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Yes indeedy, tax cuts do grow the economy [1]

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An interesting new paper looks at the effects of tax cuts on the UK economy. The finding won't surprise you and me but it's interesting to wave at others [3]:

> This paper estimates the effects of tax changes on the U.K. economy. Identification is achieved by isolating the ?exogenous? tax policy shocks in the post-war U.K. economy using a narrative strategy as in Romer and Romer (2010). The resulting tax changes are shown to be unforecastable on the basis of past macroeconomic data. I find that a 1 per cent cut in taxes stimulates GDP by 0.6 per cent on impact and by 2.5 per cent over three years. These findings are remarkably similar to the corresponding estimates for the United States.

This is another piece of evidence to illuminate our basic problem over the size of government and the taxation necessary to pay for it.

We know very well that some government spending is just great: both in what it achieves for us and also in the economic growth it produces. I'd certainly argue that a decent court and legal system is worth the money spent on it.

However, we also know very well that all and every taxation has deadweight effects: there's some economic activity that simply doesn't happen as a result of the imposition of the tax. Thus, if we want to maximise GDP we should be spending money only up to the level where the growth produced is greater than the growth not happening as a result of the taxation.

As it happens, of course, maximisation of GDP is not our goal. Maximising the utility of the population is meaning that all those things like leisure which detract from GDP are just fine. Indeed, those things like leisure are very much part of the point of the whole game: we want everyone to be as happy as it is possible to be without bursting from the joy of it all rather than everyone to be as rich in material goods as possible. That happiness to be determined by the lights of the individual concerned of course.

But even if we restrict ourselves to talking only of that small part of political economy which is indeed about GDP growth this paper does provide us with an interesting metric.

There is some part of the government's spending that is, nominally at least, about increasing GDP. The sort of stuff that Vince Cable's department does for example, all those various investment funds, the Green Investment Bank and so on. What this paper gives us is an interesting metric to use in measuring their performance. Say, just imagine, that all of this aid to business costs £15 billion a year. I use this number just to make the maths easy for that's 1% of GDP near enough. We now know that raising this much in tax costs us 0.6% of GDP in the short term and 2.5% in the medium term. We'd therefore very much like not to be raising this amount in tax: unless, that is, the spending of it produces a greater than 2.5% rise in GDP.

OK, hands up everyone who thinks that government "support" for business and development increases GDP by 2.5%?

Quite, time to close it all down and get the growth without bothering to do the taxing and spending, isn't it?

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