

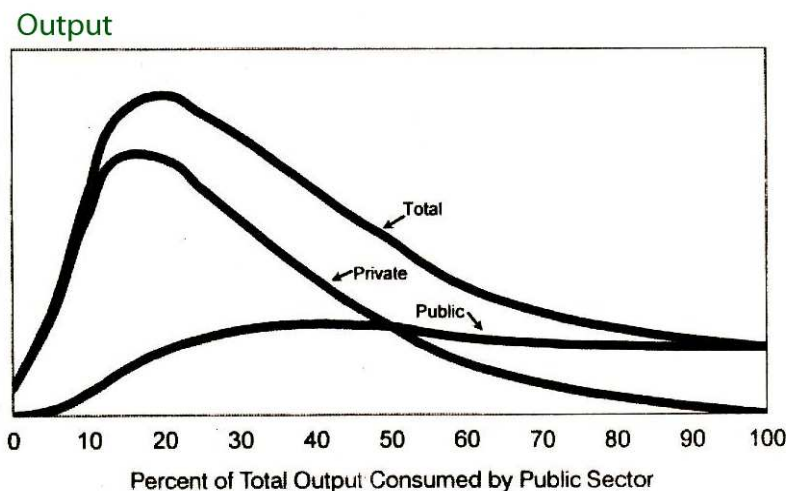
## Principles of Fiscal Finance

### A Macro Perspective

It is useful to set out some broad perspectives about the relationships between government and the economy generally, and specifically the relationship between government spending and tax policies on the one hand and the rate of economic growth on the other.

As a general proposition, and within relevant ranges, an economy functions better with a reasonably-sized government. Without government to secure property rights, enforce contracts, and assure tranquility there is less incentive to produce. At some point, however, government can become so large that it detracts from total output. The reason is that it takes so much out of the private sector that people have less incentive to produce. This relationship is illustrated in Figure A-1: as government grows and takes on core responsibilities the private sector grows as well. But as government goes beyond core responsibilities and commands an even larger portion of total output, private-sector growth attenuates and ultimately falls. The public sector can continue to grow, but past some point total output begins to fall, followed by public-sector output as well.

Figure D - 1

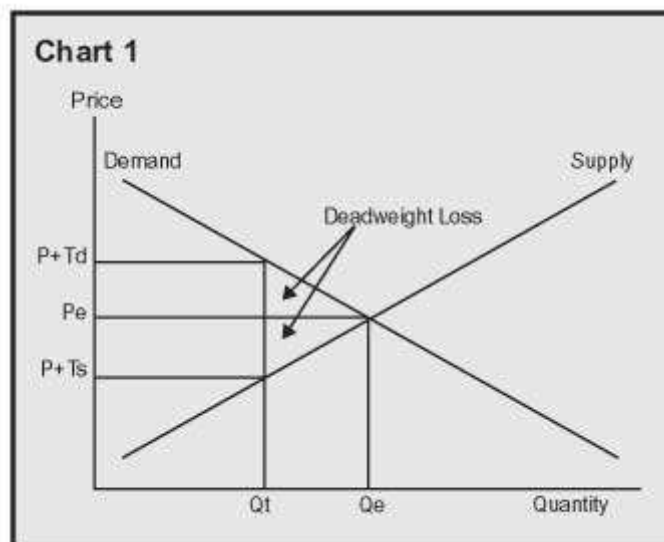


A similar relationship can be shown between the size of government and the rate of economic growth. Government on too small a scale retards growth. Government on too large a scale also retards growth. The policy goal, presumably, is to choose the size of government that maximizes output and/or growth by providing needed services efficiently and is thus neither too large nor too small.

A good deal of academic research has been undertaken to determine the optimal size of government (in the sense of maximizing GDP and/or GDP growth). The results, of course, depend on the specific economy studied, the time frame covered, and the specific quantitative methodology employed. But if maximizing GDP is the objective, the evidence points to limiting the size of government to around 20 percent of the total.<sup>1</sup>

### The Ideal Tax Regime

From an efficiency standpoint, tax policy should be designed to minimize disruptions to economic activity. The underlying theory is that a tax system based on this principle will generate the most economic growth, leading to a large tax base and high living standards. Fulfilling this principle, in practical terms, means the tax system should have the following features:



1. Low tax rates – Taxes are a price imposed by government. The tax can be on activities such as work, saving, or investment. The tax can be on ownership, as in the case of property taxes. And taxes can be levied on goods and services. In all cases, however, taxes increase the price of whatever it is that is subject to the levy. And as the Chart 1 above illustrates, this creates a “deadweight” loss for the economy – as measured by a reduction in whatever activity is being taxed (from  $Q_e$  to  $Q_t$ ). But since producing, owning, and buying are behaviors that contribute to a more prosperous society, it is generally agreed that this deadweight loss should be minimized by keeping tax rates low.

<sup>1</sup> Extensive references can be found at <http://www.heritage.org/Research/Budget/bg1831.cfm> and [http://www.heritage.org/Research/Budget/bg1831\\_suppl.cfm](http://www.heritage.org/Research/Budget/bg1831_suppl.cfm).

2. **Neutrality** – When taxes are unevenly applied, this distorts the price system and encourages people to avoid the behaviors subject to high rates and increase behaviors with preferential tax rates. A simple example is that tariffs on fruit will lead people to purchase less fruit and more of other foodstuffs. That may sound innocuous, but from a macroeconomic perspective, output will suffer if people are lured into making decisions for tax reasons rather than underlying economic considerations. This is especially true with regards to earning income as well as saving and investment, as tax preferences and penalties can influence the choice of how much to save and invest.<sup>2</sup>

Efficiency arguments, taken to their logical extreme, indicate that "head" taxes (sometimes known as poll taxes) are the ideal fiscal regime. From an economic perspective, there is no penalty on productive behavior with such a system. A taxpayer owes a fixed amount to the government for being part of society. The tax is the same, regardless of how much income that person generates or how much that person consumes, so there is no disincentive to earn more income or create more wealth.

While low rates and neutrality are long-standing principles of good taxation, there are other (contradictory) features that arguably can boost efficiency. Depending on the assumptions, policymakers can improve overall economic performance by taxing some activities at high rates. These higher (and often discriminatory) rates are justified because of a desire to:

1. **Tax to correct externalities** – Externalities exist when people do not bear the full cost of certain behaviors. In theory, taxing those behaviors can compensate for such increased costs. The traditional example is pollution, which often is assumed to be higher than the socially optimal amount because air and water are commonly-owned resources. Taxing activities that pollute (with revenues used, in some cases, to mitigate pollution) addresses this problem. Another example is taxes on smoking and drinking, though that example only works if individual healthcare costs can be imposed on taxpayers.
2. **Target inelastic revenue sources** – Some activities are very sensitive to taxes (meaning demand is elastic) and others are not sensitive to tax (demand is said to be "inelastic"). Demand for tobacco is thought to be inelastic, for instance,

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<sup>2</sup> Many tax systems impose "double taxation," which occurs when income is taxed once when it is earned, but then subject to additional layers of taxation if it is saved and invested rather than consumed. Taxes on interest, dividends, and capital gains usually are examples of this practice, as are taxes on wealth and estates. These extra layers of tax discourage saving and investment, thus making consumption artificially attractive. There is nothing wrong with consumption, of course, but every economic theory agrees that saving and investment are necessary for long-run growth and higher living standards.

meaning smokers will not significantly reduce consumption in response to a tax, whereas a tax on capital gains may substantially reduce sales of taxable assets. If the goal is to minimize deadweight loss, this suggests that there should be heavier taxes on inelastic things such as smoking (setting aside externality issues).

A final consideration, which is very relevant to the Caymans, is that governments commonly utilize taxes that are borne by outsiders. Hotel taxes imposed by cities are the classic example, since almost all those taxes are borne by non-voters. Whether this type of tax is “efficient” or “ideal” is a separate matter, particularly if the tax is imposed on an elastic activity.

For the Caymans, non-residents presumably bear a substantial share of the taxes on tourism and financial services. This approach is sensible so long as the taxes on these activities are not so high that consumers choose other jurisdictions.

### The Efficiency-Equity Tradeoff

An oft-cited alternative to the general notion of efficiency is the idea that taxation should be used to redistribute income and/or wealth. This is the ability-to-pay principle and it is the usual argument for both a progressive tax rate structure and for “double taxation” of income that is saved and invested. Proponents of this approach generally argue that the negative economic impact of high tax rates is not that significant. They also argue that double taxation is desirable both because it takes more money from rich people and also because it is good to tax both income and changes in net worth.<sup>3</sup>

The ability-to-pay argument is criticized, though, for focusing on short-run redistribution. If the goal is to improve absolute (as opposed to relative) living standards for the less fortunate, proponents of lower tax rates argue that faster long-run growth is the better approach.

### The Revenue-Estimating Process

Any significant change to the tax system will affect taxpayer behavior. This complicates the revenue-estimating process. It is highly unlikely, for instance, that revenues would double if a tax were raised by 100 percent. Recalling the analysis

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<sup>3</sup> Technically, this is known as the Haig-Simons approach to taxation, which justifies double taxation on the basis that any increase in wealth (such as rising asset values and returns to saving and investment) reflects a greater ability to consume.

above, that would require a tax on something with completely inelastic demand, such as perhaps insulin treatments for diabetics.

If lawmakers were to contemplate raising tax rates or imposing taxes that currently do not exist, they should be fully aware that the “deadweight loss” discussed above is the same thing as a smaller tax base. This does not mean that higher tax rates would not lead to more revenue, but it does mean that higher tax rates generally would not collect as much money as governments hope. Similarly, tax cuts (at least tax cuts resulting from lower tax rates on work, saving, and investment) usually do not result in as much foregone revenue as governments fear. This is sometimes known as “Laffer Curve” analysis.

### Not All Taxes are Created Equal

Finally, not all taxes are created equal. Some levies impose more damage, per dollar raised, than others. If policymakers want to generate revenue while doing the least amount of damage, they should use this list as a guide.

- High deadweight loss – Any tax that imposes a high tax rate on productive activity such as work, saving, investment, and entrepreneurship imposes a high dead-weight loss. Extra layers of tax on capital are particularly harmful since taxpayers always have the option of consuming any disposable income. Also harmful are estate taxes, wealth taxes, and taxes on personal and corporate incomes, especially if they have high tax rates and/or contain extra layers of tax on income that is saved and invested (the Haig-Simons tax base).
- Medium deadweight loss – While design issues are very important, property taxes and payroll taxes fall into a broad middle category. Though these taxes can be punitive, they rarely do as much damage as income taxes. And while they can be intelligently structured, they almost always are less conducive to growth than consumption taxes.
- Low deadweight loss – Taxes on consumption usually have only a modest negative effect on incentives, assuming tax rates are reasonable. This is true for broad-based consumption taxes, as well as energy taxes and (at least for import-dependent economies where tariffs are a de facto consumption tax) customs duties.

- No deadweight loss – Rational user fees generally impose very little economic damage. In some cases, this is because they are voluntary transactions, such as the fee to enter a park. In other cases, user fees are a tax, but a tax closely tied to the use of a government-provided good (such as automobile property taxes or taxes on fuel).

### Types of Spending and the Role of Deficits

In many ways, how government spends money is as important as the level of spending. In the academic literature, public finance experts often draw a distinction among capital spending, transfer spending, and consumption spending. Capital spending can be for physical capital such as sewage systems and human capital such as education, and economists generally agree that this is the type of spending most likely to generate benefits. On the other hand, transfer spending and consumption spending, such as entitlement programs and subsidies, are much less likely to have positive impacts on economic performance.

Another key fiscal issue is the role of deficits. Economists from the Keynesian perspective argue that deficits can be very desirable, based on the theory that government can boost growth by borrowing money from one group of people and distributing the funds to a different group of people. Other economists argue that deficits are very damaging because they supposedly boost interest rates and dampen investment.

Most economists would agree, though, that the key goal should be to avoid persistently large deficits, especially if total debt is climbing as a share of GDP. Another key issue is why money is being borrowed. To some extent, government borrowing is like household borrowing. If a family borrows to start a business, finance a child's education, or buy a house, that may be a very sensible financial decision, especially since an asset has been created that rings the benefits of increased future income. But if money is borrowed to finance a shopping binge on consumables, that will not be a good thing, because once the consumables are gone the debt remains and so does the requirement to spend disposable income to service that debt.

In other words, while it is generally a good idea to avoid debt, borrowing is quite defensible if the money is being used to acquire or build assets that generate long-term benefits. But as we have seen in previous chapters, when it comes to borrowing, a government's credibility and effectiveness depends on its fiscal sustainability. That means, its ability to live within its means and not impoverish current and future generations by borrowing amounts that are beyond the population's ability to repay.