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Income taxes, spending composition and long-run growth

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Abstract

The focus of this paper is threefold. First, it reexamines the impact on long-run growth of changes in flat-rate income taxes when a fraction of total government expenditures is used to provide public services that affect the productivity of privately held inputs. Second, for a given tax policy, this paper studies the impact of government expenditure composition on the rate of economic growth. Third, since demographics follow an overlapping generations structure and fiscal policy affects the economy's productivity, the paper features the role of productivity as a means of redistributing income across generations. The economy is analyzed numerically and policy experiments are carried out.

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1. Introduction

1.1. Overview

Economists have long recognized that fiscal policy may affect economic growth. In the last three decades, numerous papers have studied how and to what extent taxation, spending, transfers, and other aspects of fiscal policy affect growth performance. Part of this literature concentrates on the study of the equilibrium relationship between fiscal policy and growth. From this analysis a broad support for the hypothesis that income taxes are detrimental for growth has emerged ([Rebello, 1991](#); [Jones and Manuelli,](#)

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1992; Easterly and Rebelo, 1993; references therein). The mechanism through which this seems to take place is intuitively simple: an increase in the capital income tax rate decreases the rate of return to the investment activities of the private sector and leads to a decline in the rates of capital accumulation and growth. Even on normative grounds there seems to be a case against income taxation. Particularly, it is argued that eliminating tax rates on capital income could lead to increases in growth and welfare (Chamley, 1986; Lucas, 1990).¹

More recent theoretical work, however, puts forth provocative evidence that income taxation may affect growth positively. In the US, for example, the empirical support that low capital income taxes may foster growth seems less clear than has been proposed. Capital gains seem to be relatively unresponsive to changes in taxation in the long run and the time series for the personal savings rate and the capital income tax rate, despite short-run divergence, seem to be positively correlated (Uhlig and Yanagawa, 1996; references therein). When government spending is allowed to affect private decisions to acquire education and accumulate human capital, simultaneous reductions in capital income taxes and government spending on education reduce the long-run growth rate, though it could be argued that such a relationship is not quantitatively significant (Glomm and Ravikumar, 1998). Despite large bodies of work in both the growth and optimal fiscal policy literatures, many issues remain unsettled. Whether government size affects growth remains a controversial issue, especially in the absence of *stylized* facts (Temple, 1999). In addition, the question of composition of government spending and its effects on the rate of growth remains open.

In the next section, I describe an endogenous growth model and study two important aspects of fiscal policy. First, I reexamine the impact on long-run growth of changes in flat-rate income taxes when a fraction of total spending affects private decisions to invest. I refer to this category of spending as *public services* (or *productive spending*), and it refers to government expenditures on the maintenance of (or additions to) the stock of infrastructure such as highways, educational facilities, hospitals, water and sewers, communication systems, and others; improvements in the legal system (law and order); enforcement of property rights, etc.² Second, this paper examines the impact of spending composition on the rate of economic growth for tax revenue can also be allocated to the purchase of consumption goods and to transfers. It is assumed that public services are provided without user charges and although part of these services may be subject to congestion effects, the latter are ruled out to keep the analysis as simple as possible.

It is found that the long-run growth effects of income taxes are generally ambiguous, even when a fraction of spending is allocated to productive services that affect the productivity of privately held inputs. How fiscal policy affects growth depends a great deal on the sensitivity of savings to changes in long-run interest rates. While it is

¹ Chamley and Lucas provide theoretical and quantitative evidence supporting this line of thought. Lucas uses a framework similar to that of Chamley, but incorporates human capital into the model.

² For a review of the literature on how public spending affects the productivity of private factors see Gramlich (1994) for the case of spending on infrastructure and Barro (1991) and Alesina et al. (1996) for the case of law and order.

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