Policy Brief

Taxes and State Economic Growth: The Myths and the Reality

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By Peter S. Fisher and Elaine Ditsler

Are tax cuts an effective tool of economic development? Many public officials and others in Iowa take it as an article of faith that they are — a view supported by a report released by the Public Interest Institute (PII) in Mt. Pleasant, Iowa, titled "Tax Reduction and Economic Growth in Iowa."[1] That paper proposed two "proven pro-growth policies that the state government should follow: exempting capital gains from taxation and cutting personal and corporate income taxes."

A review of the literature on the relationship between taxes and economic growth reveals that cutting taxes is by no means a "proven pro-growth" policy. In fact, many factors dictate economic performance. The impact of state taxes on economic growth, if any, is dwarfed by far more powerful economic forces that determine business opportunities.

Developing sound economic development policy for Iowa is important. However, this policy should be developed within a context of the specific goals and advantages of our state. The most appropriate and cost-effective economic development programs will follow from our pursuit of these goals and competitive advantages that flow from them. Iowa's economic development policy should be a combination of programs, such as research parks, job training, technical support for potential entrepreneurs, extension services to help businesses modernize and export, infrastructure improvements, and investment in Iowa's quality of life. Increasingly, workforce quality is seen as a key determinant of economic growth and development, with the quality of the state's education system important to the development of that human capital. Championing tax cuts without examining all the other components to economic growth is reckless. In fact, given that Iowa's tax system is already competitive, further tax cuts will most likely be counterproductive.

Myth #1: *Tax Cuts Are an Effective Tool for Generating Growth*
Reality Check: *Taxes Have Minimal Impact on Economic Growth*

State and Local Taxes Are Only a Small Share of the Cost of Doing Business

Cutting corporate income taxes, and other taxes on business, is advocated by PII and others as a way of reducing business costs and attracting a larger share of investment. However, state

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and local taxes represent only a small share of the cost of doing business. Small differences in other costs overwhelm large differences in the tax burden.

In fact, one study found that even the very generous tax cuts of state enterprise zones, which on average amounted to a 34 percent reduction in a manufacturer's state-local tax burden (corporate income, sales and property taxes), would be offset by a mere 3.8 percent difference in wage rates.[2] Wages vary by more than that from one part of Iowa to another, and interstate differences would be even larger.

Does this mean that taxes never affect location and expansion decisions? No it doesn't. As unimportant as taxes are generally, they may tip the balance in a few cases. However, careful statistical analyses must be done to determine just what effect taxes do have. These analyses have been done in abundance over the past 25 years. The best of them do a careful job of controlling for the other factors that influence business location decisions: distance to markets, presence of important inputs such as raw materials or business services, wage rates, size and education level of the labor force, utility prices, access to air and rail transportation, and the quality of public services. The question is: when all of these other factors are taken into account, do taxes matter?

The best studies control for all factors that influence decisions on locating a business.

While many early studies found no significant relationship between business taxes and growth, more recent ones have found statistically significant, though small, effects. Timothy Bartik reviewed a large number of studies that had been conducted in the 1980s and concluded that differences in taxes across states have measurable but small effects on business investment or growth in employment or gross state product.[3] Michael Wasylenko reviewed the literature more recently and came to a similar conclusion. His study showed that state and local taxes have a small effect on the location decisions of firms within a region. In other words, taxes are of some importance to economic development only where a state's overall tax burden is significantly different from that of the states it competes against. He concluded that the effect is probably even smaller than that found by Bartik.[4]

There are two very important cautions that need to be heeded in drawing policy conclusions from this research. First, these studies show the effect of lower taxes, *holding all else constant*, including the level of public services. There has been substantial research, in fact, that shows that public services, particularly the quality of infrastructure and education systems, are also an important determinant of growth.[5] Robert Lynch came to the same conclusion after reviewing hundreds of studies in 1996. He found that state and local tax cuts have little impact on growth and may have a negative impact if they are paid for by cutting state and local public services.[6] Lynch also found that there is little evidence that the level of taxation figures prominently in business location decisions. Instead, factors such as the cost and quality of labor, quality of public services, proximity to markets, and access to suppliers are more important.

Second, even accepting the conclusions of the research showing that taxes affect growth, the effects of taxes are small. What they show is that if a state were to cut taxes on business by 20 percent, for example, without cutting public services, it could probably expect an increase of about 4 percent in the state's growth rate.* Let us be clear what this means. In the latter 1990s, for every 100 establishments in a state, about 10 new ones appeared in a given year.[7] This is the average gross rate of growth. If state taxes on business were cut by 20 percent, then growth would be expected to increase by about 4 percent, from 10 percent to 10.4 percent per year, or 10.4 new establishments per 100. This means that of all the subsequent new plant openings, just 0.4 out of 10.4 each year, or 4 percent, will actually be due to the tax cuts. Yet tax incentives are typically provided to every new or expanding firm, meaning that 96 percent of the incentives will have been simply a waste of money, going to firms whose location decisions were not affected by taxes. Across-the-board cuts on taxes to all businesses, even those not expanding or moving, will of course also be very expensive, with very little of the cuts tipping the balance in a location or expansion decision.

Tax cuts are an expensive way to bring about a small increase in growth.

Tax cuts are an expensive way to bring about a small increase in growth. And significantly, if they are accompanied by cuts in government services, which they most likely will be, even these small effects could disappear.

Cutting the Capital Gains Tax: Irrelevant to Iowa's Economic Growth

Currently, Iowa subjects capital gains to the same graduated structure as all other sources of income. PII argues that eliminating the capital gains tax will stimulate economic growth. However, the research on this topic does not support this contention. A 1998 report by the Congressional Budget Office concluded that reducing the federal capital gains tax rate from 20 percent to 15 percent would increase private saving and national GDP by the minuscule amounts of 0.3 percent and 0.02 percent respectively.[8] Other analyses by the Urban Institute and the Brookings Institution found that no relationship exists between federal changes in the capital gains tax rate and economic growth.[9] Indeed, economists have consistently found that the prospect for sales growth is much more important than the cost of capital in determining business investment.[10]

There are several reasons for the limited effects of capital gains taxes on growth at the national level. One reason is that about half of "taxable" gains are not taxed anyway because their basis is stepped up at death.[11] Also, a cut in capital gains taxes reduces only the cost of investment financed by equity, e.g. corporate stock (approximately one-third of corporate investment is financed through debt). Finally, capital gains taxes are already low relative to regular income rates.

Reasonable minds may differ over the efficacy of capital gains tax incentives for stimulating economic growth at the national level. At the state level, however, the argument for using capital gains tax incentives to stimulate economic growth breaks down entirely. Whereas a federal capital gains tax incentive is successful if it generates new investment that would

* Bartik's 1994 review ("Jobs, Productivity, and Local Economic Development: What Implications Does Economic Research Have for the Role of Government?" *National Tax Journal* 47, pp. 847-62) concluded that the preponderance of evidence supported an elasticity of about -0.3 for interstate location decisions, while Wasylenko's later review (see note 4) concluded that the likely elasticity was -0.2 (the majority of more recent studies falling between 0 and -0.26). In this example we use the later figure of -0.2.

otherwise not have occurred, a state-specific capital gains tax incentive must also generate the investment *within the borders of the state*. When Iowans purchase shares of stock or of mutual funds, they invest in companies with operations all over the world; any increased investment by Iowans as a result of a capital gains tax cut will flow primarily to out-of-state corporations. Exempting capital gains from taxation will increase the returns that some Iowans make on their investments, but it will not stimulate investment in Iowa.

Exempting capital gains from taxation will not stimulate investment in Iowa, and is a costly tax-relief strategy.

More than one-third of the benefit would go to the federal treasury.

It is also a point of fact that a cut in capital gains taxes will chiefly benefit the most well-off Iowans. In 1999, the top 2 percent of all taxpayers paid more than 75 percent of all federal capital gains taxes.[12] The capital gains tax represents a negligible amount of the tax bill for non-wealthy Americans. This is because the wealthiest 10 percent of American households own 82 percent of all stock and 91 percent of all business assets.[13] Furthermore, any capital assets owned by the non-wealthy are usually exempt from capital gains taxes (i.e., owner-occupied housing and pensions).

Exemption of capital gains taxes is also a very costly tax relief strategy. Since capital gains are received overwhelmingly by the richest Iowans, and upper income Iowans almost invariably itemize deductions on their federal returns, the reduction in Iowa taxes will be offset in part by an increase in federal taxes. The vast majority of Iowa capital gains taxes are paid by taxpayers in the 35 percent and 38.6 percent federal tax brackets, which means that 35 percent to 38.6 percent of the Iowa tax savings will be taken back in higher federal taxes.* So every dollar of revenue loss to the state of Iowa produces only about 61 to 65 cents of tax benefit to Iowans, the rest going to the federal treasury.

PII also claims that the capital gains tax should be eliminated in order to foster innovative enterprise in Iowa. However, the Congressional Research Service found that “there is no apparent relationship between venture capital investments and the capital gains tax.”[14] Economists Richard Florida and Donald Smith Jr. discovered that strengthening the technological base and supporting infrastructure for entrepreneurial firms is the most effective way to encourage start ups.[15] According to their study, venture capital suppliers are proficient at identifying where business opportunities exist; incremental differences in tax rates are not a factor. This explains why California, with the highest capital gains tax rate in the country, also receives 40 percent of total U.S. venture capital investment.[16]

It is also important to note that Iowa already exempts capital gains taxes on sales of business assets, real property used in a business, and more. These are direct exemptions for businesses with investments in Iowa. Smart economic development policy may include incentives for investment in Iowa, but should not also exempt taxes on investments made

* For every dollar taxpayers save in Iowa taxes, there is one less dollar they can deduct on their federal returns, since itemizers deduct Iowa income taxes paid. This means that their federal taxable income is one dollar higher. That additional dollar will be taxed at their marginal federal tax rate, 35 percent or 38.6 percent, so their federal taxes rise by 35 or 38.6 cents.

outside Iowa. *The capital gains that might matter to Iowa's economic development are already fully exempt.*

Cutting the Individual Income Tax Could Hurt More Than Help Economic Growth

At the national level, cutting personal income taxes, particularly for middle and lower income earners, puts more money into the hands of people who will spend it, and this provides a short-run economic stimulus.* (Whether there are long-run positive effects is controversial.) This kind of demand-side stimulation is not an effective strategy at the state level, however. The state of Iowa, unlike the Federal government, must balance its budget. Tax cuts will be accompanied by spending cuts, so that the effects of additional disposable income in the hands of taxpayers due to the tax cuts will be canceled out by reduced government payroll and reduced government purchases of goods and services from the private sector. Furthermore, the increased spending brought about by cuts in Iowa taxes would produce most of its effects outside of the state since most of what we buy is produced elsewhere, and much of what we produce depends on demand generated elsewhere.

Some would like to make a supply-side argument instead: Cutting personal income taxes will cause businesses to locate or expand in Iowa who otherwise would not have done so. Supporters have little or no evidence to back up such claims, other than anecdotes from self-interested parties. The extensive research on business taxes cited earlier suggests that business investment decisions will be affected very little, if at all, by state personal income taxes. First of all, personal taxes are not a direct expense of the business. They affect business costs only to the extent that tax differences across states are so noticeable to wage earners that a business in a high-tax state must pay higher wages and salaries to compensate for the higher personal taxes.

Business investment decisions are affected very little, if at all, by state personal income taxes.

On average, state and local personal income taxes represent about 2.6 percent of personal income. Payroll (wages, salaries and compensation of officers) on average represents about 16.5 percent of a corporation's costs of operations.[17] That means that, even if personal income taxes were somehow a business cost, they would represent just four-tenths of 1 percent of costs (2.6 percent of 16.5 percent) and would be even less significant than state and local corporate income and property taxes. And we showed above that even sizeable direct business tax reductions have only small effects on rates of investment or location decisions. States have even less leverage trying to affect business decisions by changing the taxes their employees pay.

Let's take a fairly extreme case, where state A's income tax is 50 percent higher than state B's, which is average. Even if the higher tax in A were entirely offset by higher wages there, the firm's payroll would increase by just 1.3 percent, and this would increase the total cost

* Lower and middle income households spend a larger fraction of their incomes than upper income households, who tend to save a larger percentage; therefore a given dollar amount of tax cuts will result in more spending and more stimulus to the economy if it is targeted at low and middle income rather than upper income households.

of doing business in state A by just two-tenths of a percent.* Such small differences simply could not affect the vast majority of location decisions.

Some tax cut advocates would like to make the argument that the income taxes that really matter are those on upper income individuals, the executives making the location decisions. But then the costs to the firm are even less, since compensation of officers represents just 2.1 percent of the cost of operations of the average corporation.[18] Furthermore, since we are now talking about upper income taxpayers who itemize on their federal returns, differences in tax burdens across states are substantially less than they appear. If state A has a 50 percent higher income tax on the rich than state B, the actual tax burden is only about 31 percent higher because the higher state tax in A produces a lower federal tax.**

> ***'As a businessman, I never made an investment decision based on the Tax Code.'***
>
> ***Paul O'Neill,***
> ***former Alcoa CEO***
> ***and former U.S. Treasury Secretary***

It strains credulity, frankly, that profit-making corporations would shun the best economic locations for their plants and offices simply to avoid making slight adjustments to executive salaries to compensate for after-tax cost of living differences. Those who would argue that Iowa's high top marginal income tax rate of 8.98 percent scares businesses off must somehow believe that executives intelligent and resourceful enough to run successful and growing businesses and make smart investment decisions are nonetheless unable or unwilling to figure out the most basic implications of tax laws — that federal deductibility in Iowa drastically lowers the top rate (to about 5.75 percent), or that any income tax differences between Iowa and another location could be offset with higher salaries at a trivial cost to the business.

Paul O'Neill, former CEO of Alcoa, said during his Senate confirmation hearing to be President Bush's Treasury Secretary: "As a businessman, I never made an investment decision based on the Tax Code... (I)f you are giving money away I will take it. If you want to give me inducements for something I am going to do anyway, I will take it. But good business people do not do things because of inducements, they do it because they can see that they are going to be able to earn the cost of capital out of their own intelligence and organization of resources."

High personal income taxes also correlate with high levels of public services, and vice versa. In an era when every state is competing for the better paying jobs in technology sectors, and when Iowa is struggling to keep its college graduates in the state, quality of life factors assume particular importance. The public sector has a major role to play in maintaining high-quality public education systems, promoting environmental quality, and providing opportunities for culture and recreation. Cutting state revenues could do more harm than good to the state's efforts to increase jobs for more educated workers if it undermines

* State B has average taxes amounting to 2.6 percent of personal income; State A has 50 percent higher taxes, which therefore amount to 3.9 percent of personal income. The extra tax burden in State A represents 1.3 percent of personal income and therefore approximately 1.3 percent of wages and salaries. Finally, 1.3 percent of the 16.5 percent of firm costs consisting of wages and salaries is just two-tenths of a percent of the firm's total cost of operations.

** For every dollar in additional taxes paid to state A, the taxpayer gets another dollar of federal deductions. With a marginal tax rate of 38.6 percent, this saves the taxpayer 38.6 cents in federal taxes, so the net tax burden rises only 61.4 cents.

the state's ability to make Iowa the kind of place those workers want to live.

Finally, it is clear that high rates of personal income taxation can go hand in hand with robust economic growth, if the growth ingredients that really matter are already there. (And if they are not there, cutting business costs by a trivial amount is not going to help.) Minnesota and Wisconsin, which for a long time have had higher and more progressive income taxes than Iowa, have also for a long time had rates of economic and population growth that exceed Iowa's.

Myth #2: *Iowa is a High Tax State*
Reality Check: *Iowa's Taxes are Average and Competitive*

We have argued that tax cuts and tax incentives are an expensive but largely ineffective tool for stimulating state economic growth. The case for tax cutting in Iowa is further weakened by the fact that Iowa's tax system is already competitive.

The Public Interest Institute argues that Iowa's top individual and corporate income tax rates are a deterrent to growth. Top rates, however, are misleading and inaccurate measures of tax burden. The relevant tax rate is the effective tax rate, defined as actual income tax paid as a percent of income before taxes. Effective tax rates reflect all provisions in the tax code, not just rates, including itemized deductions, types of income excluded from taxable income, exemptions, credits, federal deductibility, and so on. These provisions vary substantially from state to state. While it would be useful to have such effective rates for different income levels, the best we can do is look at a proxy for the average effective rate: tax revenue collected as a percent of personal income.

Table 1 demonstrates that Iowa's average tax burden is comparable to other Midwest states and the nation. State and local taxes as a percentage of personal income average

Table 1: A Comparison of Tax Burden Among Midwestern States

State	2000 Total State and Local Taxes as % of Personal Income	1999 Corp. Income Tax as % of GSP	2000 Personal Income Tax as % of P.I.	2000 Property Taxes as % of Pers. Income	2000 Sales/ Gross Receipts Taxes as % of Pers. Income	2000 Other Taxes as % of Pers. Income
Illinois	10.40%	0.49%	2.0%	3.8%	3.5%	1.2%
Indiana	10.30%	0.55%	2.7%	3.5%	3.2%	0.9%
Iowa	10.80%	0.28%	2.6%	3.5%	3.6%	1.1%
Kansas	10.60%	0.32%	2.6%	3.0%	4.0%	0.9%
Michigan	11.00%	0.79%	2.7%	3.3%	3.5%	1.5%
Minnesota	11.90%	0.47%	3.6%	3.0%	3.9%	1.4%
Missouri	9.70%	0.17%	2.6%	2.3%	3.9%	0.8%
Nebraska	10.70%	0.26%	2.5%	3.3%	3.6%	1.2%
South Dakota	9.10%	0.24%	–	3.3%	4.6%	1.2%
Wisconsin	12.60%	0.42%	4.0%	3.9%	3.6%	1.1%
Midwest Avg	10.72%	0.40%	2.53%	3.29%	3.74%	1.12%
National Avg	10.80%	0.38%	2.6%	3.1%	3.8%	1.3%

Note: Corporate income taxes include bank franchise taxes and other franchise taxes, as well as Michigan's single business tax.

10.7 percent for Midwest states. At 10.8 percent, Iowa fell exactly on the national average in terms of overall tax burden in 2000.

Table 1 shows that Iowa taxes corporations at a low rate compared to other Midwest states and compared to the nation. Corporate taxes represent only about 0.28 percent of Iowa's Gross State Product, compared to 0.40 percent for all Midwest states and 0.38 percent for the nation. Gross State Product is used here instead of personal income because the corporate income tax is a tax on income generated by business activity occurring in the state, not a tax on the incomes received by persons living in the state. Thus tax revenues as a percent of the value of goods and services produced is the best summary measure of the burden on business activity.

Only 2.3 percent of Iowa's 2002 net total tax collections (gross collections – refunds) were derived from corporate income taxes.[19] This amount also includes all capital gains taxes paid by corporations. As recently as 1996, almost 5 percent of Iowa's net tax collections were derived from corporate income taxes. What has happened? Corporate income taxes collected have decreased dramatically in recent years as a result of various tax incentives, such as the New Jobs Tax Credit and the Enterprise Zone Tax Credit, and increasingly sophisticated maneuvers by corporations acting across the nation to shelter income from taxes. Indeed, the corporate income tax component of state tax revenue in all 50 states decreased from about 8 percent in the early 1990s to less than 4 percent in 2001.[20]

Table 1 also shows that Iowa's individual income tax is not out of line with other Midwest states or the nation. It should be noted that state personal income taxes include all capital gains taxes paid by individuals.

Myth #3: ***Statistics Show Effectiveness of Tax Cuts*** *Reality Check:* ***Bad Research Doesn't Prove Anything***

The Public Interest Institute employs a crude research method in an attempt to show that tax cuts generate growth. The PII approach is far from the sophisticated statistical analysis needed to control for all the variables that influence economic growth. Even in its basic analysis, PII makes several mistakes by ignoring the timing and size of the tax changes it claims to spur economic growth, failing to measure the actual tax burden, and selecting inadequate measures of economic performance.

Timing and Size of Tax Changes Must be Considered in Analysis

A major flaw in PII's analysis is that it ignores the effective date and size of changes in state tax rates. States are grouped for comparison based on whether top tax rates increased ("tax hikers") or decreased ("tax cutters") over the 1990 to 2001 period. Yet the economic performance of states, which is presumed to be a result of the tax change, is measured over the same period. This has the effect of attributing all growth over those 11 years to a tax change that in many instances occurred only late in the period. Furthermore, PII ignores the percentage change in the tax rate when evaluating how tax changes affect its erroneously chosen economic indicators. By simply comparing the average economic growth of "tax hikers" with "tax cutters," PII does not even measure whether the *size* of the tax change matters.

Three of PII's supposed corporate "tax hikers," Vermont, New Hampshire and Alabama, did not increase their top corporate tax rates until 1997, 1999 and 2001, respectively. Vermont and New Hampshire, in fact, actually *decreased* their rates between 1987 and 1996. Five supposed corporate "tax cutters" — Connecticut, Idaho, Michigan, New York, and North Carolina – did not reduce their tax rates until 1997 or later. And two of these, Idaho and North Carolina, actually *increased* their rates between 1987 and 1996. Ridiculous as it may seem, we are apparently to believe that Alabama, whose top corporate tax rate remained the same from 1987 through 2000, experienced sub-par economic growth from 1990 to 2001 because its lawmakers raised the rate in 2001! North Carolina, meanwhile, *raised* the top rate in 1991, and still managed a 43 percent increase in real personal income from 1990 to 2001 (well above average), yet we are to believe that all of this growth is to be attributed to a *cut* in the top rate in the late 1990s (phased in from 1997 to 2000). In fact, North Carolina actually grew more prior to 1997 than after.

The data presented by PII tell us nothing about the causal relation between taxes and growth. A reasonable statistical analysis would, at the very least, have to take into account the timing of tax changes, so that a tax change in a given year is given credit only for growth that occurs *after* the change. Such an analysis would also take into account the size of the changes. If there is a causal relation, then the larger the tax change, the larger the effect. PII made no attempt to take this into account. Finally, as we argued previously, any reasonable analysis would have to control for the other factors that affect state economic growth.

Faulty Measures of Tax Burden: Top Tax Rates Don't Give Accurate Picture

PII uses changes in *top* tax rates instead of *effective* tax rates to categorize states as "tax hikers" or "tax cutters." This is an important distinction because top tax rates are much higher than effective tax rates. Federal tax deductibility, tax exemptions and deductions, and apportionment formulas differ from state to state with drastic effects on the effective tax rates. Iowa is one of very few states that allow 100 percent of federal personal income taxes and 50 percent of federal corporate income taxes to be deducted on state tax returns. This deductibility lowers the effective top individual income tax rate from 8.98 percent to 5.5 percent[#] and the corporate income tax rate from 12 percent to 9.9 percent.[21] Iowa companies are also exempt from property taxes on inventory and on new machinery and equipment. In addition, various capital gains exemptions are allowed in Iowa, including for the sale of business assets and the use of real property.

The steepest drop in the effective corporate income tax rate occurs because Iowa is one of a growing number of states that have a single-factor apportionment formula.[##] This means that corporations located in Iowa pay income taxes only on the portion of income generated from sales in Iowa. For a company selling products nationwide or internationally, sales in Iowa represent, at the most, a tiny fraction of total sales and income. As a result, the effective income tax rate for these companies is close to 0 percent.

* Small Business Survival Index 2002, www.sbsc.org/Media/pdf/SBSI2002A.pdf . Recent tax analyses by the Iowa Department of Revenue and Finance, however, indicate that federal deductibility reduces the effective top individual rate to about 5.75 percent.

** Any corporation doing business in Iowa and in other states is taxed only on the portion of its total income that is apportioned to Iowa. Iowa relies on "single-factor apportionment," meaning that the destination of the firm's sales is the only factor used in the apportionment formula (whereas most states rely on payroll and property as well). For example, if 20 percent of the firm's sales are destined for Iowa, then 20 percent of its profits are taxed in Iowa.

Inadequate Measures of Economic Performance: Don't Ignore Individuals' Income

PII's final major flaw is in its selection of measurements for economic performance: employment, population, and total real personal income. Gross State Product is a more useful measure of the overall size of the economy. But all of these measures are inadequate indicators of how well citizens are faring. We should not, in fact, conclude that states with higher rates of both population and employment growth necessarily exhibited superior economic performance. If population grows more rapidly than employment in those states, because unemployment rises or because the job growth is largely in low-wage sectors, we would hardly want to celebrate such economic performance. It is important, therefore, to include per capita income growth as a measure of how well a state economy has performed, because this measures the change in the economic well-being of the state's population, not just the size of the economy.

Indeed, if PII had used per capita income growth as the indicator of economic performance, then its conclusion would be the opposite. Between 1990 and 2001, *corporate* income "tax hike" states experienced per capita personal income growth of 59.5 percent compared to just 56.5 percent for "tax cutters." During the same period, *personal* income "tax hike" states experienced per capita income growth of 57.0 percent compared to 56.2 percent for "tax cutters."

In summary, there are multiple determinants of growth that PII would need to control for in order to isolate any connection between economic performance and taxes. PII's other mistakes include (1) ignoring the timing and size of the tax changes it claims to spur economic growth, (2) failing to measure the actual tax burden, and (3) selecting insufficient measurements of economic performance. PII's conclusion that their analysis proves causality is nonsense.

Myth #4: *Budget Cutting Does No Harm to the Economy*
Reality Check: *Cutting Services Hinders Growth*

In 2000, Iowa's per capita state and local tax revenue was $2,765, which placed Iowa 27th among all 50 states.[22] A reduction in state revenue collected could actually undermine economic development policy as a result of cuts in public health and safety, education, transportation, and other important government services that provide the foundation for economic growth. Robert Lynch found evidence that tax cuts, accompanied by reductions in public services, cause job loss and economic decline. Professor David Alan Aschauer found that "more than half of the decline in our productivity growth over the past two decades can be explained by lower public infrastructure spending."[23] One of the nation's foremost experts on state economic development policy reviewed 30 studies on the effects of public service spending on state economic growth and concluded that a majority of the studies found significant effects: higher levels of service produce higher rates of growth, and vice versa.[24]

Local governments would also be strained from a decrease in state tax revenues. Already this year, the state of Iowa has cut $70 million in funding to city and county governments due to a state-level budget shortfall. State-level tax cuts often merely shift the tax burden to local governments along with more fiscal responsibilities.

When Jim Barton, founder of biotech company Hematech Inc., visited Sioux Falls, South Dakota, he recalled saying, “Wow, this is a real city” as he stood in the city’s new multipurpose arts and entertainment center.[25] Hematech has since relocated to that city. This story underscores the importance of tax revenues for entertainment venues, parks, and other public amenities, which are needed to attract business and complement Iowa’s other advantages, including a well-educated workforce, relatively low housing costs, and minimal traffic congestion.

States often are faced with difficult choices in recessionary times, where revenues that supported public programs and spending have declined. Unlike the federal government, they cannot deficit spend but must choose whether to raise taxes or cut services. Joseph Stiglitz, the 2001 Nobel laureate economist, has concluded: “A reduction in government spending on goods and services is thus likely to be more harmful to the economy in the short run than an increase in taxes or a reduction in transfer program spending. Within the sphere of changes to taxes and transfer programs, the impact on the economy depends primarily on the propensity to consume — that is, on how much of an additional dollar of income is spent rather than saved — among those who receive the transfer payments or pay the taxes…. Since higher-income families tend to have lower propensities to consume than lower-income families, the least damaging approach in the short run involves tax increases concentrated on higher-income families.”[26]

In short, there are occasions where, at the state level, tax increases may be a sounder approach to economic development than cutting taxes. In fact, however, according to a National Governors Association report, Iowa cut its expenditures more than any other state except Alaska between the fiscal 2001 and 2003 years, an 8.8 percent reduction in nominal terms, while states as a whole increased their spending by 2.6 percent over those years.[27] On this account, Iowa has been outside the mainstream of states, and currently is examining further state tax cuts at the same time it is battling severe revenue difficulties.

Conclusions

PII’s analysis of taxes and economic performance is ill-conceived, myopic, and unreliable. Our own survey of the literature demonstrates that tax cuts are not an effective stimulus for economic growth. Indeed, slashes in tax revenue may harm the Iowa economy if government services suffer as a result, and they would increase the federal taxes that Iowans pay. Furthermore, Iowa’s overall tax burden is not out of line with other Midwest states or the nation as a whole. A more concerted effort at developing strategic economic development policy for Iowa would focus on exploiting Iowa’s competitive advantages, and increasing government investment in Iowa’s human and physical infrastructure.

Notes

[1] David Hogberg and Amy K. Frantz, “Tax Reduction and Economic Growth in Iowa.” Policy Study No. 03-02, March, 2003, Public Interest Institute, Mt. Pleasant, Iowa.
[2] Alan Peters and Peter Fisher, *State Enterprise Zone Programs: Have They Worked?* Kalamazoo, Michigan: W.E. Upjohn Institute for Employment Research, 2002, chapter 3. These figures were averaged across 75 enterprise zones in 13 states, for 16 manufacturing industries.
[3] Timothy Bartik, *Who Benefits From State and Local Economic Development Policies?* Kalamazoo, Michigan: W.E. Upjohn Institute for Employment Research, 1991.
[4] Michael Wasylenko, “Taxation and Economic Development: The State of the Economic Literature,” *New England Economic Review* (Federal Reserve Bank of Boston), March/April 1997, pp. 37-52.
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