Do Cuts in State Income Taxes Boost Economic Growth?

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As the United States struggles to recover from the recession of 2007-2009, loud voices are calling for cuts in state and local taxes to spur economic growth. In particular, advocates argue that cuts in personal income taxes will promote growth and development. But what is the evidence for this idea? Objective scholarly research on the economic effects of state and local expenditures and taxes is often neglected or misrepresented by tax cut proponents.

Evidence from my own studies and those of many others suggests that adjustments in state and local taxes and spending can, at most, spark marginal gains in economic performance. Across the United States in recent decades, states and localities have adopted more similar tax and spending policies, leaving less room for improvement. Crucially, there is no evidence that tax cuts pay for themselves by boosting future growth and tax collections. For public officials, there is no escape from carefully considering how various balances of taxes and spending affect both government budgets and surrounding economies. The truth is that certain kinds of tax reductions may have little effect on economic growth – even as they drain government coffers of revenues needed for crucial economic and social goals.

Success Must be Carefully Defined and Measured

Effective state and local tax and spending policies are those that increase general social well-being. But how is this measured? Proponents and opponents of any given policy shift typically highlight just the economic indicators that best support their position. But a single indicator may not accurately reflect overall well-being. To measure that, we must examine a full range of indicators known to get at social well-being, especially when used in combination to track developments across all sectors.

- Wages and housing prices can be jointly tracked to assess the attractiveness of various state and local tax and spending policies to businesses and people who move around.

- Other useful area economic indicators include employment, per capita income, population growth, poverty levels, and trends in economic productivity.

Using such measures, I have discovered important facts about the effects of various policies.

Government Budgets and Economic Activity

Cuts in personal income taxes sound nice – but they must be offset either by increases in other taxes or by reductions in state and local spending. My research suggests that cuts in individual income taxes lead to only slight increases in economic activity, yet produce a substantial net reduction in tax revenues. Governments can keep providing services to residents and businesses only if they increase other taxes to offset the losses from reduced personal income taxes.

However, there is no clear evidence that other taxes are preferable to income taxes, or that cuts in spending can be achieved without harm to the economy. The overall economic effects depend on the exact compensating adjustments states and localities make, given the following realities:

- State and local property taxes have negative effects on county-level economic activity, as do some other state taxes. But corporate income taxes do not affect local economies.
- State spending on highways, housing, and the environment has positive economic effects.
- County spending on education and public safety increases economic activity – and the boost from stronger public safety exceeds negative effects from local property taxes.

Should Oklahoma Imitate Texas?

I looked in some detail at whether my home state of Oklahoma should imitate Texas by cutting or eliminating its personal income tax. Texas has been featured in tax cut debates, because it has robust economic growth and has never had a state personal income tax. As noted by others, Texas raises revenues by levying higher tax rates on other sources such as on the value of personal and business properties. A comparison of Texas to other states provides the basis for evaluating whether the policy mix in Texas is economically beneficial.

Comparisons across states can shed light on which policy mixes are most beneficial to economic growth, but using Texas for comparisons can be tricky, because the Lone Star state has unique characteristics. It is, for example, a border state with high levels of international trade and immigration, and it has a large international seaport. Texas also has lots of land and bank-lending regulations that keep housing prices low, plus an energy hub at Houston and abundant oil and gas resources. The climate and culture also differ from that of the Upper Midwest or Northeast.

A better approach is to compare Texas counties with similar counties in another state. Doing this for the decade from 2000 to 2010, I found that Texas counties did not enjoy any growth advantages over similar Oklahoma counties. When I closely compared counties along the Texas-Oklahoma border with shared cultural, geographic and socio-economic characteristics, I found slower per capita income growth in Texas, particularly in the panhandle. My overall results suggest that the policy mix in Texas – featuring no personal income tax and higher property taxes – did not encourage greater economic growth.

Moving Forward

The research findings I have summarized should make us highly skeptical that tax cuts are a simple cure for what ails state and local economies. To use a football metaphor, altering taxes and spending to improve economic performance is a game of inches, not yards. And our team must not lose sight of the end zone. Over time, investments in education and physical infrastructure are vital, so state and local governments must find efficient ways to provide such services. Tax cuts all the time may make for stirring campaign rhetoric, but they won't lead to optimal economic performance – in Oklahoma or other states.

Read more in Yihua Yu and Dan Rickman, "U.S. State and Local Fiscal Policies and Non-Metropolitan Area Economic Performance: A Spatial Equilibrium Analysis." *Papers in Regional Science* 92, no. 3 (2013): 579-597 and Dan Rickman, "Should Oklahoma be Like Texas? A Taxing Decision." *The Review of Regional Studies* (2013).