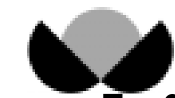
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Taxes, Growth and Inequality

By Andrew Jackson

Pick up just about any paper today, and you would think that the debate for and against tax cuts in the next federal Budget was one between economic efficiency and social justice. Business lobby groups press the case for tax cuts for high income earners and corporations as the recipe for stronger economic growth and higher productivity, while social groups say that we need investment in social programs to redistribute income and to provide decent public services to all.

In a sense, this is not terribly surprising. Social groups do indeed say, quite rightly, that we need to invest the large and growing federal fiscal surplus in programs to reverse growing inequality, and to respond to pressing needs such as child poverty and homelessness. After all, the deficit was largely eliminated through painful cuts to social program spending (federal program spending fell from 16% to 12% of GDP, 1993-2000) and the burden of cuts fell disproportionately on lower income families in the form of lower transfers and reduced public services. For their part, business would not get very far if they said that their real aim was to boost already buoyant corporate profits, and to further inflate bloated senior management salaries.

The only publicly saleable case for proposed corporate and high income tax cuts such as lower taxation of capital gains income and elimination of the high income surtax is that they would "*grow the pie*", as Tom d'Aquino of the BCNI predictably put it to the House of Commons Finance Committee in November. Yet, while we can all acknowledge that private investment is important to growth, the economic evidence for the growth-boosting properties of tax cuts is remarkably weak.

In the short term, as shown in macro-economic models, most forms of public spending have a greater impact on growth than tax cuts, since part of a tax cut will "*leak*" from current spending through increased savings and higher imports. In the Informetrica model, the year one stimulus to GDP from spending on public services such as health and education is double that of a general personal tax cut, and a corporate tax cut has less than one-third the growth impact of an increase in transfers or an across-the-board income tax cut. The real debate should be over what drives longer-term growth.

The tax-cutters point mainly to the U.S. (where taxes were just 28.4% of GDP in 1994) as proof of the power of low taxes and small government. But the fact of the matter is that, as shown in Table 1, average annual growth of real income per person in the U.S. in the 1990s through 1998 was, at 1.7%, no greater than in many smaller European countries with much higher tax levels. For example, real income growth per person in the 1990s has averaged 2.3% in Denmark, 2.1% in the Netherlands and 3.2% in Norway, even though taxes in these countries came in at 49.9%, 44.7% and 41.3% of GDP respectively in 1994.

Real income per person is the single most reliable indicator of the growth of living standards, though it does not take into account access to public services financed from taxes, and hours worked. The smaller European countries would fare even better in a broader comparison which included these dimensions.

It is, of course, possible to pick and choose countries to make these comparisons.. But the data set includes all OECD countries (with the exception of recent new members). **The Chart shows no link between the tax "bur-**

den" and economic growth, and this is confirmed by statistical measures. (The correlation coefficient is weak and insignificant.) The case for low taxes is just as weak when it comes to labour productivity growth (output per hour worked). As shown in Table 1, in the 1990-98 period, real GDP per hour worked grew by an average 1.2% in the U.S., compared to 2.1% in Denmark, 1.3% in the Netherlands, and 2.7% in Norway. Again, the correlation coefficient between taxes and productivity growth for the whole OECD sample is weak and insignificant.

While the precise mix of taxes does have economic impacts, this general finding of a very weak link from the size of the total "*tax burden*" to economic performance is not at all at odds with the mainstream economic literature as recently surveyed by the OECD and the IMF (See Leibfritz, 1997 and Gerson, 1998). Personal tax rates have very little impact on the willingness of workers to work, and little or no impact on the level of personal savings (which is in turn linked to the level of private investment). Taxes on corporations have been found to have only very small, if any, effects on the total level of private investment in a national economy, which is driven much more by macro-economic policies which determine the overall growth rate. Businesses invest more because of a growing market than because of a low cost of capital, and the impact of taxes on the cost of capital is only one small element in the overall cost situation. It is true that there are serious compliance issues raised by differing corporate tax rates, but that is a different issue than the impact on investment and on growth.

On the other side of the equation, both the OECD and IMF studies acknowledge that many areas of public expenditure (obviously financed through taxes) have positive impacts on growth and productivity. Particu-

Table 1

Taxes and Economic Performance

	Growth of GDP per Capita, 1990-98	Taxes as % GDP, 1994	GDP per Hour Worked, 1990-98
Australia	2.2	28.7	2.3
Austria	1.5	43.3	1.8
Belgium	1.5	45.9	2.4
Canada	1	35.1	1.2
Denmark	2.3	49.9	2.1
Finland	1	46.7	3
France	1	43.7	1.5
Germany	0.9	38.4	2.9
Greece	1.2	31.7	1.3
Iceland	1.1	30.9	
Ireland	5.5	35.7	4.2
Italy	1.1	41.4	1.9
Japan	1	27.8	1.9
Netherlands	2.1	44.7	1.3
New Zealand	0.6	36.7	0.2
Norway	3.2	41.3	2.7
Portugal	2.2	32.6	3.2
Spain	1.9	35	1.8
Sweden	0.6	49	1.9
Switzerland	-0.3	33	0.8
United Kingdom	1.7	34.5	2.2
United States	1.7	28.4	1.2

(Korea, Mexico, Czech Republic, Hungary, Poland excluded.)
SOURCE: OECD Statistical Working Party. Economic Growth in the OECD Area: Are the Disparities Growing? November, 1999 (DSTI/EAS/IND/SWP (99)3

larly strong links have been established for public investment in education, basic infrastructure, and research and development.

It follows from this general line of argument that, while tax systems can obviously be improved, tax incentives to investment may just cost a lot in foregone revenues while producing no investment payoff. A classic example was the Mulroney government's lifetime $500,000 capital gains tax exemption. Studies commissioned by the Department of Finance in 1995 found that there was a substantial revenue loss for the federal government, most of which went to very high income earners, and no significant stimulus to investment (Mintz and Richardson, 1995).

By contrast to the growth and productivity story, the link between a large tax/transfer system and low income inequality is very strong. Data from the Luxemburg Income Study show that in Denmark, the Netherlands and Norway, the top 10% of the population have after-tax incomes which start at about three times higher than those of the bottom 10%. In the U.S., the top 10% have incomes more than 6 times higher than the bottom 10%. (Canada, with a middling overall tax rate of 35.1% in 1994 had a gap of about 4 to 1 between the top and bottom 10%). Data for a large sample of OECD countries are presented in Table 2. As indicated in the Charts, there is a strong and significant relationship between the Tax-to-GDP ratio (a proxy for a sizeable tax/transfer system) and low-income inequality as measured by the Gini coefficient and the Decile Ratio.

In the 1990s, a handful of countries, including the U.S., have been able to achieve strong growth and low unemployment. But several smaller European countries have done this while maintaining a strong set of social programs and public services. Private investment has played a role, but so has public investment financed from a much larger tax base than in the U.S. Meanwhile, stronger social programs (in combination with strong labour movements) have played a major role in countering income inequality.

There is growing evidence that the idea of a fundamental trade-off between efficiency and equity — the basis for supporting tax cuts for the affluent and for corporations as opposed to reinvestment in social programs — is wrong-headed. Social equity itself can have many positive impacts on growth and productivity.

The development of "*human capital*" is inevitably compromised if large parts of the population experience poverty or ill-health, or are unable to access high quality education and training systems. There is every reason to believe that high levels of public investment in education, health, and child care will have an impact on productivity, and that leaving these areas to the

Table 2

	Inequality*	**Taxes****	**Decile Ratio*****
United States	0.368	28.4	6.44
Japan	0.315	27.8	4.17
Germany	0.3	38.4	3.84
France	0.324	43.7	4.11
Italy	0.255	41.4	3.14
UK	0.346	34.5	4.56
Canada	0.287	35.1	3.93
Belgium	0.23	45.9	2.79
Denmark	0.239	49.9	2.86
Netherlands	0.249	44.7	3.05
Norway	0.242	41.3	2.85
Sweden	0.229	49.0	2.78

* Gini Coefficient of Disposable Income (Luxemburg Income Study). Data for the mid-1990s (Data presented by Smeeding to 1999 Canadian Economics Association Meetings).
** Taxes as % GDP, in 1994 (OECD)
***The Decile Ratio is the ratio between the top of the bottom decile and the bottom of the top decile, and thus slightly understates the gap between the top and the bottom of the income distribution.

market will lead to exclusion and weaker economic performance.

The central point is that the current debate over whether to spend the federal government surplus on spending or tax cuts should be more closely rooted in the economic evidence. Most Canadians want a growing economy and a fairer, more decent society. That will involve high levels of public investment. Calls for the lion's share of the surplus to go to tax cuts for the well-off should be rejected.

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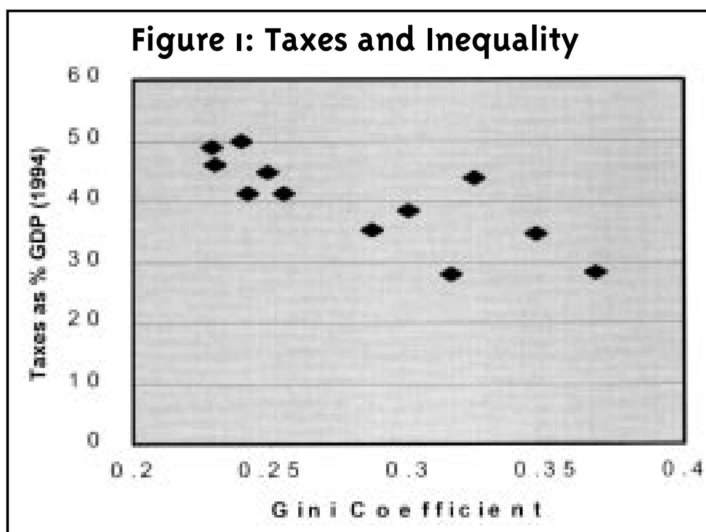

Figure 1: Taxes and Inequality

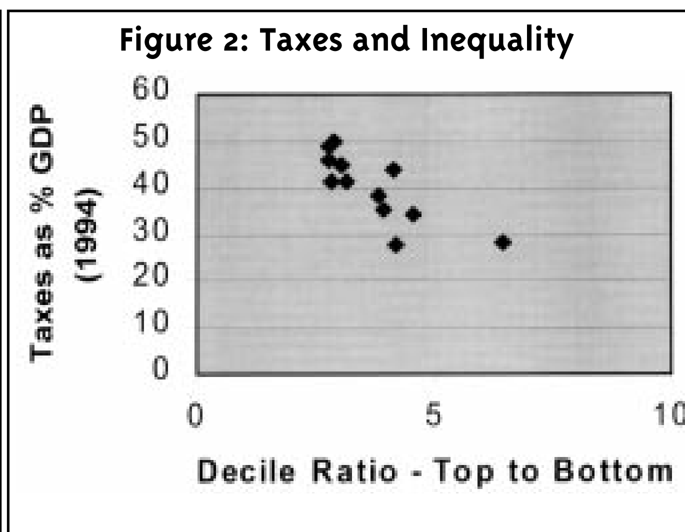

Figure 2: Taxes and Inequality

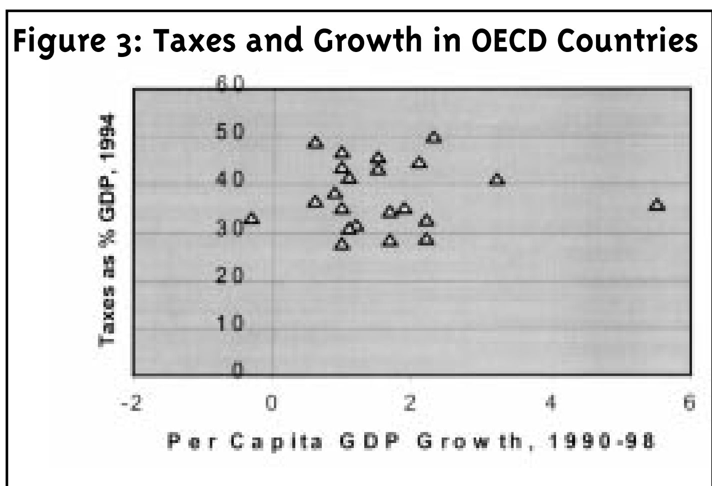

Figure 3: Taxes and Growth in OECD Countries

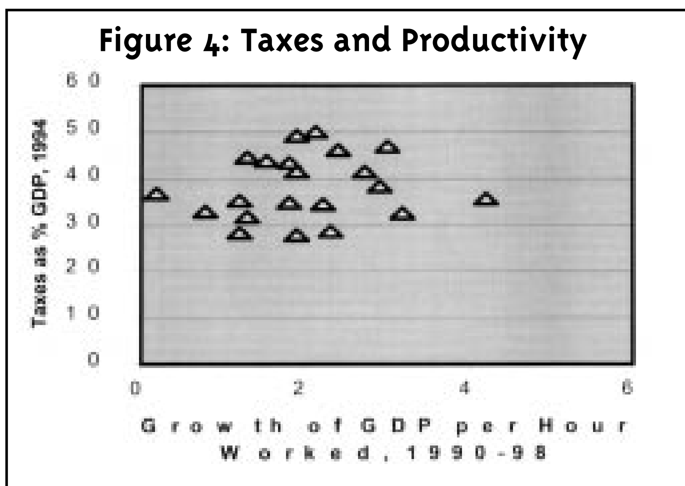

Figure 4: Taxes and Productivity

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