

The Effects of Business Taxes on State Growth

Peter Fisher

Research Director, Iowa Policy Project
Professor Emeritus, University of Iowa

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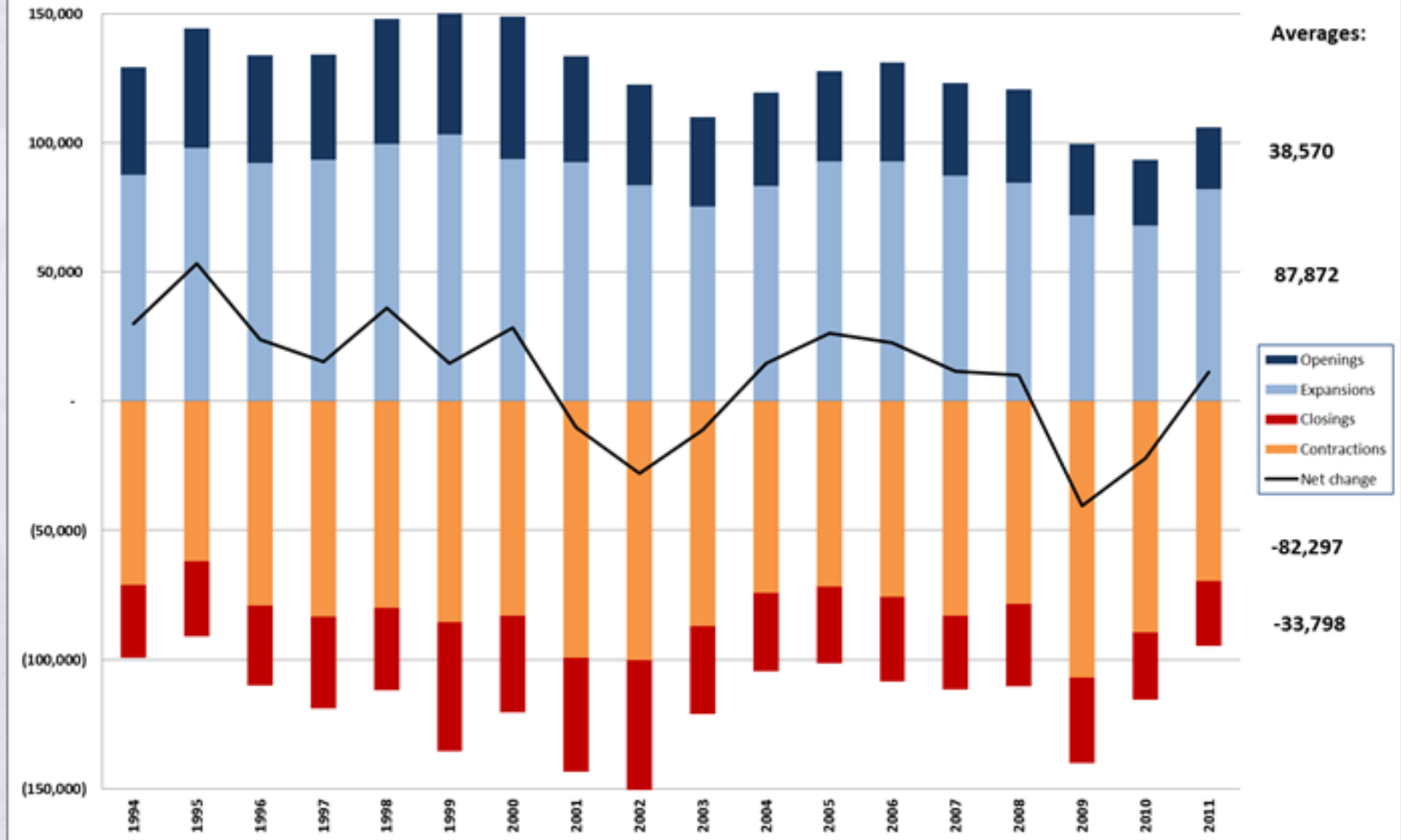
Focus of This Presentation

- ▶ Some estimates: States spend upwards of \$50 billion annually on business tax incentives
- ▶ How effective are they? Are states getting their money's worth?
- ▶ Are incentives costless – do they generate additional revenue through increased economic activity?

How Much Influence Does State Policy Have on the State Economy?

- ▶ Short Run: Largely at the mercy of national and global economic trends
- ▶ Longer run: Largest factor affecting state economic growth is the rate of new firm formation
- ▶ Very long run: Education level of the workforce and capacity for innovation the most significant factors explaining state income growth (FRB study)

Private Sector Employment Change in Iowa, 1994-2011, In Establishments that Opened, Expanded, Contracted, and Closed



Firm Location Decisions

- Businesses take many factors into account when making an investment location decision:
 - Access to markets and to suppliers
 - Transportation costs
 - Access to a pool of labor with appropriate skills
 - Wage rates
 - Energy costs
 - Quality of schools, recreation, climate and other amenities important in attracting skilled labor
 - Quality of state and local government services
 - And taxes?

State and Local Taxes Too Small to Matter Much

- ▶ For all businesses: State and local taxes just 1.8% of total business costs
- ▶ Corporate income tax: 9.5% of all state and local business taxes (if we believe COST)
- ▶ Cutting the corporate tax rate in half thus cuts business costs by $.018 \times .095 \times .5 = .009$
 - ▶ 9 hundredths of a percent!

What Does Research Show?

- ▶ If taxes really matter, then we should observe greater growth in states with lower taxes on business, or greater incentives.
- ▶ Simple correlation not the way to go.
- ▶ Using statistics to do a controlled experiment: Holding constant all those other factors that influence location, do taxes matter?

Research Results

- ▶ Research best compared and summarized by unfortunate economic term: Elasticity of GSP (Gross State Product) with respect to taxes.
- ▶ Elasticity = percent change in GSP brought about by a given percent change in business taxes
- ▶ Consensus range: -.1 to -.6. Bartik: -.3
Waslyenko -.2. Our research -.3 to -.5
- ▶ Example: If elasticity is -.3, a 10% reduction in taxes produces an eventual 3% increase in GSP

What these Results Don't Mean

- ▶ That a 10% cut in the corporate income tax produces a 3% growth in manufacturing.
- ▶ That a 10% cut in overall state and local business taxes would produce 3% growth in the overall economy – much of the tax cut would go to local market sectors like retail.
- ▶ That a 10% cut in overall state and local business taxes offset by a 10% cut in state and local expenditure would produce any growth at all.

Mistakes to Avoid

- ▶ Assuming tax cuts have no cost
- ▶ Forgetting the “other things equal” condition: States must balance their budgets
- ▶ Ignoring the public sector job losses caused by the cut in public revenue
- ▶ Ignoring the long-term consequences of declining support for education, infrastructure, and other public services

How One Economist Summarizes the Issue

- ▶ “[A]n economic development policy of business tax cuts may fail to increase jobs in a state or metropolitan area if it leads to a deterioration of public services to business. An economic development policy of tax increases may succeed in increasing jobs if it significantly improves public services to business.” -- Timothy Bartik

Tax Cuts are Costly

- ▶ One implication of the low elasticities: Tax cuts do NOT pay for themselves. Cut in revenue from firms who get incentives but didn't need them, will exceed gain from any new investment induced by incentives.
- ▶ Some studies try to impute indirect revenue gains and personal taxes from new employees: But households bring with them public service demands at least equal to the taxes they pay. No fiscal gain here.

Tax Cuts are Costly (cont'd)

- ▶ Much of the benefit of across-the-board cuts will go to local market sectors – retail, utilities, transportation, much of the service sector. Not footloose: Driven by local demand. Taxes largely irrelevant.
- ▶ If tax cuts financed by public sector layoffs, this will reduce local demand; local sector could decline instead of growing.

Counterargument #1

- ▶ *Taxes may be a small share of costs, but they are a big share of profits so they matter a lot.*
- ▶ Every component of cost is a higher percentage of profit than it is of costs; so what? States can affect profits only by affecting costs, and through the tax code they can affect only 1.8% of costs. Small difference in larger factor costs still outweighs a large difference in taxes.

Counterargument #2

- ▶ *We know they work, because we deal with corporations every day and they say taxes matter.*
- ▶ Most businesses engaging in tax incentive competition see it in their best interest to argue that taxes matter and that their location choice is up for grabs, whether or not this is the case.

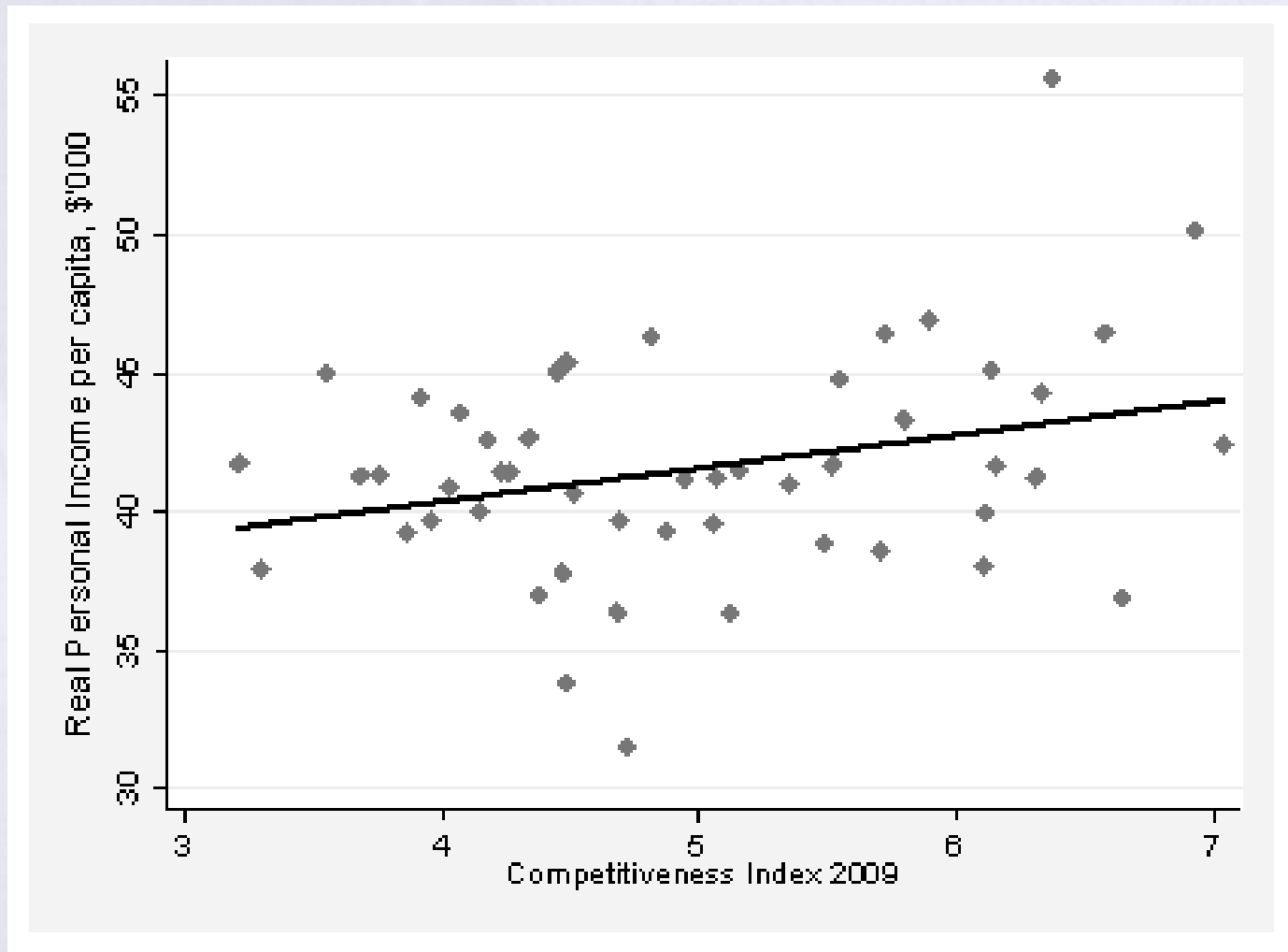
Beware of Bogus Research by Ideologically Driven Groups

- ▶ Beacon Hill Inc. (BHI): “State Competitiveness Index”
- ▶ The Tax Foundation’s “State Business Tax Climate Index”
- ▶ The Small Business and Entrepreneurship Council: “Small Business Survival Index”
- ▶ American Legislative Exchange Council: “Rich States, Poor States”

Example: BHI's Competitiveness Index

- 44 measures grouped in 8 subindexes:
 - Government and fiscal policy
 - Security (crime)
 - Infrastructure (phones, housing costs, travel time)
 - Human resources (education, health)
 - Technology (patents, scientists & engineers)
 - Business incubation (firm births, minimum wage)
 - Openness (exports, foreign born)
 - Environmental policy (emissions)
- 8 subindexes averaged = overall index

BHI claims Index predicts a state's per capita income



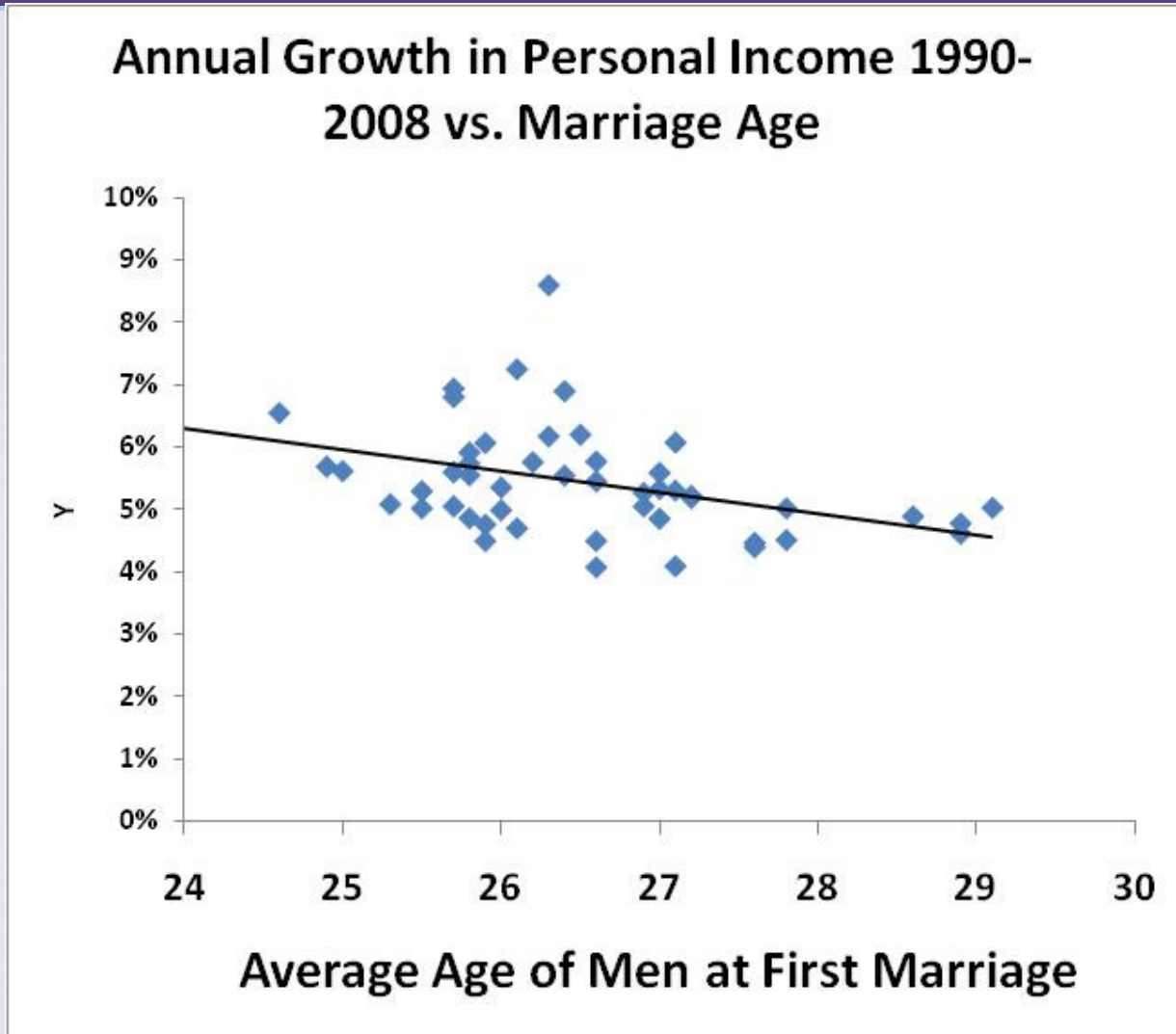
BHI: Stacking the Deck

BHI: Each point in the index is worth \$1,453 in higher per capita income!

Of course the index predicts income: 6 of their 44 variables are proxies for income:

- Lots of high-tech, science & engineering workers (2 variables)
- % of homes with phones/broadband (2)
- Low unemployment rate
- High bank deposits per capita

A Better Predictor: A State's Average Age of Men at First Marriage



Better Business Climate Indices

- Moody's (Economy.com's) "North American Business Cost Review" for states and metro areas
- *Forbes* magazine's "Best Places" ranking of metro areas
- *Expansion Management* magazine's six "quotients" for states, cities, or school districts
- The Milken Institute's "Cost of Doing Business Index" for states

Better Indices (cont'd)

- ▶ Audience: Business executives and site selection consultants
- ▶ Broad range of factors included: labor costs, cultural and recreational amenities, climate, energy costs, transportation, educational attainment, school quality, health care; taxes a small component

The Fallback Argument

- ***We have to do it because everyone else does.***
- This is often expressed as the danger of unilateral disarmament in the economic war among states. But if incentives are costly and inefficient, let your competitor states continue to squander their money on them, and pursue instead a smarter and more cost-effective approach to economic development that focuses on long-run fundamentals.

Alternative Policy Approach

- Recognize that the core governmental functions are essential to economic health and long run growth
- State government's job is to stick to the fundamentals, and do them well:
 - Education, from pre-school to grad school
 - Job training
 - Infrastructure
 - Public Safety
 - Health
- Avoid costly incentive strategies that drain resources from these essential services

Further Resources

- ▶ Check the Iowa Policy Project web site for the report “Corporate Taxes and State Economic Growth”:
<http://www.iowapolicyproject.org/2011docs/110209-IFP-corptaxes.pdf>
- ▶ *Grading Places: What Do the Business Climate Rankings Really Tell US?* Available at:
http://www.epi.org/publication/books_grading_places/