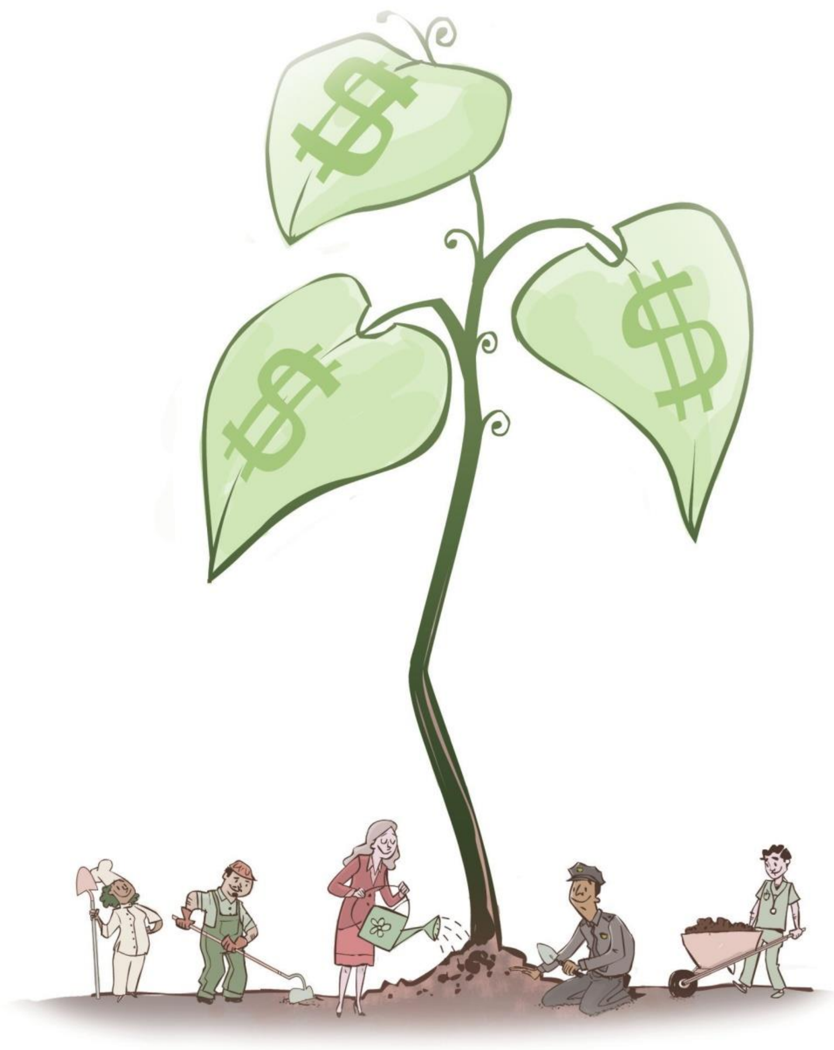
The Economy Hits Home: Economic Growth

What makes the economy grow?



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What Makes the Economy Grow?

Everyone should want the economy to grow. A growing economy puts more money in families' pocketbooks and charities' budgets, the poor and unemployed have an easier time finding jobs, and families saving for retirement or their children's education can see their nest eggs grow.

So what makes the economy grow? You don't need a degree in economics to answer this, you just need to think carefully. Common sense can help expose this popular but mistaken myth.

Tax cuts simply pad the pockets of the rich without helping a weak economy.

FACT: Smart tax cuts encourage work, savings, and investment to help stimulate economic growth that benefits people across the board.

Some argue that cutting taxes and tax rates doesn't help a weak economy and might even make it worse by increasing deficits. This ignores the way in which people at all income levels benefit when the overall economy grows—which happens when taxes are cut and people have more money in their pockets. As we have seen, government spending does not increase income; it merely diverts income from some people to others.

The United States has what is called a progressive income tax. This means that, as a family's income rises, so does the rate at which their income is taxed. The last dollar earned is taxed more heavily than the first dollar. This is different than a proportional tax in which taxes would increase proportionally with incomes (see sidebar for further explanation). A progressive system does far more damage to incentives that generate economic growth such as working, saving, and investing.

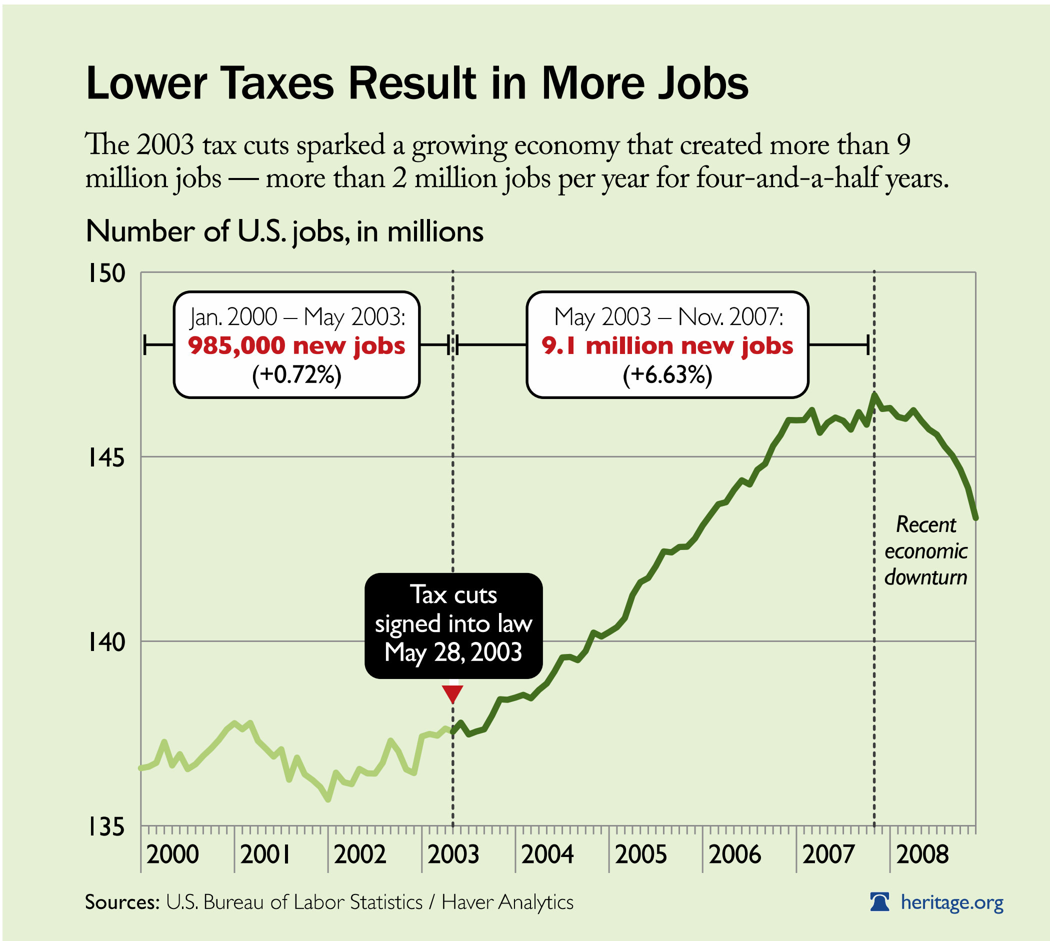
Progressive taxation is problematic because it decreases the incentive for people to be productive and generate wealth for themselves and the economy. For example, suppose a parent pays a child an hourly wage for helping around the house, but the wage decreases after each hour. The child's motivation will wither along with his hourly wages. A progressive tax creates the same problem in the adult world.

Proportional Taxation vs. Progressive Taxation

It seems fair that those who earn more should pay more in taxes. The best way to achieve that is with a proportional tax, such as the proposed flat tax. With a flat tax, for example, someone earning $40,000 might pay $4,000 in tax and someone earning $80,000 would pay $8,000 in tax. Each faces a 10 percent tax rate.

In contrast, a progressive tax system, such as the system we have in the United States, imposes higher and higher tax rates on people that have higher incomes. So the individual earning $80,000 might pay $16,000 in tax—a 20 percent tax rate—while those earning less pay taxes at a lower rate.

For the economy to grow, businesses must either produce increasing amounts of goods and services or create new ones. This in turn requires consistently higher investment in new production facilities and technologies and a motivated, productive workforce— therefore businesses and individuals must have financial resources to invest. Yet imposing higher tax rates on the last dollars earned shrinks the amount of money a worker keeps as he creates more value. These taxes discourage all of the wealth-creating activities mentioned above, since the last dollars earned are the ones most likely to be saved and invested rather than consumed.



Think of it this way: You spend your first dollars on necessities like food and rent, which everyone needs; but the more you earn, the more of your additional income you can save and invest—but also the more tax you pay. That's why lower tax rates on those dollars encourage working and saving, which, in turn, grow the economy.

History confirms common sense. High tax rates were reduced during the 1920s, 1960s, and 1980s. In all three decades, lower tax rates contributed to increased investment, and robust economic growth followed: The economy grew by 59 percent from 1921 to 1929, 42 percent from 1961 to 1968, and 34 percent from 1982 to 1989.[1]

But lawmakers often reject tax cuts and spending restraint that foster long-term economic growth. Instead they propose stimulus gimmicks to "put money in people's pockets" and "get people to spend money." They are counting on taxpayers to notice the check in the mail while markets ignore the borrowing that financed the check.

Take past tax "rebates" as an example. Washington borrowed billions from investors and then mailed that money to families. In 2001, typical families received $600; in 2008, it was $1,200. This simple transfer of borrowed money had a predictable effect: The consumer spending rate went up, while investment spending went down. No *new* income was created because the so-called rebates did not increase productive behavior: No one had to work, save, or invest more in order to receive a rebate. Does anyone really believe that we can improve our economy by borrowing and consuming more and saving and investing less?

In contrast, the 2003 tax cuts reduced unemployment and helped grow the economy since they encouraged long-term productive behavior.[2] But this success was not well reported. By contrast, there has been much more commotion over fake stimulus schemes that only put money in consumers' pockets for the short run.

Reporters and lawmakers should ask which policies will best encourage the work, savings, and investment needed to expand the economy's capacity for growth. Such growth benefits not just the rich, but also those looking for jobs, saving for their kids' educations, or simply hoping to increase their earnings from hard work.

Opportunity for All

"As they say on my own Cape Cod," President John F. Kennedy was fond of noting, "a rising tide lifts all the boats." President Kennedy meant that overall economic growth benefits everyone. That's why one of his major acts as President was to slash the top income tax rate from 91 percent to 70 percent, helping to trigger the increased prosperity of the 1960s.

Government policies can have a huge effect on the U.S. economy— and on the family bank account. Policies that try to transfer income from one group to another are based on myths, not reality. They do far more harm than good. In contrast, if public officials will pay attention to the lessons of history and common sense, avoid short-term "stimulus" gimmicks, and instead enact reality- based economic reforms, they can put the country back on the road to sustained prosperity.

1. Daniel J. Mitchell, "Lowering Marginal Tax Rates: The Key to Pro-Growth Tax Relief," Heritage Foundation Backgrounder No. 1443, May 22, 2001, at http://www.heritage.org/research/taxes/BG1443.cfm.

2. James Sherk, "Remember the Bush Tax Cuts This Labor Day," Heritage Foundation Web Memo No. 1204, September 1, 2006, at http://www.heritage.org/Research/Economy/wm1204.cfm