Tax and Economic Growth: Do lower taxes lead to higher growth?

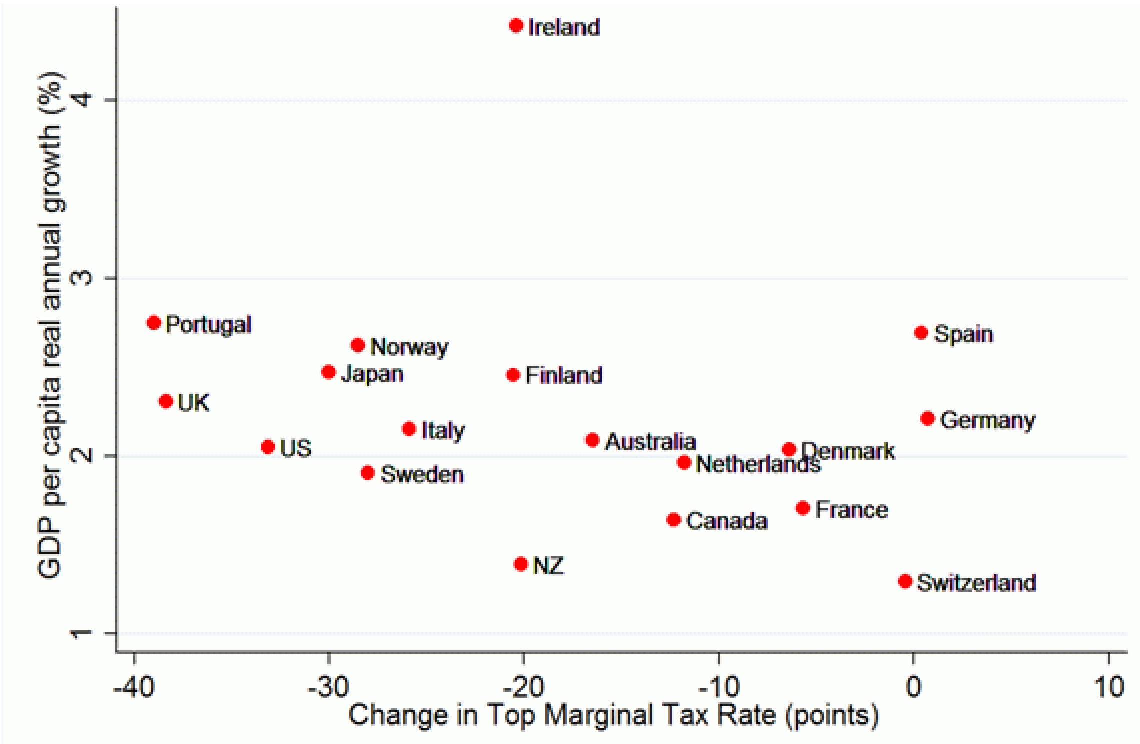
On the 23 September the former Chancellor, Kwasi Kwarteng, introduced a range of tax cuts. He announced a 1p cut to the basic rate of income tax. As well as cutting the basic rate he also abolished the additional rate which meant that there would only be a single higher rate of income tax of 40%. This he said was designed to attract the best and the brightest to the UK workforce, helping businesses innovate and grow. The rise in Corporation tax from 19% to 25% was cancelled and the thresholds for paying stamp duty when buying a house were increased.[1] The former Prime Minister, Liz Truss told reporters that "*lower taxes lead to economic growth, there is no doubt in my mind about that*." [2]

Liz Truss's policy of cutting taxes to achieve growth attracted a good deal of support. For example the Daily Mail headline was "*At last! A true Tory budget*." The paper's editor wrote that it would lift confidence and propel a rise in consumption and investment. The Sunday Telegraph editor described the budget as the greatest in his lifetime "*by a massive mile*". He predicted that there would be "*dozens of canary wharfs on steroids*" and that money and jobs would flow in from the eurozone. Nine Tory MSPs wrote to the Times extolling the virtues of Liz Truss and claiming that cutting taxes would "*get Scotland's economy moving.*" [3] Now that she has resigned and the tax cuts have been largely abandoned, some still argue that the policy was correct, it was just the way it was presented that was wrong.[4]

Patrick Minford, Professor of Applied Economics at Cardiff University, also supported the idea of low taxes and claimed that high taxes "*destroy entrepreneurial innovation and investment*." He went on to say that the policies of Liz Truss had been tried before by Margaret Thatcher: "*It is no accident that the decade of strongest growth we have seen in the UK since 1970 is that of the 1980s when it reached nearly 3%*." [5] One of the key features of the tax system in the 1980s was the significant reduction in rates - prior to 1979 rates had been very high. In June 1979 Geoffrey Howe cut the top rate of income tax from 83 to 60% and the basic rate from 33 to 30%. By 1988 the top rate of tax had been reduced to 40% while the basic rate had been reduced to 25%. Corporation tax in 1979 was 52% - by 1989 it was 35%.[6]

The lower tax rates of the 1980s however did not result in higher growth as Patrick Minford seems to imply. He was correct to say that UK growth in 1970 was strong – it was 6.3%. However his 3% average figure for the 1980s can only be reached by missing out 1980 because in that year growth fell by 2%. The average percentage increase in GDP between 1970-79 was 2.99%. This compares with 2.67% between 1980 and 89.[7] Economic growth during the 1980s was clearly lower than in the 1970s.

When we look over the longer term we can again see that lower taxes have not led to higher growth. The chart shows GDP-per-capita growth rates against the changes in top tax rates between 1975 and 2008 for a range of countries. [8] There is little or no correlation between cuts in top tax rates and the average growth of GDP per person. Countries that made large cuts in top tax rates such as the United Kingdom and the United States did not grow faster than countries that did not, such as Germany and Spain.



Another more recent paper by Hope and Limberg reached similar conclusions. It used data from 18 countries covering the last five decades from 1965 to 2015. It estimated the effects of tax cuts on inequality, economic growth and unemployment.[9] The authors found that the tax cuts which have taken place since the 1980s led to higher income inequality, with the top 1% of earners increasing their share of the national income after each major tax cut. However, the tax cuts did not result in an increase in economic growth or a reduction in unemployment.

Instead of cutting taxes some argue that we need to increase them if we want to keep the NHS and state education, along with a reasonable social security system. But we need to broaden the tax base by taxing areas which are currently untaxed. For example it has been reported that the UK government is currently planning £35bn in spending cuts.[10] A recent report concludes that the government should raise taxes on dividends and the share buy-back schemes undertaken by Britain's largest companies. This would help households and businesses to weather the cost-of-living crisis "*without resorting to public service cuts*." [11] A second report from Tax Justice UK recommends that income from wealth such as investments and inheritance should be taxed at least as much as income from work. The authors calculate that their proposals could bring in an estimated £69 billion.[12]

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Note

Income tax and corporation tax continued to fall after the 1980s. When New Labour took office in 1997 the basic rate of income tax was 24%. By 2008 Labour had reduced this to 20%. From 1988 to 2010 the highest rate of income tax was 40%. The 'additional rate' on incomes over £150,000 was introduced by Labour in 2010 and was set at 50%. It was reduced to 45% by the Conservatives in 2013. Corporation tax was 33% in 1997 which Labour had reduced to 28% by 2010. The Conservatives reduced it even further to 19% in 2017.