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State of the Art Thinking on Taxes, Government Spending and Economic Growth and Development

by

Robert G. Lynch
Department of Economics, Washington College

Creating jobs and growing the economy are top priorities for state and local officials. Their tools of choice to achieve these goals may be the least effective among those available to them. Too often public officeholders first embrace lowering taxes and creating tax incentives as their chief economic development tools, with public investment usually ranking as a distant third option. An analysis of the relevant research literature, however, finds little grounds to support tax cuts and incentives—especially when they occur at the expense of public investment—as the best means to expand employment and spur growth.

It is commonly thought that firms will migrate to a particular state for the purpose of reducing costs, since lower costs may result in higher profits for business owners. But state and local taxes are not typically a significant cost of doing business. All state and local taxes combined make up but a small share of business costs and reduce profits only to a limited extent. Indeed, the costs of taxes pale in comparison to many other location-specific costs, and numerous location factors—including qualified workers, proximity to customers, and quality public services—can be more critical than taxes. The availability of these vital location factors depends in large part on each state and locality's commitment to public investment—and their ability to pay for it. Research, in fact, substantiates that public investment plays a positive role in helping lower costs for firms.

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Ultimately, the proof of the power of tax cuts and incentives to attract or retain business and create jobs lies in how firms respond to them. On this score, the evidence fails to support the claim that growing the economy requires shrinking the public sector and reducing taxes. In particular, there is little evidence that state and local tax cuts—when paid for by reducing public services—stimulate economic activity or create jobs. There is evidence, however, that increases in taxes, when used to expand the quantity and quality of public services, can promote economic development and employment growth.

There are five main types of arguments given for cutting taxes and offering tax incentives at the state and local level; these arguments raise issues such as the tax burden, the supply-side effects, the demand-side effects, the business-climate impacts, and the competitiveness implications of taxation. These kinds of arguments have been repeated so frequently that they are often accepted uncritically. Almost any time a tax increase on individuals or businesses is proposed politicians or special interest groups invoke one or more of these arguments to assert that the proposed tax increase will seriously damage the economy and cause a significant loss of jobs. While not totally without merit, these five arguments overstate the case for reducing taxes, as well as ignore counter evidence and disregard the economic impacts of the spending alterations that governments take in response to tax changes. The significant weaknesses in these arguments show them to be less than persuasive as justifications for state and local tax cuts.

A review of the hundreds of survey, statistical, and representative firm studies that have evaluated the effects of state and local tax cuts and incentives also makes clear that these strategies are unlikely to stimulate economic activity and create jobs in a *cost-effective* manner. A close examination of recent statistical based studies on the effects of tax cuts demonstrates how these kinds of studies have been misused to justify tax cuts on economic grounds. In particular, this literature review points out that some recent statistical studies find that state and local taxes have either a positive or no effect on economic activity, and most of the studies that suggest taxes have a small negative effect on economic activity do so only when public spending is held constant as taxes increase—a circumstance that is highly uncommon in the real world. Moreover, even the small negative effects of state and local taxes that some statistical studies find are likely somewhat exaggerated and do not support the notion that state and local tax cuts and incentives can be counted on to create numerous jobs or to do so in a cost-effective way. ***The bottom line is that state and local taxes, at their current low levels, may be largely irrelevant to business investment decisions.***

The literature on the effects of state and local public services indicates that state and local spending may stimulate economic growth and create jobs. In addition, the studies that have examined the net effects of simultaneously changing taxes and public spending—arguably those studies that provide the best "real world" measure of the effect of state and local tax cuts—generally find that raising taxes and using the additional revenues to pay for more public services enhances economic growth and expands employment.

It follows that, if taxes are not a decisive factor and public spending can be a positive force, then the use of tax cuts to create jobs can carry uneconomical "costs per job." Even with optimistic assumptions, for each private-sector job created by state and local tax cuts, governments may lose between $39,000 and $78,000 or more in tax revenue annually. This substantial revenue loss forces governments to lay off public employees in numbers that probably exceed the number of jobs created in the private sector. The net effect of tax cuts is thus likely to be a loss of employment. In addition, the public would lose the value of the public services that would no longer be provided. So, while access to jobs is clearly a vital concern in today's economy, public officials and voters should focus not solely on faith in tax cuts but on the best ways to get employment results. ***In the end, any jobs that might be gained by cutting taxes can be more than offset by the jobs lost as a result of cuts in public services.***

State and local tax cuts and incentives are probably not the best use of public revenues, even when the object is to encourage business firms to put more people to work. This finding confirms that state and local officials should take into account public-service as well as tax effects on the economy when considering fiscal policy designed to promote optimal job growth. Tax increases used to enhance public services can be the best way to spur the economy. By stimulating growth, generating jobs, and providing direct benefits to residents, improvements in state and local public services can be one of the most effective strategies to advance the quality of life of citizens.

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This essay is drawn from the Executive Summary of "Rethinking Growth Strategies How State and Local Taxes and Services Affect Economic Development" Economic Policy Institute, 2004.

Steven C. Deller
Community Development Economist

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