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No Economic Silver Lining in Tax Hikes

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Taxes harm the economy. Traditionally, the tax policy debate centers on whether the economic costs of tax increases are smaller or greater than the social benefits of more government spending. A new approach, the “silver lining” theory, mistakenly suggests that higher taxes may be benign or even beneficial to economic growth.

Taxes affect economic activity through many channels. Some evidence suggests that higher taxes lead to lower interest rates, which would stimulate business investment. The silver lining theory emphasizes this narrow positive channel but ignores taxation’s many other deleterious economic effects. As with most fads, the new justification for higher taxes will pass because the silver lining is threadbare while the dark clouds remain.¹

The following discussion reviews two studies that respectively consider, first, the historical evidence for the effects of taxation on the economy and, second, the revenue feedback effects of tax changes. Both studies confirm the conventional wisdom that, on balance, taxes are harmful to the economy. The discussion then reviews the evidence for the new silver lining theory and finds it wanting. As the tax burden in the United States continues to rise, policymakers at all levels of government should pursue tax relief to preserve and enhance a strong economy.

Taxes and the Overall Economy: The Dark Clouds. Christina Romer and David Romer, Professors of Economics at the University of California at Berkeley, examined significant tax changes and

ensuing economic performances during the post-war period.² Their study presents strong evidence that, as a rule, higher taxes diminish economic activity: A tax increase of 1 percent of gross domestic product (GDP) initially has a modest downward effect on the economy, but the effect grows rapidly before leveling off after 2.5 years, eventually lowering GDP by 3 percentage points. Thus, for example, a tax increase of 1 percent of GDP today (about \$135 billion) would eventually shrink the economy by about \$400 billion annually.

Conversely, the study found that “tax cuts have very large and persistent positive output effects.”³ Moreover, the authors emphasized that these results were “strongly significant, highly robust, and much larger than those obtained using broader measures of tax changes.”⁴ In other words, the modern historical record indicates a clear and robust relationship between lower taxes and higher GDP.

A recent study by Greg Mankiw and Matthew Weinzierl, both of Harvard University, sheds additional light on the relationship between taxes and economic growth by identifying the feedback effects of historical tax changes.⁵ For example, if Congress reduces the marginal tax rate on capital income,

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then tax receipts will surely fall if we assume no changes in taxpayer behavior; this is the static revenue effect. However, in fact, the tax cut would increase investment and, therefore, the size of the economy. The tax revenue gained from this increase in economic activity is the revenue feedback effect, or the dynamic effect.

Mankiw and Wienzierl found that reducing taxes on capital produced a dynamic revenue effect equal to about one-half the static effect, meaning that after a cut in the tax on capital, the actual revenue loss is generally about one-half the projected static effect.

This dynamic revenue effect also suggests the extent of the subsequent change in the overall economy. For example, if the initial effective tax rates on capital and labor are 25 percent, and if a 1 percentage point increase in the tax on capital is expected to raise \$20 billion per year on a static basis, then the resulting slowdown in the economy will reduce the revenue gain to \$10 billion. At a 25 percent effective tax rate, this result implies that the tax hike would permanently reduce the size of the economy by about \$40 billion annually.⁶

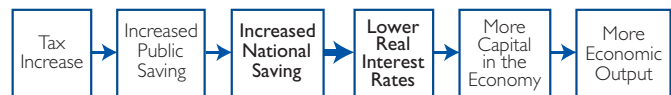
Changing the tax rate on labor supply also produces a significant, although smaller, dynamic effect of about 17 percent. That is, a tax increase on labor that was intended to raise \$20 billion by static scoring would increase actual receipts by only \$16.6 billion, because it would reduce economic activity by \$13.4 billion.

Both the Romer and Romer study and the Mankiw and Wienzierl study confirm the conventional

wisdom that higher taxes diminish economic vitality. Their importance is heightened when considered together, because the two studies took different approaches.

The Silver Lining Theory. Proponents of the contrary view on taxes and the economy argue that higher taxes lead to an increase in national saving, which in turn puts downward pressure on real interest rates, encourages business investment, and thus leads to a bigger economy. This narrow yet plausible argument rests on a chain of testable economic relationships.⁷

The following chart illustrates the chain of events that comprise the silver lining theory:



The strength of the argument is that all but one of the links are uncontroversial, but a major weakness is that all of the links must be valid, and they must all be robust for the theory to be relevant. A more fundamental weakness is that even if the narrow theory is valid, the positive effect from higher taxes must still be weighed against the broader range of strong, negative effects that taxes have on the economy and on investment specifically.

The narrow theory ultimately hangs on one link in the chain: that a significant reduction in budget deficits (increase in government saving) will produce a material reduction in interest rates.⁸ Two recent studies examine this link and find it lacking.

1. For a more complete discussion of the issues raised in this paper, see J. D. Foster, "Tax Hikes, Economic Clouds, and Silver Linings: A Review of Deficits and the Economy," Heritage Foundation *Backgrounder* No. 2095, February 25, 2008, at www.heritage.org/Research/Taxes/upload/bg_2095.pdf.
2. Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," University of California at Berkeley, July 2007, at <http://elsa.berkeley.edu/~cromer/RomerandRomer707.pdf> (December 6, 2007).
3. *Ibid.*, p. 20.
4. *Ibid.*, abstract.
5. N. Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide," National Bureau of Economic Research *Working Paper* No. 11000, December 2004.
6. A \$40 billion reduction in an economy facing a 25 percent effective tax rate subtracts \$10 billion in tax revenues from the \$20 billion posited static gain.
7. The argument also rests on the assumption that Congress abstains from spending the additional revenue.
8. Those who make this argument are generally referring to long-term real (inflation-adjusted) interest rates.

In the first, Eric Engen of the National Bureau of Economic Research and Glenn Hubbard, Dean of the Columbia Business School, recently examined the historical record of government debt and interest rates.⁹ In their study, they proposed a simple, intuitive theoretical relationship in which the value of the additional output from an additional unit of capital determines the real interest rate.

Engen and Hubbard then assume that the level of national savings at any point in time is fixed, so more government debt means less private savings available for investment. Thus, issuing an additional dollar of government debt reduces private investment by a dollar. With less capital employed, the last unit of capital becomes more productive, and the real interest rate rises.

Using this theoretical framework relating government debt, investment levels, and real interest rates, Engen and Hubbard found a reliable but very small effect on interest rates from changes in the relationship between federal debt and the economy: An increase in the debt-to-GDP ratio of 1 percent would increase the long-term real interest rate by about 3 basis points, or 0.03 percentage points.

A second study performed by Thomas Laubach at the Federal Reserve found a similar result using a different framework.¹⁰ Laubach considered the effects of projected fiscal policies as opposed to current policies and looked at longer-horizon interest rates rather than current levels of long-term interest rates.

The Laubach framework's advantage is that many factors affect interest rates, especially in the short run. However, these effects are usually transitory—such as when automatic fiscal policy stabilizers like increases in unemployment insurance payments operate during a recession. Levels of government debt expected to continue several years into the future are unlikely to be materially affected by current business conditions and thus are more likely to indicate the influence of government debt on future real interest rates.

Laubach found that a 1 percentage point increase in the projected debt-to-GDP ratio would be expected to raise future interest rates by about 4 to 5 basis points. This result is quantitatively small and remarkably close to the 3-basis-point effect found by Engen and Hubbard.

The Weakest Link and the Remaining Burdens of Tax Increases. Together, the two studies on interest rates suggest a developing consensus: For deficits and debt levels in the ranges seen in recent years and projected in the medium term, the effects on real interest rates appear to be slight—measured in terms of a handful of basis points—and therefore would have little appreciable effect on the level of economic activity. With the effective breakdown of the deficit-to-interest-rate link, the silver lining theory likewise breaks down.

Tax changes affect the economy through many channels. The silver lining theory emphasizes the effects of deficit reduction on investment, but taxes also distort economic decision-making directly by reducing the amount of investment that businesses are willing to undertake and the amount of labor that workers are willing to supply. Taxes also distort how capital and labor is allocated within the economy. As demonstrated by the Romer and Romer study and by the Mankiw and Weinzierl study discussed above, the harmful effects of these various distortions are quite real, while a beneficial effect of higher taxes on the economy associated with the silver lining theory is illusory.

Conclusion. The flawed implication of the silver lining theory is that higher taxes could lead to a stronger economy through a chain of connected effects, which includes a real interest rate effect. On the contrary, the evidence indicates that the link between deficits and debt on the one hand and real interest rates on the other is very weak. Therefore, the increase in business investment and in the economy that would result from a tax increase would be commensurately weak. In contrast, clear and com-

9. Eric M. Engen and R. Glenn Hubbard, "Federal Government Debt and Interest Rates," National Bureau of Economic Research *Working Paper* No. 10681, August 2004.

10. Thomas Laubach, "New Evidence on the Interest Rate Effects of Budget Deficits and Debt," Board of Governors of the Federal Reserve System, May 2003, at www.federalreserve.gov/pubs/feds/2003/200312/200312pap.pdf (December 6, 2007).

pellent evidence shows that higher taxes have multiple harmful effects on the economy.

The silver lining theory is superficially appealing and has the rhetorical merit of being relatively easy to explain. However, its strengths end there. The potential gains in business investment from deficit reduction are miniscule, while the evidence confirms that reductions in both business investment and labor supply from a tax hike are significant.

The evidence therefore supports the view that higher taxes weaken economic performance. As the tax burden in the United States continues to rise, policymakers at all levels of government should pursue tax relief to preserve and enhance a strong economy.

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