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The International Importance of Low Tax Rates

During the 1980s more than 50 countries including the United States and the United Kingdom sharply reduced their highest tax rates, particularly on capital. However, in the early 1990s most of the largest economies reversed course and began raising rates on income and payroll taxes or both. By the fall of 1991 an observant columnist for the *Financial Times* noted that, "In the early 1990s, the name of the game is raising taxes. . . . The nostrums of the supply-siders look as dead as the celebrated dodo."

Rates were increased under President George Bush in the United States, Prime Minister Brian Mulroney in Canada, Chancellor Helmut Kohl in Germany and a seemingly endless series of prime ministers in Japan — all of whom were subsequently turned out of office.

However, the news about raising taxes must not have reached government leaders of the fastest growing economies of Asia, Africa and Latin America, many of whom continued to bring tax rates down — including, among others, Argentina, Bolivia, Botswana, Brazil, Chile, Colombia, Hong Kong, India, South Korea, Malaysia, Mauritius, Mexico, New Zealand and Singapore.

The table shows changes in the highest individual tax rates for the largest G-7 economies and for 19 other countries that either kept their top tax rates at 20 percent to 35 percent throughout the 1990s or at least continued to move in the direction of reducing the steepest tax rates. As the last two columns show, the growth of real gross domestic product has been far more rapid among countries with low and/or falling tax rates.

When most G-7 countries did a U-turn and started putting tax rates back up, their economic growth slowed markedly, from an average of 2.9 percent in 1980-90 to an average of 1.7 percent in 1990-96.

Meanwhile, growth among the 19 tax-slashing economies generally accelerated, from an average of 4.5 percent in 1980-90 to an average of 5.8 percent in 1990-96.

Thus the gap between the average growth rates of these two groups widened from 1.6 percentage points in the 1980s to 4.1 percentage points from 1990 to 1996.

Top Marginal Tax Rates on Individual Income

	Highest Tax Rate:				GDP *growth:*	
	1979	1984	1989	1996	1980-90	1990-96
Countries with Low and/or Falling Tax Rates:*						
Argentina	45	62	30	30%	-0.3	4.9%
Bolivia	48	30	10	13	0	3.8
Botswana	75	60	40	35	10.3	4.1
Brazil	55	60	25	25	2.7	2.9
Costa Rica	50	50	30	25	3.0	4.3
Chile	60	57	50	45	4.1	7.2
Colombia	56	49	30	30	3.7	5.5
El Salvador	60	48	30	30	0.2	5.8
Hong Kong	15	17	20	15	6.9	5.5
India	60	62	53	40	5.8	5.8
Indonesia	50	35	35	30	6.1	7.7
S. Korea	89	55	48	40	9.4	7.2
Malaysia	60	45	45	30	5.2	8.7
Mauritius	60	35	35	30	6.2	5.0
New Zealand	66	66	33	33	1.7	3.3
Pakistan	50	60	35	39	6.3	4.6
Peru	65	50	37	30	-0.2	6.0
Singapore	55	40	33	28	6.4	8.7
Thailand	60	65	55	37	7.6	8.3
Average	54	50	35	31%	4.5	5.8%
G-7 Countries:						
Canada (Ontario)	58	50	47	53	3.4	1.9
France	60	53	53	52	2.4	1.1
Germany	56	56	53	58	2.2	2.2
Italy	72	65	50	51	2.4	1.0
Japan	75	70	50	50	4.0	1.4
United Kingdom	83	60	40	40	3.2	1.6
United States	70	50	28	40	2.9	2.4
Average	68	58	46	49%	2.9	1.7%

* Some countries that sharply reduced top tax rates to 25-35% in recent years — such as Uganda, Ghana, Sri Lanka, Tunisia, and the Dominican Republic — are excluded due to lack of detailed historical information. State and local tax rates are not included for Japan, where they can add up to 15 percentage points, or for the U.S.

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Fallout from the Asian Flu. Some of these "emerging economies" were recently mauled in the fallout from Asia's currency crises and capital flight (just as some were hurt by reverberations from Mexico's devaluation in late 1994). But it is not reasonable to blame regional or global financial crises on the policies of each affected nation, much less on low tax rates.

Until 1998 Hong Kong had not had a recession since 1975, and South Korea had not had one since 1980. The longer-term economic performance of these and other emerging economies has been quite extraordinary, with *sustained* economic growth of 5 percent to 8 percent a year. Despite the belated emphasis on what a few of the wounded "tigers" have done wrong, we must not forget what many of them did *right.* One thing they did right was to slash the highest marginal tax rates.

Incentives to Produce. The highest marginal tax rate on individual incomes is a very rough measure of marginal tax rates for the entire tax system. Moreover, the highest tax on individuals invariably sets a similar limit on the corporate tax rate. Under any coherent economic theory, higher marginal tax rates on productive effort and capital accumulation ought to result in less of such activity. If people do not respond to tax incentives, then they do not respond to price incentives either, which would leave economics adrift with nothing to say about anything. Taxes are an important part of the cost of production as well as the cost of living. If the marginal cost of taxes does not matter, then neither does the cost of labor, oil, credit or anything else.

People generally have to produce more to earn more, except in cases of theft or legal "rent-seeking" (buying government favors). It follows that *any tax system which penalizes added income with high marginal tax rates must also penalize added output (growth of real GDP).*

The table also contains some rough "time series" evidence. Although the dates of tax reform vary, it is nevertheless possible to see dramatic improvement in economic growth rates since the late 1980s, when a number of Latin American countries (following Asia's lead) made deep cuts in their highest tax rates. Argentina, Bolivia, El Salvador and Peru are good examples.

Stopping Economic Decline. Such broad before-and-after generalizations are supported by case studies of the specific countries involved. One finding of such a country-by-country analysis is that many in the top list were in serious economic decline before they began cutting tax rates. These included South Korea in 1980, Mauritius in 1982, Singapore in 1985 and the four Latin American countries previously mentioned. Aside from the recent debacle in Asia, most of these countries have done remarkably well ever since their tax rates came down. In Hong Kong, the first to go to low tax rates, "sustained growth" means nearly five decades in which economic growth averaged about 7 percent a year.

A sharp reduction in marginal tax rates was certainly not the only policy change that may have accounted for improved economic growth. Progress also requires defined and secure property rights, unrestricted competition (which implies free trade), uncontrolled prices and (the most obvious lesson of 1998) sound money and transparent banking.

Conclusion. Although good tax policy alone does not ensure a good economy, world history offers no examples of economies that prospered with punitive tax rates. Governments, like companies, must compete in producing the most value at the lowest possible cost. Countries in which the marginal cost of government is relatively high find it more difficult to attract and retain physical capital, financial capital and human capital. Just as so-called "tax havens" attract investment and skilled immigrants, countries with punitive tax systems face chronic capital flight and brain drain.

In some countries in the top part of the table, taxes on trade (tariffs) were reduced. In others, such as Argentina, the monetary regime was changed. In still others, Social Security was privatized and the payroll tax burdens on employment thus were eased. But the one thing *all* of the fastest-growing economies of the past two decades have had in common is this: they either had very low tax rates to begin with or moved rapidly in that direction.

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