Available online at www.sciencedirect.com
SCIENCE DIRECT
European Journal of Political Economy
Vol. 20 (2004) 1011–1025
European Journal of POLITICAL ECONOMY
www.elsevier.com/locate/econbase

Taxation, growth, and the spirit of capitalism

Wen-ya Chang[a,b,*], Hsueh-fang Tsai[a], Ching-chong Lai[c,d,e]

[a] Department and Graduate Institute of Economics, Fu-Jen Catholic University, Hsinchuang, Taipei 24205, Taiwan
[b] Institute of Economics, National Sun Yat-Sen University, Kaohsiung 804, Taiwan
[c] Sun Yat-Sen Institute for Social Sciences and Philosophy, Academia Sinica, Taipei 115, Taiwan
[d] Institute of Economics, Academia Sinica, Taipei 115, Taiwan
[e] Department of Economics, National Taiwan University, Taipei 100, Taiwan

Received 25 February 2000; received in revised form 20 January 2003; accepted 18 July 2003
Available online 5 March 2004

Abstract

This paper uses a general two-sector model of endogenous growth to examine how the spirit of capitalism affects the relation between public finance and growth. The spirit of capitalism is defined as acquisitive personal objectives. We find that if the spirit of capitalism is present, an increase in the share of government spending in output reduces the long-run growth rate. The negative relationship between fiscal spending and growth is consistent with empirical evidence.

JEL classification: D90; E62; O40
Keywords: The spirit of capitalism; Fiscal spending; Lump-sum taxes; Endogenous growth

1. Introduction

The effects of tax and fiscal spending policies on an economy have long been studied in the macroeconomic literature. The analysis within the past two decades has focused on this issue predominantly from the viewpoint of intertemporal optimization. Previous studies (for example, Atkinson and Stiglitz, 1980; Abel and Blanchard, 1983; Chamley, 1981, 1985, among others) suggest that an increase in income tax rates depresses economic activities in the long run. In their basic neoclassical growth model with inelastic labor

* Corresponding author. Tel.: +886-2-29031111x2695; fax: +886-2-22093475.
E-mail address: ecos1001@mails.fju.edu.tw (W. Chang).

0176-2680/$ - see front matter
doi:10.1016/j.ejpoleco.2003.07.001

supply, Barro (1981), Judd (1985), and Blanchard and Fischer (1989) examined the effect of government spending and concluded that a permanent government spending shock has no effect on investment and real output. A common finding in these studies is that taxation and government spending policies do not affect economic growth.

A number of papers have extended the focus to analyze fiscal policies and economic growth in models in which the long-run growth rate is endogenous. As noted by Stokey and Rebelo (1995, p. 519), "Growth models with endogenously determined rates of technical change provide a useful framework for studying the effects of fiscal policy on the long-run growth rate." Using a two-sector model of endogenous growth with joint accumulation of physical and human capital, Mino (1989), King and Rebelo (1990), Rebelo (1991), Devereux and Love (1994), Stokey and Rebelo (1995), and Milesi-Ferretti and Roubini (1998) examined the effects of tax policies on economic growth in the long run. Specifically, these studies focused on the growth rate effects of factor taxation, consumption taxation, and/or income taxation. Two key factors in determining the growth rate effects of tax policy are found in the literature: a general production function for human capital that uses not only human capital but also physical capital and endogenous labor supply.

It is, however, curious that there has been very little investigation of how government spending affects the economic growth rate in the endogenous growth literature. To our knowledge, Devereux and Love (1995) are the only exception, in their examination of the impact of government purchases through alternative forms of tax financing (lump-sum taxes and income taxes) on an economy's balanced growth rate.[1] One of their major propositions is that a rise in government spending financed by a lump-sum tax has a positive effect on economic growth if there is endogenous leisure–labor discretion, but has a zero effect on growth if there is no leisure–labor discretion.

In contrast to Devereux and Love (1995), this paper introduces the role of the spirit of capitalism to analyze how spending policy affects economic growth. The spirit of capitalism is defined as acquisitive personal objectives. The importance of the spirit of capitalism has long been recognized as the underlying driving force for economic growth (see, for example, Smith, 1776; Weber, 1958; Keynes, 1971). In capitalist societies, individuals accumulate wealth not only for the consumption reward, but also for social status. As stressed by Veblen (1922) and Weber (1958), and further elaborated by Cole et al. (1992), Robson (1992), Zou (1994, 1995), Bakshi and Chen (1996), Corneo and Jeanne (1997), Futagami and Shibata (1998), Corneo and Grüner (2000), and Chang et al. (2000), individuals care about their social status in a market economy. People therefore accumulate wealth in order to advertise their wealth and achieve higher social position and power. This status-seeking motive induces individuals to undertake growth-enhancing economic activities. As a consequence, the spirit of capitalism is a driving force of economic growth. Given that endogenous growth theories concern themselves with the determinants

[1] In fact, Turnovsky (1995, 1996) uses the Barro (1990)–Rebelo (1991)-type 'AK' model of endogenous growth to examine the effect of government consumption expenditure and/or government infrastructure expenditure on the economic growth rate.