IT MAKES A LOT OF SENSE FOR GERMANY TO PROCEED WITH TAX REFORM

Glasshouse interview with Professor Richard K. Vedder[1]

Wachtberg, June 7, 2010

During the electoral campaign the newly elected German government promised to lower the tax burden and simplify the extremely complex tax code. But, although more and more people in Germany are becoming aware that the policies of high taxation of the past decades have led the country into a dead-end street, the new government obviously has not the heart for a tax reform. Will Germany miss another historic opportunity to change the direction of its ecomomic policies after the government of chancellor Helmut Kohl missed the opportunity already in the 1980s? Can Germany afford to delay a far-reaching tax reform even further into the future?

For Richard K. Vedder the answer is obvious. In this Glasshouse interview – produced in cooperation with the Taxpayers Association of Europe (TAE) – the well-known US economist explains, why Germany should proceed with tax reform and significantly cut taxes now. His recent study 'Taxes and Economic Growth: Implications for German Tax Reform' clearly assesses that the tax burden of Germany exceeds the average tax burden of the United States and also the average tax burden of the OECD countries. History shows ample evidence that high taxes usually are associated with relatively low levels of economic growth, lower effective after-tax incomes, and lower wealth. Thus, Germany has not been able to exploit its potential for economic growth for many years now. In other words: For Germany tax cuts would be beneficial. They would allow higher economic growth and higher tax revenues in the long run.

Glasshouse: Is the German government operating in the prohibitive range of the Laffer curve, where high taxes are associated with lower rates of economic growth?

Richard K. Vedder: Based on the results of my recent tax study for Germany and my experiences with my own nation, the United States, the answer is obviously yes.

Prof. Richard K. Vedder: „A significant reduction of the tax burden is really needed in Germany."

[1] Richard K. Vedder is professor for Economics at Ohio University. He was advisor to among others Ronald Reagan and Wladimir Putin. Professor Vedder is well-known for his publications all over the world (especially for his Book ‚Out Of Work – Unemployment and Government in Twentieth-Century America').

Glasshouse: To what extent should Germany cut taxes?

Richard K. Vedder: I would think if Germany were to cut its tax burden by 25 percent it would be much better off than it is today. The question is: Would it be even better off if it cut taxes by 30 percent or by 40 percent? At that point I am not precisely sure of what the optimum rate of taxation would be in Germany. But a significant reduction of the tax burden is really needed. Lower taxes, higher rates of economic growth. That means more income available for families to buy automobiles, travel, and provide good educational opportunities for their children and grandchildren.

Glasshouse: What kind of taxes should Germany cut?

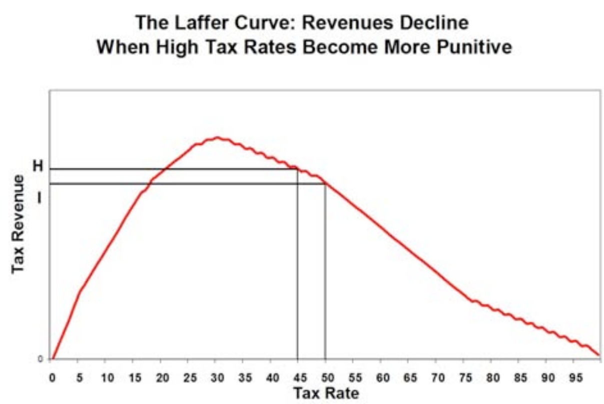
Richard K. Vedder: To me all taxes have harmful effects. They all impose an excess burden on people. High tax rates discourage people to work and invest as much as they would do at lower tax rates. Thus, high taxes are causing a loss of welfare over and above what people transfer to government, so called deadweight losses. Taxes on income are particularely harmful. They usually have a greater negative effect than consumption based taxes like the value-added tax. My sense is that taxes on inheritances also tend to have a pretty negative effect. So, I would recommend the lowering of the personal income tax rates, the lowering of the corporate income tax rates, and the elimition of inheritance taxes.

Glasshouse: So the total tax burden is even higher than the tax revenues collected by government?

Richard K. Vedder: The burden of taxation is not best measured by the revenues collected. Some studies in America, which has a lower tax burden than Germany, suggest that deadweight losses and wasted tax revenues amount to maybe 15 percent to 25 percent of tax revenues. I would be surprised if in Germany the losses are less than that. Whether they are more than that is a possibility given the high rates at the marginal taxation in Germany.

Glasshouse: A few days ago Germany´s new finance minister Wolfgang Schäuble, due to high budget deficits, ruled out a major tax reform before 2013. Does it make sense for fiscal policy to promise tax cuts a few years in advance?

Richard K. Vedder: It makes a lot of sense for Germany to proceed with tax reform. And that tax reform is probably a multiple year tax refom. If you tell people today that their taxes are going down tomorrow and next year and the following year and then again three years from now that probably will lead to a burst in entrepreneurial initiative and thus in economic growth. So I favor tax cuts that are announced in advance and then are phased in over a period of years.



Richard K. Vedder: „The German government is operating in the prohibitive range of the Laffer curve.“
Source: Center for Freedom and Prosperity Foundation / Washington

Glasshouse: Wouldn´t there be the risk that people hold off their entrepreneurial initiative until the tax cuts are effective?

Richard K. Vedder: That is the one danger. That is why at least part of the tax cuts must occur immediately. Let us suppose you want to reduce your income taxes by 30 percent. Take 10 percent immediately, 10 percent next year and 10 percent the following year. That was the idea of the Kemp-Roth bill[2] and what Reagan did in the United States.

Of course you can not promise tax cuts in advance for let me say in 2015. That could produce even more harmful effects. People do not trust politicians very much. That is the same in Germany as it is in my country and all over the world. I think people want some proof that tax cuts are real.

Germany should proceed with tax reform. There are no budget problems. If you are operating in the prohibitive range in the laffer curve the fiscal effects of tax cuts are likely to be positive.

Richard K. Vedder: „In general, on average, and most of the time, increases in taxation bring harm to an economy, while reductions in taxes improve the economy and the people within it.“

Glasshouse: But Schäuble makes the point that Germany has to stick to the EU Stability Pact and therefore first has to balance its budget before it can cut taxes.

Richard K. Vedder: The notion, first we must balance the budget and then we can talk about tax refom and tax reduction has not worked very well in the past. Just the opposite is true. If you reduce taxes it tends to put pressure on the politicians to reduce expenditure as well. The big problem is that governments want to spend too much money. It also makes a good deal of difference how the government uses taxpayer money. Expenditures on, for example, infrastructure investments may have more positive effects than spending which reduces incentives to work or save, such as payments for long-term unemployed workers.

Glasshouse: A few months ago Germany amended the 'Grundgesetz' (German constitution) by a paragraph allowing budget deficits of more than 0.35 as a percentage of GDP only in exceptional cases. Do you think this is really a victory for the taxpayers?

Richard K. Vedder: A group of taxpayers organizations in the United States have favored a so called Balanced Budget Amendment. In principle it is probably a good thing. But people put too much faith in it as a way to seriously reduce the size of government. The problem for taxpayers is that government is simply too big. I favor lower taxes in part because I think it is

[2] The Kemp-Roth tax bill of March 15, 1978, proposed to slash personal income tax rates across-the-board by 30 percent over three years. It was endorsed by Ronald Reagan in his 1980 campaign and pretty much enacted as the 1981 Reagan tax cut. The Kemp-Roth argument was that lower tax rates would increase the after-tax return for both labor and capital and thus would stimulate the economy by boosting incentives.

a way to force governments to reduce expenditure.

Normally I am reluctant to have fiscal policy put into constitutions. Although I have on occasion supported balanced budget amendments in the United States where I thought such a move would be a way to make government smaller.

Glasshouse: Wouldn´t balanced budget amendments be an excuse for politicians to adhere to a high tax policy?

Richard K. Vedder: Exactly. That is why I am basically sceptical of those proposals. In America the argument is often used: We must have a balanced budget first. Then we can talk about tax cuts. That is not a good strategy. This is making a balanced budget and thus high taxes almost constitutionally required as long as government does not cut expenditure.

Glasshouse: History shows ample evidence that major tax cuts normally lead to stronger economic growth and thus have a self-financing effect. How strong is this effect in general?

Richard K. Vedder: When countries with very low taxes like Hongkong reduce taxes, I am not sure if this would have very much impact. But if Germany were to reduce taxes I think, because the marginal tax rates are very high, this would significantly affect the economic behaviour of people. And those effects would be rather strong. But they are not instantaneous. It takes from the time a tax cut is announced, two or three years, before the effects of tax cuts are fully in effect. But those effects are strong when tax rates are as high as they are in Germany.

Glasshouse: How strong were those self-financing effects after the Reagan tax cuts?

Richard K. Vedder: The Reagan tax cuts led to extraordinary positive effects on economic growth. Again, it did not happen over night. Finally the Reagan tax cuts took place over a four year period. By the end of that period tax revenues were well above what they were at the beginning of this period. The first year that the Reagan tax cuts went in, the unemployment rate for that year averaged almost 10 percent in the United States. Three years later it was under 7 percent. With that of course came high economic growth around 7 percent of GDP and Reagan raised tremendous amounts of tax revenues. Of course a healthier economy produces more tax revenues than a sick one. So the long-term effect was a largely self-financing Laffer-curve effect.

In the first year after you announce a tax cut it may be that your tax revenues will actually slightly decline. But if you look at them two or three years later, and look on the long-term economic growth effects, you will see a huge impact. So tax cuts would imply deficits, but perhaps not larger than would result from lower economic growth that you would have without tax cuts. Particularly in Europe, where tax rates are high, where you have taxes at the 'Länder'-level as well as on the national level adding up to large tax burdens you would have a very strong self-financing effect. The fiscal concerns in terms of debt are exaggerated.

Glasshouse: The true supply-siders around Reagan never promised tax cuts would have a totally self-financing effect. They always argued it would be necessary to cut government spending to avoid budget deficits. Finally Reagan got tax cuts but Congress did not cut government spending. Reagan used to say there were 535 reasons for this – the number of senators and representatives in US Congress. What could Germany learn from Reagan´s experiences?

Richard K. Vedder: What Germany has to think about is: Is it possible, given the current political state, the way Germany is politically organized, to have meaningful expenditure reduction? I would argue that there is a train wreck coming from a growing aging population in Germany that is going to absolutely force significant changes in finance. Some of the subsidies that are now provided to people probably will have to be reduced. Maybe you need a national effort to overcome special interest groups and to appeal to the broader public. You need to have a big vision. If it is big enough and broad enough and bold enough you can succeed. This is a political question.

We had a 28 percent rate flat tax briefly in the United States in 1986. Everybody before said that is impossible, because the special interest groups would not let it happen. Well, when you would try to take on one tax privilege or one expenditure, the lobbyists, the special interest groups, will always try to prevent those changes from happening. But if you present it as an entire package you will have a better chance. That is one of the political lessons of the 80s.

Glasshouse: We do not have such a general view here in Germany.

Richard K. Vedder: And we generally do not in America. It takes a special type of politician enormously respected by the public. A person with an enormously great ability to communicate and an enormous willingness to run political risk. It takes people with unusually strong characteristics. Unfortunately they are in short supply. Not only in Germany, but worldwide these days.

Richard K. Vedder: „International tax competition is the best thing that could have happened for the EU and for Germany.“

Glasshouse: Obviously there is another reason why our government does not have the heart for a major tax reform: Many people in Germany believe we need high taxes and redistribution of wealth to reduce income inequality. According to the recently published OECD report 'Income Distribution and Poverty in OECD countries' the rate of increase in US income inequality declined after the Reagan tax cuts. How did this effect work?

Richard K. Vedder: This question strikes at the heart of something that many people do not understand. Tax reductions impact human behaviour at all levels of income. Of course wealthy people, wealthy investors are impacted by tax reductions. But also lower income people can be impacted by tax reductions. You can improve incentives to work more, to buy homes more, to build a whole variety of activities that lower income people normally would not do. Many people said Reagan was for the rich people. But especially the poor people, the middle-class people in America had rises in their consumption in the 80s and even in the 90s. There was an equation far greater than it would have been the case had taxes remained at levels as hihg as they were before 1981 when Reagan took office.

Income inequality has to be looked at in the long run, not in the short run. Do not look at a person´s income of one year. We need to look at the lifetime distribution of incomes. If you have an economic opportunity society, a society that promotes economic growth, people in the long run get more jobs, they will go to school more, they want to be better educated, because they can keep more of their income and because more new jobs are being created. There are greater opportunities. Fewer people will consider moving to other countries or investing in other countries. So, in the long run the lower income people are the biggest beneficiaries of low taxes and economic growth. They are the ones at the bottom. They are the ones who are unemployed. They are the ones who get the new jobs that are created. It is not the rich who get the new jobs. They have jobs already.

Glasshouse: Are supply-side tax cuts generally a recipe for less income inequality?

Richard K. Vedder: In the long run they are. Not necessarily in the short run. Politicians always look a year or two heading into the next elections. But most of us human beings like to think about where we are going to be in five or ten or even twenty years from now. And we also like to think of our children and grandchildren as well.

Glasshouse: Would you recommend Germany to adopt a tax regime that builds on a flat tax?

Richard K. Vedder: Flat taxes work beautifully. It does not take a scientist to observe whether it is going on in Eastern Europe these days. Starting with Estonia in 1994 and even in Russia in 2000, much of Eastern Europe has embraced flat tax fever. The fact that economic growth rates have averaged two to three times as much in most Eastern European countries as in the EU has demonstrated the possibilities for economic growth if nations adopt relatively low taxes. Some of that would have happened anyway because of the lower labour costs. And there might have been some migration of businesses from the west to the east and so on. But economic growth has been accelerated dramatically by the flat tax revolution. No question, a flat tax would be to the benefit of economic growth in Germany as well. And you can deal with the income distribution issues in a flat tax system as well.

Glasshouse: Almost nobody in Germany is in favor of a flat tax.

Richard K. Vedder: That is too bad. But the expansion of the EU has led to a net migration of businesses to the East. Thus, it is becoming too costly to have high marginal tax rates. International tax competition is the best thing that could have happened for the EU and for Germany. The number one beneficial fiscal policy development in modern EU history has been the tax competition largely based around the flat tax systems.

Glasshouse: How far can tax competition finally go?

Richard K. Vedder: In principal until there are no more taxes. But I do not think a world without some minimum forms of government is a realistic possibility. So there are always going to be some taxes. But Europe is way, way, way beyond that in terms of high taxation. You could get to a situation in Europe where perhaps you will eliminate income taxes or everyone imitate Russia´s or Slovakia´s flat tax income tax systems. That would be quite a revolutionary change. There is still a lot of room for that. Long live Slovakia! Long live Estonia! And long live all the countries that break from the Franco-German mode of high taxation and the big welfare state.

Our children and grandchildren will be better off, live more interesting and prosperous lives, if we succeed in moderating the tax burden that they will face. Thus our mission is not only an economic one, but a moral one. After all, our children and our unborn grandchildren and great-grandchildren are helpless to do anything about the tax climate in which they live or will live. The first duty of each generation of adults is to protect the next generation. Whenever we expand the welfare state, we usually are doing the opposite, because we must finance that expansion, typically through taxation.

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Glasshouse: Some scientists say income taxes are a precondition for governments leaving the economy in the hands of the private sector and thus are the price for economic freedom. Would you agree?

Richard K. Vedder: No. From my point of view the opposite is true. America in the Nineteenth Century became the strongest country in the world and developed a fair society, a just society, a prosperous society without any income tax whatsoever. Income taxes are an invention of the twentieth century. Economists have generally concluded that income taxes as taxes on productive activity have more negative effects than comsumption based taxes.

Glasshouse: Could you imagine the United States would someday abolish income taxes?

Richard K. Vedder: People would like to. There is a possibility that we could move to what we call a National Sales Tax that would be closer to a value-added tax system. It might not be feasable in the short run. But it might in the long run. Whenever people say it can not happen I always remind them that no one thought it possible that the Soviet Union could disappear in 1990. And it did. So I think it is possible the United States could abolish income taxes. But it would not happen overnight.

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