

The Effect of Income Taxes on Economic Growth

Income Taxes - Looking at Extreme Cases



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One of the most commonly discussed issues in economics is how tax rates relate to economic growth. Advocates of tax cuts claim that a reduction in the tax rate will lead to increased economic growth and prosperity. Others claim that if we reduce taxes, almost all of the benefits will go to the rich, as those are the ones who pay the most taxes. What does economic theory suggest about the relationship between economic growth and taxation?

Income Taxes and Extreme Cases

In studying economic policies, it is always useful to study extreme cases. Extreme cases are situations such as "What if we had a 100% income tax rate?", or "What if we raised the minimum wage to \$50.00 an hour?". While wholly unrealistic, they do give very stark examples of what direction key economic variables will move when we change a government policy.

First suppose that we lived in a society without taxation. We'll worry about how the government finances its programs later on, but for now we'll assume that they have enough money to finance all the programs we have today. If there are no taxes, then the government does not earn any income from taxation and citizens do not spend any time worrying about how to evade taxes. If someone has a wage of \$10.00 an hour, then they get to keep that \$10.00. If such a society were possible, we can see that people would be quite productive as any income they earn, they keep.

Now consider the opposing case. Taxes are now set to be 100% of income. Any cent you earn goes to the government. It may seem that the government would earn a lot of money this way, but that's not likely to happen. If I don't get to keep anything out of what I earn, why would I go to work? I'd rather spend my time reading or playing baseball. In fact, going to work would risk my ability to survive. I'd be much better off spending my time trying to come up with ways to get the things I need without giving them to the government. I'd spend a lot of my time trying to grow food in a hidden garden and bartering with others for the things I need to survive. I wouldn't spend any time working for a company if I didn't get anything from it. Society as a whole would not be very productive if everybody spent a large portion of their time trying to

evade taxes. The government would earn very little income from taxation, as very few people would go to work if they did not earn an income from it.

While these are extreme cases, they do illustrate the effect of taxes and they are useful guides of what happens at other tax rates. A 99% tax rate is awfully like a 100% tax rate, and if you ignore collection costs, having a 2% tax rate is not much different from having no taxes at all. Go back to the person earning \$10.00 an hour. Do you think he'll spend more time at work or less if his take home pay is \$8.00 rather than \$2.00? I'd bet you that at \$2.00 he's not going to spend a lot of time at work and he is going to spend a lot of time trying to earn a living away from the prying eyes of government.

Taxes and Other Ways of Financing Government

In the case where government can finance spending outside of taxation, we see the following:

- Productivity declines as the tax rate increases, as people choose to work less. The higher the tax rate, the more time people spend evading taxes and the less time they spend on more productive activity. So the lower the tax rate, the higher the value of all the goods and services produced.
- Government tax revenue does not necessarily increase as the tax rate increases. The government will earn more tax income at 1% rate than at 0%, but they will not earn more at 100% than they will at 10%, due to the disincentives high tax rates cause. Thus there is a peak tax rate where government revenue is highest. The relationship between income tax rates and government revenue can be graphed on something called a *Laffer Curve*.

Of course, government programs are **not** self-financing. We'll examine the effect of government spending in the next section.

Even an ardent supporter of unrestricted capitalism realizes that there are necessary functions for the government to perform. [The Capitalism Site](#) lists three necessary things a government must provide:

- **An Army:** To protect against foreign invaders.
- **A Police Force:** To protect against domestic criminals.
- **A Court System:** To settle honest disputes that arise, and to punish criminals according to objectively predefined laws.

Source: [The Capitalism Site - FAQ - Government](#)

Without the last two functions of government, it is easy to see that there would be little economic activity. Without a police force it would be difficult to protect anything that you've earned. If people could just come by and take anything you owned, we'd see three things happen:

1. People would spend a lot more time trying to steal what they need and a lot less time trying to produce what they need, as stealing something is often easier than producing it yourself. This leads to a reduction in economic growth.
2. People who have produced valuable goods would spend more time and money trying to protect what they've earned. This is not a productive activity; society would be much better off if citizens would spend more time producing productive goods.
3. There would likely be a lot more murders, so the society would lose a lot of productive people prematurely. This cost, and the costs people incur in trying to prevent their own murder greatly diminishes economic activity.

A court system also promotes economic growth. A large portion of economic activity depends on the use of contracts. When you start a new job, normally you have a contract specifying what your rights and responsibilities are and how much you will be compensated for your labor. If there's no way to enforce a contract like that, then there is no way to ensure that you will end up getting compensated for your labor. Without that guarantee, many would decide it is not worth the risk to work for someone else. Most contracts involve an element of "do X now, and get paid Y later" or "get paid Y now, do X later". If these contracts are not enforceable, the party who is obligated to do something in the future might decide then that he doesn't feel like it. Since both parties know this, they would decide not to enter into such an agreement and the economy as a whole would suffer.

Having a working court system, military, and police force provides a large economic benefit to a society. However it is expensive for a government to provide such services, so they'll have to collect money from the citizens of the country to finance such programs. The financing for those systems comes through taxation. So we see that a society with some taxation that provides these services will have a much higher level of economic growth than a society with no taxation but no police force or court system. So an increase in taxes *can* lead to larger economic growth, if it is used to pay for one of these services. I use the term *can* because it is not necessarily the case that expanding the police force or hiring more judges will lead to greater economic activity. An area which already has many police officers and little crime will gain almost no benefit from hiring another officer. Society would be better off not hiring her and instead lowering taxes. If your armed forces are already large enough to deter any potential invaders, then any additional military spending drags down economic growth. Spending money on these three areas is *not necessarily* productive, but having at least a minimal amount of all three will lead to an economy with higher economic growth than none at all.

We saw in the previous section that higher taxes can lead to higher economic growth *if* those taxes are efficiently spent on three areas which protect the rights of citizens. A military and a police force ensure that people do not have to spend a great deal of time and money on personal security, allowing them to engage in more productive activities. A court system allows individuals and organizations to enter into contracts with one another which creates opportunities for growth through collaboration motivated by rational self interest.

There are other government programs, which bring a net benefit to the economy when fully paid for by taxes. There are certain goods that society finds desirable but individuals or corporations cannot supply. Consider the problem of roads and highways. Having an extensive system of

roads on which people and goods can freely travel greatly adds to the prosperity of a nation. If a private citizen wanted to build a road for profit, they would run into two major difficulties:

1. **The cost of collection.** If the road was a useful one, people would gladly pay for its benefits. In order to collect fees for the use of the road, a toll would have to be set up at every exit and entry to the road; many interstate highways work this way. However, for most local roads the amount of money obtained through these tolls would be dwarfed by the extreme costs of setting up these tolls. Because of the collection problem, a lot of useful infrastructure would not be built, although there is a net benefit to its existence.
2. **Monitoring who uses the road** Suppose you were able to set up a system of tolls at all the entrances and exits. It may still be possible for people to enter or leave the road at points other than the official exit and entrance. If people can evade paying the toll, many will.

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Governments provide a solution to this problem by constructing the roads and recouping the expenses through taxes such as the income tax and the gasoline tax. Other pieces of infrastructure such as the sewage and water system work on the same principle. The idea of government activity in these areas is not new; it goes at least as far back as Adam Smith. In his 1776 masterpiece, [*The Wealth of Nations*](#) Smith wrote:

"The third and last duty of the sovereign or commonwealth is that of erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expense to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect or maintain."

Higher taxes which lead to improvements in infrastructure *can* lead to higher economic growth. Once again, it depends on the usefulness on the infrastructure being created. A six-lane highway between two small towns in upstate New York is not likely to be worth the tax dollars spent on it. An improvement to the safety in the water supply in an impoverished area might be worth its weight in gold if it leads to reduced illness and suffering for the users of the system.

Next we'll consider the situation where higher taxes are used to finance social programs.

In most Western democracies the majority of government spending goes towards social programs. While there are literally thousands of government funded social programs the two largest are generally health care and education. These two do not fall into the category of infrastructure. While it is true that schools and hospitals must be built, it is possible for the private sector to profitably do so. Schools and health care facilities have been built by non-government groups all over the world, even in countries that already have extensive government programs in this area. Since it is possible to cheaply collect funds from those who use the facility and to ensure those who do use the facilities cannot easily evade paying for those services, these do not fall into the category of "infrastructure"

Can these programs still provide a net economic benefit? Being in good health will improve your productivity. A healthy workforce is a productive workforce, so spending on health care is a boon to the economy. However, there is no reason the private sector cannot adequately provide health care or why people will not invest in their own health. It's tough to earn an income when you're too sick to go to work, so individuals will be willing to pay for health insurance that will help them get better if they are ill. Since people would be willing to buy health coverage and the private sector can provide it, there is no market failure here.

To purchase such health insurance you must be able to afford it. We could get into a situation where society would be better off if the poor got proper medical treatment, but they do not because they cannot afford it. Then there would be a benefit to giving health care coverage to the poor. But we can get the same benefit by simply giving the poor cash and letting them spend it on whatever they want, including health care. However, it could be that people, even when they have enough money, will buy an inadequate amount of health care. Many conservatives argue that this is the basis of many social programs; government officials do not believe that citizens buy enough of the "right" things, so government programs are necessary to ensure people get what they need but won't buy. While I doubt this is the motivation behind social programs, if it is the case that people will naturally consume the wrong amount of health care, then having a social program like this could lead to economic growth.

The same situation occurs with educational expenditures. People with more education tend to be on average more productive than people with less education. Society is better off by having a highly educated population. Since people with higher productivity tend to get paid more, if parents care about the future welfare of their children, they will have an incentive to seek an education for their children. There is no technical reasons why private sector companies cannot provide educational services, so those who can afford it will get an adequate amount of education.

As before, there will be low income families who cannot afford a proper education although they (and society as a whole) are better off by having well educated children. It would seem that having programs which focus their energies on poorer families will have a greater economic benefit than those which are universal in nature. There seems to be a benefit to the economy (and society) by providing an education to a family with limited opportunities. There is little point in providing an education or health insurance to a wealthy family, as they will likely buy as much as they need.

On the whole, if you believe that those who can afford it will buy an efficient amount of health care and education, social programs tend to be a deterrent to economic growth. Programs which focus on agents who are unable to afford these items have a greater benefit to the economy than those that are universal in nature.

A tax cut does not necessarily help or hurt an economy. You *must* consider what the revenue from those taxes is being spent on before you can determine the effect the cut will have on the economy. From this discussion, though, we see the following general trends:

1. Cutting taxes and wasteful spending will help an economy because of the disincentive effect caused by taxation. Cutting taxes and useful programs may or may not benefit the economy.
2. A certain amount of government spending is required on the military, the police, and the court system. A country which does not spend an adequate amount of money in these areas will have a depressed economy. Too much spending in these areas is wasteful.
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3. A country also needs infrastructure to have a high level of economic activity. Much of this infrastructure cannot be adequately provided by the private sector, so governments must spend money in this area to ensure economic growth. However too much spending, or spending on the wrong infrastructure can be wasteful and slow economic growth.
4. If people are naturally inclined to spend their own money on education and health care, then taxation used for social programs is likely to slow economic growth. Social spending which targets low income families is much better for the economy than universal programs.
5. If people are not inclined to spend towards their own education and health care, then there can be a benefit to supplying these goods, as society as a whole benefits from a healthy and educated workforce.

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