

The Limits To Tax: Efficiency, Equity and International Competition

Lecture at Politeia, London, 7 March 2006

Irwin Stelzer*

I approach this assignment with some trepidation, for three reasons. First, Politeia has already sponsored so much good work on tax policy that I fear I have very little to add.

Second, the various aspects of tax policy are too many to discuss other than in a pre-dinner talk of a length that only Fidel Castro, with the coercive force of the state at his beck and call, would dare. As Eugene Steuerle has pointed out:

Tax policy today involves far more than issues of how to collect revenues fairly and efficiently; it has evolved into a major tool for both macro or fiscal policy and, more than ever, expenditures and social policy.¹

Third, I do not want to over-emphasise the effect of tax policy on economic growth. High-tax jurisdictions with superb transport and other public services can be more attractive to businesses, and to the highly educated employees on which they increasingly rely, than low-tax jurisdictions with poor transport, rotten schools and polluted air. Worst of all, of

* Columnist, The Sunday Times; Director of Economic Policy Studies, the Hudson Institute; contributing editor, The Weekly Standard.

¹ Eugene Steuerle, "Tax Policy From 1990 to 2001," in *American Economic Policy in the 1990s*, Jeffrey Frankel and Peter Orszag (eds.). Cambridge, Mass., MIT Press, 2002, p.139. Mr. Steuerle is a senior fellow at the Urban Institute, and has served in the Treasury Department under four different presidents.

course, are high-tax jurisdictions with public services so inefficient that the high level of expenditure does not produce an attractive level of services.

With these caveats, I will try to add something useful to what has already been put before you, and narrow the subject to a digestible bite.

This is a good time to discuss tax policy, since rarely has there been so much nonsense spoken by politicians of all stripes on this subject. The Chancellor of the Exchequer, a man with a complete and deep understanding of the theory of taxation, seems committed to a perpetual increase in the tax burden, despite what he sees before him: the stagnant, high-tax major European economies; a rapidly growing, low-tax Ireland; and the flight of capital to low-tax Eastern Europe. None of these examples, nor the demonstrated inefficiency with which the state disposes of its taxpayers' hard-earned funds, appears to suggest to the Chancellor that he is steering the British economy from the foundations for the prosperous condition in which he found it, through the now-ended period of prudence, and into stagnation at best, and penury at worst. Prosperity to Prudence to Penury is not exactly a progression of which to be proud

On the other side of the aisle we have a Tory Party that has managed to insulate itself from the past decade's learning concerning the relationship between taxation and fiscal stability, what is called in the trade "dynamic scoring" that counts against revenues foregone those generated by cuts in tax rates. To the shadow cabinet, now engaged in an effort to have the party's members endorse a new charter that seems to abandon platitudes only to commit errors, we have a choice: tax cuts or economic stability. In fact, properly crafted tax cuts contribute to, rather than detract from, economic stability.

Before deciding that tax cuts are dangerous to a nation's economic health, and contribute to the "black holes" that so worry the City, "we must carefully think through what happens to the overall economy as well as to individual taxpayers when tax rates are cut."² Larry Lindsey, the economist who crafted the tax cuts that helped President Bush rescue America from a recession, and whom I have just quoted, points out that the direct effect of a tax cut is to reduce revenues, other things remaining equal. But, he quickly adds, in the face of other-than trivial tax cuts, other

² Lawrence B. Lindsey, The Growth Experiment: How The New Tax Policy Is Transforming the U.S. Economy. New York: Basic Books, Inc., 1990, p.57.

things do not remain equal: tax rates affect economic behaviour.

For one thing, a reduction in tax rates allows workers and entrepreneurs to keep more of what they earn. That increases their incentive to work harder, and to take risks, both of which stimulate economic growth and, with it, tax receipts. Whether the increase in receipts will compensate fully, or more, for the revenue loss resulting from a reduction in tax rates will depend on many factors, including the precise nature of the reduction in rates; the stage of the business cycle at the time the reductions become effective; and cultural factors that affect the elasticity of the supply curve of labour and of entrepreneurship – the trade-off between work and leisure, and risk and safety, varies from country to country.

A reduction in tax rates also stimulates inbound investment,³ other things being equal – a phrase I add to make it clear that I doubt that Mr. Mugabe could do much to his nation's tax structure to make Zimbabwe attractive to foreign investors.

There is another effect of a reduction in tax rates that cannot be ignored. Lowering the tax on corporate profits

³ “This study demonstrates with great clarity that countries cutting taxes – especially on business – see more inward investment, higher growth and higher tax revenues.” Charlie Elphicke and William Norton, “The Case For Reducing Business Taxes,” Centre for Policy Studies, London, February 2006, p.1.

makes it more attractive to own shares, since a large portion of pre-tax profits flows through to shareholders, and less attractive to incur debt, since the deductible feature of interest payments becomes less valuable. Those who worry about over-leveraging might give this effect of a reduction of tax rates, especially corporate tax rates, some thought: they encourage higher equity:debt ratios.

Finally, in a world in which international competition is becoming more heated, the ability of capital to flow more or less freely across borders (with the possible exception of the borders of France) allows companies to flee high-tax jurisdictions in favour of countries with more benign and welcoming tax regimes, taking jobs with them.

There are other examples, but I believe I have made my point: tax cuts are not the antithesis of a healthy, growing economy, and do not necessarily result in a shrinkage of revenues flowing to the Treasury. Nor are tax cuts that have net beneficial effects necessarily confined to what some prefer to call “the rich”. As Lindsey puts it so well, “The mission for tax reformers ... is to apply the lessons and benefits of supply-side economics to the middle and working class....[T]he important job is to eliminate the extra burdens of taxation that do little to raise revenue but discourage thrift

and industry...”.⁴ The pity of today’s Britain is that of the three main parties

- the Liberal Democrats want to raise the marginal rate, probably the change most likely to discourage work and risk-taking, and least likely to generate revenue since, as Harvard economics professor Robert Barro points out, “upper-income people are very responsive to changes in the tax code; when tax rates rise, the reported amount of taxable income drops sharply.”⁵ Perhaps even worse, the economy’s best and brightest turn their attention from producing goods and services to devising tax-avoidance schemes, “a waste of energy and effort which progressive taxation in so many ways leads to”, to quote Hayek.⁶ One can only hope that the newly ordered policy review will result in the depositing of this policy in the bin that now contains Labour’s Clause 4.
- the Labour Party seems to fit Ronald Reagan’s wonderful description, ““The government’s view of the economy could be summed up in a few short

⁴ Lindsey, op.cit., p.151.

⁵ Robert J. Barro, Getting It Right: Markets and Choices in a Free Society. Cambridge, Mass. and London: The MIT Press, 1996, p.119.

⁶ The Constitution of Liberty. London, Routledge & Kegan Paul, Ltd. 1960, p.322.

phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidise it,” and

- the Conservatives, the one grouping that might have fought to reduce the tax burden if for no other reason than to restrain the growth of the state, has ceded that role in its search for what it perceives to be the vote-rich centre ground, and now sees lower taxes as the enemy of economic stability.

There is, in short, no voice for cutting taxes.

Does this matter? After all, the British economy is in pretty good shape, and by the standards of the major continental European economies, in robust good health, thanks largely to the combination of (a) the structural reforms pushed through by Margaret Thatcher, (b) the Chancellor’s decision to grant quasi-independence to the Bank of England and to make the temporary acquaintance of Prudence, and (c) his insistence on remaining a foreigner in euroland, outside the baleful influence of the accompanying monetary and fiscal policies (the noGrowth and inStability Pact) that have done so much to produce persistent double-

digit unemployment in France and Germany, stagnation in Italy, and inflation in Spain.

Indeed, the usually critical International Monetary Fund Executive Board very recently concluded, with a caveat tossed in here and there:

“Executive Directors welcomed the U.K. economy’s remarkable performance that has lasted more than a decade, and has been marked by continued economic expansion, falling unemployment, and sustained low inflation. Directors attributed this success to sound policies....”⁷

This satisfactory condition, which the usually gloomy manufacturing sector anticipates will continue,⁸ and the London stock market’s longest uninterrupted bull run since the 1950s,⁹ demonstrate that the multiple tax increases imposed by Gordon Brown, his tinkering with the tax structure, his retroactive tax increases and other sins have not produced the cataclysm that his critics say wait just around the corner, and if not this corner, then the next one, or the one after that. I hate to mention this, but one reason that these various raids on taxpayers’ purses have not triggered a major downturn might be that the increases were

⁷ IMF Executive Board, “Article IV Consultation with the United Kingdom,” March 3, 2006.

⁸ The first quarter engineering outlook survey by EEF, a trade organisation and RSM Robson Rhodes “suggests that the weakness in manufacturing in 2005 was temporary and that growth prospects should continue to improve during the course of this year.” Press release dated 06 March 2006.

⁹ Financial Times, March 6, 2006.

“stealthy”, which my OED defines as “...calculated to elude observation, proceeding by imperceptible degrees...”.

Not being noticed, the stealthy increases could not affect behaviour. Contrast that, say, with the proposal to raise the top marginal rate from 40% to 50%, a proposal which, if enacted, would send entrepreneurs scurrying to reduce their exposure to risk, workers wondering whether the reduced net reward for extra work is sufficient to warrant getting home late of an evening, and executives questioning their reason for enduring London’s weather. So, like greed in the movie “Wall Street,” stealth is good.

At least until its cumulative effects become noticeable. At some point the imperceptible becomes perceptible, with effects that I suspect will become obvious in the North Sea, where oil companies are reacting to the retroactive imposition of taxes on their allegedly obscene profits by reordering the priority ranking of their planned capital outlays. This is an important point: the theory of retroactive tax increases is that they are a tax on past behaviour, and therefore have the advantage of not affecting the current and future willingness of taxpayers to work and invest. But, as Harvard’s Barro points out, “If the government imposes a levy today, then rational people will worry that the

government will impose another in the future....”¹⁰ The present Government has resorted to retroactive taxation at least twice: in the case of the windfall tax on utilities, and, now, by retroactively taxing oil company profits. All save the most trusting of investors must be aware that they risk such raids in the future, which may account for the fall-off in new business start-ups.

But, as the man who jumped off the 102-storey-tall Empire State Building said as he passed the 50th floor, so far, so good. Whether Gordon Brown and the UK economy will land with a thump as consequential as the one in store for the mythical jumper, we do not yet know.

So it is easy to criticise all the players in the tax game – with one exception – the tax avoiders. Let me explain. No one defends those who illegally evade taxes. That is not an issue. But the tax avoiders are those who study the arcane tax code carefully, and find ways to reduce their tax burden without breaking the law. In other words, the avoiders struggle to find ways of rendering unto Gordon that part of what they earn and own that is by law Gordon’s, and keeping the rest for themselves. It is, after all, theirs. To stigmatise this process of avoidance is to assume that all of

¹⁰ Barro, *op.cit.*, p.124.

the nation's income belongs to the Treasury, which then benignly allows the public to keep some portion of it, a portion that "avoiders" attempt unreasonably to enhance by consulting their lawyers and accountants.

I would be remiss if I confined this talk to a discussion of the effects of high taxes on economic growth, without also mentioning their consequence for civil society. The historian Gertrude Himmelfarb has set forth in great detail the web (no pun intended on the Webbs) of private philanthropic organisations and activities that characterised Victorian Britain,¹¹ and Charles Murray has described just how extensive civic participation once was in pre-welfare-state-America: "Broad networks, engaging people from the top to the bottom of society, spontaneously formed by ordinary citizens, provided sophisticated and effective social insurance and social services of every sort."¹²

Those networks have shriveled in the face of expanding tax-funded bureaucracies. As Murray put it to me, pleas for philanthropic contributions of time and money can now be met by, "I gave at the office," meaning that the tax man had already cometh, I have done my share, so I need not join or

¹¹ Gertrude Himmelfarb, The De-Moralization of Society: From Victorian Virtues to Modern Values. London: The Institute of Economic Affairs, 1995, espec. Pp.143-169.

¹² Charles Murray, In Our Hands: A Plan to Replace the Welfare State. Washington, D.C: AEI Press: Washington, D.C., 2006, pp.116-117.

support voluntary organisations. That shift from private organisations to government bureaucracies, from voluntary giving to compulsory extraction, “ultimately degrades society as a whole,” concludes Murray.¹³

It is thoughts such as these, combined with the knowledge that there is now no effective force in Britain for reining in the size of the state or its desire to claw a larger and larger portion of the national income for use by its bureaucracy, that I find so depressing. The Liberal Democrats make it quite clear that they favour higher taxes; there is no reason to believe that a Brown-led Labour Party will suddenly decide that higher taxes and further income redistribution are bad ideas; and the Cameron-led Conservative Party has promised to devote half of any growth in national income to a further expansion of the public sector, a process that a simple bit of arithmetic shows will steadily expand the portion of GDP claimed by the state.

We should have predicted this. As liberal (in the American sense) Harvard economist Benjamin Friedman has recently pointed out:

A potential risk to a country’s growth prospects in a democratic system is that the lower-income majority will seek to use the government’s tax and

¹³ Ibid., p. 122.

spending authority to create jobs on unproductive public works projects..., pad the employment rolls in government-run companies..., and provide overly generous outright welfare programs – in each case using resources that could otherwise go into productive investment.¹⁴

A better description of developments in Great Britain could not have been written. The growth of the low-productivity public sector¹⁵ -- the confusing data recently published by the Office for National Statistics (ONS) should not be allowed to obscure the appalling performance of the NHS¹⁶ -- has pulled national productivity growth down to levels that, if not reversed, will seriously reduce living standards – and soon. It has also created a larger constituency for continued growth in spending: public sector employment has risen 13 percent from its recent low point in 1998 (compared with an increase of less than half that rate in the private sector), and now exceeds 5.8 million, accounting for one-in-five jobs in Britain.¹⁷ Since many of

¹⁴ Benjamin M. Friedman, The Moral Consequences of Economic Growth. New York: Alfred A. Knopf. P. 337.

¹⁵ “The concentration of outlays on unproductive labour was observed [by Adam Smith] to lie in the public or government rather than in the private sector of the economy.” James M. Buchanan, “Public Goods and Natural Liberty,” in The Market and the State: Essays in Honour of Adam Smith. Thomas Wilson and Andrew S. Skinner (eds.). Oxford: Clarendon Press, 1976, p.284.

¹⁶ The ONS has published a wide range of estimates, including seriously flawed productivity measures that show annual improvement of 1.6% between 1999 and 2004. The more plausible figures suggest the productivity is declining, perhaps by as much as 1.5% annually in that period. ONS, “Public Service Productivity – Health”, February 2006. See also The Economist, March 4, 2006.

¹⁷ Office of National Statistics, Labour Force Survey, as reported by Stephen Hicks, “Trends in Public Sector Employment,” December 2005.

these public sector jobs are concentrated in various constituencies, the voting power of public sector employees exceeds their numbers, and that power is multiplied further by the dependence of the governing party on contributions from trade unions representing those employees.

Candour compels me to report that a similar expansion of the state is underway in America. Compassionate conservative George W. Bush has expanded the size and reach of government at a rate that would bring smiles to the lips of Franklin D. Roosevelt and Lyndon B. Johnson. Education, once a function reserved for states and localities, is now benefiting from the ministrations of the federal bureaucracy; a blindingly complex and deficit-enhancing prescription drug programme is now available to senior citizens; having failed to react promptly to the devastation caused by Hurricane Katrina, the federal government is now providing trailer homes for its victims, despite high vacancy rates in the rental market.

Unlike Britain, this expansion of the role of the state has not been accompanied by higher taxes. Indeed, taxes on incomes, dividends, capital gains and inheritances have been reduced. Unfortunately, although some cuts in tax rates produce some offsetting increases in revenues, all cuts

in tax rates do not produce equal increases in revenues. So we have deficits, not a bad thing when the economy was weak, but less desirable now that the economy is growing. Still, government in the US is a long way from gobbling up the national income at anything like the rate in the UK.

That bodes well for the prospects of economic growth in America, and badly for the growth prospects of Great Britain, which suffers from a malady additional to the burden of its high and rising taxes. That burden is the mounting complexity of the tax system. Recall Adam Smith's admonition that the timing, manner of payment, and amount of a tax should "be clear and plain to the contributor, and to every other person" – an admonition not closely followed by Smith's later-day townsman.

It is often the case that the brightest minds at our respective Treasuries ignore two things. First, as Milton Friedman has pointed out, stability in tax policy is important, often more important than any possible improvement. Second, improvement bought at the cost of increased complexity often is not worth having. One American observer described the work of our National Economic Council (NEC) in terms that are applicable to your Treasury:

The NEC was incredibly effective at creating ideas that sounded like they might work. But the

problem was that the new tax incentives would have added great complexity to a system that people already don't understand....[T]he constant flow of complicated proposals tied up Treasury staff and got in the way of necessary improvements ... that might have informed future policy development."¹⁸

Britain, then, faces a situation in which taxes are high, and likely to rise, stealthily or otherwise, retroactively or otherwise; the tax structure is becoming increasingly complex; the relative growth of the public sector is driving down average productivity, which bodes ill for future living standards; the expanded public sector and welfare dependency creates a constituency for continuation of these trends; and all political parties are agreed that this state of affairs is acceptable – the sort of consensus that last formed when, before Margaret Thatcher began wielding her handbag, all parties agreed that the role of government was to manage decline.

Unfortunately, there is worse. All we need do is look to what might be F.A. Hayek's greatest work, The Constitution of Liberty:

“It is questionable whether a society which will recognize no reward other than what appears to its

¹⁸ Leonard Burman, “Comments”, in Frankel and Orszag, op.cit., p.182.

majority as an appropriate income, and which does not regard the acquisition of a fortune in a relatively short time as a legitimate form of remuneration for certain kinds of activities, can in the long run preserve a system of private enterprise.”¹⁹

But let me conclude on a cheerier note – three cheerier notes, to be exact.

First, even if we are forced to accept the expansion of the state to a point where it is gobbling up over 42% of GDP (and rising), there is room to improve the efficiency with which that money is spent. After all, objections to the massive rise in spending on the NHS would certainly be muted if that money had been and was being well spent. We know from experience – experience in the Kremlin and in Horse Guards Road – that centralised setting of targets produces gamesmanship rather than efficient behaviour.

That means that if we are to get value for the money spent by an increasingly large state, we must develop mechanisms that force public sector employees to do more than serve time until their generous pensions become available. Not all such workers: no disciple of Adam Smith would deny that we wish to appear admirable in our own eyes and in the eyes of others, and that therefore it is

¹⁹Hayek, *op.cit.*, p. 319

unsurprising that many public sector workers are dedicated, and probably expend huge amounts of energy circumventing rules that prevent them from doing a good job in the public interest.

Still, as the state expands, it becomes increasingly important to create incentives for efficient behaviour. The great economist and Nobel Prize winner R.H. Coase points us in the direction of a solution, which he acknowledges is merely an extension of Adam Smith's earlier argument. He writes, "Private individuals are constrained in their folly because they personally suffer its consequences.... But...men who bankrupt a city or nation are not necessarily themselves made bankrupt."²⁰

The question, then, is how do we remove the insulation that protects public service workers from the consequences of such of their acts as result in the efficient use of the resources made available to them? The answer is to inject competition into the provision of such services, to – and I hesitate to use this much over-used word – “empower” the consumers of these services. We have seen from experience that the transformation of the providers of a wide range of services from nationalised monopolies into private

²⁰ R.H. Coase, Essays on Economics and Economists, Chicago and London: The University of Chicago Press, 1994, p. 115.

sector competitors results in enormous efficiency gains. Given the blessing and power of choice, consumers forced their gas, electricity, telephone, airline and other companies to improve the quality, value and variety of services on offer.

Therein lies the guide to future policy vis-à-vis the public sector: introduce competition wherever feasible so that poor service will result in an atrophying of inefficient providers that prove unable or unwilling to improve their performance. Parents with education vouchers would be free to flee bad schools and provide funds for the expansion of good ones, and patients with freedom to choose their doctors and courses of treatment would put unhelpful health care institutions that refuse to upgrade out of business – the idea that “information asymmetry” makes this impossible is a nonsense (but that is a subject for a separate talk). Bad teachers, inattentive doctors and nurses, would be forced, if I might use a nautical phrase, “to shape up or ship out” in favour of educators and health care providers who best meet parents’ and pupils’ needs.

No doubt transition will involve pain, but that pain would be transient, and trivial compared to the pain being inflicted by the current system of provision. After the injection of huge sums into the public services it is no longer reasonable for

opponents of submitting public service workers to the refreshing gale of creative destruction to argue that there is insufficient excess capacity to provide meaningful choice. Such capacity will develop further only when the demands of thousands of parents and patients can find expression. The response won't be instantaneous, but it will be noticeable a lot sooner than most who oppose these reforms are willing to concede – which may explain the rabid hostility of some interested parties to such reforms.

So, the first bit of good news is that even an overarching state can be forced to produce services more efficiently if exposed to competition, and policies that would create such competition are well understood, and, I would guess, of broad political appeal.

The second bit of cheer comes from a very rough analysis of the figures. The portion of GDP claimed by the state at the lowest point in recent years was 37% in 1999-2000. It is now about 42%. So the battle to return to what we can probably use as representing a reasonably satisfactory relationship between Britain's private and public sectors – I, for one, consider that too tilted in favour of the public sector, but then I am an American, and therefore less interested in a safety net than in the opportunity provided individuals by low

taxes and rapid economic growth – is a battle over five percentage points. If the economy can grow at an annual rate of something like 3%, and the growth in public sector spending can be held to something significantly below that figure, the portion of the wealth produced by workers and entrepreneurs that is absorbed by the public sector will decline – even as the public sector expands.

That, of course, is a rather big “if”. Which brings us back to where we started. A relative shrinkage of the public sector will require tax policies that contribute to, rather than stifle, economic growth. And it will require a government willing to restrain the rate of growth of the public sector to below that of the private sector, a policy for which no party has expressed any enthusiasm. If a Blair-led Labour Party presided happily over the rapid expansion of the public sector, we can only imagine the glee with which a Brown-led government will step on the gas rather than the brake. The Liberal Democrats, who do not even have the nodding acquaintance with Prudence that the Chancellor once had, would probably expand the public sector even faster, with no attention to how such an expansion might be funded, other than by taxing the rich, with consequences I have already discussed. And the new-model Conservatives have

promised to share the proceeds of any economic growth equally between the public and private sectors, although that 50:50 promise might be modified if one of the many panels designing Tory policy use the 18 months allotted to them to come up with a different answer.

Still, despite the current supine attitude of the major parties, the battle for the public's ear is worth fighting. It just might be possible to persuade voters, even the large number now beholden to the state for their jobs and benefits, that their long-run interests are not best served by assigning increasing portions of their incomes, or the incomes of others, to the public sector.

Let me conclude with a final bit of cheer. The standard of living in Britain today is probably as high as it has ever been; the country has established itself as a world-class competitor in the globalised market for financial services; it has the advantages of the English language – still spoken in parts of this country – and of a time zone that maximises the ease of doing business around the world; it has been to the brink of decline before, and pulled back before plunging over the edge. There is no reason to believe that it is incapable of doing so again.

Thank you for your attention.

END