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TAXES AND GROWTH: A REVIEW OF THE EVIDENCE

NOTE: This briefing paper makes shorthand reference to several economic studies, such as “Tiebout (1956),” that can be found cited more completely in the reference section on page 4.

The economic literature comparing state taxes with economic growth shows that tax rates and economic activity are inversely related. Furthermore, taxes between jurisdictions are interrelated; changes in the tax policies of one state can spur other states to make similar changes. There is a tension in the literature regarding the role of government spending, with some studies suggesting that it increases economic activity and others showing a negative effect. Finally, tax policy in one state has an impact relative to the tax policies in the states surrounding it.

The 50 states provide an excellent laboratory to study the impact of different

tax policies, because they are subject to the same federal laws and tax system and share a widely similar culture. However, even with those similarities, establishing a causal relationship remains very difficult for a number of reasons.

Tiebout (1956) argued that individuals and businesses choose locations based upon their optimal combination of taxes and services, and the quantity and quality of government services are difficult to measure. Both facts make it more difficult to measure only the impact of taxes. The impact of tax policies is also dependent on the mobility of consumers, labor, and capital. Of these three, capital is the most mobile, but all can move over the long run. Edwards (2007) made the case that, in addition to fiscal policy, firm location depends on proximity to product market, quality of labor, and quality of the transportation network.

Studies on taxes and economic growth are further complicated by re-

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verse causality — for instance, changes in economic activity could drive a change in tax policy, as opposed to the other way around. Studies disagree on whether to use the average tax rate (ATR) or the marginal tax rate (MTR) to determine the impact of taxes on economic activity. The MTR is a better measure for calculating the effect of a change in tax policy or economic activity on taxpayers, but ATR is easier to calculate and is often similar to the MTR. Finally, findings of individual studies may not be reversible; if economic activity falls after a tax hike, we cannot assume it will rise after a tax cut.

LITERATURE REVIEW

Most of the literature has focused on the impact of the general tax burden on economic activity, not the specific effects of income taxation. Before 1980, the literature shows no significant relationship between taxes and economic growth, but new more sophisticated techniques show a definite effect. The size of the effect is a matter of contention, but the consensus range is an extra 1.5 to 8.5 percent in extra economic activity for a 10-percent tax cut. So, to create one new job in this way, a state would need to cut between \$1,906 and \$10,800 per year in taxes. Reed (2008) looked at data from the 48 continental states from the years 1970 to 1999 and found that higher taxes are correlated with lower investment, lower employment growth, and lower population growth. Padovano and Galli (2001) examined 23 countries in the Organization of Economic Cooperation and Development (OECD), including the United States, from the 1950s through the 1980s and showed that higher marginal effective tax rates lead to lower economic growth.

Tax policy undoubtedly affects migra-

tion, but there is a tension in the literature regarding whether people migrate to jobs or jobs migrate to people. Rork (2003) demonstrated that people are less mobile than corporations because of personal attachments, but corporations still incur substantial costs by moving their operations to a new state, so the impact of tax policy is limited by mobility. Although both people and corporations are attracted to low taxes, they also seek out efficient public services.

Changes in taxes and spending in one state can cause changes to the fiscal policies of other states. Multiple studies confirm that a \$1 rise in state spending can lead to between a 33 and 88 cent spending increase in neighboring states. Furthermore, Besley and Case (2003) found that voters look to the policies of neighboring states when changing their tax codes. However, some taxes are subject to more interstate competition than others. Excise taxes, for instance, are most easily influenced by changes in the tax codes of neighboring states, while corporate, income, and general sales taxes are less affected by such competition. The most likely explanation for this phenomenon is that it is more difficult for residents of a state to relocate to another state to avoid higher taxes than it is to purchase some specific goods in a state with lower taxes. Because some taxes are more interdependent on neighboring states than others, states that rely on more mobile tax bases, like excise taxes, will have less stable revenues.

The literature generally either estimates a direct relationship between taxation and economic activity or examines how expenditures of tax dollars change economic activity, often by dividing total government spending into general fund expenditures and fund transfer payments. General fund



expenditures are used to provide core government services, enhance the amenities of an area, etc., and are generally admitted to have a small positive impact on economic growth. For instance, Helms (1985) found that companies may be attracted to a state with higher taxes provided that the money is used on general fund expenditures. Fund transfer payments, on the other hand, are the distribution of income for which no good or service is received, such as welfare payments and food stamps. Spending on fund transfer payments has either a negligible or negative impact on economic activity. Although general fund expenditures boost economic activity somewhat, according to Fisher (1997) there is mixed evidence about the economic impact of an increase for any specific spending category, such as education, public safety, and infrastructure.

This tension in the literature can be resolved by using a cost-benefit analysis of specific expenditures. If a state uses its general fund expenditures to offer services beyond those demanded by the public, reducing general fund expenditures on those services and cutting taxes would likely have a positive impact on economic growth. However, if a state is already spending relatively little on general fund expenditures, cutting taxes could force cutbacks in vital public services and drive businesses and workers away from the state, thus lowering economic activity.

MISSOURI'S TAX POLICIES COMPARED TO OTHER STATES

Although there are many studies on the effect of overall tax rates on economic activity, there is less information in the

literature on the effects of tax structure on economic activity, and this gap should be filled.

Comparing MTR, a better measure when trying to understand changes in spending from rising income, Missouri is ranked as a relatively low tax state at 41st in the nation, with a 9.92-percent tax rate for each additional dollar of personal income. This compares to the highest MTR of 14.11 percent in New York, and the lowest MTR of 8.01 percent in Alaska.

Missouri's ATR is also lower than most states. Between 1970 and 2007, the ATR in Missouri is 10.1 percent, which is 34th in the nation. That ATR is also below the national average of 11 percent.

When compared with its neighbors, Missouri has a fairly low rate of taxation but a less progressive system, in which most taxpayers fall into the highest tax bracket of 6 percent. Missouri is one of only two states among its neighbors (Iowa is the other) and seven states nationwide that allow federal income taxes to be deducted from state tax liability.

MISSOURI TAX REVENUES

In 2005–2006, the most recent year for which Census data is available, corporate and income taxes made up 33 percent of Missouri's general (own source) revenues, while 21 percent came from the general sales and use tax and 11 percent from excise taxes. The term "own source" revenues refers to total revenues minus intergovernmental transfers from other governmental units, such as cities, counties, or the federal government.

There have been a number of shifts in the sources of Missouri's own source

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revenues since 1977. The state relies less on total taxes, which dropped from 87 percent to 71 percent of own source revenues between 1977 and 2006. These funds have largely been made up through miscellaneous sources of revenue like charges for services, interest earnings, and sale of property, which together rose from 13.1 percent to 30.3 percent of own source revenue during the same period.

Missouri also receives less of its revenue from the sales tax than it did in the past. The general use sales tax provided 35 percent of own source revenue in 1984 but declined to 21 percent by 2006. This led to an increased reliance on the income tax, which stood at 27 percent of own source revenue in 1977 and increased to 35 percent in 1998, where it largely stabilized. If the sales tax were expanded to include services, the rate could be lowered while still allowing revenues generated to parallel increases in income.

CONCLUSION

The body of economic literature studying the relationship between taxation and economic growth shows that higher rates of taxation reduce economic activity, but spending on essential services can also increase economic activity. Furthermore, low taxes and good government services attract firms to a state but may not be enough to overcome the costs of relocation. Neighboring states compete against each other to offer the best combination of taxes and government services, and presently Missouri has one of the lowest tax rates among its neighbors.

Although this study does not offer a clear policy choice, it shows the potential costs and benefits of many different policy options.

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For more details and citations, please see Show-Me Policy Study no. 23, which is available at ShowMeInstitute.org.



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