Taxing Texans:

A Six-Part Series Examining Taxes In The Lone Star State

by Richard Vedder, Ph.D.

Part 2

Executive Summary

In the arguments over flat taxes, regressive and progressive taxes, hidden taxes, loopholes, and all the other technical matters, it is easy to lose sight of the fundamental question: How does any particular tax or level of taxation improve the material welfare of the citizenry? Does taxation spur or impede economic growth for everyone?

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No one denies that some government is essential for prosperity, since property rights have to be protected and the nation defended. But the overwhelming weight of the evidence shows that, in most industrialized countries, government has grown to the point where it has become a serious drag on economic growth.

For example, studies have shown that each one percent tax increase lowers output per worker by about two percent. That finding has been confirmed by state-by-state comparisons between high-tax and low-tax states. The most recent studies by Martin Feldstein of Harvard concluded in 1997 that "the deadweight burden caused by incremental taxation ... may exceed one dollar per dollar of revenue raised, making the cost of incremental government spending more than two dollars for each dollar of government spending." Economists working overseas have observed similar effects.

Other studies have shown that high taxes discourage business entrepreneurs from locating in a given area; reduce the inflow of new residents into a region and increase the outflow of residents out of a region; and reduce job opportunities and sometimes lead to higher unemployment.

What does a growth-oriented fiscal policy look like? It would stress general tax relief for the entire citizenry rather than targeted tax abatements or other subsidies for specific individual businesses. It would emphasize public investment in highways and parks rather than entitlement or income maintenance programs. Finally, a growth-oriented policy would minimize business governmental regulation and keep a rein on unemployment and worker compensation costs. **Fortunately, Texas, with its low tax burden, has all of these things.**

The Effect of Taxes on Economic Growth:

What Research Tells Us

In the arguments over flat taxes, regressive and progressive taxes, hidden taxes, loopholes, and all the other technical matters, it is easy to lose sight of some fundamental questions: How does any particular tax or level of taxation improve the material welfare of the citizenry? Does taxation spur or impede economic growth for everyone? What is the right mix of taxes, or the right level of fiscal support, that will provide for the functioning of government while not hurting growth?

High Taxes = Low Growth

No one denies that some government is essential for prosperity, since property rights have to be protected and the nation defended. But the overwhelming weight of the evidence shows that, in most industrialized countries, government has grown to the point where it has become a serious drag on economic growth (Vedder and Gallaway 1998, 1999b; Gwartney, Lawson and Holcombe 1998).

... the higher the level of taxation, the lower the rate of economic growth ...

So does the corollary hold true? Do the high taxes that support the growth of government also check economic growth by curbing the growth of taxpayers' income? The evidence is clear that they do. In fact, several decades of studies by economists confirm the proposition that *the higher the level of taxation, the lower the rate of economic growth*, holding non-tax factors constant.

This finding reversed earlier conventional wisdom that the effect of taxation on economic growth was negligible. For example, speaking about industrial locations of firms, Distinguished University of Illinois public finance expert John F. Due opined in 1961 that studies "suggest very strongly that the tax effects cannot be of major importance." By the late 1970s, however, research was reaching different conclusions – in part because the negative effects of taxes grew as the tax burden itself grew larger.

Fortunately, our federal system of government provides an excellent laboratory to evaluate tax policy, since there are 50 different states and thus 50 different tax systems. In what may have been the first empirical analysis, economists Robert J. Genetski and Young D. Chin used a simple regression model to show that economic growth was negatively correlated with changing rates of state and local taxation. I replicated and expanded upon that conclusion in two studies for the Joint Economic Committee of Congress in 1981 and 1995. Meanwhile, other economists were

showing how high taxation had an adverse impact on states or territories such as Illinois (Heins 1976), Puerto Rico (Canto and Laffer 1979), and Massachusetts (Kadlec and Laffer 1981). The scholarly studies were reinforced by articles and books written for broader audiences: Gilder (1981), Bartlett (1980), Adams (1984), Wanniski (1978), and Brookes (1982).

... a progressive income tax rate structure causes more damaging economic effects than a flatter rate tax schedule ...

This early research was confirmed by refinements and extensions to the tax growth literature that took place in the mid and late 1980s. In 1985, Jay Helms demonstrated that the impact of a particular tax depended on how the revenues were used. Welfare expenditures, for example, had a negative impact on economic growth. His findings were confirmed by Alaeddin Mofidi and Joe Stone in 1990 in the *Review of Economics and Statistics*. In 1986, Benson and Johnson showed that the negative impacts of taxation often ripple out over several years, sometimes as many as three. Canto and Webb (1987) concurred, roughly, with Helms's work. Other studies confirmed the tax-growth relationship using other data sets or methodologies, albeit with some variation in conclusions as to the strength of the relationship (for example, Yu, Wallace, and Nardinelli 1991). Still other studies showing the negative effects of government on growth stressed government spending instead of taxes (Scully 1989, Vedder 1993).

In 1995, Paul Cashin found that each one percent tax increase lowers output per worker by about two percent. Cashin did observe some positive effects of spending from taxes, but typically those positive effects were only about one-half as large as the negative tax effect. This is akin to saying that private-sector spending is twice as productive as public-sector outlays. A new study by Holcombe and Lacombe compares counties on both sides of state borders and observes that high taxes impede growth.

It has also been shown that a progressive income tax rate structure causes more damaging economic effects than a flatter rate tax schedule (Vedder 1985, Vedder 1986, Hunter and Scott 1986), a conclusion that extends a pioneering observation of Romans and Subrahmanyam (1979). The early studies using U.S. state data were supported by numerous international studies as well (Marsden 1983, Reynolds 1985). In particular, Gerald Scully's 1988 study "The Institutional Framework and Economic Development" showed that when combined with taxes, governmental intrusions on the economy such as excessive regulation and restrictions on imports, hurt growth. These studies have become larger and more sophisticated with time (Engen and Skinner 1999; Newell and Symons 1993; Barro 1989; Koester and Kormedi 1989; and Rebello 1991). In 1993, Jarig van Sinderen reached a conclusion that serves well as a summary of all these studies:

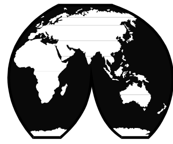
Balanced budget reductions in taxes on wages and profits exert favorable effects on employment and growth. The relative impact depends on the specific government outlays and taxes which are cut back. In the long run, tax revenue decreases less than the amount of the initial tax reduction.

New Research and Looking Overseas

... state and local taxes had an impact on where foreign firms chose to invest in America.

The research has continued up to the present, generally confirming the basic proposition that taxes have adverse effects on economic change. Much of the work has been done at America's premier economic research center, the National Bureau of Economic Research (NBER). Its president, Martin Feldstein of Harvard, concluded in 1997 that "the deadweight burden caused by incremental taxation ... may exceed one dollar per dollar of revenue raised, making the cost of incremental government spending more than two dollars for each dollar of government spending." A recent NBER study by Robert Carroll and others concluded that Feldstein's finding "is consistent with the view that raising income tax rates discourages the growth of small businesses." James Hines, in a 1996 paper originally written for the NBER but published also in the prestigious *American Economic Review*, found that state and local taxes had an impact on where foreign firms chose to invest in America.

These conclusions are not limited to American economists. Angel de la Fuente, a Spanish economist writing for a British research center, concluded, speaking of government taxation, that "there is evidence of a sizable negative 'externality' effect on the level of productivity." Italian economists Tabellini and Daveri have argued that "the increase in European unemployment and the slowdown in economic growth are related because they stem from a common cause: an excessively high cost of labor. In Europe labor costs have gone up for many reasons, but one is particularly easy to identify: higher taxes on labor."



Using a complex general equilibrium model, German economist Bernhard Heitger concluded that for "the most important OECD countries, taxation turns out to be growth-retarding." In 1998, Roubini, Milesi and Gian concluded that "in general, the taxation of factor incomes ... is growth-reducing." ("Factor incomes" are derived by providing resources for production in the form of wage and salary payments, corporate profits, earnings of unincorporated business enterprises, and so forth).

In an interesting recent study (Gittell, Kaufman and Karson 2000), the authors explore regional and state patterns in American economic change. They conclude that the role of geography itself is modest in explaining differentials, but that other factors, including state personal income taxes, play a more important role. Analysis in Canada shows similar adverse effects of taxes on growth, both impacting on supply and demand (Fougere 1998).

Looking more broadly at nation-members of the Organization for Economic Cooperation and Development (OECD), Boyle and McCarthy (1996) criticize studies showing a modest role for taxes in explaining inter-country growth rates, showing how labor taxation very strongly negatively impacts on the full utilization of resources. In a 1996 study of New Zealand, Gerald Scully (1996) concludes that

the country would have to cut its taxes roughly in half to maximize the rate of economic growth, and that "the marginal cost of taxation...is $2.64 for each extra dollar of taxes collected," showing even greater "deadweight losses" and inefficiencies than Feldstein observed for the U.S.

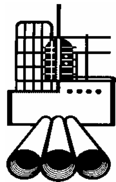
In a study in the highly regarded *Journal of Monetary Economics,* economists from the Federal Reserve and the University of Florida examined changing marginal income tax rates in the U.S. over time, concluding that "lowering taxes significantly raises economic growth and that changing the tax rate schedule also has significant effects on economic growth" (Hakkio, Rush, and Schmidt 1996). This last conclusion reflects the view that **not only do high taxes lower income generation, but that the *type* of tax itself can make a difference.**

Adding Detail

... high taxes deter businesses from investing capital.

So far, we've looked at about 40 different studies that point to the negative impact of taxes on economic growth. Yet there are a large number of studies looking at related issues, such as the impact of taxes on business location. As early as 1977, Grieson, Hamovitch and Morgenstern used econometric techniques to argue that high taxes discouraged business entrepreneurs from locating in a given area. Bernard Weinstein, alone (1977) and with Robert Firestine (1978), noted that high taxes drove up labor costs, as employers had to compensate employees for the burden of high taxes, a conclusion verified empirically in a later NBER study (Gyourko and Tracy 1986).

Follow-up studies in the 1980s which used even more sophisticated models confirmed the earlier conclusion that high taxes deter businesses from investing capital (Carlton 1983; Papke and Papke 1986; Papke 1987; Bartik 1989). Research in the 1990s agreed that taxes matter in business location, albeit with some qualifications, such as Fox and Murray's 1990 conclusion that the sensitivity to taxes varies considerably with industry and firm size (see also Friedman, Gerlowski and Silberman 1992). The Hines study showing that foreign investors are deterred by high taxes confirmed what an earlier study by Couglin, Terza, and Aromdee showed in 1990. One of the more interesting studies used a distinctly low-tech approach of sending questionnaires to business leaders to conclude that high-tech firms were swayed considerably by tax considerations in making location decisions (Premus 1983).



Other research has demonstrated that high taxes reduce the inflow of new residents into a region and increase the outflow of residents out of a region. Early works noting the debilitating effects of taxes on local population growth by Cebula (1974), Browne (1979), and Ecker and Syron (1979), have been replicated by others in the past decade, including Niskanen (1992), Kotlikoff and Raffelhueschen (1991), and Cadwallader (1991).

More recent research reinforces the general conclusion by providing added detail. A

new study in the *National Tax Journal,* for example, suggests that the elderly are influenced by low personal income and death taxes, and prefer states that exempt food from sales taxation (Conway, Smith, and Houtenville 2001). This is consistent with Assadian's 1995 finding that the elderly in Florida were less likely than the general population to migrate into counties with high taxes.

Finally, there is mounting evidence that high taxes reduce job opportunities and sometimes lead to higher unemployment. Wasylenko and McGuire (1985) noted a negative correlation between taxes and metropolitan-area employment growth between 1973 and 1980. Even stronger findings were observed by Plaut and Pluta (1983). Goss, Preston and Phillips (1994) concluded that previous studies understated the adverse employment effects of taxes by failing to control for other factors fully. Lowell Gallaway and I observed in 1996 that high taxes are often positively associated with unemployment, both in the U.S. and internationally. Other research using state and local data makes similar conclusions (Dalenberg and Partridge 1995; Mark, McGuire and Papke 2000).

Looking at the States

More specific detail demonstrating the negative effect that taxes have on economic growth is available when you gather together extensive tax and expenditure data on

U.S. states over long term. I recorded by state several dozen measures of taxes and spending in the years 1957, 1977, and 1997, drawing on three of the *Census of Governments* conducted every five years by the U.S. Census Bureau. Most of the evidence is simple comparisons of average performance of high- and low-tax states. Some economists would argue that such comparisons are simplistic, but in reality, the results are similar to those obtained using complicated statistical procedures.

For the first comparison, I calculated the average tax burden for the 50 states for the years 1957, 1977, and 1997, defined as state and local taxes as a percent of personal income. Taking the average burden for the three dates, I obtained an average tax burden over four decades. I arbitrarily defined the 25 states with the highest average burden as "high-tax states," and the 25 with the lowest burden as "low-tax states." Texas is in the "low-tax" category.

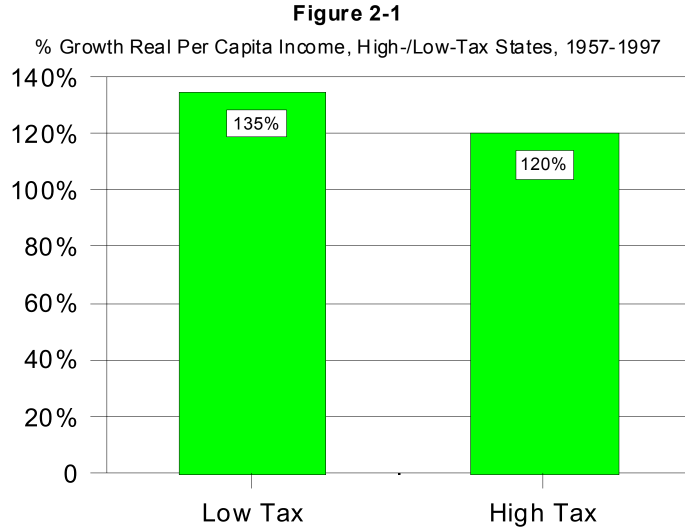
Then I used two different measures of income growth: growth in total personal income, adjusted for inflation; and, growth in real per capita personal income, adjusted for population change. The first measure is the better indicator of overall economic change, while the second is the better measure of income available for individuals for consumption and other uses.

the lower the tax burden, the higher the rate of economic growth.

The results (Figure 2-1 and Figure 2-2) show that the low-tax states outperformed the high-tax states by either measure. Income per person rose by 135 percent from 1957 to 1997 in the low-tax states, compared with 120 percent in the high-tax ones (Figure 2-1). Using the broader measure of growth, real personal income rose dramatically more in the low-tax states, going up by an average of 315 percent, compared with 268 percent in the high-tax jurisdictions (Figure 2-2). This implies that not only were individuals benefiting from faster income growth in the low-tax states, but also that population growth was larger in the jurisdictions with lower tax burdens. In general, the lower the tax burden, the higher the rate of economic growth.

Figure 2-1

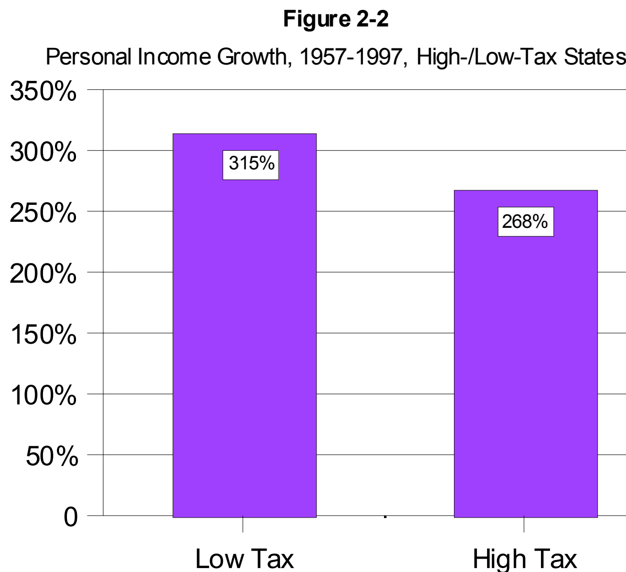
% Growth Real Per Capita Income, High-/Low-Tax States, 1957-1997



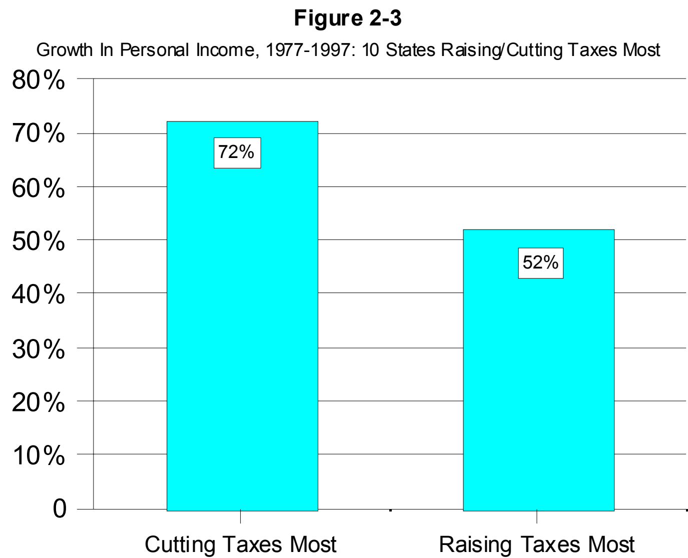
Some individuals believe that a better measure of fiscal policy actions is the change in tax burden over time. Usually most changes in the tax burden reflect new legislative initiatives, and it is the change in burden that more likely will alter behavior. It could be argued that the 40-year time horizon used above is too long, posing issues in measuring tax burdens and the like. So I did some other comparisons, using the change in average tax burden as a measure of tax policy, and using 20-year time periods, specifically 1977 to 1997.

Figure 2-2

Personal Income Growth, 1957-1997, High-/Low-Tax States



Finally, it might be a stretch to call the 25 states with the highest taxes "high-tax" states. Therefore, in Figure 2-3, I looked at the highest ten states and lowest ten states with respect to tax burdens, confining our analysis to states that clearly were at the extremes of the tax burden distribution.[1] The graph reports total real personal income growth, although the pattern holds as well on a per capita basis.



The ten states reducing their tax burden the most grew 72 percent, versus 52 percent for those raising their tax burden the most. In every case, the results are consistent: **high or rising taxes are associated with lower amounts of economic growth**. The use of more sophisticated statistical models produces the same sort of result: higher taxes, lower growth.

Whys and Wherefores

Why is this? It is not because the people working in the public-sector are inherently less efficient, less creative, and less productive than their private-sector counterparts. What is different about the two sectors, however, is that the private-sector responds to the discipline of markets. When firms are facing high costs or low demand, profits suffer. Those firms either adjust or go out of business. When firms are efficient, cutting costs, and selling more appealing products, profits rise. Higher profits usually mean increased wealth and income for stockholders, bigger bonuses for managers and often for even rank-and-file employees. Thus, there are considerable incentives in the private sector to be efficient, lower costs by minimizing the use of resources, and expand revenues by offering an appealing product or service.

But those market incentives are absent in the public sector. Indeed, public-sector bureaucrats often want to *increase* costs, since it means a larger budget. More

[1] In these comparisons, we confined our analysis to the 48 contiguous states. Alaska and Hawaii were not states at the beginning of the period examined. Alaska has always been an outlier because of its enormous oil revenues, and it receives abnormally large federal payments as well. Texas is not on either list. Its tax burden rose slightly, but it was not in the top ten.

resources means more power to the public-sector managers, which often makes it easier for them to do their jobs. Thus, while companies try to cut their labor usage, public-sector enterprises like schools are constantly trying to increase staff. One such way is by reducing teacher-student ratios.

So what does a growth-oriented fiscal policy look like?

- It would stress general tax relief for the entire citizenry rather than targeted tax abatements or other subsidies for specific individual businesses.
- It would emphasize public investment such as highways and parks rather than entitlement or income maintenance programs.
- Finally, a growth-oriented policy would minimize business governmental regulation and keep a rein on unemployment and worker compensation costs.

Fortunately, Texas, with its low tax burden, has all of these things. It would be wise of Lone Star State policymakers to protect the tax system that has helped to make Texas such an economic powerhouse.

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