



Taxes and State Economic Growth: A Response, Part I

by David Hogberg and Amy K. Frantz

In May 2003 the Iowa Policy Project (IPP) released a Policy Brief entitled “Taxes and State Economic Growth: The Myths and the Reality.” This was a critique of our Policy Study called “Tax Reduction and Economic Growth in Iowa.” IPP attempted to dispel various “myths” about taxes and economic growth that our study supposedly reinforced. However, it did little more than propagate myths of its own. This Brief is the first in a three-part response to IPP’s study. It focuses on the myths that IPP promotes about the impact taxes have on economic growth.

Myth: Taxes Have Minimal Impact on Economic Growth

The IPP study argues, “As unimportant as taxes are generally, they may tip the balance in a few cases.” The authors’ main evidence for this is a review article by Professor Michael Wasylenko that shows business taxes have a very small impact on new business start-ups and location decisions. IPP states, “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.” The authors then point out that of every 100 businesses in a state in a given year, 10 are new ones. Thus, “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.”¹

However, this example minimizes the effect of taxes on economic growth by overlooking the impact taxes have on employment growth and investment. The same Wasylenko article also shows that a 10% reduction in overall taxes equals a 5.8% increase in the growth in total employment, a 1% increase in the growth of manufacturing employment, and a 6% increase in investment in manufacturing.² And those are impacts for only one year. If one considers the effect that a tax cut would have over multiple years, then reducing taxes has far more than a minimal impact.

Indeed, some of IPP’s evidence for the minimal impact of taxation on economic growth is anecdotal, including a quote from former U.S. Treasury Secretary Paul O’Neill. In one instance, the report uses an anecdote about a biotech company that relocated to South Dakota from the East coast to show the importance of public services over taxes:

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. 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.³

While quality of life issues, such as entertainment, certainly can play a role in business location, we’re certain Mr. Barton also noticed that South Dakota has no personal income tax, and that aside from a franchise tax on financial institutions, corporations are not subject to income-based taxes in that state.

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Steve Kurtenbach, who relocated his technology and management consulting business from California to South Dakota in 1997, had this to say in the *Sioux City Argus Leader*: “One key drawing card is the quality of people,” Kurtenbach said. “The cost of doing business in a state with no corporate income tax is also an advantage.”⁴

Myth: Effective Tax Rates Matter, Marginal Ones Do Not

IPP also takes issue with our use of the top marginal personal and corporate income tax rates. According to the report, top rates “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.”⁵

We would not dispute that the effective tax rate is a relevant measure of the tax burden, and one widely used in the academic literature on tax effects. However, our contention that the top marginal tax rate affects economic growth is supported by the academic literature. Early research by Professor Charles T. Clotfelter found that tax evasion was linked to high marginal income tax rates.⁶ More recent research “found that decreasing the entire marginal tax rate schedule raised the growth rate for GDP substantially,” and that “it may not be possible to capture all the impacts of marginal taxes *by using only one average tax rate.*”⁷ [Italics added]. Finally, Federal Reserve economist Zsolt Besci examined the effect state and local taxes had on relative state growth and found “a negative relation between relative growth and both initial income and relative marginal tax rates.”⁸ He also found that the growth effects of marginal tax rates strengthened over time.

What IPP seems to overlook is the effect top marginal rates have on incentives to create wealth. Since a marginal rate is the amount paid on each additional dollar of income, the top marginal rate falls heavily on those who are upper-income earners. Since a higher top marginal rate lowers the after-tax return for such earners, it affects their incentives to work, invest, and expand businesses. Indeed, given the detrimental affects they have on economic activities that lead to job creation, top marginal rates affect not only upper-income earners, but all income earners.

We will explore more of IPP’s myths on the subject of government spending and economic development in Part II of this INSTITUTE BRIEF (Vol. 10, No. 21) and in IOWA ECONOMIC SCORECARD.

ENDNOTES:

¹Peter S. Fisher and Elaine Ditsler, “Taxes and State Economic Growth: The Myths and the Reality,” Iowa Policy Project, *Policy Brief*, May 2003, pp. 2-3.

²Michael Wasylenko, “Taxation and Economic Development: The State of the Economic Literature,” *New England Economic Review*, March/April 1997, p.44.

³ Iowa Policy Project, p. 11.

⁴Randy Hascall, “Outlook Increasingly Bright as High-tech Firms Find Success,” *Sioux Falls Argus Leader*, May 22, 2002, found at <www.argusleader.com/specialsections/2002/bestbiz/Wednesdayfeature.shtml> (June 6, 2003).

⁵Iowa Policy Project, p. 27.

⁶Charles T. Clotfelter, “Tax Evasion and Tax Rates: An Analysis of Individual Returns,” *The Review of Economics and Statistics*, August 1983, p.372.

⁷Craig S. Hakkio, Mark Rush, and Timothy J. Schmidt, “The Marginal Income Tax Rate Schedule From 1930 to 1990,” *Journal of Monetary Economics*, August 1996, p.132.

⁸Zsolt Besci, “The Marginal Income Tax Rate Schedule From 1930 to 1990,” *Economic Review*, March/April 1996, p. 32 and 33.

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