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The best thing the state can do for growth is to go away

Europe is suffering a loss of competitive vigour thanks to the welfare state as well as high spending and taxes

high spending and taxes

"Taxes drive a wedge between the market value of an activity and the amount received by the producers of it" Photo: PSL Images / Alamy

By **Roger Bootle**

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I have never received such a large e-bag in response to one of my articles as I did after last week's piece on the moral case for low taxation. And I am delighted to say that it was overwhelmingly favourable. So I have decided to follow it with my take on the economic arguments for low taxation.

Taxes drive a wedge between the market value of an activity and the amount received by the producers of it. When taxes are imposed on the returns from work, the risk is that less labour will be supplied. At the margin, as and when they can, people will choose untaxed leisure over taxed work. Some may even choose a life on benefits.

The tax wedge may also substantially affect the use of leisure time. Doubtless there are some people who actually enjoy DIY or washing the car, but for most surely the choice to “do it yourself” is about cost. They could work a bit more to earn more money and use the money to employ a builder/decorator/car washer but if they do this they will pay tax on their extra income and the workman will pay tax on the money they pay him. By contrast, if they decide to do these jobs themselves no extra tax is due. This represents a gross distortion in the economy. In a world of low tax on incomes, a host of activities which people currently perform themselves outside the money nexus would instead be bought in from outside professionals, thereby freeing up their customers’ time for real leisure or more work.

But the efficiency of the tax system has to be viewed together with the economics of public spending. There are some forms of expenditure which can only reasonably be undertaken at the community level. These are the so-called public goods, of which defence is the most obvious, but they also include law and order and the provision of various sorts of infrastructure.

Since these public goods are essential, some loss of economic efficiency from the imposition of the taxes necessary to fund them becomes acceptable.

But the share of state spending and tax revenues in GDP has gone well beyond this point.

How did our society reach the stage where the state spends more than 40pc of national income? Before the First World War, as a share of GDP government spending was running at less than 15pc. The two world wars brought massive expenditures and huge interest payments to finance the accumulated debt. At one point the share of government spending in GDP topped 60pc.

After the Second World War, as military spending was reduced and debt interest fell as a share of GDP, there was the possibility of government spending falling back sharply. As a share of GDP, it did fall back, but rising expenditure on the welfare state slowed the fall.

Moreover, in common with most of the developed world, the British democratic process led politicians into dishing out all manner of bread and circuses, with the result that government spending rarely dipped below 40pc of GDP, with correspondingly high rates of taxation.

For a good while the consequences of this situation were kept largely out of view. But they are starting to be visible now.

In my recent book, The Trouble with Europe, I showed that over recent decades, the countries of the EU have done relatively poorly compared to lots of other countries in the world. I argued that the EU was partly responsible for this as it has taken a range of daft economic decisions, of which the formation of the euro was the dottiest and the most dangerous.
But not everything that has gone wrong with the European economy is down to the EU.
There seems to be a more general European malaise. What could it be? I think it is the loss of competitive vigour which is connected with excessive generosity of the welfare state and the waste of resources and the blunting of incentives brought about by bloated levels of public expenditure and correspondingly high taxation.
By no means all countries in the world take the “European” attitude to government spending and taxation. In fact, if you look for countries with ratios of government spending to GDP at 40pc and above, they are nearly all in Europe. Interestingly, most of the dynamic economies of Asia have very low ratios of government spending to GDP. Strikingly, Hong Kong’s ratio is just over 20pc while Singapore’s is more like 16pc. As I well know from employing people in Singapore, the top personal tax rate there is 20pc. Could this be the explanation for their economic dynamism?
Now, even if this is a major reason for these countries’ economic success, there are three motives for high spending and taxation which an analysis of their economic costs and consequences would not undermine. Firstly, there is the argument that the tax system should be used to reduce the gap between high and low post-tax incomes. That objective will lead towards high tax rates at the top, and also, if you wish the government to distribute the proceeds, into high ratios of government spending to GDP.
The second argument is that, above and beyond a certain point, the pursuit of higher incomes is a snare and a delusion since what people are seeking is relative rather than absolute prosperity. By definition, this cannot be achieved by everyone. Accordingly, people work too hard. If the tax system can be used to discourage them from working then so much the better for human happiness and well-being.
The third argument is that economic growth is harmful to the environment and the health of the planet. Accordingly, if high taxation and government spending blunt economic growth then they will be doing us all a favour.
I don’t know about you, but I find none of these three arguments persuasive. I would like the UK and its people to be more prosperous and I believe that this would increase well-being as well as GDP. Admittedly, there are several

areas where increased government spending could lead to higher economic growth, not least infrastructure and research and development. But the single most important thing that the state can do to boost economic growth is to go away – that is to say, to radically reduce the size and scope of its spending and correspondingly to reduce tax rates.

No, before you ask, I do not expect to be recommended for a gong by the Lib Dems.

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