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Is Mr Greenspan behind the curve?

Upward pressures on inflation have returned

Too much complacency on inflation

Very low inflation numbers or even a falling price level were reported across the industrial world in the early 1990s. Many people take it for granted that "we live in a world of low inflation" and do not bother to check the main price indices. This sort of complacency also affects the authors of official reports, such as the Federal Reserve's Beige Book in the USA. According to the latest Beige Book (published on 14th January), "manufacturers in most districts ...held their selling prices steady, despite substantial increases in the prices of raw materials such as steel and natural gas" and "the only signs of pricing power were in the New York and Kansas districts, where some firming in selling prices was reported". But this is not the message from the latest producer price indices prepared by the Bureau of Labor Statistics. They show that in the year to December 2003 the price of finished goods rose by 4.0%, compared with 1.2% in the year to December 2002 and a fall in the previous year. On this basis significant inflation has returned.

US producer prices up by 4.0% in year to December

Big recent cost increases still to hit prices

Admittedly, sharply higher prices of food and energy were a large part of the story. The price index of finished goods excluding food and energy was up by only 1.0% in the year to December 2003. But why they should be excluded? After all, people have to eat, drive cars and heat their homes. Moreover, the impact of all the inflationary developments in late 2003 has yet to be fully felt. The Commodity Research Bureau's index of metal prices jumped by 30% (yes, 30%) in the final four months of 2003, while all through the second half of the year shipping freight rates were soaring to unprecedented levels. These cost increases have hurt manufacturers in Europe, despite the strong euro. But in the USA the effect must be much greater. The dollar has been sliding against other currencies for over 18 months, and fell very sharply in November and December. The message has to be that US factory-gate inflation - already at 4% - will rise further in 2004.

Until the middle of 2003 the recovery of the American economy from the recession of 2001 was generally slow and disappointing. But since then it has gathered pace. When combined with the Asian boom, the result has been a strong global upturn. Even business surveys in such dowdy European nations as Germany, France and the UK have registered an improvement in orders. The phrase "behind the curve" is a rather fatuous one, but it has become the label attached to central bankers who have been too slow to respond to changing news. Mr. Greenspan has many worries (including the rather strange drop in US money growth noted on this page in the last *Monthly Economic Review*), but a case can be argued that he is behind the curve on US inflation and interest rates. The Fed has just warned that it may raise interest rates in the next few months. That looks sensible.

Fed may tighten sooner than expected

Professor Tim Congdon **30th January, 2004**

Summary of paper on

'Is there a limit to taxation?'

Purpose of the paper

With government spending and taxes rising relative to national income in most advanced nations, the question arises, "is there a limit to the 'tax ratio' (i.e., the ratio of tax to gross domestic product)?"

Main points

* In 1945 the Cambridge-based economist, Colin Clark, proposed that nations with tax above 25% of national output would suffer serious inflation. Keynes cautiously endorsed Clark's position, saying that 25% was "about the limit of what is easily borne".

* In practice nearly all industrial nations had a tax burden above 25% of GDP for most of the post-war period, and yet they still enjoyed rapid economic growth and rising living standards. The tax ratio was not under 25%, but varied between 25% and 60%.

* 60% appears to be the highest economically viable tax ratio. It has never been exceeded for long periods in any country during peacetime.

* A tax rate of 100% obviously makes working or saving pointless. A nation with a tax ratio of 70% or 80%, or even 100%, would not have tax rates as high as 100%, because both direct and indirect tax bases are available. (See p. 4)

* But, with the tax ratio above 60%, many effective marginal tax rates would be in 70% or 80% area. This would damage the economy because of
  1. adverse effect on incentives to work, to save, and to seek and offer employment,
  2. high costs of collecting taxes and complying with the tax system, and
  3. the challenge to civic institutions from successful tax avoidance, evasion and "avoision" (to quote from Arther Seldon).

* Living standards in the modern European state are threatened by adverse demographic trends. The privatisation of the supply of heath and education would allow taxes to be cut by 10% to 15% of GDP, helping to restore economic growth.

This paper was written by Professor Tim Congdon. A slightly different version will be published by the Institute of Economic Affairs in a volume of essays later this year.

Is there a limit to taxation?

High taxation reduces the equilibrium level of national output

Before 1939 "the tax ratio" rarely more than 25%; since 1945 in 25% - 60% band across the industrial world

High taxation does not mix well with political freedom and economic efficiency. Despite this tension, and the commitment of Western democracies to both freedom and efficiency, the second half of the 20th century was a period of extraordinarily heavy taxation by long-run historical standards. Before the Second World War it was unusual for taxation to exceed 25% of national output; after it very few significant industrial countries had a lower tax burden. Instead the ratio of tax to national output ("the tax ratio") varied in the nations of the industrialised West from a low of about 25% to a high of 60 %.(1) Indeed, a large state sector, and a powerful and omnipresent fisc, are widely regarded as among the defining features of the modern industrial state.

Taxes at the very high levels of recent decades are an aberration by long-run historical standards

But - to repeat - by long-run historical standards societies with a tax burden equal to 40, 50 or 60 % of national income are an aberration. At the start of the post-war period economists raised questions about the viability of the tax burden implied by the welfare state, then at an embryonic stage. In 1945 Professor Colin Clark wrote a paper for *The Economic Journal*, presenting evidence that a tax take above 25 % of net national product would be inflationary. This paper became widely-quoted and was still being discussed in an Institute of Economic Affairs pamphlet over 30 years later. (2) In Clark's view anything above the 25% figure carried such serious inflation risks that it must be an upper bound. Keynes - as editor of *The Economic Journal* – endorsed his position, opining that 25% was "about the limit of what is easily borne". Given Clark's and Keynes' warnings, the surprise must be economic performance has been so good over the last 60 years. Output growth has been continuous, so that living standards today are vastly better than in the late 1940s. It seems that Clark and Keynes were wrong. The facts suggest that considerable economic dynamism can be achieved even with tax levels far above the quarter of national income that they regarded as the maximum.

Clark's 25% limit to the tax ratio has been much exceeded, but no nation has gone above 60%

But there is another way of looking at what has been happening across the industrial world since the 1940s. It turns out that tax is subject to a limit, an absolute upper bound, just as Clark and Keynes thought. But the limit is 60% of national output, not 25%. On what evidence is this assertion based? The answer lies in the simple and plain facts of experience. *No nation in peacetime has had a tax ratio above the 60% figure.* In the post-war period – the period when the state sector has been more extensive than at any other time in history – several nations have had many years with a tax ratio above 50% and the majority of advanced nations have had at some time or other a

tax ratio above 40%. But no nation has exceeded 60% for any noticeable length of time.

Economic activity continues with a tax ratio of 50% - 60%, but only with a big loss of output

Somehow a few nations – virtually all of them in Scandinavia – have coped with a tax ratio of about 60%. But their economic performance has hardly been encouraging and taxpayer resistance has become a major political force. No government in these nations has dared to breach the 60% figure for long. A tax ratio of 50 or 60% may be viable, in the sense that everyday economic life proceeds more or less as normal and national income is stable or even growing slightly. But it is very far from ideal. In fact, an increasing body of evidence argues that the equilibrium level and/or the growth rate of national output is inversely related to the tax ratio. An important study on the subject by Andrea Bassanini and Stefano Scarpetta appeared in the OECD's *Economic Studies* in 2001. The numbers depended on the specification adopted, and allowed room for judgement and debate. (3) But in one particularly ambitious formulation, where the tax ratio affected investment and, at a further remove, also influenced the capital stock, a rise in the tax ratio of 1% reduced national output by 0.6 - 0.7 %. In other words, the equilibrium level of output in a nation with a tax ratio of 50% is 12 to 14% lower than in one with a tax ratio of 30%, and the equilibrium level of output in a nation with a tax ratio of 60% is no less 21 to 25% lower than in one with a tax ratio of 25%.

When tax reaches 70% or 80% of GDP, the burden of the state becomes unsustainable because of

The existence of a limit to taxable capacity can hardly be unexpected. If a tax rate of 100% ends voluntary economic activity altogether, a tax rate of 70% or 80% must have drastic adverse effects on incentives. A nation could in theory levy taxes equal to national output without having any tax rate at 100%, because it could combine very high rates of both direct and indirect taxes. (4) This nation might also have a large private sector, with the state handing back enough to the citizens in the form of transfer payments for the bulk of their expenditure still to be on privately-produced goods and services. But in practice a nation with a 100% tax ratio – or even a 70 or 80% tax ratio – would be impractical and unsustainable, for three reasons.

1. Adverse effect on incentives to work, to save and to seek

First, the nation would suffer from severe disincentives to work and save, and for people to seek employment and for companies to offer it, even on the assumption that collection and compliance costs were nil, and that taxpayers were wholly honest and paid their taxes in full. This statement should hardly need proof, but the admirers of modern European societies with their large state sectors – such as Adair Turner in his book *Just Capital: the Liberal*

and offer employment

Economy – sometimes appeal to economic theory for a counter-argument. The counter-argument needs to be noted and rebuffed.

What about "the income effect"?

A tax change can be regarded as a kind of price change. As is well-known, the effect of a price change on the quantity demanded depends on two effects, a "substitution effect" and an "income effect". The substitution effect of an increase in price is always to reduce quantity demanded, but the income effect is ambiguous. If the income effect of an increase in price is significantly to increase quantity demanded, it may - in certain special circumstances - outweigh the negative substitution effect. So an increase in price is followed by an increase in quantity demanded! When applied to the labour market, this argument leads to the claim that an increase in tax rates sometimes causes people to work *longer.* (5)

High taxation interacts with generous benefit system to destroy incentives

But in today's conditions this sort of response is unlikely. In modern industrial societies people are cushioned against the loss of income from not working by social security payments and the apparently "free" supply of certain so-called "public services" (health, education and low-quality housing). The existence of these benefits reinforces the negative substitution effect of high taxation. For many millions of low-skilled or unskilled workers there is no point working. A prevalent tendency across the industrial world in the last 30 years has been a decline in the proportion of working-age men who actually work. This tendency has been most pronounced in some European countries, such as France and Italy, where the rise in the tax ratio has been greatest.

Declining work participation in labour force has been offset by rising female participation,

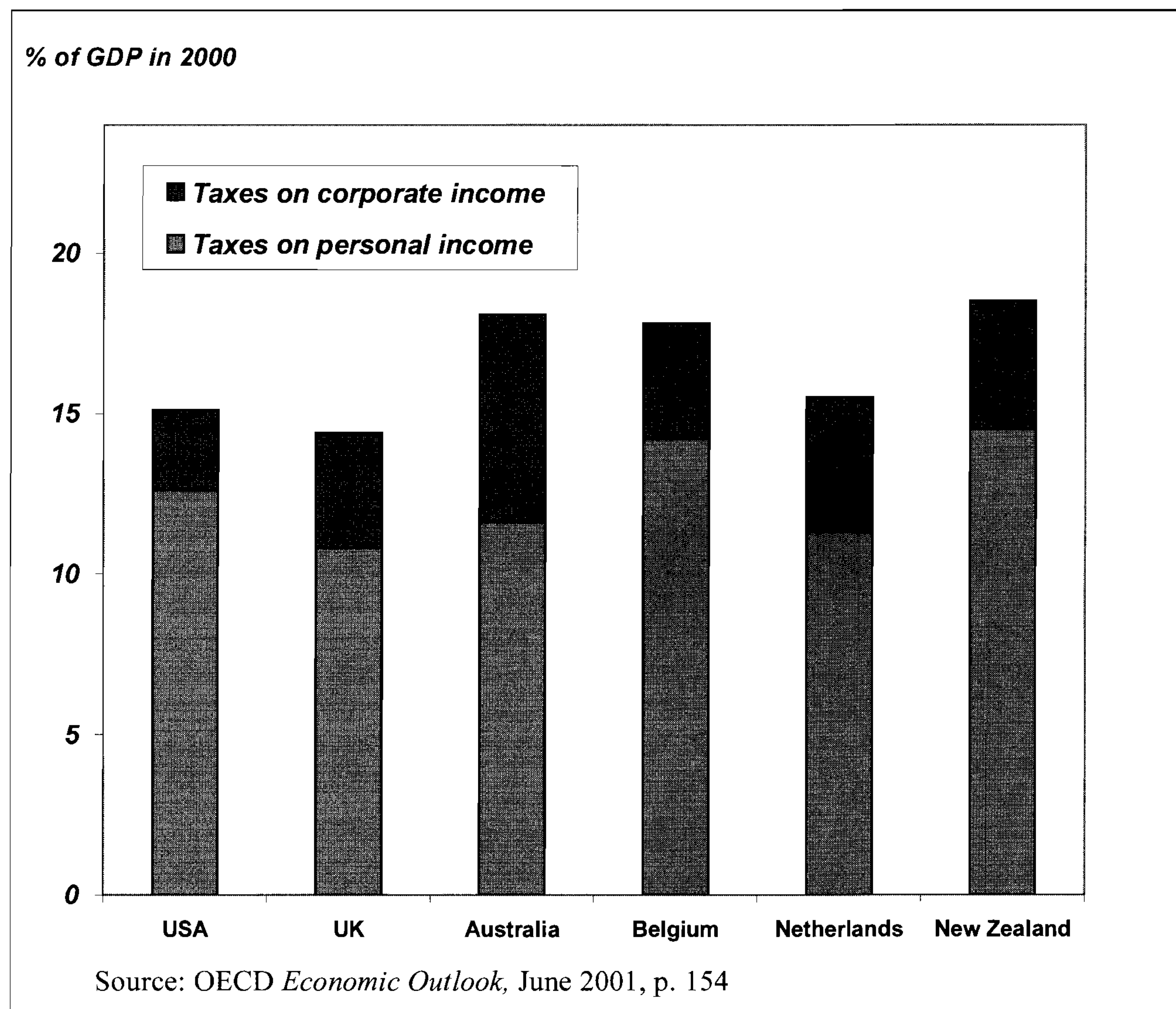
but this may have lowered the birth rate

Fortunately, the decline in male participation in the labour force has been offset by an increase in female participation. Two further prevalent tendencies across the industrial world since the 1960s have been an increase in female participation and a sizeable reduction in the pay differential between men and women. It is clear that - without the entry of more female workers into the jobs market - economic growth would have been much lower in recent decades than has actually been the case. But, as this mobilization of the female working-age population can happen only once, the associated output gain will not be repeated. (6) Further, an argument can be made that one of its by-products has been a sharp decline in fertility. Disturbingly, the decline in fertility has reached the point that the populations of nearly all European countries are no longer replacing themselves. The long-term sustainability of the high taxation associated with the welfare state can there-

How much do income and corporation taxes raise?

Typically 10% - 15% of GDP

Chart shows taxes on personal and corporate income as a share of GDP in 2000



Source: OECD *Economic Outlook,* June 2001, p. 154

Taxes on personal and corporate income are between 10% and 15% of GDP in most industrial nations. So - if government spending could be reduced by that much - they could be abolished. As it happens, government expenditure on health and education combined is also typically 10% - 15% of GDP. (See p. 10.) The transfer of these services from the public to the private sectors could therefore lead to the end of income and profits taxes. Not only would there be favourable incentive effects, but also the collection and compliance costs connected with these taxes would go. Of course, people would have to pay for health and education from their increased post-tax incomes, and would not be better-off by 10% - 15% of GDP. However, considerable efficiency gains are likely to be possible when the usual private sector incentives are at work in these parts of the economy. (Even the OECD has warned the UK government that the recent large increases in health spending have been wasteful.)

fore be questioned from a wider demographic perspective. (7)

2. High costs of tax collection and compliance

There can be no doubt that - even in societies where tax payment is frictionless - an increase in the tax ratio reduces the equilibrium level of national income. But tax payment is not frictionless. The second way that a high tax ratio lowers national output is through the increased costs of collection and compliance. The cost of collection is ostensibly to the government, but of course "the government" is a legal fiction. Ultimately the cost has to be borne by the taxpayer. Further, the compliance costs - of filling up long and difficult forms, of preparing correspondence with accountants, of learning about the tax system and seeking advice on how best to structure one's affairs - fall directly on the taxpayer. They must rise with the tax ratio, particularly if an increase in the tax burden is associated (as is invariably the case) with a higher number and a greater complexity of taxes. Mr. Gordon Brown, the Chancellor of the Exchequer since 1997, has tried to counter the disincentive effects of the UK's tax-and-social-security arrangements by elaborate "tax credit" schemes, in which tax is reduced as incomes rise. These schemes may have encouraged formerly unemployed workers to take up a job, but they have added to employers' costs and been accompanied by large increases in the tax and social security bureaucracy.

3. Encouragement to tax avoidance and evasion,

Finally, the higher are tax rates, the greater are the incentives both to avoid tax (i.e., to find legal means not to pay tax) and to evade it (i.e., not to pay tax, regardless of whether the law is being broken). Different people respond to these incentives in different ways. Of course, the dishonest and unpatriotic have less compunction about avoiding or evading tax than the majority of the population. If they "get away with it", citizens with a strong sense of civic responsibility feel cheated and angry. The long-run effect is to undermine respect for law and civic institutions. In these conditions illegal tax evasion may be widely regarded as no more reprehensible than legal tax avoidance.

leading to Seldon's "tax avoision"

As Arthur Seldon warned in the 1970s, the resentment caused by excessive taxation led to "tax avoision" in a "new twilight of law-breaking". (8)

Tax avoision is tempting to all groups in society

Tax "avoision" is often thought to be the preserve of low-income fringe operators, such as building sub-contractors or minicab drivers, in or close to the black economy. But - when confronted with true tax rates of possibly as much as 70 or 80% of income - even high-income professional people and members of wealthy families structure their assets to escape the attention of national revenue authorities. (9) Favourite strategies are the registration of

personal assets in bogus companies in order to exploit the better tax treatment of corporate entities, the transfer of assets from companies with a transparent pattern of beneficial ownership to nominee companies where beneficial ownership is opaque, the movement of wealth from heavily-taxed jurisdictions to tax havens, and the relocation of individuals with the deliberate intention of exploiting tax residence rules (which differ considerably between nations).

Absurd combination of high taxation of rich nationals and negligible taxation of rich "foreign investors", as governments try to maximise tax take

All these devices take up an immense amount of time and effort, both for the wealthy people themselves and their armies of professional advisers (lawyers, accountants, brokers of various description). Even so, there is often considerable uncertainty about whether a particular course of action is "tax efficient" or not. Much of the activity is a ridiculous zero-sum game, as governments both impose heavy taxation on their own long-standing citizens (in the UK's case, those deemed to be "domiciled" here) and have advantageous tax arrangements for wealthy people of foreign origin who come to live in their borders. Rich French people live in the UK to take advantage of the low tax on people with foreign domicile and rich Britons live in France to take advantage of the favourable taxation of pension income, rich Americans come to live in the UK and set up artificial companies which masquerade as "foreign investments" and rich Britons live in the USA to establish exemption from UK capital gains tax, and so on.

Arbitrary decisions by tax authorities forfeit taxpayer loyalty

Understandably, the national revenues authorities try to catch up with the fiscally-motivated peregrinations of the rich. But decisions by their officials are sometimes arbitrary or downright vindictive, which ends the citizen's sense of loyalty to the state and utterly destroys taxpayer morality. It is striking in this context that a large chunk of European saving is now held in portfolios of bearer securities (so-called "eurobonds"). Because these securities are not registered, it is difficult, or even impossible, for revenue authorities to determine the location and identity of their owners. Regrettably but unsurprisingly, when the owners receive the income (by handing over a coupon detached from the bond to a paying agent in Luxembourg or Switzerland), they often do not report it to their tax inspectors. Most governments in the European Union want a withholding tax to be levied on the income from such securities, but the UK (where most eurobonds are arranged and underwritten) and Luxembourg (because of the importance of paying-agent activity to its economy) have resisted its imposition.

The boom in holdings of eurobonds, where owner cannot be easily identified, is a measure of breakdown of taxpayers' morality

When the IEA was founded, eurobonds had not been invented. At the end of 2003 the value of the outstanding stock of such bonds was about $11,000b., up from $2,000b. a decade earlier. No one knows the proportion of total eurobond issuance owned by citizens of European Union states, but it is almost certainly over half and may be more than two-thirds. (The concept of "the citizen of a nation" has become increasingly complex. As already explained, many wealthy Europeans live in - or, at any rate, have residence status - in tax havens or nations with congenial tax regimes for "foreign investors".) If it were 60%, European ownership of this type of security - an almost perfect example of Seldon's tax avoision - would amount to almost $7,000b. That would imply that the average holding for the citizens of the EU would be almost $20,000 and that it had risen dramatically, by four, five or six times, in the previous decade. There could hardly be a better illustration that high tax, at the levels seen in the modern European state, corrode taxpayer morality and undermine efficient tax collection. (10)

To summarise, high taxation reduces economic efficiency, because of

- the disincentive effects on the amount of work in any particular employment, on the level of employment and on savings,
- the cost of collecting taxes and of complying with tax codes, and
- the erosion of the citizen's loyalty to the state and taxpayer morality.

Recent slow growth in Europe, largely due to over-taxation, may give way to trend output contraction from 2010

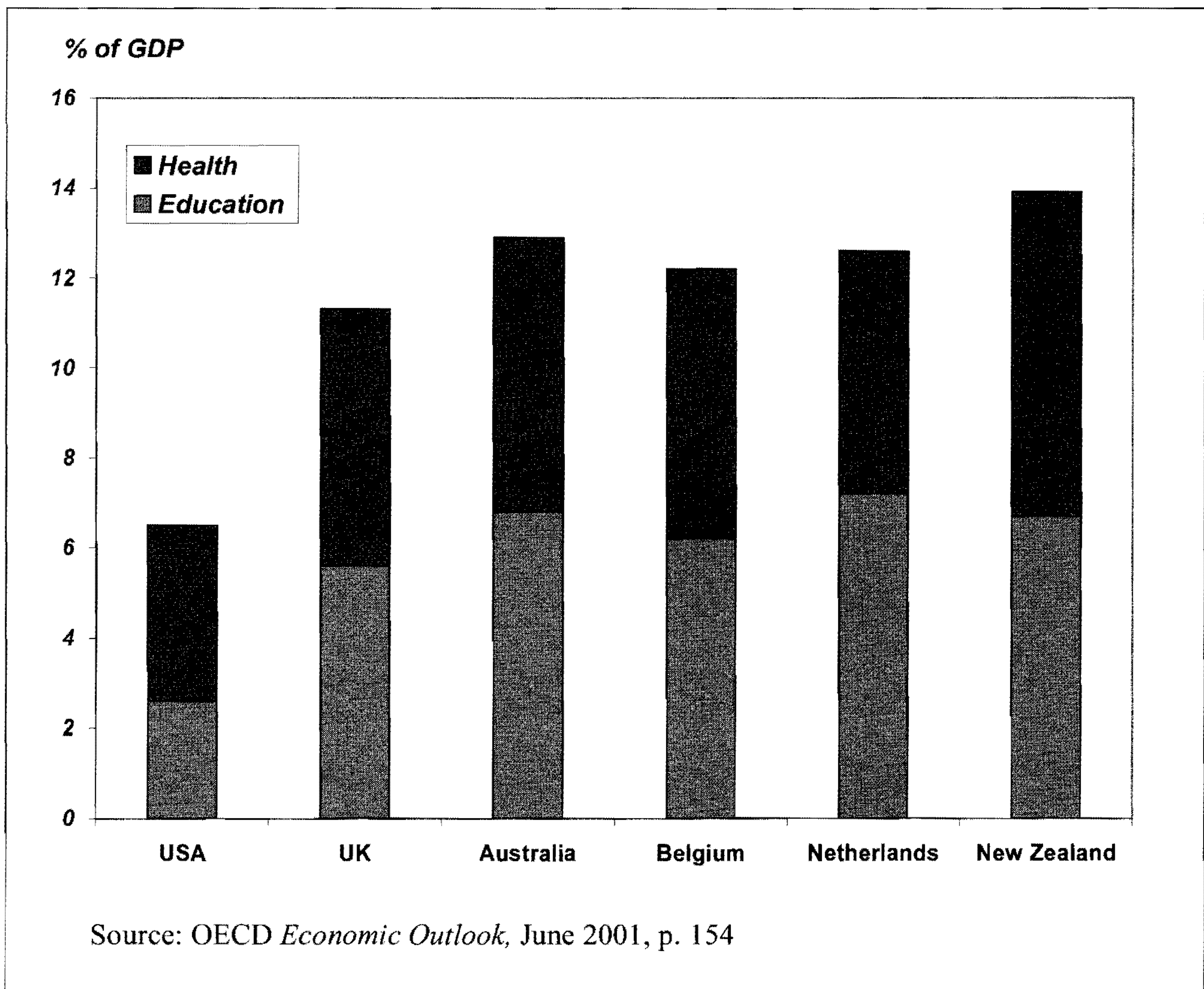
Given the combined power of these three damaging effects of taxes on production and saving, it is hardly surprising that the rise in taxes in the OECD area since the 1960s has been accompanied by a decline in the rate of economic growth. This decline has been particularly marked in Europe, which is also the continent with most nations suffering from tax ratios of over 45%. So far economic growth has continued, if at increasingly trivial annual rates of 1% or so. But the demographic situation is certain to worsen sharply in the 2010s when the working-age population of such nations as Germany and Italy will start to fall. If productivity growth comes to a halt under the weight of further increases in tax and regulation, and if employment contracts in line with the working-age population (typically projected in the nations affected at ½ to 1% a year), then significant European nations could experience a trend decline in output. It is not inconceivable that living standards could fall over extended periods, such as five or ten years. (11)

At this point attitudes towards the big-government, high-tax modern European state may change. Leading politicians and high-ranking civil servants

How much do health and education cost?

Typically 10% - 15% of GDP

Chart shows public spending on health and education as a share of GDP in 2000



Source: OECD *Economic Outlook,* June 2001, p. 154

In most European nations health and education spending combined are 10% -15% of GDP. (The source for the above chart is an article in the 2001 issue of the OECD publication, *Economic Outlook*, on the effects of age-ing on government expenditure.) Of course, health spending increases sharply with age. A rise in the proportion of old people to the total population therefore implies more government expenditure relative to GDP. It is possible at in 2020 or 2030 the ratio of public health spending to GDP will have increased to over 10% in these countries and the ratio of spending on education and health together to GDP to between 15% and 20%. Demands for greater efficiency are inevitable. A fair conjecture is that continued supply of these services by the public sector would be accompanied by the sort of waste seen in Mr. Gordon Brown's public spending surge since 1998. According to a report from the International Monetary Fund, the annual increase in hospital admissions was 1.9% from 1999 to 2002 (during the spending surge), which was *lower* than in the previous decade.

may recognise that tax burdens of 40, 50 or 60% of GDP are the main cause of the economic malaise. They may look more favourably on radical proposals for reducing the size of the state and the burden of taxation. For example, they might see the wisdom of privatising the supply of health and education, cutting taxes by the full cost of public expenditure on these items and suggesting to their citizens that they use their much enhanced post-tax incomes to pay for them directly. Of course, hospitals and schools would charge for their services, and the market would establish an efficient equilibrium between supply and demand. (12) The privatisation of health and education would reduce the ratio of government spending to GDP by about 12 to 15% of GDP in most advanced countries. That would allow the tax ratio to fall correspondingly. As it happens, income and corporation taxes represent about the same share of GDP as spending on health and education in many countries. Income and corporation taxes could therefore be abolished, ending both their adverse effects on incentives and the destructive nonsense involved in their current methods of collection.

Privatisation of health and education would allow taxes to be cut by 12 - 15 % of GDP in most countries

NOTES

(1) Table 27 at the back of the 2003/1 issue of the OECD's *Economic Outlook* publications shows the values of the ratio of tax and government non-tax receipts to nominal gross domestic product in 27 nations between 1985 and 2002, with projections for 2003 and 2004. Some values are missing, but in total there are almost 500 values. All are between 25 and 60%, with two exceptions. First, the ratio exceeded 60% in Sweden between 1986 and 2001, apart from one year (1992). But it never exceeded 65%, even in Sweden. When allowance is made for non-tax receipts, the ratio of tax to GDP would have been under 60% in Sweden in this period. Secondly, the values for Korea were under 25% from 1985 to 1996, but Korea was not an OECD member (i.e., "a significant industrial nation") at that time.

(2) Alan R. Prest and others *The State of Taxation* (London: Institute of Economic Affairs, 1977), pp. 21 - 3.

(3) Andrea Bassanini and Stefano Scarpeta 'The driving forces of economic growth: panel data evidence for the OECD countries', pp. 9 - 56, in *OECD Economic Studies* (Paris: Organisation of Economic Cooperation and Development, 2001, 2nd issue). See, in particular, p.35.

(4) This may seem surprising, but - if direct and indirect taxes were both 50% of national income - tax revenues would equal 100% of national income, and yet the average rates of direct and indirect taxation would be 50%. Note that an important constraint on indirect taxation is the risk of diverting economic activity into the very small-scale tax-exempted sector, into cash or even barter transactions, or into illicit activities such as smuggling. As far as the author is aware, there is no example of indirect taxation amounting to 50% of national income.

(5) Adair Turner *Just Capital: the Liberal Economy* (Basingtoke and Oxford: Macmillan, 2001), pp. 250 - 253. But Mr. Turner concedes that, "The case for avoiding very high marginal rates, say above 50%, is strong."

(6) In the USA the proportion of working-age women actually at work climbed from just over 42% in 1960 to almost 72% in the early years of the current century. It plainly cannot rise to 103% in the next 40 years. Assuming that the maximum proportion is about 75% (and only one OECD country much exceeds this), the USA cannot enjoy the same output boost from extra female participation in future. The same is true in most industrial countries.

(7) See the paper by the author 'Does the Eurozone face 50 years of economic stagnation?', pp 47 - 60, in April - June 2002 issue of *World Economics* (Henley-on-Thames: NTC Economic & Financial Publishing).

(8) See Arthur Seldon's comments in *Tax Avoision: The Economic, Legal and Moral Inter-relationships between Legal Tax Avoidance and Illegal Evasion* (London: Institute of Economic Affairs, 1979). Also the same author's *Capitalism* (Oxford: Basil Blackwell, 1990), p. 178.

(9) The UK has a 40% top tax rate on income from work, income from assets and inherited assets. So it may appear that the highest "tax rate" is 40%. But that is not so. Suppose that a wealthy individual saves out of income, receives income from his saved assets during the rest of his life and passes on the assets to the children. Then all three activities (working, saving and dying) are taxed at 40%. The true tax rate is (1 minus [0.6 to the power of three])%, which is just over 78%. No wonder wealthy people want to locate themselves in jurisdictions with no income or inheritance taxes. John Stuart Mill was the first economist to notice - in his *Principles of Political Economy* - that, when a system of income taxation levied both on income from employment and income from assets, it involved double taxation of the income from assets accumulated from taxed income. If allowance were also made for inheritance tax, the system would be better characterised as treble taxation.

(10) The data on the issuance of international bonds (or eurobonds) are given by the Bank for International Settlements on its website. Interest on the bonds held by "Europeans" might on average have been 6%. Total interest payments would be about $400b. and tax lost perhaps $100b.

(11) Again, see the paper by the author on "Does the Eurozone face 50 years of economic stagnation?" in the April-June 2002 issue of *World Economics*.

(12) The idea is not new. In his book *Charge*, published in 1977, Arthur Seldon argued that the so-called "public servcies" should be privatised, and that people should pay for education, health and housing from increased post-tax incomes. (*Charge* [London: Temple Smith, 1977].)