



Taxes and State Economic Growth: A Response, Part II

by David Hogberg and Amy K. Frantz

This INSTITUTE BRIEF continues the examination of the myths propagated by the Iowa Policy Project’s report “Taxes and State Economic Growth: The Myths and the Reality.”

Myth: An Effective Way to Stimulate Iowa’s Economy Is Through Government Spending

The authors of the IPP report conclude that “increasing government investment in Iowa’s human and physical infrastructure” should be a part of Iowa’s economic development policy, citing their concern that “slashes in tax revenue may harm the Iowa economy if government services suffer as a result.”¹ Their view, it would appear, is that more government spending is an effective way to grow Iowa’s economy.

We do not dispute that there is some role for government in encouraging economic growth in our state and the nation. Without government, there is no rule of law, and private property rights would not be enforced. Without some assurance that what you own and what you earn cannot be arbitrarily taken from you, the economy will not thrive.

However, IPP’s argument cuts both ways. Increased government expenditures can be counterproductive if they require increases in tax revenues. Indeed, the cost of government spending to the private sector is not a one-to-one relationship. In a study for the Joint Economic Committee, Senior Economist Kurt Schuler states that many people think only of the benefits of government spending, without considering the costs. He notes that research indicated “the cost of raising an additional \$1 in taxes is not \$1, but closer to \$1.40.”²

In fact, it costs more to boost the economy through government spending than it does through cutting taxes. For example, let’s compare the effect that per-capita tax burden has on employment growth with the effect of per-capita education spending. The same article that IPP uses to downplay the effect of corporate taxes on business start-ups also shows that, on average, a 10% reduction in the per-capita tax burden would have a 5.8% increase in employment growth.³ By contrast, the articles that examine the effect that per-capita education spending has on employment growth find that a 10% increase in such spending results in an average increase in employment growth of only 1.6%.⁴ Consider that in 2002, the per-capita tax burden in Iowa was about \$1,705, while state government per-capita education spending was \$732. Over the last five years, average employment growth in Iowa has been 8,218 jobs per year.⁵ Thus, a 5.8% increase in employment growth would mean the creation of almost 477 new jobs. Table 1 shows the calculations of tax cuts vs. education spending on employment growth.

Table 1: Amount of Tax Cuts vs. Education Spending Needed to Create 477 New Jobs			
	Per-Capita Amount in 2002	Change Needed to Create 477 New Jobs	Cost of Change
Tax Burden	\$1,705	-10%	\$170.50
Education Spending	\$732	36%	\$263.52

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What Table 1 shows is that the cost of increasing education spending to achieve the same amount of jobs as a tax cut of 10% is \$263.52 per-capita, \$93.02 *more* than the cost of reducing taxes. This is not surprising since the private sector generally makes far more efficient use of resources than does the public sector.

Furthermore, it is by no means clear that more government spending has a positive impact on the economy. While a certain level of spending is necessary to maintain government's essential functions, increased spending may result in diminishing returns to the point of being negative. In a study for the Joint Economic Committee, Professors Richard Vedder and Lowell Gallaway look at the size of government and the impact it has on economic growth.⁶ To find the optimal size of government, the authors use the Arney Curve, developed by former U.S. Representative Dick Arney, an economist.

The Arney Curve demonstrates that with no government (anarchy) or too much government ("all input and output decisions are made by the government") output per capita is low. Output per capita will rise as a government develops and expands, but as government grows too large it has an adverse impact on the economy. Vedder and Gallaway employ sophisticated statistical techniques to show that government spending in the U.S. at all levels—federal, state, and local—currently exceeds the optimal amount. For state and local governments they estimate that the optimal size is about 11.4% of Gross Domestic Product. In 2000, the year for which data is most recently available, state and local expenditures in Iowa absorbed 15.2% of Gross State Product.⁷ This strongly suggests that state and local spending in Iowa has exceeded optimal levels. Not only would cutting back on public spending *not* have an adverse economic impact—as IPP argues—it could be economically beneficial.

While some government spending is necessary to prevent anarchy and allow the economy to flourish, at some point, government spending becomes counterproductive to economic growth. The key is to find the optimal amount of government spending. Given current levels of government expenditures, it is more cost-effective and efficient to boost economic growth through tax cuts rather than additional spending.

ENDNOTES:

¹Peter S. Fisher and Elaine Ditsler, "Taxes and State Economic Growth: The Myths and the Reality," Iowa Policy Project *Policy Brief*, May 2003, p. 11.

²Kurt Schuler, "Hidden Cost of Government Spending," Joint Economic Committee, December 2001, Summary.

³Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review*, March/April 1997, p.44.

⁴Bryan D. Jones, "Public Policies and Economic Growth in the American States," *Journal of Politics*, February 1990; and Nguyen T. Quan and John H. Beck, "Public Education Expenditures and State Economic Growth: Northeast and Sunbelt Regions," *Southern Economic Journal*, Vol. 54, 1987. Of the significant coefficients for education spending, the median coefficient was .16.

⁵Data on Iowa tax burden from U.S. Census Bureau. Data on state education expenditures from the Iowa Legislative Fiscal Bureau. Data on employment from Bureau of Labor Statistics.

⁶Richard K. Vedder and Lowell E. Gallaway, "Government Size and Economic Growth," prepared for the Joint Economic Committee, December 1998.

⁷Data on state expenditures from Iowa Legislative Fiscal Bureau. Data on local expenditures and Gross State Product from U.S. Census Bureau.

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