

Commentary: Investment Policies to Promote Growth

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With his comprehensive and well-founded paper, Alan Auerbach has made it difficult for me to add anything of a comparable level. The radical demand that if you don't know what you are talking about you should keep your peace was made by Ludwig Wittgenstein. If we were to follow this maxim, human communication and scientific progress would largely come to a standstill. For this reason, I have generously interpreted Wittgenstein's call for silence as a call for moderation and would like to make only a few selective comments.

For this purpose, let me sum up the central points made by the previous speaker:

There is certain empirical evidence that countries with higher investment ratios also generate higher growth rates. But at the same time, there are well-performing countries (such as Hong Kong and Singapore) with widely differing investment shares in GNP (Singapore much higher, that is, less efficient investment). Even if these results demonstrate shaky correlation more than stark causality, there still is reason to ask about the possibilities of stimulating capital spending and growth.

An initial analysis has a sobering effect. The precise correlation between capital spending and technical progress is unknown. There are no operational criteria for particularly **growth-intensive** types of investment (public or private investment, expenditure on machinery and equipment, or expenditure on building

and inventories). And, finally, the widely used concept of the user cost of capital has a number of limitations in predicting the impact of tax policy on investment.

Nevertheless, Mr. Auerbach believes that some general statements can be made on the adequate design of a **growth-promoting** tax policy. For one thing, it should, in his view, consist of investment incentives rather than of saving incentives. In order to lose less tax revenues, he prefers selective and marginal investment incentives to general investment incentives.

My remarks will primarily concentrate on the associated policy options and the aspects which Alan Auerbach deliberately did not mention.

Growth as an objective of economic policy

Economic growth is the result of an economic process based on millions of single decisions. The question is whether such a heterogenous and highly abstract aggregate can be taken as an appropriate goal of economic policy and whether it is possible, and sensible, to steer growth. Let there be no doubt: growth is highly desirable. We need growth to alleviate distribution conflicts in our affluent societies, to finance environmental protection as well as the required transfer of resources to the East and the South and, above all, to satisfy the understandable wish for a continuing increase in living standards. But what you want isn't always what you get. Achieving a pre-determined growth rate is beyond the scope of economic policy based on a free-market economy. The government can improve the conditions for economic growth. It can create the regulative framework but cannot fix the time preference for individuals and "organize" private creativity. In the words of the German Minister of Economics Karl Schiller, it can "lead the horse to water but cannot make him drink;" the government has no influence on whether "the horse drinks or not." The government can also—via public expenditure—bring about an economic flash in the pan through a quick fix, so to speak. The results are well known. They are counter-productive for both stabilization (forecasting problems; asymmetry in the behavior of economic policymakers because of elections) and growth. It would be preferable

if the government—under the pressure of public opinion—did not have to make more promises than it can keep, that is, if it were responsible only for its *contribution* to growth (public goods, stable and useful regulatory framework) and not for growth in general.

Selective investment incentives—a wrong way

At first sight, the promotion of capital spending, not indiscriminately but by concentrating on particularly growth-promising investment, sounds convincing. At a closer look, however, the pitfalls of this concept become obvious. In fact, we do not know and cannot know what kind of capital spending—under consideration of all direct and indirect growth effects—is particularly fostering growth. It would ask too much of any bureaucracy and group of experts to select "good investments. It is still the market—that unparalleled mechanism for collecting and assessing decentral information—which is in the best position to detect growth-intensive and promising investments. But for this purpose—apart from the establishment of a competitive system—no state support, but rather government restraint is required in order not to distort market signals through subsidies and taxes.

An important exception, which is also mentioned several times by Alan Auerbach, is investments with high externalities, that is, investments that can be expected to generate high social returns which can only insufficiently be internalized by private investors. The education system or basic research are examples of this. Here, government promotion is undisputed because goods in these sectors are public goods or at least merit goods. Apart from such more or less typical tasks of government, the externalities concept is unlikely to be of much help in growth policy. The imagination of those interested in government financial aid with regard to inventing positive externalities is probably more than a match for the perseverance and expertise of policymakers (spillover effects being seen as a means of securing special concessions).

Dangerous overcharging of the tax system

The main purpose of the tax system is to raise state revenue. It ought to be simple and fair and interfere as little as possible with the work

incentives. As if this task were not difficult enough, tax law has always been perceived as an appropriate vehicle for all kinds of interventionist measures. All sectors—be it family, social, environmental, energy, competition, or structural policy—try to anchor incentives for their specific targets in tax law. The consequences are well known: the many, partly conflicting, objectives and measures render the tax system non-transparent, complicated, unfair, and make it impossible to calculate its full effect on both distribution and allocation. Hence, the alternatives are either a spiraling intervention or a radical clean-up. The U.S. tax reform concept—flat rates on a comprehensive tax base—has therefore been closely observed and copied many times in Europe.

Therefore, you will be hardly surprised that I do not show much sympathy for a growth policy using selective investment incentives. My objections are partly theoretical (it is impossible to solve the selection problem as this would require the state to have higher knowledge than all market participants taken together) and partly political (if tax law is seen as an instrument for all kinds of ends this arouses desires among lobbies of all kinds). They refer, however, only to the idea of encouraging selected investments through tax incentives. They do not appertain to the proposition of my colleague, Alan Auerbach, to increase the neutrality and allocation efficiency of the tax system by reducing distortions. Neither are they directed against the desirable concept of a tax system that is generally investment-friendly. I would doubt though, whether one ought to go as far as to cling to tax policy mistakes simply because they encourage saving: you can fool some of the people some of the time, but not all the people all of the time. On the other hand, I would favor it if, under a tax regime like a general spending tax, growth were to settle at a sustainable higher level—as is likely. The process of saving, investing, and taking risks (that is, eventually growth and employment) can then be fostered without interfering with individual investment decisions in a rewarding or discriminating way. This would also vote against discrimination of investment abroad and against discrimination of foreign investors (at home), which is, in the end, rarely more efficient; in most cases, the opposite is true.

Example: Europe

To conclude, I should like to quote two examples from my immediate environment which show that generally good framework conditions for competition and open markets are more important for growth than specially designated growth programs.

Europe did not have a good start to the 1980s; key words like Eurosclerosis and Europessimism dominated the picture. This has changed radically with the conception of the single market program. Annual fixed capital formation in European Community (EC) countries increased by 50 percent in the second half of the 1980s, not least due to Europe '92. This dynamic is not due to the efficiency of special incentives but purely to vested interests on the part of companies. For the single market program stands for deregulation, intensification of competition as well as the redefinition and redistribution of markets. The modified environment with its greater opportunities and greater risks forces businesses to put capital into adjustment — not one-time changeover investments but investments to secure longer-term positioning in the new single market. It can therefore be assumed that the realization of a North American free trade zone will trigger a significantly higher growth impetus than any tax program.

The other — negative-example refers to experience with German unification. After it turned out that the state of East Germany's economy and environment was much more deplorable than even pessimists had predicted, the task to start a self-sustaining growth process is of crucial importance. In its most recent monthly report, the Bundesbank quotes more than 40 support measures offered by the federal government alone in order to boost investment activities in the new federal states. In addition, there will be further aid schemes on both state and EC level. The entire range of support measures is offered — from investment subsidies, tax relief, and interest rebates to special guarantee programs.

So far the enormous input of funds did not have the desired success. The reasons for this are, on the one hand, the reserved attitude that is usual in a phase of economic uncertainty and, on the other, the absence of major complementary investments in the public sector. Although

work has started on the development of public infrastructure, the organization of a functioning public administration, and the creation of legal security (especially in ownership matters), they will take their time. East Germany is therefore a typical example for exorbitant yields (including spillovers) on public investments, and a horrifying example of the low efficiency of strong tax incentives or spending programs. We can only hope that a lesson will be learned from this experience for the much larger "testing ground" of Eastern Europe. Legal, institutional, and financial infrastructure has to come before physical infrastructure. Only then can private investments get off the ground.

Alan Auerbach's analysis thus needs to be extended in time and geographically. The special case of the postwar United States is interesting but not too helpful for the particularly "urgent cases."