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THE GROWTH MIRAGE: STATE TAX CUTS DO NOT AUTOMATICALLY LEAD TO ECONOMIC GROWTH

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ABSTRACT

Cuts in top state income taxes are intended to raise economic growth, but could instead force punishing spending cuts, as revenues fall and states confront borrowing constraints. Previous work shows no clear impact of state taxes on growth. In new research, we build on a widely cited study that identifies a robust negative relationship between tax rates and state growth. We find that the negative effects disappear when we extend the sample beyond 2000 and that the relationship is unstable over time and across taxes. Likewise, examination of recent state tax cuts reveals little evidence of tax cuts driving growth.

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Over the past 40 years, many conservative politicians have argued that the cure for what ails the economy is lower taxes and, more specifically, lower income tax rates on high-income households. Beginning with Arthur Laffer's famous napkin, the theoretical concept that reducing the top income tax rates would boost economic growth and revenue has been accepted as fact in some circles.

Although there is scant evidence that cuts in top federal income tax rates have actually boosted growth rates, the movement for lower income tax rates spread to state governments long ago. Failure at the federal level for this tactic to work as intended does not necessarily imply tax cuts would fail to increase output and jobs at the state level. For one thing, lower taxes might lure existing businesses and jobs from other states, even if they do not yield a national increase in jobs. But the stakes are higher for the states. The federal government can finance revenue shortfalls by borrowing from the public, but states are far more constrained, both by skeptical private credit markets and constitutional prohibitions against deficit finance. The failure of supply-side economics to work its magic at the state level could force punishing cuts in spending.

Indeed, evidence that state tax cuts boost growth is weak. In recent research (Gale, Krupkin, and Rueben 2015), we found an array of conflicting evidence in the vast literature on this topic. Even in the minority of cases where tax cuts had positive impacts on growth, the implied effect would often be economically negligible. In that study, we further built on one widely cited study that identifies a robust negative relationship between tax rates and growth. We found that the underlying relationship disappears when we extended the data to cover the period since 2000, and that the relationship was unstable over time and across taxes. Further examination of recent state experiences with changing tax structures reveals little evidence of tax cuts driving growth.

SUPPLY-SIDE ECONOMICS

Ever since the 1970s, when Jude Wanniski and Arthur Laffer put forward the ideas now referred to as supply-side economics, conservative politicians have been unable to resist the siren song of tax cuts for high-income households. The claim is not merely that high-end tax breaks benefit successful individuals, but that tax cuts serve the broader public interest by encouraging work, business expansion, and job creation.

In the extreme versions that thrived early in the Reagan administration, advocates, or "supply siders," argued that federal tax rates were so high and the response to tax cuts was so large that tax-cut packages that reduced income tax rates would increase economic growth enough to pay for themselves. After decades in which lower tax rates generated less revenue, however, today's supply siders are more inclined to claim that, though tax cuts cost some revenue, the boost in economic activity is worth the loss. Still, some proponents cannot help

themselves and lapse into the more hyperbolic [claims](#) of economic benefits.¹ Yet the evidence that income tax cuts affect economic growth is weak.

FEDERAL EVIDENCE

At the national level, there is virtually no evidence that broad-based income tax rate cuts have a positive effect on growth. The Reagan tax cuts in the early 1980s coincided with a period of average growth—measured from peak to peak of the business cycle. Evidence that the tax cuts affected growth is weak or nonexistent. In 1989, [research](#) by Martin Feldstein, President Reagan’s chief economic adviser, and Doug Elmendorf, former Congressional Budget Office director, concluded that the 1981 tax cuts had essentially no net impact on growth. They found no evidence that the 1981 tax cuts induced people to work more, and concluded instead that the 1980s recovery was chiefly the result of monetary policy.

No one now credibly claims that the 2001 and 2003 Bush tax cuts stimulated growth. The two acts slashed tax rates on ordinary income, capital gains, dividends, and estates, but economic growth remained sluggish from 2001 through 2007, when the economy tanked. The growth that did occur is widely thought to be a result of the Federal Reserve System’s easy money policy, which led to more borrowing, especially in the housing market.

But the Reagan and Bush tax cuts, each about 2 percent of gross domestic product (GDP), were tiny compared with the tax increases during and after World War II. During this period, federal taxes rose more than 10 percent of GDP. Income tax rates went up for nearly everyone and stayed high for decades. Between 1944 and 1963, the top income tax rate never fell below 90 percent. According to supply-side theory, this tax rate should have killed the economy. Instead, [Stokey and Rebelo \(1995\)](#) found real per capita growth differed little from the historical averages. Granted, World War II was a unique historical experience, and the United States emerged from the war as the world leader in economics and politics, so an equivalent-sized tax increase would likely have a more deleterious effect now. Still, it is informative that growth rates were essentially uninterrupted by the massive and permanent shift in government revenues and spending the war induced.

INTERNATIONAL COMPARISONS

Tax rates as determinants of long-term growth fare no better in cross-country comparisons. [Research](#) by Thomas Piketty, Emmanuel Saez, and Stefanie Stantcheva (2011) analyzed data from 18 developed countries and found no relationship between how a nation changed its top marginal tax rate and how rapidly it grew between 1960 and 2010. For example, in the United States, which cut its top rate over 40 percentage points during that period, GDP grew just over 2

percent annually per capita. Germany and Denmark, which barely changed their top rates, experienced about the same growth rate.

The story is much the same when total tax burdens are compared. Over the 1970–2012 period, taxes as a share of GDP were 7 percentage points higher in the rest of the combined countries in the Organisation for Economic Co-operation and Development countries (32 percent) than in the United States (25 percent). Yet, annual per capita growth was virtually identical (at 1.8 percent) in these countries and the United States.

STATE-LEVEL EXPERIENCES: 1990–2010

Six states enacted major income tax cuts during the 1990s (Leachman and Mazerov 2015). Their subsequent growth records were mixed. Output grew faster, on average, in Connecticut, New Jersey, and New York than in the nation as a whole. But that growth is mostly explained by the booming [financial sector](#), which played an outsized role in those three states (Philippon 2008). The three other states (Colorado, Delaware, and Massachusetts) experienced slower economic growth than the rest of the country. The divergent records indicate that something other than state tax policy drove economic growth. Moreover, employment grew faster in the rest of the country than in the six tax-cut states combined.

New Jersey's tax cut was anchored by a 30 percent reduction in personal income taxes from 1994 to 1996. Using county-level data on employment, Reed and Rogers (2004) [found](#) that New Jersey experienced strong employment growth after the tax cut, but so did counties with similar economies in nearby states without tax cuts. The net effect of the tax cut, measured by the difference in employment gains between New Jersey and the other economic regions, was small and not statistically different from zero.

Big tax cuts remained popular in the following decade. Between 2001 and 2007, Arizona, Louisiana, New Mexico, Ohio, Oklahoma, and Rhode Island cut personal income taxes with no discernable impact on economic activity. From 2001 to 2012, the economies of these states grew, on average, at the same rate as the US economy. In fact, extending the measurement period through 2014, four of these six states experienced declines in their shares of total US employment. New Mexico and Oklahoma experienced net gains in employment share over the extended period, but that was more likely the result of sharp increases in oil and gas production (Leachman and Mazerov 2015).

NEW ENTHUSIASM FOR STATE TAX CUTS

As revenues improved in the aftermath of the Great Recession, many states revived the mantra that cutting state taxes, especially top income tax rates, would lead to many more private-sector jobs and jump start their economies. Kansas enacted a much-publicized state income tax cut in

2012. In the previous 30 years, Kansas’s economic growth consistently lagged that of both neighboring states and the nation as a whole. To reverse the trend, Governor Sam Brownback pressed for a tax cut that would be “[like a shot of adrenaline](#) into the heart of the Kansas economy” and turn the state into a [Texas-like economic powerhouse](#).²

Brownback initially submitted a revenue-neutral plan that reduced income tax rates across the board and effectively exempted small business income from taxes, and offset these cuts by making an expiring sales tax increase permanent and eliminating itemized deductions. The legislature, however, enacted the income tax cuts and business exemption without any offsetting revenue changes. Starting in 2013, the plan eliminated the 6.45 percent top rate, cut the next rate from 6.25 to 4.8 percent, and dropped the lowest rate from 3.5 to 2.7 percent. The plan also eliminated taxes on pass-through income from small businesses, reducing the effective state income tax rate on those businesses to zero. Brownback adopted the plan as his own, calling the legislation a “[real live experiment](#)” in supply-side economics.³ In 2013, the legislature cut taxes again. It passed a measure to gradually lower rates even more over five years. By 2018, the top rate would fall to 3.9 percent. It also partially restored some of the credits it eliminated in 2012.

The tax cuts did not produce the hoped-for growth, though, and revenue losses were greater than anticipated, coming in \$330 million below projections in 2014.⁴ Responding to the gloomy news, both Moody’s and Standard and Poor’s lowered Kansas’s credit rating. In its downgrade report, Moody’s specifically identified the tax cuts as contributing to the depletion of Kansas’s fund balance.⁵

The tax cuts were not a boon to jobs. Kansas failed to keep up with the region’s pace of job growth or increase its job growth relative to the previous period. From January 2013 through May 2015, Kansas’s total and private employment growth rates (2.5 percent and 3.5 percent, respectively) lagged that of both its neighboring states (3.2 percent and 3.8 percent) and the United States (4.7 percent and 5.6 percent) (Bureau of Labor Statistics 2015).

Under the threat of looming deficits and large spending cuts, especially funding for schools, the Kansas legislature raised taxes this June. But instead of reversing the already-in-place income tax cuts and closing the loophole that eliminated tax liability for small businesses, both of which would have been progressive changes, Kansas increased its regressive taxes. The sales tax rose to 6.5 percent (from 6.15 percent); excise tax on cigarettes rose from 79 cents to \$1.29 a pack. In what could be interpreted as an acknowledgment that the income tax cuts were not leading to budget-balancing growth, the legislature did cancel the planned income tax rate cut to 3.9 percent and froze income tax rates.

Over the past few years, other states have cut income taxes and partially offset the revenue losses by raising sales taxes (Francis and Sammartino 2015). Since 2011, Governor Scott Walker of Wisconsin has signed a series of tax cuts that reduced revenue by roughly \$2 billion—a

remarkable loss for a state with general fund spending of about \$15 billion. The expected job growth and budget surpluses in Wisconsin that were hoped for with this cut have not arrived.⁶ To balance the budget, Governor Walker recently signed legislation that cuts funding for higher education, roads, and scientific research.

After the economic boon and resulting surge in tax revenue from the reconstruction following Hurricane Katrina, Louisiana governor Bobby Jindal pushed through \$700 million in income tax cuts in 2008. Unfortunately, these cuts and a decline in reconstruction efforts, in part because of the recession, turned Louisiana's \$1 billion budget surplus in 2007–08 into a projected budget deficit of \$1.6 billion for 2015–16, adding to the woes of a state budget that is perpetually vulnerable to changing economic conditions related to oil production. Governor Jindal's administration responded by freezing public employee wages, scaling back tax expenditure benefits, raising the cigarette tax by 50 cents per pack, and increasing motor vehicle fees.

Idaho, North Carolina, and Oklahoma have jumped on the bandwagon and recently reduced income tax rates, and Illinois let its temporary hike expire as scheduled. In the spring of 2015, sustained efforts to cut individual income tax rates created political gridlock that made it difficult to enact budgets and pushed several states to the brink of shutdown.⁷

SYSTEMATIC EVIDENCE

Recent studies of state taxes and economic growth have reached contradictory conclusions: tax cuts raise, reduce, do not affect, or have no clear effect on growth. In addition, the effects of changing different taxes—income, corporate, property, and sales—vary dramatically within and across studies. Methodological factors complicate interpretation of these findings: the studies use different dependent variables, analyze different time periods, employ alternative measures of tax revenues and rates, include different measures of government spending, control for different independent variables, and use different control groups and identification methods. Additionally, balanced-budget rules imply that revenues and spending should be closely correlated, making it especially difficult to study the independent influence of taxes or spending.

In our own recent [research](#), we worked to be fair to all sides, making fresh estimates of how state tax policy affects economic growth and entrepreneurial activity (Gale, Krupkin, and Rueben 2015). Using Reed's (2008) framework, which found significant, negative, and robust effects of taxes on income growth during the period between 1970 and 1999, we extended the sample period and performed a variety of sensitivity tests. Our results showed that neither tax revenues nor top marginal income tax rates bear any stable relation to economic growth rates across states and over time. We found the results were unstable over time—there was a negative relationship between taxes and growth in the 1980s and 1990s, but a positive one in the last two decades. The results also varied enormously across different revenue sources.

Consistent with these findings, we also found that tax revenues have unstable effects on employment over time and that marginal tax rates do not affect employment levels. Though top income tax rates negatively affected the rate of firm formation, the effects are small. The gist of these results is that, consistent with our long list of state experiences described above, states should not presume that cutting state income taxes will boost economic growth.

CONCLUSION

At the core of supply-side economics is Art Laffer's [curve](#) illustrating the obvious reality that, at some point, higher tax rates lead to lower revenue (Wanniski 1978). But that does not mean that real-world tax rates are so high that cutting them would create jobs or growth. That has been amply demonstrated at the national and international levels, where tax cuts have eroded revenue without a discernable effect on economic activity.

Additionally, the results from our recent state-level research are not consistent with the view that cuts in top income tax rates generate growth. Drawing on the related literature and states' historical and more recent experiences, we find that states have no good reasons to believe that cuts in income tax rates will bring the desired benefits. Yet, states continue to erode their tax bases in the name of economic growth during a time when few states can afford to cut services, such as education and infrastructure repair, that are critical for both businesses and households.

Some ideas live on and on, no matter how much contrary evidence accumulates. Faced with the severe budget crisis caused by his tax cuts, Governor Brownback now says that the tax cuts just take time to work their magic.⁸ Though it is unclear if that is true, states do not have the budget flexibility the federal government does, and they cannot wait for the long run to come.

NOTES

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