The Impact of State Tax Policy on Economic Growth

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Good afternoon, I am delighted to be here to share with you some of the findings of my research on the economic effects of state tax policy, in general, and business tax incentives, in particular. This is, of course, an especially important subject now given that we are in the midst of a serious economic downturn and the State of Maryland is grappling with projections of multi-billion dollar budget deficits in the years to come.

As you know, all across the nation State officials are trying to create jobs and grow their local economies. And to achieve these goals they often use tax incentives. So much so, in fact, that they have *may* have become the most widely used economic development tool at the state level. Unfortunately, there is no complete data on the amount of tax incentives provided each year but, several scholars have provided partial estimates. For example, Ken Thomas (2000) estimated that in 1996 alone state and local tax incentives summed to over $48 billion. And by all indications we are far beyond that amount today.

Now, the typical justification for business tax incentives has been that they are one of the best ways to create jobs and spur growth. But, at a time like this when states cannot afford to waste scarce resources on ineffective programs, we have to ask the tough question: is this in fact true? Do tax incentives promote growth and create jobs in a cost effective manner?

I became interested in this question over 25 years ago when I was living and teaching in upstate New York. In the 1970's and 80's, one of the most discussed economic development programs in New York State involved its Industrial Development Agencies

(IDAs) which provide an array of tax incentives to businesses. The IDAs regularly issued press releases in which they reported that they had provided tax incentives to over three thousand firms operating in New York State and that these tax incentives had created or saved over 270,000 jobs in the state between 1970 and 1991. In addition, officials of the IDAs reported that the tax incentives had caused state and local governments to lose very little revenue. In fact, for many IDA sponsored projects they explained that their had been no tax revenue losses because hundreds of out-of-state firms would not have relocated to New York State in the absence of the tax incentives and the investment projects of many in-state firms would not have gone forward were it not for the tax incentives.

These results were remarkable and I wanted to document them. So, I spent the better part of 4 years trying to confirm these claims. I collected, analyzed, and cross-referenced data from the more than 3000 firms who had received the tax incentives, from the IDA's, from the New York State Department of Economic Development, the NYS Department of Commerce, the Office of the State Comptroller, and from various state commissions and agencies. I then published my findings in two studies.

What I found was the following. Between 1987 and 1991, instead of costing little or nothing, IDA activity caused NY state and local governments to lose $2.6 billion (2009 dollars) in tax revenues. In addition, the actual number of jobs created or retained by the tax incentive receiving firms was at most only one-third of the number that the IDAs had claimed so that each job retained or created by tax incentives cost at least $74,000 (2009 dollars) in lost tax revenues.

As I noted at the time, my estimate for the number of jobs saved or created by IDAs was probably an overestimate because it was likely that at least some of the IDA sponsored firms would have undertaken their projects in the absence of the tax incentives and, thus, at least some of the jobs saved or created by the IDA sponsored firms were not a consequence of the tax incentives. Subsequent research has suggested that about 80% or more of the hiring would have taken place in the absence of the tax incentives.

But, what about those hundreds of relocating firms? Well, as it turns out, I found that IDA's had provided tax incentives to a grand total of just 23 firms (with 1,322 jobs) that relocated to NYS (over a ten year period). Only two of these firms told me that the tax incentives played any role in their decision to relocate to NYS. In short, NYS's business tax incentives failed to create a significant number of jobs or to create jobs in a cost effective manner, and they cost billions in lost tax revenues.

As you can imagine, I was disappointed by these results and I wondered if New York's dismal experience with business tax incentives was somehow unique. So, I have spent subsequent years reviewing and analyzing *hundreds* of studies that have examined the effects of state and local taxes on business location and investment decisions, on growth, and on job creation. In addition, I have reviewed the studies that have examined the effects of public services on economic development. Let me summarize four key conclusions that can be drawn from an analysis of what firms actually do in response to tax incentives as opposed to what some claim that they do:

1. There is little evidence that state and local taxation figures prominently in business location or investment decisions. Many studies found no effect of state and local taxes on business location or investment decisions and most studies that did discern an effect, found it to be very small.

Consider the findings of a study done by Lee (Dec 2004), an economist at the Federal Reserve Bank of Cleveland. After analyzing data on all relocations of manufacturing plants in the United States between 1972 and 1992, Lee found that the states with the most generous tax incentives were no more successful in attracting businesses than were the states with the least generous incentives. And, in any case, relocating firms typically accounted for less than 4% of employment growth. Lee concluded that, “Overall, the results of this study support previous findings that the use of public money for tax incentives to attract large industrial plants is not very effective.”

2. There is little evidence that state and local tax incentives, when paid for by reducing public services, stimulate economic activity or create jobs. What studies have found is that state and local economies would be stronger if they could maintain public services while paying less for them in taxes. For example, econometric studies have found that the long-run elasticity of business activity with respect to state and local taxes is about -0.2 when public services are held constant (Wasylenko 1997). This means that if we cut business taxes by 10%, we could expect employment over 20 years to increase by an additional 2% assuming

that public services are not cut to pay for the tax incentives. But, in the real world, unless you have rainy day funds or other surplus funds, when you provide state tax incentives you must cut public services too and when you do both simultaneously the net result is not growth and job creation.

3. State and local business tax incentives, to the extent that they create jobs do not do so in a cost-effective manner. In fact, unfortunately, business tax incentives may be causing a net loss of jobs. For every private sector job "created" or "saved" by tax incentives, state and local governments typically lose somewhere between $45,000 and $90,000 in revenue annually (Lynch 2004). And, in enterprise zones, where the business tax incentives are most generous the costs per job created by incentives have been estimated to be even higher: from $70,000 to over $110,000 (Peters and Fisher 2002).

In the absence of rainy day funds or surplus revenues, these substantial revenue losses force governments to cut back on public services and lay off public employees (and those who work for private firms and not-for-profits that subcontract from the state) in numbers that may be greater than the number of jobs created in the private sector. The net effect of business tax incentives, thus, may be a loss of jobs. Keep in mind too that on top of this job loss, citizens suffer from the loss of public services whether it is fewer teachers or fire fighters or police officers.

4. There is evidence that reductions in public services due to tax incentives cause job loss and economic slowdown. Studies that have measured the effects of raising taxes and using the revenues to improve public services have found positive economic results (Helms 1985, Bartik 1989, Munnell 1990, Goss and Phillips 1994, Bartik 1996). These studies have an implication for how the state of Maryland should close its budget deficit. They inform us that the State of Maryland will probably fare better if it raises $2 billion in revenues than if it cuts public spending by $2 billion to eliminate its impending deficit. We can also learn from the experiences of many other states. For example, in fiscal 2004, the state of Michigan closed a nearly $1 billion deficit largely by cutting public spending. The results were not good and an econometric study (by Bartik and Erickcek 2003) concluded that if the state balanced its budget by increasing revenues instead of cutting spending, employment in Michigan would be higher by over 7,600 jobs and personal income would be greater by $309 million. These numbers give us a rough idea of what may happen in Maryland.

You may be wondering why the research shows that business tax incentives are ineffective and yet business lobbyists assert over and over again that state and local taxes significantly raise the cost of doing business, substantially lower profits, and destroy jobs. In addition, they will tell you that differences in tax burdens across states cause firms to flee from the high tax to the low tax states. Therefore, business tax incentives, by lowering costs and raising profits should foster growth and attract businesses and jobs to Maryland.

These arguments sound plausible until you look at the facts. IRS business income tax return data show that all state and local taxes paid by businesses in 2000 accounted for only 1.2% of business costs.[1] In other words, if all state and local taxes paid by business were not just reduced but, instead, totally eliminated, then the costs of doing business in Maryland would be lowered by about 1%. Likewise, all state and local business taxes, assuming that they are all paid by businesses, reduce profits by only a small amount. For example, for a typical firm with a pre-tax profit rate of 10%, state and local taxes typically reduce that profit rate to somewhere between 9.3% and 9.6%

This means that relatively small differences in the other 99% of the costs of doing business will swamp the effects of tax incentive induced differences in profit rates. Consider, for example, labor costs which are more than twenty times greater than state and local business taxes. A 5% increase in labor productivity in Maryland, which is about one dollar per hour, would do more for a firm's bottom line than a 100% reduction in Maryland's business taxes.

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[1] According to the Internal Revenue Service's Statistics on Income Bulletin (Spring 2003), total business receipts and costs (deductions) in 2000 (the most recent year for which complete data are available) amounted to $24,032.2 billion and $22,634.4 billion, respectively. According to Census data, in Fiscal year 2000-2001 total State and Local tax revenues were $914.1 billion. The methodology developed by the U.S. Advisory Commission on Intergovernmental Relations (1981) suggests that the share of state and local taxes paid by business was roughly 30% in 2000-2001. Applying this methodology, the amount of state and local taxes paid by business in 2000-2001 was approximately $274.2 billion (thirty percent of $914.1 billion). Dividing $274.2 billion first by $24,032.2 billion and then by $22,634.4 results in the estimates that state and local taxes paid by business reduced revenues by 1.1% and represent about 1.2% of the total costs of doing business. Given a federal corporate income tax rate of 35% and a top marginal tax rate on income derived from partnerships and sole proprietorships of 39.6% in 2000, the impact of federal deductibility is conservatively estimated to reduce the burden of state and local taxes by one third.

A business sponsored trade association, The Council On State Taxation (see Cline, Fox, Neubig, and Phillips, 2003), has calculated that state and local business taxes amounted to $371.6 billion in 2000-2001 or 40.4% of total state and local taxes. Using this much higher estimate of the burden of state and local taxes on businesses does not substantially change the results reported above: state and local taxes paid by business represent about 1.5% of business receipts and 1.6% of total business costs before deductibility, and 1% of receipts and 1.1% of total costs after federal deductibility.

These other 99% of the costs of conducting business are the most important factors affecting business investment and location decisions. These key factors include first and foremost, the cost and quality of labor but also include access to quality public services such as transportation networks, good schools, health services, recreational and cultural facilities, public safety, and quality housing. These factors have a much greater impact on a firm's bottom line than state taxes do, as they influence almost 99% of total costs. Tax incentives, therefore, can only sway an investment location decision if the differences in all of the primary location factors at alternative sites are very small.

A broad range of studies of the relative multiplier effects of business tax incentives versus spending on public services confirms these conclusions. Consider for example the multiplier estimates put out by Moody's Economy.com in January 2010. They calculated the multiplier effects for general state government spending at 1.41 and increased infrastructure spending at 1.57. By contrast, business tax incentives such as accelerated depreciation and loss carryback had multiplier effects of only 0.25 and 0.22.

The tax burden argument ignores the fact that taxes are not just burdens. Taxes are also the means by which businesses pay for the numerous benefits they receive from government - the public services and infrastructure that businesses rely on to thrive. When tax incentives cause reductions in public services, firms may be forced to spend more, for example, on the education and training of their workers, on health services for employees and their families, on security for the workplace, and on basic infrastructure and transportation costs. As a consequence, in the absence of adequate taxation, the provision of "public" services becomes an internal cost to firms. Thus, tax incentives may not reduce the costs of doing business but may, instead, contribute to rising business costs, falling profits, slower growth and job declines.

So, what works in creating jobs and raising living standards? In general, we know that states should be focusing on strengthening those attributes which make a community a great place to live. Policies that strengthen our schools, improve infrastructure, make our communities clean and safe, ameliorate health care, reduce crime, and support families make a state a great place to invest, work, and live.

The research is very strong in several specific areas. We know that public investment in high quality pre-k programs generate enormous bang for the buck eventually generating 8 or more dollars in economic benefits for every dollar invested in the programs. Likewise, summer school programs, strengthening our k through 12 education system, and adult job training programs can significantly increase the productivity of the labor force and substantially reduce the cost of doing business in Maryland. Similarly, customized training programs subsidized by the state, offered at community colleges, and made available to private sector employers have been shown to be cost-effective in creating jobs. Research evidence also shows that manufacturing extension services can create jobs more cost-effectively than business tax breaks. These programs help manufacturers become more competitive and successful by providing consulting services to manufacturers in areas such as engineering, computers, marketing, and business planning. Another effective program is to temporarily subsidize new job creation by public and private employers for the long-term unemployed. The MEED program in Minnesota which was active from 1983–1989 is a good example. It provided subsidies to employers of up to $10 an hour to hire individuals and is estimated to have been about twice as cost effective in creating jobs as are business tax incentives.

The bottom line is that state and local taxes *at their current levels* are relatively unimportant factors in business investment decisions so that tax incentives are not likely to be very helpful in creating jobs or spurring growth. Investing in public services, on the other hand, can serve as a catalyst to economic and job growth and can contribute to improving the quality of life of citizens. Hence, state and local governments may be wasting billions of dollars annually on tax incentive policies that are failing while under funding programs that can promote long-term growth and job creation.

My hope is that this Tax Reform Commission helps put an end to ineffective tax policies and encourages the State to focus its attention on economic policies that work to create jobs and promote growth. Thank you.

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