would argue that if taxes were high, people in general, not just the wealthy, would have less incentive to work longer hours or work harder.

A. Sure, the higher the marginal tax rate, the lower the after-tax rewards to working more, and therefore, the theory says, people will, on average, work less. So the question is, how much less? The evidence is that, in the aggregate, people will work a little bit less, but not much less. For males, the evidence is that the behavioral response is very small. For females, in particular on the dimension of participating in the labor force or not, there is evidence of a significant response. But, combining male and female hours worked and participation, the evidence suggests that the response is fairly small.

Q What about whether the wealthy will work less hard or invest less aggressively or think less hard about new businesses if marginal taxes are high?

A. Yes, this is a question addressed in a book I edited called *Does Atlas Shrug?* (Harvard University Press, 2000). Certainly the wealthy take notice of taxes and arrange their businesses to take advantage of what the tax system makes more attractive. The evidence is that, to the wealthy, for some sorts of decisions, taxes matter a lot. An example of a big effect is the timing of capital gains realization. When capital gains taxes change, and especially when they are known to be temporary, there is a huge response among the wealthy to time their sales to minimize taxes.

Q. That is, when they sell their securities and take their gains.

A. The timing of the sale of securities with capital gains seems very sensitive to taxes, as is the timing of receipt of income. If the tax rate is going to change, there is evidence that wealthy people understand which year to exercise their stock options, which year to take their bonuses, and so on. For example, many wealthy people chose to accelerate their bonus payments into the end of 1992, anticipating the Clinton tax increase of 1993.

Q. In 1993, when the marginal rate was raised on the top bracket from 31 percent to 39.6 percent, economists predicted that incomes for the wealthy would fall.

A. The tax increases in the early 1990s were important to understanding the impact of taxes on incentives. In the previous decade, the trend had been lower tax rates at the top of the income scale. At the same time, there was an acceleration in reported income of high-income people. So there seemed to be a clear connection between lower tax rates, particularly for high-income people, and more reported income. And that is why, purely from a research point of view, the tax increases of 1993 were important. The tax increase, if the theory held, should have stunted the growth of income for the wealthy, but it did not. The increase in the concentration of income at the top continued, and so it looks as if the biggest explanation for those trends in the 1980s and 1990s was probably not the tax system, but other economic factors.

Q. The incomes of the wealthy took off to unprecedented levels proportionately in the late 1990s.

A. That is true. The data that is just out for 2000 shows a continuing acceleration in the concentration of income received by the top 1 percent. So this trend started in the 1980s, accelerated in the 1990s, and did not seem to be much dampened by the tax increases at the top that occurred in the early 1990s.

Q What about the impact of taxes on savings and investment? Can we draw any interesting conclusions about that?

A. The evidence on investment suggests that higher effective tax rates will dampen investment—not to a great degree, but to some degree. On the savings side, the evidence is much murkier. It has been very difficult to establish a clear connection between the rate of saving in the United States and the after-tax return to that saving.

Q What do you think might explain that?

A. I am not sure. It is tricky to find an explanation for something that does not appear in the data. The problem with studying saving, in particular, is that it is very difficult to measure, as is the after-tax return to savings, because there are so many different instruments of saving. So we are not sure whether the fact that we cannot find an association means there is none or that it is just hard to pick one up with the kind of data and methods we have.

Q In general, then, the evidence shows not that taxes have no effect but that they have a rather small effect.

A. That is absolutely right. Clearly, taxes affect behavior; they affect some behaviors more than others. What has not been established is that the level of taxes has a clear and important impact on overall economic growth. And one reason is that this is not a well-posed question. How government activity affects prosperity depends not only on the level of taxes, but also on what the money is used for. No one doubts that raising taxes and wasting the money is not good for any economy. Raising taxes and using the money for education and certain infrastructure could certainly be beneficial to an economy, and especially in most developing countries, where raising taxes and using the money for education, health care, and infrastructure almost certainly would be good for growth.

Q Of course, the tax money is also used for other issues that many economists find important: maintaining institutions that support the right to private property, for example, and support contracts.

A. Yes. There is a lot of recent evidence that government intervention in an economy in the ways you just mentioned can also be critical for economic growth.

Q. So, there are two general categories that may help to explain why high taxes do not necessarily undermine economic growth. One is that the disincentive impacts do not seem nearly as high as people might have hypothesized. Another is that governments may spend the money they collect in ways that actually promote economic growth. I suppose one could argue that taxes may not have slowed down growth, but that we would have grown even faster in many of these countries with less government and lower taxes.

A. But that is exactly the association that these Barro-type studies have tried to coax out. As we have already discussed, the evidence there is quite mixed. So regardless of the mechanism that causes an association between tax level and growth, in cross-country studies it has been difficult to find it.

Q. Short-term tax cuts are a different issue. Can they provide a short-term stimulus to the economy?

A. Yes, that is mostly a different issue, although, like all economics, when it comes to determining how to do short-term macro stimulus, it gets tied up with issues of size of government and distribution.

Q That leads me to one final question about capital gains taxes. When I travel around or talk in the media, I constantly hear that people think—and maybe I am talking about only *Wall Street Journal* editorial writers—that the capital gains tax cut of 1997 led to more federal revenues, by which I believe they mean that it led to the boom of the late 1990s. Is there any evidence of that, and, secondly, is there any plausible case one can make concerning that?

A. Capital gains taxes are a good example of how taxes can matter in one sense and not in another. There is a lot of evidence that capital gains realizations, that is, the sales of assets that have capital gains, are quite sensitive to capital gains tax rates, and especially to rates that are thought to be temporary. Americans respond to sales of all kinds. So, lowering capital gains tax rates almost certainly increased capital gains realizations above what they otherwise would have been. That is one sense in which the revenue loss from these tax cuts was not as large as you might otherwise have thought. Whether the realizations went up so much that no revenues were lost is controversial. I personally do not believe it is true. The second question, though, is whether the capital gains tax cuts stimulated the economy generally and whether that stimulation led to higher revenues. For that second question, there is no evidence that links aggregate economic performance to capital gains tax rates. That argument is not implausible, but I know of no evidence that establishes a connection between prosperity and at what rate we tax capital gains.

Q It seems the politics of the moment—the economic policies of the moment—are all about tax cuts. The Republicans under President Bush talk about tax cuts almost only in terms of economic policy. The Democrats do not seem to be able to put forth a program that does not include tax cuts as well. Are you a little disturbed about the amount of misinformation out there about how low taxes or high taxes affect the economy?

A. I do not know whether there is more or less misinformation than usual out there. But I do think your observation is especially important in light of the fact that in the last year we have entered a war on terrorism and may be entering a war on Iraq. The fact that politicians are talking not about sacrifice, but quite the opposite in the form of tax cuts, at the beginning of a war may be unprecedented in American history. There is an economic cost to diverting resources to military purposes, and not reflecting that in the tax system only means that we are putting off assigning those resource costs to people. So in that sense, the fact that the political debate is not discussing anything but tax cuts is particularly important.

I believe that for many observers, tax cuts are simply a tactic to limit spending. In other words, the real objective effect is to lower government spending, while playing on fears of deficits. So to me, tax cuts are often a Trojan horse. The argument about growth and incentives gets you in the door, but the real objective is to reduce the size of government. So you have to discuss not only incentives, but what type of government spending might be forgone.