What Effect Do Taxes Have on Economic Growth?

The nature of the effect of taxation on economic growth may be a controversial conversation topic, but it is not very controversial among professional economists. Almost invariably, economists maintain that increasing taxation has a negative effect on economic growth, and that lowering taxes encourages growth. To examine the empirical evidence for these claims, and to demonstrate the consensus among economists in peer-reviewed journals, Dr. William McBride of the Tax Foundation surveyed the recent scholarly literature for studies on the real-world effects of taxation.[1] He found twenty-six studies on the relationship between taxes and economic growth published in peer-reviewed academic journals since the early 1980s. Of these, twenty-three studies found a negative relationship between taxes and growth.[2]

David and Christina Romer's study[3] published in 2010 examined the relationship of taxes and economic growth using broad measures, calculating the overall federal tax burden in the United States as a share of GDP. They carefully examined the narrative of taxation in the United States, and used a methodology designed to avoid the possibility of mistaking cause for effect. The Romers' study found that a tax increase of one percent of GDP reduces real GDP by about three percent within as little as two years.[4]

A pair of studies[5][6] on efforts to reduce deficits and to stimulate economic activity found a number of revealing relationships between taxes, spending, and the state of the economy. Alberto Alesina and Silvia Ardagna found that fiscal stimulus via tax cuts is more effective than increases in government spending to spur growth. They also concluded that use of government spending cuts without tax increases tends to be more successful than tax hikes as a method for eliminating government deficits without triggering recession.[7] A study published by the International Monetary Fund analyzed numerous deficit reduction efforts in fifteen developed nations over thirty years and found that spending cuts are far less harmful to short term growth than tax increases.[8]

Comparing state to state here in the U.S., a 2008 study[9] by Robert Reed identified a strongly negative relationship between high tax burden and economic growth.[10] At the national level, an analysis by Mertens and Ran[11] shows that while cuts to personal income tax immediately result in an increase in GDP, corporate tax cuts are more sure to generate long term growth while expanding the tax base to avoid impacting revenues.[12]

Not only are taxes an impediment to economic growth, but some taxes are more harmful than others. McBride summarizes:

“Corporate and shareholder taxes should mainly affect investment and capital formation, while income taxes affect labor and savings by individuals as well as investment by non-corporate business owners. [...] Consumption taxes, such as sales taxes, affect suppliers of labor and capital, but neutrally. Corporate and personal income taxes are not neutral, as they represent… double taxes on future consumption. These empirical studies typically find that corporate and personal income taxes are the most damaging to economic growth, followed by consumption taxes and property taxes.”[13]

Working papers published by the Organisation for Economic Co-operation and Development (OECD)[14] offered a ranking of taxes in terms of their propensity for harming economic growth. Corporate taxes ranked as most negatively affecting economic growth, followed by personal income taxes, consumption taxes, and property taxes.[15] This is because corporate and personal income taxes directly reduce investment and the growth of productivity, substantially dampening entrepreneurial activity.[16]

These and other studies compiled by McBride arrive again and again at the same essential conclusion: taxation harms economic growth, and tax cuts are a proven way to stimulate productive economic activity. This is not the atypical conclusion of a lone scholar. It is the consensus view of economists who have analyzed the available data and published on the topic in peer-reviewed journals.

For a complete list of the studies examined by William McBride, go to
http://taxfoundation.org/article/what-evidence-taxes-and-growth

---

[1] McBride, William. “What is the Evidence on Taxes and Growth?” Special Report No. 207. Tax Foundation. December 18, 2012. [URL: http://taxfoundation.org/article/what-evidence-taxes-and-growth]

[2] Ibid., p. 2.

[3] Romer, Christina and David Romer. “The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks.” 100 *American Economic Review* 763–801. 2010.

[4] McBride, p. 3, citing Romer and Romer.

[5] Alesina, Alberto and Silvia Ardagna. “Large Changes in Fiscal Policy: Taxes Versus Spending.”*Tax Policy and the Economy*, Vol. 24. University of Chicago Press. 2010.

[6] International Monetary Fund. “Will it Hurt? Macroeconomic Effects of Fiscal Consolidation.”*World Economic Outlook: Recovery, Risk and Rebalancing*. 2010.

[7] McBride, p. 3, citing Alesina and Ardagna.

[8] McBride, p. 3, citing International Monetary Fund.

[9] Reed, Robert. “The Robust Relationship Between Taxes and U.S. State Income Growth.” 61*National Tax Journal* 57–80. 2008.

[10] McBride, p. 3, citing Reed.

[11] Mertens, Karel and Morten Ravn. “The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States.” *American Economic Review*. 2012.

[12] McBride, p. 4, citing Mertens and Ravn.

[13] McBride, p. 4.

[14] Johansson, Asa, Christopher Heady, Jens Arnold, Bert Brys, Cyrille Schwellnus, and Laura Vartia. “Tax and Economic Growth.” OECD Economics Department Working Papers No. 620. 2008.

[15] McBride, p. 5, citing Johansson, Asa, Christopher Heady, Jens Arnold, Bert Brys, Cyrille Schwellnus, and Laura Vartia.

[16] Ibid.