Center on Budget and Policy Priorities

State Taxes and State Economic Performance

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How might tax cuts benefit a state's economy?

- There are two ways that cutting business or household taxes could -- in theory -- help a state's economy:

  1) By leaving more money in their hands that they could use, in the case of a business, to hire more people or invest in a new facility, or, in the case of a household, to spend on goods and services that <u>indirectly</u> provide employment and income to the businesses and people furnishing them (demand-side argument)

  2) Changing the <u>incentives</u> that businesses have to make an investment/create a job/locate in a particular state and that households have to work or reside in a particular state (supply-side argument)

What's wrong with the demand-side argument?

- States have to balance their budgets!

- Every dollar of tax cut that a business or household receives and could conceivably re-circulate into the local economy has to be offset with a dollar of higher taxes for someone else. And that's $1 less that <u>those</u> people have to spend in the local economy.

- Or that tax cut has to be matched with a spending cut. That spending is someone else's income that they spend in the local economy: state employees, state contractors, medical providers paid by state share of Medicaid, etc.

Tax cuts are actually likely to lead to <u>less</u> total in-state spending in the short run

- The previous recipients of the no-longer available state payments and/or those paying higher taxes must cut their spending almost immediately, but the recipients of the tax cut may very well not re-inject it into the state economy -- either immediately or at all:
  - If the recipient of the tax cut is an affluent individual, she may save it or spend it on out of state travel, tuition, etc.
  - If tax cut recipient is a multistate corporation, it may invest the $ out-of-state or pay bonuses to out-of-state execs or dividends to out-of-state owners
  - The federal treasury will pocket 1/3 of it due to lower deductions for state taxes on federal returns

Negative demand-side effects of tax cuts can, in theory, be offset in long run by positive supply-side effects

- Business tax cuts increase the profitability of business investments and therefore the incentive to make them; can turn marginally-unprofitable investment into a marginally- profitable one; i.e., tip balance, incentivize investment/job creation that wouldn't otherwise have happened at all
- Increases the relative profitability of making an investment in the state that cut the taxes, possibly shifting the location of a business investment and associated job creation into the state
- For PIT cut, incentivize individual/household to reside in state cutting taxes rather than another one (with indirect economic development effect due to shift in location of household spending)

Why would we expect hypothetical incentive effects of tax cuts to be weak/non-existent in real world?

- All S/L taxes paid by corporations are very small share (2-4%) of total expenses; even substantial cut won't have much effect on profitability; overwhelmed by cost of labor, energy, etc., which are much bigger cost items and vary more among states

- Lots of other things important to the location decisions of businesses and households differ among locations
  - For businesses: distance to suppliers/customers; skill level and availability of workforce; road quality
  - For households: climate, school quality, distance to friends/relatives/jobs

Why would we expect hypothetical incentive effects of tax cuts to be weak/non-existent in real world?

- Business investment responds primarily to anticipated demand for its products, not small cut in tax expense or marginal tax rate.

- Wages are already fully deductible in calculating profit, so taxes on profits aren't a disincentive for hiring

- Relocating is costly; e.g., it can be hard for a business to find new workers with the right skills in a new location. Relocation is therefore extremely rare and accounts for tiny share of net job growth. Not likely to be driven by such a marginal issue as differences in tax expenses.

Why would we expect hypothetical incentive effects of tax cuts to be weak or non-existent in real world?

- What really explains most of the relative rate of job growth among states is their ability to give birth to and ensure the survival of the small number of start-ups that develop an innovative technology, product, or business model and grow rapidly – e.g., Facebook/Google/Amazon

- Tax cuts don’t help these businesses take off because they earn little if any profit in their early years to begin with; they’re plowing their cash flow into R&D, marketing, etc.

Why would we expect hypothetical incentive effects of personal income tax cuts to be weak/non-existent in real world?

- Most people don't own businesses, most small and/or start-up businesses don't earn enough profit to get much $ from PIT cuts, most small businesses don't employ anyone other than the owners and have no intention of ever doing so, many small business owners are passive investors with no authority to "create jobs"
- PIT cuts won't attract entrepreneurs; they almost never move before they start their businesses. They start them where they live, where they have personal relationships with potential employees, bankers, suppliers, and customers; where they know the local market; where the industry from which they've spun off their firm is already clustered (e.g. Silicon Valley)
- Cutting family/friend ties is painful. Selling and buying a new house is costly. Finding a new job across a state border is difficult/risky.

Academic research

- Relationship between state tax levels and state economic performance has been studied extensively by economists.
- People on both sides of the debate can point to well-done studies by reputable economists published in peer reviewed journals supporting the assertion that relative state tax levels do and don't affect relative rates of economic growth, job creation, etc.
- But these results aren't robust; several replications of widely-cited earlier studies have completed undermined them
- Results are contradictory; one study will find CIT matters and PIT doesn't, and the next will find exactly the opposite
- Beware of cherry-picking!!! E.g., Laffer/Moore
- The weight of academic research concludes that state and local tax levels have, at most, a small impact on relative rates of state economic performance.

Considerable statistical research supports conclusion that business tax cuts don't have major impact on state economic performance

- As summarized by economist Tim Bartik, probably leading expert on this literature:
  - Takes 10% cut in total business taxes (i.e., combined CIT, property tax, sales tax, not one of them in isolation) to generate 2-3% boost in long-run economic output/jobs. Significant loss of revenue for small number of jobs.
  - Long-run means 15-20 years; only 3/5 of impact occurs in first 10
  - Even this modest impact assumes quality of public services needed by business (education, infrastructure) doesn't decline. Essentially requires offsetting taxes on non-job creating households only, which almost never occurs.

Considerable statistical research supports conclusion that business tax cuts don't have major impact on state economic performance

- Bartik, continued:
  - Incentive effects this small translate into $20,000 cost per job paying less than twice that amount (1984 estimate); i.e., <u>very</u> large subsidy of wages
  - Even in first couple of years, 20%-50% of jobs go to in-migrants rather than increasing employment of existing residents; 80% of jobs will go to in-migrants in long run (and they will need costly new roads, sewers, and schools)

Personal income tax cuts and state economic performance

- Not as many studies of impact of state PIT cuts/interstate differentials as of business tax cuts, so no one has attempted to summarize PIT cut elasticities in literature as Bartik has for business taxes

- While PIT cut proponents can cite a couple of studies that find some inverse relationship between state PIT level and economic performance, majority find none (see CBPP: "State Personal Income Tax Cuts: A Poor Strategy for Economic Growth;" cites 6 recent studies that find no significant impact of PITs on state economic performance and 2 that find positive impact)

- Several recent studies show millionaire tax brackets don't lead to significant out-migration

Some implications of discussion up to now

- Theoretically-possible positive incentive effects of cutting business taxes and PITs are so small that in short run they are not powerful enough to overcome negative impact on growth of reducing state spending to finance tax cut; net combined effect on state economic growth likely to be negative

- Across-the-board tax cuts are not a cost-effective means of stimulating state economic growth/job creation

- If states are going to use more narrow tax incentives to stimulate economic growth, they really can't afford for them to take a form that isn't directly conditioned on in-state investment (e.g., capital gains tax cuts, single sales factor, and domestic production deduction conformity are misguided)

Another implication: tax cuts don't pay for themselves – ever!

- Bartik: incentive effects of business tax cuts "are not large enough to produce a Laffer Curve, in which cuts in tax rates would raise the tax base enough to increase revenue. . . The higher business tax base would offset only about a quarter of the [initial] revenue loss. . ."
- Oregon Tax Incidence Model and California Dynamic Revenue Analysis Model predict feedback effects of tax cuts on economic growth recoups only 16-18% of initial CIT and PIT tax cuts
- Well-known REMI model generates 5%-18% dynamic revenue estimates
- Feedback effects this small mean state services benefitting businesses are likely to be cut if taxes are cut, which itself has additional negative impact on long-run growth

A real world “experiment”: Kansas, 2013—present

- 29 percent cut in top income tax rate (taxable income above $30k) from 6.45% to 4.6%
- Exemption of all income received from ownership of sole proprietorships/S corps/LLCs/partnerships/farms (6.45% to 0%)
- Enacted 5/12, effective 1/13

Result: Kansas underperforms US and all but one neighbor in job creation, economic output, business formation

	KS	US	CO	MO	NE	OK
Total private employment growth 12/12-10/16	3.3%	8.4%	13.1%	6.3%	4.6%	1.7%
Nominal GDP growth 2012:IV – 2016:II	8.8%	13.3%	15.7%	13.0%	11.2%	-0.3%
Growth in number of federal personal income tax returns reporting passthrough income, 2012-2014	3.5%	4.5%	4.3%	0.9%	4.2%	4.7%

According to Kansas' own data, passthrough business formation has *slowed* since income tax exemption enacted

Recent Growth in Kansas Passthrough Entities		
	Number	Percent
Between 2010 and 2011 (before tax exemption in effect)	2338	2.9%
Between 2011 and 2012 (tax exemption enacted in May 2012)	2784	3.4%
Between 2012 and 2013 (first year tax exemption in effect)	2543	3.0%
Between 2013 and 2014 (second year tax exemption in effect)	2141	2.4%

Source: KS Dept. of Revenue, "Governor's Consensus Revenue Estimating Working Group Final Recommendations," 10/4/16

A real world experiment: Ohio, 2005 - present

- Since 2005:
  - 33.7% cut in top personal income tax rate from 7.5% to 4.97%
  - Phase-out of corporate income tax and replacement with gross receipts tax
  - Phase-out of all local property taxes on machinery/equipment/ inventories
  - Net reduction in business taxes of at least $1B annually
  - 50% of first $250k of passthrough income exempted from state personal income tax; remainder taxed at top rate of 3%

Result: Ohio underperforms US and all but one neighbor in job creation and economic output

	OH	US	IN	KY	MI	PA	WV
Total private employment growth 01/06-10/16	1.6%	8.0%	3.7%	4.7%	1.8%	4.2%	-1.1%
Nominal GDP growth 2005:IV – 2016:II	32.0%	38.2%	41.0%	33.3%	24.0%	40.3%	31.5%

North Carolina: the New Shining Star of Tax "Reform"?

- Since 2013, North Carolina has:
  - Cut the corporate income tax rate from 6.9% to 3%
  - Enacted single sales factor apportionment
  - Substituted a flat-rate income tax for a progressive one, cutting the top rate by 25.8 percent (from 7.75% to 5.75%)
  - Repealed the estate tax

Result so far: North Carolina underperforming 3/4 of its neighbors in job creation and economic output; only slightly outperforming US as a whole

	NC	US	GA	SC	TN	VA
Total private employment growth 12/13-10/16	7.2%	6.2%	9.7%	8.0%	8.0%	5.9%
Nominal GDP growth 2013:IV – 2016:II	11.2%	10.6%	14.8%	14.0%	12.8%	8.4%

Many other experiments with similar failed results

- New Mexico – deep personal income tax, capital gains tax, and corporate income tax cuts
- Oklahoma: 24.8 percent cut in top personal income tax rate, 2004-2016
- West Virginia: eliminated corporate franchise tax plus deep cuts in corporate tax rate
- Michigan: personal income tax rate cuts and substitution of corporate income tax for much broader Michigan Business Tax

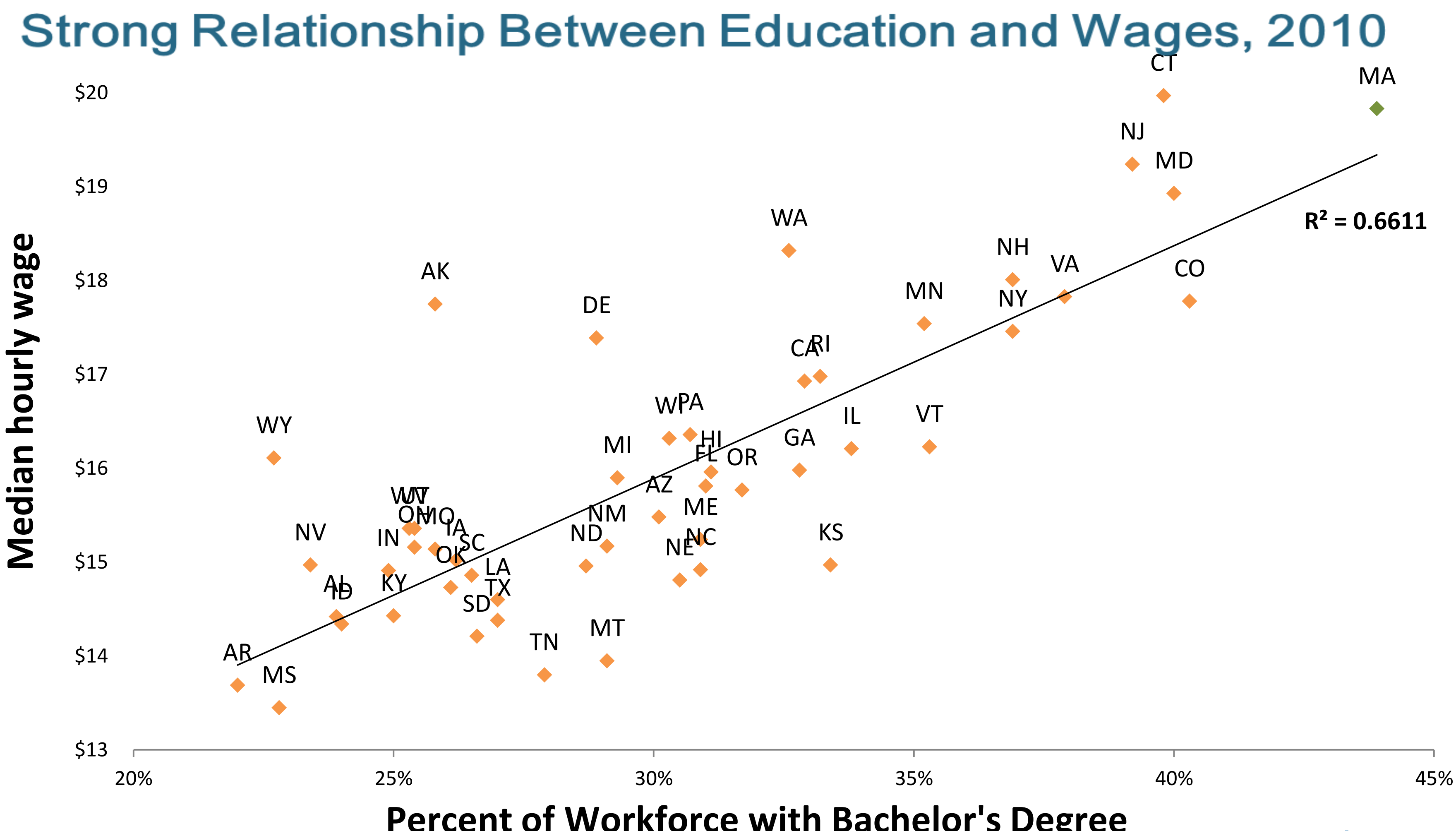
Considerable evidence that high-quality public services enhance state economic performance

- Statistical research: Many empirical studies finding positive correlation between quality of education and infrastructure (especially) and rate of state economic growth and growth in high-paying jobs

- Business executives: Most surveys of biz execs about what's important in their location decisions find quality of local labor force and infrastructure more influential than taxes/tax incentives

- "Creative class": Growing body of research finding that fastest-growing cities are those where highly-educated workforce is concentrated. They want good schools, parks, low crime, etc.

High-quality education is strongly correlated with individual economic well-being



Conclusions:

- Cutting taxes across-the-board to boost economic growth is a costly, wasteful, inefficient way to do that
- Policymakers should stop tinkering with their tax systems in search of that supposed “game changer”; many states have radically cut their taxes with no improvement in their relative economic performance but great harm to the well-being of their citizens.
- Preserving high-quality state and local services needed by businesses, especially education and infrastructure, should still be the primary economic growth strategy for states to pursue
- Cutting taxes undermines the ability of states to provide adequate, high-quality services