John Locke Foundation

spotlight

No. 452 – April 15, 2014

Lower Taxes, Higher Growth

Scholarly Research Reveals Economic Benefits of Fiscal Restraint

EXECUTIVE SUMMARY

During the Great Recession and its aftermath, few issues in North Carolina politics have been as contentious as fiscal policy. According to a literature survey of recent studies examining the relationship between public policy and economic performance at the state and local level, it is clear that the policy preferences of fiscal conservatives have strong empirical support. Most studies find that lower levels of taxes and spending, less-intrusive regulation, and lower energy prices correlate with stronger economic performance. Most studies also find that the quantity and quality of infrastructure and the level of educational attainment are linked to economic performance. However, that doesn't necessarily mean that raising taxes to fund more spending on infrastructure and education will prove to be a good investment, since the relationship between government spending and outcomes is not particularly strong.

For state and local officials, this suggests a strategy for promoting economic growth in both the short term and the long term that includes:

- **Keeping overall tax and regulatory burdens as low as possible.**
- **Spending more tax dollars on public safety and the courts.**
- **Increasing the productivity of current taxpayer spending on infrastructure and education programs.**

These implications of academic research on economic growth closely track with recent public policies adopted in North Carolina. Judging from the available empirical evidence, North Carolina's new policy mix is likely to result in stronger economic growth in the coming years.

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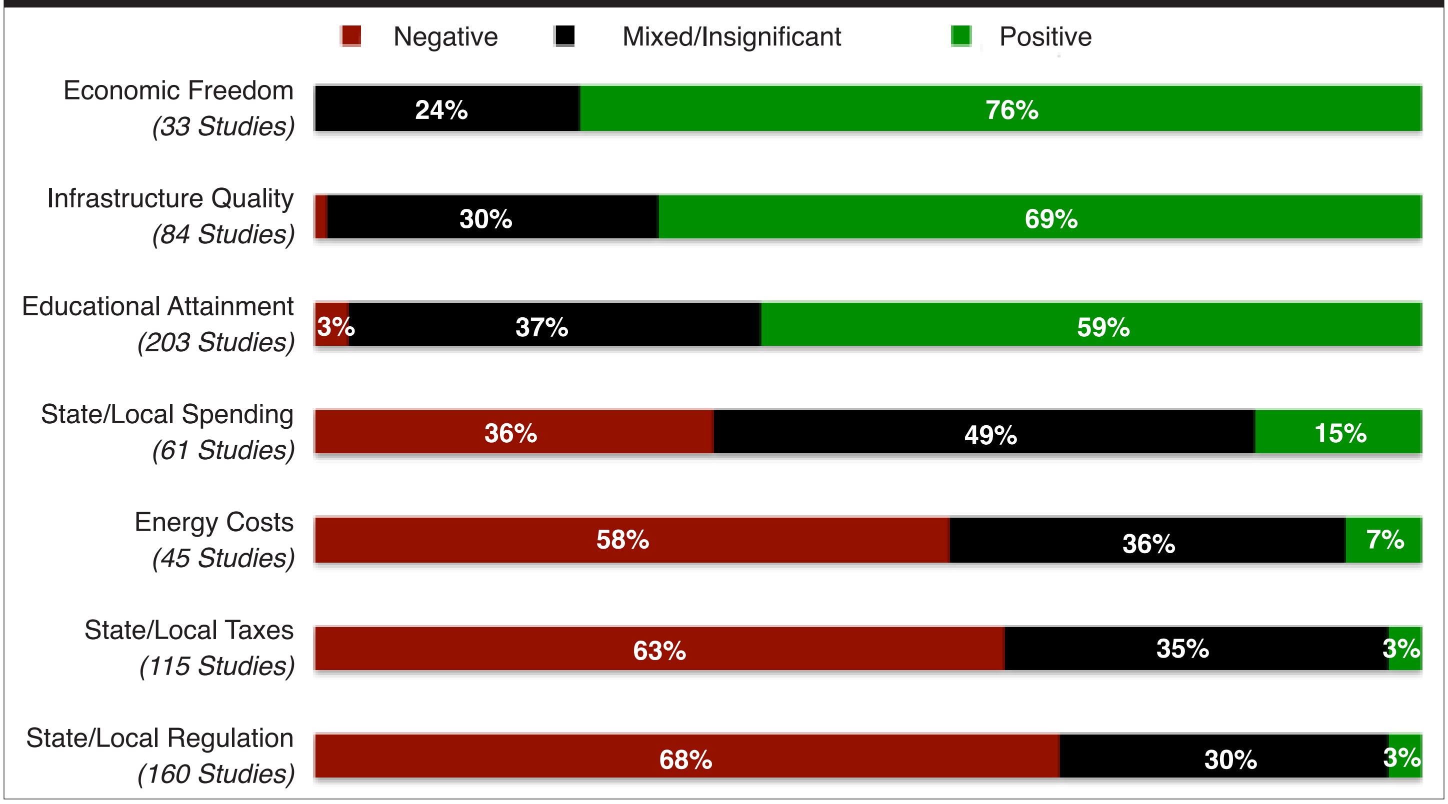
During the Great Recession and its aftermath, few issues in North Carolina politics have been as contentious as fiscal policy. As the recession opened up a massive hole in the state budget in 2009, then-Gov. Bev Perdue proposed "temporary" increases in sales, income, and other taxes to protect some state spending programs. After Republicans captured the General Assembly in the 2010 midterms, they rejected Perdue's proposal to extend those tax hikes for another two years, prompting a gubernatorial veto and legislative override. In 2013, Perdue's successor, Gov. Pat McCrory, worked with legislators to craft a reform and reduction of state taxes that gives North Carolina a simpler, flat-rate income tax, lower taxes on business investment and job creation, and a somewhat-broadened sales tax.

As governors and lawmakers debated these decisions, they revealed substantial disagreements about how fiscal policy affects economic growth. Fiscal liberals argue that higher taxes aren't harmful because they fund public services that boost economic performance, including education, infrastructure, and even public assistance programs such as Medicaid. Fiscal conservatives, on the other hand, argue that by discouraging work, savings, investment, and other economic activity in the state, higher taxes harm growth more than the programs they fund aid growth.

Obviously, this disagreement reflects a fundamental difference in political philosophy that may make each side impervious to persuasion by the other. But the claims made by the two sides are, in fact, empirically testable. That is, they can be explored by gathering data on a collection of states or localities, holding other factors constant, and then determining whether higher-taxed, higher-spending jurisdictions tend to experience more economic growth than lower-taxed, lower-spending jurisdictions.

I have recently completed a review of the scholarly studies on the topic. Many details follow, but here is the bottom line: the policy preferences of fiscal conservatives have strong empirical support. As Chart 1 demonstrates, most studies find that lower levels of taxes and spending, less-intrusive regulation, and lower energy prices (which often

Chart 1: Research Findings on Links Between Key Variables and Economic Performance



reflect fiscal and regulatory policies) correlate with stronger economic performance. Most studies also find that the quantity and quality of infrastructure (such as roads and bridges) and the level of educational attainment (such as the share of the workforce with high school diplomas or college degrees) are linked to economic performance. However, that doesn't necessarily mean that raising taxes to fund more spending on infrastructure and education will prove to be a good investment, since the relationship between government spending and outcomes is not particularly strong.

Review Methodology

In the process of researching *Our Best Foot Forward: An Investment Plan for North Carolina's Economic Recovery*, a book published by JLF in 2012, I conducted a literature survey of all recent studies published in academic or professional journals examining the relationship between public policy and economic performance at the state and local level. Since the book's publication, I have continued to add to my database of scholarly research on state economic policy.

Although I place a high value on work published by other organizations, such as think tank studies and government reports, the purpose of this study was to summarize and convey the findings of modern academic scholarship about key issues such as state and local tax policy, government spending on education and infrastructure, and the effects of state and local regulation on economic performance. That is why only articles from peer-reviewed academic or professional journals were included in this review.

As of April 2014, the database contains 681 journal articles published since 1990 that explore relationships between state or local policy and measures of economic performance such as employment, job creation, income growth, population growth, business starts, or investment flows. Dozens of different journals have published at least one relevant article during the past quarter century, although publications specializing in regional studies, fiscal policy, state governance, and urban or rural economics account for nearly half of the total works cited. These include the *Review of Regional Studies* (37), *Journal of Regional Science* (30), *Economic Development Quarterly* (30), *Journal of Regional Analysis and Policy* (24), *Regional Science and Urban Economics* (21), *Public Finance Review* (20), *National Tax Journal* (20), *Journal of Urban Economics* (19), *Growth and Change* (17), *Southern Economic Journal* (13), *Annals of Regional Science* (11), *Papers in Regional Science* (10), *Urban Studies* (9), *Contemporary Economic Policy* (9), *Regional Studies* (7), *Land Economics* (7), *Urban Affairs Review* (6), *Journal of the American Planning Association* (6), *Public Budgeting and Finance* (5), *Review of Urban and Regional Development Studies* (5), and *International Regional Science Review* (5). Other journals with multiple citations in the database include the *American Economic Review, Journal of Political Economy, Journal of Financial Economics, Public Choice, Economics of Education Review, Journal of Labor Research, Journal of Public Economics, Journal of Economic Growth, Review of Economic Studies, Quarterly Journal of Economics, Journal of Econometrics*, and *Review of Economics and Statistics*.

In some cases, the articles focused directly on an issue of interest to state and local policymakers, such as the effects of tax incentives on job creation or the relationship between income growth and education attainment. In other cases, the authors were exploring other issues — such as the economics of industrial concentration — and used fiscal, regulatory, or other factors as control variables in their equations. For each variable of interest, I coded the study's findings as 1) negative and statistically significant, 2) positive and statistically significant, or 3) mixed or statistically insignificant.

As nearly all of the 681 studies examined more than one variable, there are actually 1,389 separate findings in the database. Of the total, state or local tax policy (433) and state or local expenditures (431) account for nearly a third each, with educational attainment (203), infrastructure quantity and quality (84), state or local regulation (160), the related issue of energy costs (45), and economic freedom rankings (33) accounting for the rest of the findings.

Findings on Taxes

State and local tax policy is far from the most important factor influencing economic growth. Market factors such as technological change, business innovation, and proximity to suppliers or consumers explain most of the differences in economic performance among states and localities. But when it comes to factors over which policymakers can exercise direct control, taxes clearly matter. They have a significant effect on business and household decisions. Anyone who claims that overall tax burdens and specific tax policies have little effect on state and local economies has simply not read the relevant research.

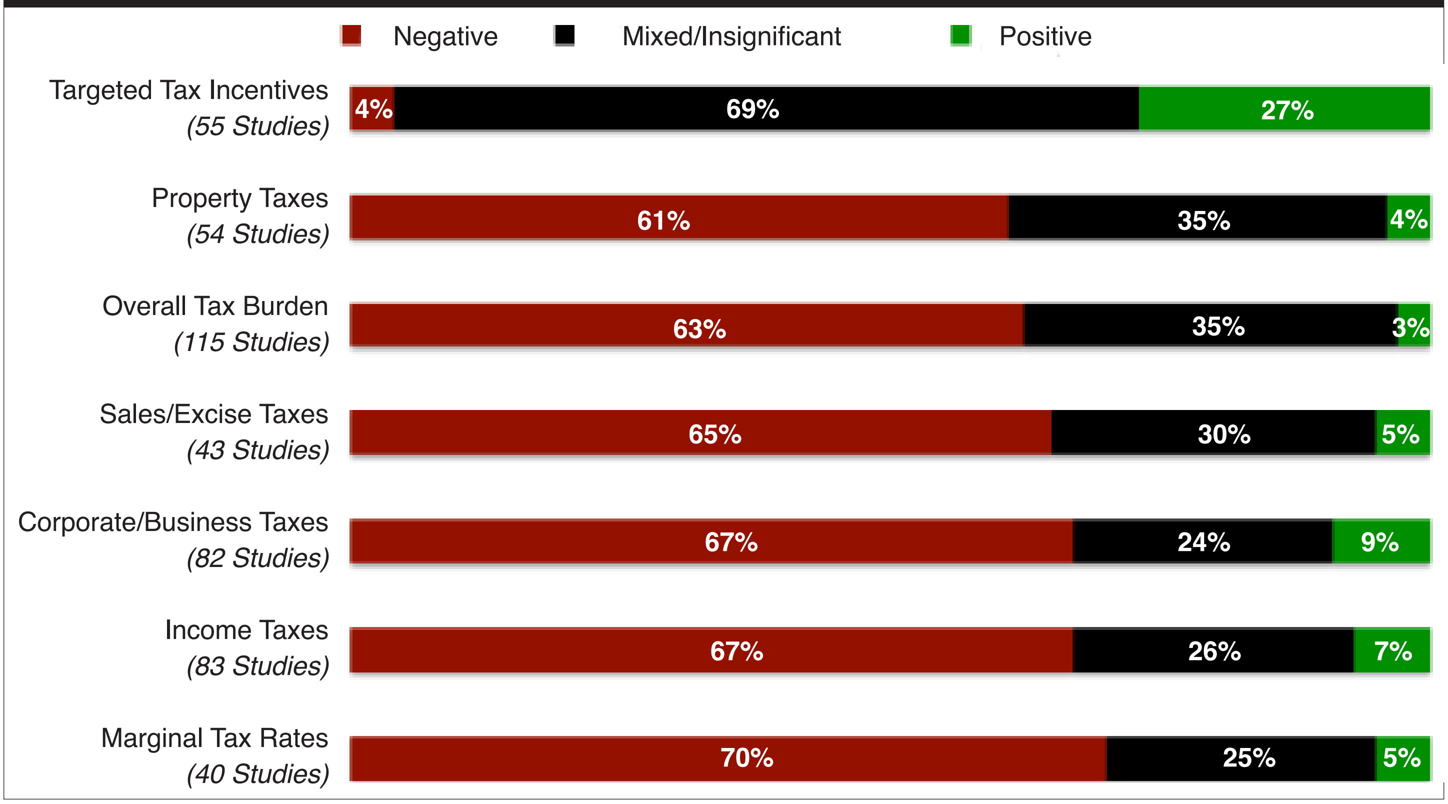
I was able to find 115 studies published in peer-reviewed journals since 1990 that examined overall state or local tax burdens, measured as either total tax revenue per capita or total tax revenue as a share of income. In 63 percent of the studies, tax burdens were negatively associated with economic performance. In only three of the 115 studies were taxes positively associated with economic performance, all other things being held equal.

The findings for specific tax polices were revealing. Property taxes were negatively associated with economic performance 61 percent of the time. The rate rose to 65 percent for sales taxes, 67 percent for corporate income taxes or other business levies, 67 percent for personal income taxes, and 70 percent for the subset of income-tax studies that examined marginal rates rather than just average taxes paid. On the other hand, recent scholarship is not friendly to the notion that states and localities can promote economic growth by offering tax credits or other targeted tax incentives. More than two-thirds of the studies found no link between tax incentives and economic performance.

Findings on Government Spending

In response to empirical evidence linking tax burdens or tax rates with economic growth, fiscal liberals often argue that cutting taxes means cutting spending on public services that also have the potential to affect economic growth.

Chart 2: Findings on Links Between State/Local Tax Policies and Economic Performance



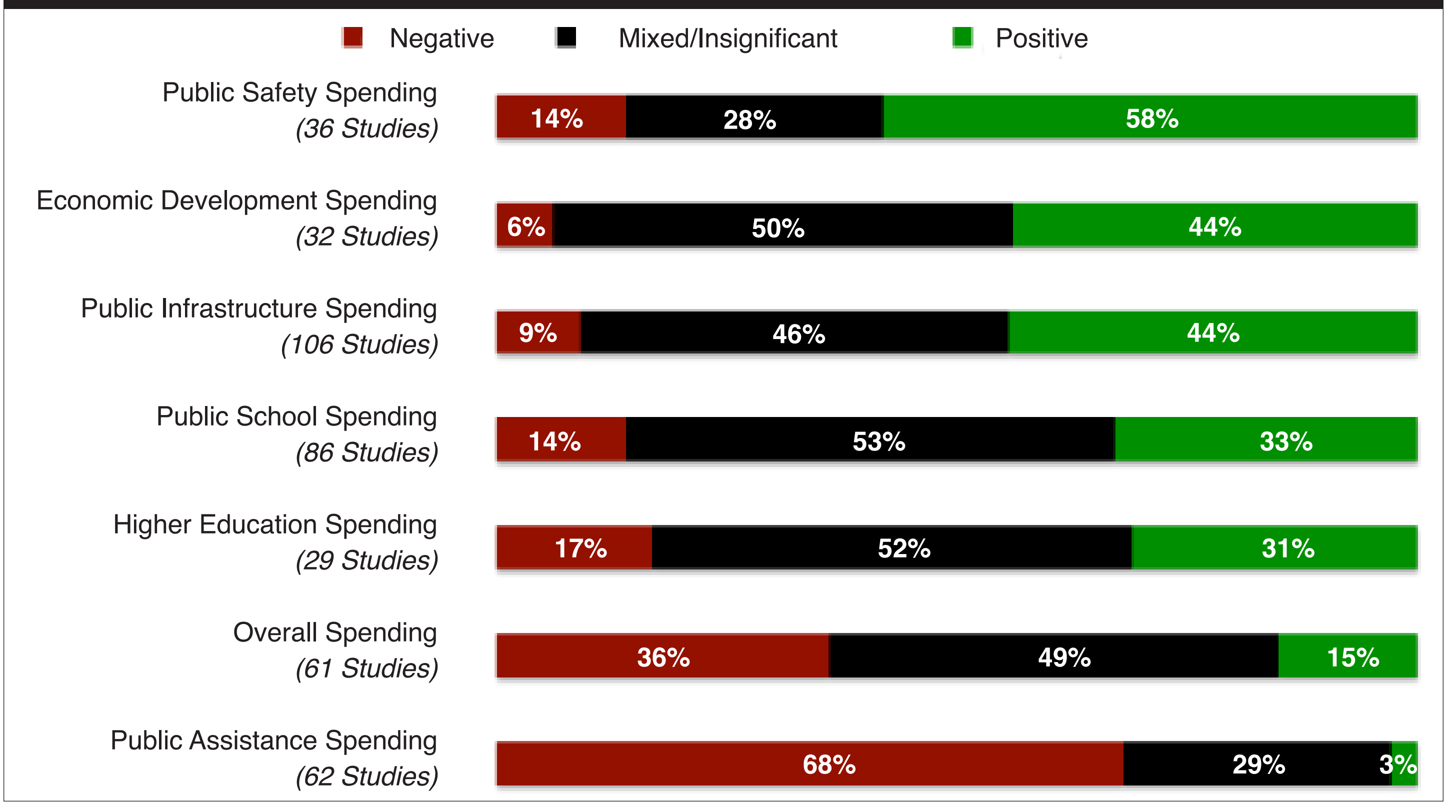
The argument is reasonable. Unless you are an anarchist who believes that a stateless society would be the most economically prosperous, you must agree that levying some taxes to fund valuable public services must result in better economic performance.

So the real questions are these. First, which public services are the most valuable to state and local economies? And second, at what point do the economic costs of higher taxes exceed the economic benefits of higher government spending?

According to the preponderance of academic research published over the past quarter century, most states and localities have exceeded the point at which additional government spending would deliver more economic benefits than costs. In the 61 studies that examined overall spending levels, measured either as expenditures per capita or expenditures as a share of income, higher spending was associated with higher economic growth in only 15 percent of the cases (see Chart 3). A plurality of studies found no relationship between spending and economic performance, while more than a third found a negative relationship.

These results for overall spending levels mask important differences in spending efficacy by category, however. Public assistance programs, for example, are strongly and negatively associated with economic performance. Those who argue that using Medicaid, welfare, or other transfer programs to redistribute income can serve as an effective economic stimulus are clearly incorrect (at least when transfers are funded with state or local revenue). Public assistance programs may be justified on other grounds, but they do not fit the definition of "public investment." On the other hand, there is one expenditure category — public safety, which includes spending on police protection, fire protection, corrections, and the court system — in which most studies find a positive correlation with economic performance. In most other categories, the relationship between government spending and economic growth is muddled. In a plurality of cases, studies find mixed or statistically insignificant effects.

Chart 3: Findings on Links Between State/Local Spending and Economic Performance



Still, in the cases of spending on infrastructure (primarily transportation) and economic development (which includes business marketing, assistance, and recruitment programs), the share of studies finding a positive link to economic performance is at least somewhat close to half. And there is compelling evidence for the idea that the intended results of government spending — such as infrastructure quality and educational attainment — do help economies prosper.

What are we to make of these findings? There are several potential explanations. One is that states and localities often struggle to translate higher funding levels into better outcomes. Some high-spending states have high-achieving schools, for example. Other high-spending states have low-achieving schools. Differences in program design and implementation could explain the variation, as could factors outside the control of educators, such as parental background.

Another potential explanation is that, as with most other goods and services in the economy, government expenditures have diminishing returns. When states and localities first built roads and opened schools, the investment may have generated strong economic benefits that far exceeded the economic costs of the required taxes. But as governments added more dollars to existing programs, the resulting economic boost weren't as large. At some point, the marginal benefit of spending will fall below the marginal cost of the required taxes. Because this review focuses only on peer-reviewed research published since 1990, it could well be that most state and local budgets have in recent decades simply grown beyond the point of diminishing returns. In several papers in this literature survey, authors described the phenomenon as a "non-linear relationship" or a "growth hill."

Findings on Regulation and Economic Freedom

In addition to fiscal policy, many scholars have studied the effects of state and local regulation on economic performance. Some studies examine overall regulatory activity, measured by rules issued, the budgets of regulatory agencies, or rankings of regulatory stringency. Other studies consider specific regulatory policies such as state minimum wages, licensing laws, product bans, or emission caps.

In more than two-thirds of the 160 peer-reviewed studies I located on the subject, higher levels of regulation were associated with lower levels of economic performance. Still, there were some cases in which regulation appeared to boost rather than retard growth. As with fiscal policy, these findings suggest a non-linear relationship between regulation and growth — that many states and localities have imposed so many rules that the ones that do confer net benefits are now outnumbered by the ones that cause net economic losses.

Several public policy organizations combine fiscal and regulatory measures to produce indexes of economic freedom. Two of them, the Economic Freedom of North America index by the Canada-based Fraser Institute (http://www.freetheworld.com/efna.html) and the Freedom in the 50 States index by the Virginia-based Mercatus Center (http://freedominthe50states.org/), have been the subjects of scholarly research. In the 33 peer-reviewed studies published since 1990, 76 percent found a positive, statistically significant association between state economic freedom and state economic performance. These findings are strongly suggestive, although additional research would be welcome.

Implications

For state and local officials, the past quarter-century of academic scholarship about the relationship of public policy and economic performance suggests the following strategy for promoting economic growth in both the short term and the long term:

- Keep overall tax and regulatory burdens as low as possible. In particular, avoid high marginal tax rates on personal and corporate income and use regulatory budgeting, cost-benefit requirements, and rule-sunset provisions to focus regulatory efforts on the greatest threats to public health and safety. Set a goal of making North Carolina one of the nation's highest-ranked states in economic freedom.

- Consider spending more tax dollars on public safety, where the potential gains in economic performance appear to be the greatest. This may reflect the importance of lower crime rates in bringing economic growth to distressed communities or the high value that entrepreneurs and business executives places on fair, speedy resolution of legal disputes in state courts.

- Increase the productivity of current taxpayer spending on infrastructure and education programs. Reform these programs to slash overhead, employ competitive bidding and consumer choice, and generate higher output for every dollar invested. If higher levels of taxpayer spending on infrastructure and education are desirable, fund them by reducing government expenditures elsewhere in the budget, not by raising taxes.

As it happens, these implications of academic research on economic growth closely track with recent public policies adopted in North Carolina. State lawmakers and the McCrory administration have adopted a Flat Tax, reduced the overall tax burden for most households and businesses, adopted regulatory reforms, and instituted changes in highway funding and school management that promise to increase the productivity of public spending. Judging from the available empirical evidence, North Carolina's new policy mix is likely to result in stronger economic growth in the coming years.

John Hood, President