

# TAXES AND ECONOMIC DEVELOPMENT

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One of the main concerns of state policymakers is how to lure jobs to their state—and too often, policymakers assume that tax cuts make the best bait. It’s not hard to understand why they might believe this: tax-cut advocates frequently assert that cutting tax rates will spur economic growth by bringing more jobs and employers to the state, and footloose businesses are constantly threatening to relocate to other lower-tax jurisdictions if state governments won’t pony up lavish tax breaks. But there is growing evidence that tax cuts and incentives are not an effective growth strategy for states—and that investing in public infrastructure such as schools, roads and hospitals can be a better approach to encouraging economic development. This chapter discusses the relationship between state fiscal policies and a state’s economic climate.

## How Taxes Affect State Economies

When state policymakers discuss proposed tax increases, the debate inevitably turns to the impact of these proposals on the state’s business climate. Business lobbyists usually argue that tax increases will hurt a state’s business climate and drive away industries and jobs. And if tax increases aren’t on a state’s agenda, the same lobbyists will push for special tax breaks to encourage new business investment—or to prevent a company from leaving the state—and will tell apocalyptic tales about what will happen if these business demands are not met.

But there is very little hard evidence to support the assertions of those who see tax cuts as a panacea for a state’s economy. A recent comprehensive survey of the economic literature on the relationship between taxes and economic development by economist Robert Lynch found little evidence that state and local taxes are important factors in determining business location decisions or in affecting state economic growth.<sup>13</sup>

Lynch’s survey suggests that there is wide variation in the quality of the “research” used to support these anti-tax arguments, and suggests that the studies that do show strong relationships between tax levels and economic development often have design flaws that invalidate their conclusions. But for the average advocate, who does not have an advanced degree in economics, it can be difficult to tell the difference between high-quality and low-quality research. Fortunately, these poor-quality studies tend to share the same design flaws. Here’s a quick overview of some important questions to ask in evaluating these studies:

**Does the study assume that tax changes have no effect on public spending?** One of the most frequent errors made by these studies is to simply ignore the linkage between taxes and public spending. This is equivalent to saying that when taxes are hiked, the resulting revenues will simply be thrown away rather than being used to fund education and other public services—and that when taxes are cut, there will be no reduction in the state’s ability to fund these services. Of course, the world doesn’t work this way. In the real world, tax cuts must be paid for—and that usually means spending cuts. And when strapped lawmakers pass politically unpopular tax increases, the new revenue is used to preserve important state services.

Studies that ignore this basic linkage and look only at the impact of tax cuts are merely stating the obvious: state economies would be stronger if they could maintain the current package of public services while paying less for them. In the best of all possible worlds, state and local governments would provide all of our public services for free. Of course, that’s unrealistic—but that’s the implication of studies that don’t factor in the impact of tax cuts in public services.

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<sup>13</sup>Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes Affect Economic Development*, Economic Policy Institute, March 2004.

**Does the study measure the impact of any other possible explanations for economic growth?**

There are many plausible explanations for the difference between fast-growing and slow-growing state economies. These differences could result from tax law changes, government spending behavior, regional and national economic changes, demographic changes, or even the weather. The simplest “studies” often measure the linkage between only one explanation—tax levels—and an economic outcome. But if the study doesn’t at least try to measure the impact of these other factors, its findings shouldn’t be taken seriously.

**Does the study measure tax burdens correctly?** Anti-tax advocates frequently resort to manipulating data in arcane ways to back up their assertions. For example, some studies use the “per capita” tax burden—that is, the

total amount of taxes collected in a state divided by the state’s population—to identify high-tax states. The problem with this is that “per capita” tax measures tell us more about how rich a state is than how high its taxes are. For example, Connecticut collects \$1,065 per capita in personal income tax, while Maine collects \$829. Yet Connecticut’s income tax has lower

<b>Comparing State and Local Taxes: Connecticut and Maine</b>		
	<b>Connecticut</b>	<b>Maine</b>
<b>Income Taxes Per Capita</b>	\$ 1,065	\$ 829
Rank	6	16
<b>Personal Income Per Capita</b>	\$ 43,173	\$ 28,831
Rank	2	33
<b>Income Tax as % of Income</b>	2.5%	3.0%
Rank	20	12
<b>Source: Census Bureau, Bureau of Economic Analysis</b>		

tax rates and higher exemptions than Maine’s income tax. Virtually anyone moving from Maine to Connecticut would, in fact, see their income taxes go down. This approach to measuring tax burdens is simply misleading—but anti-tax advocates rely on it simply because the average reader won’t know this. Other data manipulation tricks that these advocates frequently use include:

- Making assertions about how total taxes affect growth—but backing these assertions up using only state tax data. State tax hikes are often enacted to reduce local taxes, so it is important to use the combined state and local tax burden in evaluating these assertions.
- Using legal tax rates as a measure of true tax burdens. This trick is frequently used in states that combine high income tax rates with generous deductions, exemptions and other tax breaks. Effective tax rates—that is, taxes as a share of income (or profits, in the case of businesses) are a far more accurate approach to measuring tax burdens.
- Using aggregate tax collections data to measure state tax burdens instead of measuring the incidence of these taxes on state residents. Aggregate measures based on total tax collections tell us little about whether specific groups of taxpayers experience the state as a high-tax or low-tax place to live. Some nominally “high-tax” states rely heavily on taxes paid by businesses or non-residents, which don’t apply to state residents.
- Not factoring in the deductibility of state and local income and property taxes when comparing tax burdens across states. The ability to write off these taxes means that the difference in tax levels between “high tax” and “low tax” states is never as large as it may seem. For the wealthiest taxpayers (and for profitable corporations), up to 35 percent of the difference between any two states’ tax burden will disappear once federal deductibility is taken into account.

Much of the “research” that is commonly cited by anti-tax advocates is based on research methods that are dubious at best—and the tricks outlined above tend to get recycled in different states by anti-tax lobbyists. So whenever lawmakers or the media are presented with a study purporting to show that high taxes hurt economic development, it’s a good idea to ask these basic questions about the design of these studies.

## Why Low-Tax Strategies Don't Work

So why is it that the doomsday scenarios of corporate lobbyists fail to materialize when taxes are increased? No doubt, all things being equal, businesses would prefer low taxes to high taxes. But in fact, all things are *not* equal. Taxes are levied for a very important purpose: to help fund the public services that make a state more attractive to businesses. Good roads and bridges, a well-educated workforce and other government services are essential to business productivity and profitability. And there is a clear linkage between raising taxes and a state's ability to provide these important public services.

And on the other side of the coin, low taxes generally lead to low-quality public services. Providing businesses with a low-tax, low-service environment is not likely to be a winning strategy for attracting significant new investment. Moreover, compared to other costs of doing business, state and local taxes are rather insignificant. That's why heads of major corporations will candidly admit that taxes are not very important in their location decisions.

As Paul O'Neill, a former executive at Alcoa put it: "I never made an investment decision based on the tax code...If 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."<sup>14</sup>

Other corporate leaders have echoed these thoughts. For example, long-time business leader Michael Bloomberg told the *New York Times* that "any company that makes a decision as to where they are going to be based on the tax rate is a company that won't be around very long. If you're down to that incremental margin you don't have a business."<sup>15</sup>

Likewise, John Tyson, of Tyson Foods, a \$4 billion a year business, noted that tax breaks had nothing to do with his company's decision to locate a plant in Pine Bluff, Arkansas, rather than out of state. "It [the location decision] was based purely on geography. Pine Bluff was in the right place. The tax credits didn't make any difference."<sup>16</sup>

The Corporation for Enterprise Development (CFED) has issued a series of reports grading states on the characteristics that are likely to attract high-wage, high-value-added industry. Level of taxation has consistently been found to be of little significance. The factors that really drive location decisions include the quality of life in the community, a good supply of highly skilled and educated men and women to fill demanding technical and management positions, good roads and adequate transportation, public safety, and the quality of health care.

When corporations raise the "business climate" issue, it's usually nothing but a ruse to try to keep their taxes low. For example, a corporation might negotiate with two states over where to locate a facility in hopes of starting a bidding war, with each state offering more tax breaks than the other. Finally, after the corporation has been promised the tax breaks it wants (or more) from each of the states, it will locate in one state or the other. The location decision, however, very likely will have actually been made long before the bidding started. The company just plays the states off each other, promising jobs and economic growth to the lowest tax bidder. But the decision on where to locate is based on more important economic factors than taxes, such as distance from suppliers and markets, and the availability of skilled workers. It's also worth remembering that the few businesses that might actually be attracted by low taxes are likely to be low-paying, low-employment industries with little loyalty to the community and its long-term well-being.

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<sup>14</sup>Testimony before the United States Senate Finance Committee, January 18, 2001.

<sup>15</sup>*New York Times*, November 8, 2001.

<sup>16</sup>*Washington Post*, March 22, 1992, p.A22

Finally, it's important to remember that tax breaks don't buy loyalty from companies. Many states and communities have given huge tax breaks to large companies for years, only to have the company shut down the local plant for reasons unrelated to taxes.

## Ensuring Accountability in Economic Development Strategies

Even if there is little evidence that tax policy affects economic growth, state lawmakers will continue to pursue potentially damaging tax breaks in an effort to spur economic growth in their state. How can lawmakers achieve the greatest “bang for the buck” from these tax breaks, while ensuring that the footloose corporations receiving these breaks won't take them to the cleaners? The Washington-based nonprofit watchdog group Good Jobs First focuses on issues of economic development accountability, and has recommended a variety of best practices for lawmakers enacting tax breaks, including:

- **Disclosure**, for each company receiving tax breaks, of how much the tax breaks cost and what public benefits resulted from the tax breaks. For example, lawmakers should be able to determine how many jobs were created as a result of the tax breaks and whether the jobs created are “good jobs” in terms of the wage and benefit structure. This information should be made publicly available and frequently updated.
- **Strict job quality standards** should be applied to any tax breaks designed to increase in-state employment. Requiring these new jobs to provide a basic “living wage” along with health care benefits helps to avoid imposing hidden taxpayer costs on state government. If a tax break results in a company hiring employees who are paid so little that they qualify for food stamps, Medicaid, or other taxpayer-funded social supports, the cost of the tax break may exceed its benefits to the state.
- **Money-back guarantees** that companies receiving tax breaks to create new jobs will actually create these jobs—and that the jobs will remain in the state for some specified period of time. These guarantees, known as “clawbacks,” are now used by almost twenty states to ensure that lawmakers get enough “bang for the buck” out of these tax breaks.
- **Location-efficient incentives.** Tax incentives should encourage economic development in areas that are accessible to public transportation. This creates more opportunity for low-income families who cannot afford cars, and reduces traffic congestion.

## Is Business the Enemy? (No)

Believing that companies and their shareholders should pay their fair share of taxes doesn't make one “anti-business.” On the contrary, fair tax advocates fully understand the importance of a healthy economic climate for jobs and incomes. But governments must have the resources to provide the education, the roads, the sewer systems and other services that allow the economy to prosper. And unless those with the most ability to pay contribute their fair share, it will be virtually impossible for governments to provide these essential programs.

Precisely for this reason, not all corporations fight against progressive tax changes. Especially in states with low taxes, businesses may support progressive tax increases in order to improve the quality of government services. When Virginia lawmakers passed a billion-dollar tax hike in 2004, for example, it was with the blessing of the state Chamber of Commerce.

Even in states where many companies, and perhaps even the organized corporate lobby, oppose fair taxes, there may be some sectors of the business community that favor progressive tax reform. Often the organized business lobby is dominated by a few large corporations that may have very different interests than do small- and medium-sized businesses. These corporations can be an essential partner in progressive coalitions seeking to achieve tax adequacy and fairness. These partnerships are discussed in more detail in Chapter Eleven.