MACROECONOMICS AT WORK EXERCISE

TAX AND ECONOMIC BEHAVIOUR: MACROECONOMIC EFFECTS OF MICROECONOMIC REFORM

REFERENCE: **'How Tax Reform Drives Growth and Investment'** (by Robert J. Barro), *BusinessWeek,* 24 January 2005, p.12.

CHAPTERS RELEVANT TO THIS EXERCISE: 6, 15

CONTEXT

There are several forms of taxation (or 'tax bases') that governments can use to raise the revenue they consider necessary to carry out the functions of government. Among these, *income* tax (i.e. tax levied on wage/salary income) and *consumptio*n tax (i.e. tax levied on expenditure on goods and services – in Australia the GST) affect virtually everyone. In recent years, in the US (and in Australia) there has been considerable debate both about the *principles on which income tax should be levied*) as well as *the relative weight* that should be placed on taxing income as distinct from consumption. (The former has related particularly to the progressivity of the tax – the extent to which higher levels of income should be taxed at a higher rate – and the 'threshold' levels at which higher rates should start to apply.) Two *other* forms of taxation (less widely discussed because they affect fewer people) are *capital gains tax* and the *taxation of dividends* (the latter resulting from the ownership of shares in profit-making companies).

An important consideration in debates about both the principles on which these taxes should be based and their relative merits is the implications that they have for the incentive of both individuals and businesses to engage in economic activity and to earn income – and hence for *macro*economic variables such as consumption and saving, investment, GDP in total and economic growth. (This is an example of a case where *micro*economic and *macro*economic issues are intertwined.)

This article focuses particularly on taxes on *dividends* (which under the Bush administration in the US have been lowered) and their effects on incentives and hence on the macroeconomy.

QUESTIONS

1. Is there evidence that taxation on dividends influences the decisions of companies to *pay* dividends?

2. What are the likely macroeconomic consequences of an increased propensity to pay dividends?

3. Why did the study being reviewed look specifically at companies which had institutional investors as the major shareholders?

4. In what sense can it be said (as is highlighted in the article) that ‘the dividend tax cut worked well’?

5. What is implied in the concluding statement in the article (‘The Bush Administration should seize the moment and deliver a tax system that promotes growth’). Do you agree?