

# Effect of state control and high taxes on economic growth



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Theories pertaining to economic development, with particular regard to those suitable for developing countries, have changed significantly during the post Second World War era. These changes have affected the progress of developing economies, which, in this period, have grown with varying degrees of success; marked with notable successes and enormous failures. The formulation of economic policy for a country necessarily needs to deal with numerous issues, including, very importantly, a determination of the extent of state control in the economy. The last few decades have seen sharp differences in elements of economic policy and fluctuations in levels of state control between different countries, as well as in varying degrees of economic performance.

State control in the formulation of economic policy characterised economic thinking from the early forties until the late seventies. Classical economists, influenced by thinkers like Rosenstein Rodan and Leibenstein, thought of economic development as a growth process that entailed the “ systematic reallocation of factors of production from a low productivity, traditional technology, decreasing returns, mostly primary sector to a high productivity, modern, increasing returns, mostly industrial sector.” (Adelman, 1999) They also recognised that economic growth, in the long term, does not come about in a linear fashion and is distinguished by a number of stable equilibriums, one of which, the low income level trap, retards progress in underdeveloped economies. Low income and low growth equilibriums, which originally occurred because of low levels of infrastructural and productive capital, are perpetuated by low levels of economic growth, and compounded further by Malthusian population growth. In such situations, uncoordinated

and unplanned investments do not, in the first instance, allow for achievements of scale, and along with low incomes, savings, and demand, result in trapping economies in low income level snares. (Adelman, 1999)

Classical theorists argued that governmental action, investment in the public sector, and strong state control, were essential to take economies out of the unplanned and uncoordinated, low income, low growth and static equilibriums, to ones that were coordinated, dynamic, and capable of high growth and income. State ownership also had the support of socialist ideology, common planks adopted by the newly independent developing nations, partly on ideological considerations, and partly in reaction to the capitalist doctrines followed by their former colonial masters. Many governments felt strong state control to be the best route to safeguard economic independence and substitute the private sector's deficiencies in skills, management knowledge, disinclination to take risks, and lack of resolve to take up long gestation projects. State owned enterprises were thought suitable for stabilising agricultural prices, providing employment, taking care of workers, controlling customer prices, and generating money that could be used for other public work. (Osterfeld, 1992)

Much of the investment and economic policy followed by countries, mostly in the newly independent countries of Asia and Africa, arose out of this thinking, and resulted in huge investments in state run enterprises, as well as in the domination of the state in the making of economic policy. “ During the 1960s and 1970s, the public sector grew rapidly in developing countries, with state-owned enterprises often accounting for most of the growth. This

was especially true in developing countries that had recently gained independence.” (Miller, 1997)

State ownership did not succeed for various reasons. Even though there was little to dispute in the logic behind its theory, or deny the significant infrastructure created in state run economies, these countries fared miserably in terms of GDP growth, inflation control, agricultural and industrial productivity, literacy improvement, elimination of income disparities, or poverty control. Prone to corruption, influenced by partisan elements, and notoriously inefficient and slow in their interventionist actions, governments came to be thought of to be particularly unsuitable for regulating economic policy or managing commercial companies.

The widespread disillusionment with state control led to a neo classical reaction, characterised by a movement towards privatisation, like the one in the UK, during the Thatcher years. Supporters of neo classical economics stress that governmental control and intervention creates problems, rather than solutions, for underdeveloped countries, and furthermore, that liberalisation of trade is sufficient for inducing and motivating development, providing for economies of scale, and making the economy and industry internationally competitive. The optimal course of action for government is to minimise its role in economic policymaking, and improve the spread of market economies and efficiencies. A number of developing countries, racked with inflation, unemployment, sluggish growth, and burgeoning external debt, had to necessarily switch to neo classical economic policies, in the 1980s, many of them under the compulsion of the World Bank, and similar other international lending institutions. Government leaders also <https://assignbuster.com/effect-of-state-control-and-high-taxes-on-economic-growth/>

embraced privatisation because of their desire to (a) improve efficiency and productivity through private, as well as shared ownership, (b) enable managers to focus on economic and not social objectives, (c) eliminate political influence, (d) promote competition, (e) improve quality of goods and services and (f) reduce prices. Reducing state control, economists felt, would also lead to expansion of capital markets, augmentation of foreign inflows and investments, creation of additional sources of tax revenues, as well as reduction of subsidies and national debt. (Adelman, 1999)

While privatisation in developing economies is into its second decade, progress has been uneven, and in some cases, even abysmal. In fact, countries like China and India, where governments play strong roles, have been able to achieve significantly high growth rates. Their governments decisively shifted emphasis to export promotion, pushed through institutional reforms, invested significantly in infrastructure, and engaged in selective industrial policy. Experts are now realising that uniform one-shoe-fits-all policies never work and economic policies have to take account of a number of variables to be relevant, and furthermore successful. The uneven success of many developing countries, even after embracing privatisation, has also led to a consensus that governments need to be strong, capable, and committed to carry through any sort of reforms, even those that deal with opening and liberalisation of economies. Furthermore, reduced state control appears to work better in economies with high rates of literacy, stable political environments, established legal systems, developed capital markets, and strong banking structures.

Governments need to consider unique country specific attributes, be malleable, and play dynamic and changing roles in education, human capital formation, infrastructure, technology acquisition, setting up of institutions, and in the development of an honest and capable bureaucracy. The scope and ambit of governmental policy can be reduced sharply only after the domestic environment provides adequate savings and skills, entrepreneurs develop in skills, technology and capital formation, and institutions achieve maturity. While education, literacy and formation of human capital have to remain priorities, governments in developing economies need to initially work towards social development, and creation of institutions, as well as infrastructure. (Kiggundu, 2002) Economic policies, institutions, and governmental functions should allow structural change to occur on a continuous basis, and be ready to change with development; the role of government needs to be effective, not minimal.

The tax policy of a country is a major component of its total economic policy, and serves the purpose of a tool to collect revenues for governmental spending and guide the growth path of the national economy, as well as sustain and increase its international competitiveness. While the primary role of taxation is to provide money for financing governmental work it also needs to perform other functions like attracting capital, stimulating growth, enable acquisition of technology, stimulate demand and galvanise the economy.

While there is universal agreement on the necessity of taxes, there are differences on the levels of taxation regarded as optimal, as well as the point beyond which they cease to be economic drivers, and become dead burdens. <https://assignbuster.com/effect-of-state-control-and-high-taxes-on-economic-growth/>

In the traditional neo classical models of economic growth, taxation is thought to affect long term output, but not the rate of growth. (Leach, 2003) This theory, however, is being questioned by recent models, which iterate that taxation can affect incentives for investment in human or physical capital, and thereby, adversely influence the long term economic growth rate.

- Higher taxation takes away the incentive to save (a) by reducing the rate of return on savings, and (b) by reducing the income that generates savings.
- Lower savings in turn lead to lesser consumption, lowered demand for goods and services, and lesser capital investment, both at personal and corporate levels, and thus to under nourishment of the economy.
- While research studies have not been able to relate high rates of personal taxation induce individuals to work less, experience has shown that they motivate people to under declare income, manipulate expenses and indulge in falsehood. The same behavioural response holds good for business corporations and other taxpayers. Economies with very high tax rates like India have witnessed large scale evasion of taxes, hoarding of unaccounted wealth in an unproductive manner, and the emergence of a parallel, illegal, underground economy.
- Transfer of money from the private sector to the public sector through taxation results in making its use more inefficient.
- Streams of assured money to the public sector and the government pave the way for creation of further inefficiencies and misuse of funds.

The reduced rate of growth also leads to a deadweight loss, a term used to explain the loss of output that would have taken place in the absence of tax.

Deadweight costs (losses) go unnoticed, even by those who pay them, because instead of taking from people what they already have, they take from people what they would have had, but will never get. No one sees the extra output that would have been created by economic decisions made in the absence of higher taxes. (Leach, 2003)

The incidence of deadweight loss, even if it is just half a percent of GDP, can work out to a phenomenal amount, especially if compounded over a period of several years. Several empirical studies have also revealed that economies with lower tax rates perform much better than those that have higher shares of tax. Thus, while developing economies undoubtedly need significant funds for infrastructural build-up it would be reasonable to assume that excessively high tax structures have the potential to retard economic growth and cause significant harm to growth of human capital and infrastructure, the very objectives they aim to achieve.

## 2. Public Sector Deficits

Most economists agree that the role of the government, especially in the context of developing countries, is to form human capital and create infrastructure across educational, technological, financial, physical, environmental and social sectors. The obvious reason for this lies in the inability of private enterprise to do so. In addition to infrastructural development, public sector spending serves to create demand, stimulate growth, and help kick start economies. Funding for these expenses is

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primarily through collection of taxes, the shortfall being met either through national or international debt, consumption of foreign exchange reserves or printing of bills. Development that occurs because of funds obtained through deficit financing provides a solution to moving out of economic and low income stagnation. While the role of the public sector and its use of deficit financing is one of the tenets of Keynesian economics, many neo liberal economists argue that the theory is impractical, has many fallacies, and needs to be avoided by developing economies. (Rangachari, 2001)

Neo-liberals argue that excessive deficit financing of the public sector can lead to burgeoning of national or international debt, inflation, or foreign exchange crises, depending upon the method adopted. Increased local borrowing can also disincentivise private sector borrowing by sucking out money available with banks, and causing increases in interest rates.

Furthermore, the money arranged through deficit financing is very likely to be inappropriately spent because of numerous demands upon public sector funds, political considerations, bureaucratic delays, and corrupt delivery systems. Government expenditure is complex, multifaceted and driven by opposing forces. The task of ensuring proper allocation of money, as well as its efficient usage, is often beyond the ability of career bureaucrats, and results in gross budgetary distortions, increasing deficits, persistently high inflation, high external debt, increasing incidence of tax, and retardation of economic growth.

The main arguments advanced by the neo liberals is not against the theory of public spending but its implementation and management, particularly in large and federal systems with multi-tiered distribution mechanisms. While <https://assignbuster.com/effect-of-state-control-and-high-taxes-on-economic-growth/>

there is truth in their assertions, neo-liberals need to recognise that smaller East Asian economies like Singapore, Malaysia and South Korea have, at some point of time, resorted to deficit financing, but have still been able to achieve high growth rates through efficient fiscal discipline. The crux of the objections of the opposers of deficit financing lies not in the raising of money but in its inefficient and improper use. The success of deficit financing lies in the commitment of the concerned governmental agencies, and in ensuring that deficit financing is resorted to only to the extent necessary. Money raised through deficit financing should not be diverted to meet burgeoning administration expenditure, or to channels that do not aid development. It would be unjust to think of economists who object to the use of deficit financing, as dyed in the wool cynics who prefer markets to work as freely as they can, and furthermore, believe that governments should not favour any sector of the economy over the other. Their arguments are, for the most part, dependent upon the experiences of the last fifty years, wherein numerous governments resorted to unbridled state control, excessive taxation, and heavy deficit financing, with severe repercussions upon growth and development.

It needs understanding that most of these countries were coming out of centuries of colonial suppression, had very little of physical and human capital; very often their leaders took decisions without adequate knowledge of the consequences of their decisions or of their ability to control the consequences of such decisions. “ In practice, a state’s capabilities are often as important determinants of its actions as the theoretical rationale.”

(Expenditure Policy, 2007)

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The situation is vastly different now and leaderships of developing countries are both knowledgeable and competent. There is no such thing as a universal doctrine in economics, and governments recognise that the application of one-shoe-fits-all theories, without taking account of individual considerations, has led to grievous and costly errors. The same rationale holds good of deficit financing and the solution is to be circumspect and prudent while using it; a blanket ban could do more harm than good and impede sincere growth efforts. As such, while deficit financing will often be necessary in framing the economic policies of developing nations, decision makers need to be doubly careful about its use and focus on imperatives, namely (a) the formation of human and physical capital, (b) the creation of public and business infrastructure, (c) the build up of banking systems, capital and commodity markets, and economic institutions, (d) the elimination of unnecessary non developmental and administrative expenditure, and (e) the creation of a competent, honest and accountable bureaucracy. Such precautions will go a long way towards eliminating the risks associated with high deficits and enable growing nations to make optimum use of the money made available.

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