Contraditório think-tank

Briefing

Supply-side economics in Portugal | Luís Faria

First, let’s go back to the textbooks: If Portugal wants to raise the long-term rate of growth, it has to increase saving and investment, promoting education as a priority as well as scientific research and technological advancement. Right, but that takes a lot of time. Do we still have the time to wait for all that to happen? No, but if we don’t start immediately it will never work, so we don’t really have an alternative rather than do it! We cannot wait another decade for growth. Let’s face it: Nobody said it would be easy.

Now, let’s discuss real proposals. But first let me tell you that was a pleasure to see that some of Contraditório’s papers proposals are now included in the elected government program and were also mentioned in several political parties programs (all over the political spectrum) in the last legislative elections. Yes, it might have been just a lucky coincidence, but if it happened once let’s keep trying.

Proposal: Portugal should implement reforms in order to be the friendliest place in the world to do business.

Now that some crucial structural reforms are finally been decisively taken in Portugal let’s not forget what can make Portugal a sustainable country in the future. Not even the most orthodox Keynesian policy would recommend a tax increase during a recession and with a jobless rate above 12%. Tax increases won't help growth or revenues. The government should stick to insisting on spending cuts, lowering tax rates, code simplification, broadening the tax base and reducing the deficit while absorbing the impacts of the deficit of a pro-growth policy. The revenues will increase when the economy shakes off its lethargy. It is true that a country cannot trade future growth for short-term insolvency, but Portuguese economy is anemic and will not grow in the short run. The pillars of insolvency were mainly built in the last 15 years and we cannot escape from it now. At this moment the short-term is only meaningful to prepare the future. Thus, there is nothing left rather than implementing the necessary measures to promote growth within 3-5 years while simultaneously balancing spending expenditures and sending a message to the market. We should know by now that austerity measures themselves won't promote future growth.

How can we lower taxes while reducing the deficit at the same time? Let's introduce some dynamics here.

According to Mankiw & Weinzierl (2006)[1] the dynamic response of the economy to tax changes is substantial. They find that tax cuts in the US economy are at least partly self-financing. They found that, in the long run, about 17% of a cut in labor taxes is recouped through higher economic growth. The comparable figure for a cut in capital taxes is about 50%.

Also the US Treasury concluded that permanent tax cuts leads to a long-run increase in the capital stock and a long-run increase in GDP. But not all tax reductions have the same impact on growth. The US Treasury reported profound impacts from reduction in dividends and capital-gains taxes. These tax cuts produce more than half of the long-run growth. However, tax reductions that only lead to a short-run boost to aggregate demand demonstrate that not all tax cuts promote long-run growth. This is also known as supply-side economics.

Thus, do tax cuts pay for themselves? No and as Portuguese people now painfully understand, at the end of the day government has to pay its bills, which means that a tax cut should be offset by other adjustments. The US Treasury's conclusions show that if adjustments are made by increasing income taxes instead of reducing public expenditure this may lead to a decrease in GDP instead of an increase. Conclusion: some tax cuts are particularly good for growth but only if they are financed by spending restraint. The exception is that cutting taxes on dividends and capital gains promote growth, even if they require higher income taxes.

[1] http://www.sciencedirect.com/science/article/pii/S0047272705001738

Improving the efficiency of the central, local and regional administration as well as public entities is fundamental, as suggested in the Memorandum of Understanding, but will not put Portugal's growth on track by itself. In difficult times when everybody is demanding creative solutions we can find some interesting conclusions in the US Treasury Department report[2]:

1 - Lower tax rates lead to a more prosperous economy; however

2 - Not all taxes are created equal for purposes of promoting growth; and

3 - How tax relief is financed is crucial for its economic impact

"As evidenced by key economic indicators such as increased capital investment and GDP, and strong job growth, the […] tax relief played an important role in strengthening the U.S. economy as it was coming out of the recent recession, and in the longer-term by increasing the after-tax rewards to work and saving. Lower tax rates enable workers to keep more of their earnings, which increases work effort and labor force participation. The lower tax rates also enable innovative and risk-taking entrepreneurs to keep more of what they earn, which further encourages their entrepreneurial activity. The lower tax rates on dividends and capital gains lower the cost of equity capital and reduce the tax biases against dividend payment, equity finance, and investment in the corporate sector. All of these policies increase incentives to work, save, and invest by reducing the distorting effects of taxes. Capital investment and labor productivity will thus be higher, which means higher output and living standards in the long run."[3]

Portugal should use tax policy to enhance competition as a basis to promote the country as a place to do business. This takes political will to go further on spending reduction and toughness to resist the expected bullying from Brussels.

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[2] http://www.treasury.gov/press-center/press-releases/Documents/treasurydynamicanalysisreporjjuly252006.pdf

[3] p. i., A Dynamic Analysis of Permanent Extension of the President's Tax Relief, Office of Tax Analysis U.S. Department of the Treasury, 25 July 2006, http://www.treasury.gov/press-center/press-releases/Documents/treasurydynamicanalysisreporjjuly252006.pdf