Research Review

State tax and budget cuts don't boost economic activity and can cause harm

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Supporters of tax cuts often claim they will directly boost economic activity. A large body of research refutes this argument. In a comprehensive review of four decades of scholarship on this topic, two university researchers conclude, "The vast majority of the academic studies that examined the relationship between state and local taxes and economic growth found little or no effect."[1] Furthermore, new data sets and modeling techniques have revealed shortcomings of, and sometimes reversed, the results of earlier studies that found a negative relationship between tax rates and economic growth.[2]

University of Maine economist Todd Gabe reflects the mainstream academic consensus when he writes, "Taxes are one of many costs faced by businesses, and a whole host of other regional characteristics are more important in the pursuit of economic development."[3] Gabe shared this finding in his 2017 book, The Pursuit of Economic Development: Growing Good Jobs in U.S. Cities and States.[4] In an exhaustive analysis of the factors that have contributed to state economic growth since 1990, he finds no statistically significant connection between taxes and good jobs (which he defines as well-paid jobs that last).

This brief reviews recent studies on the impact of state personal income tax rates on various measures of economic growth. In all, they find that low-tax states fail to outperform high-tax states and tax cuts fail to spur economic growth.

Furthermore, recent cuts to Maine's personal income tax rate have not helped the state capture a greater share of US economic growth. This brief also summarizes several analyses that describe how reductions in state spending, whether necessitated because of tax cuts or recession-induced revenue losses, ripple through the economy in ways that detract from economic growth and equitable outcomes.

Low-tax states fail to outperform high-tax states

The Institute on Taxation and Economic Policy (ITEP) explores the impact of tax rates by comparing the economies of states on the most distant ends of the tax-rate spectrum.[5] It compares nine states with no broad-based personal income tax, such as New Hampshire and Florida, to nine states with the highest ten-year average top personal income tax rate from 2007 to 2016.

ITEP finds that high-tax states experienced higher levels of GDP growth, income growth, and employment from 2006 to 2016. Low-tax states experienced more population growth, but the study's authors attribute this to unrelated demographic and migratory trends. They observe that most of the low-tax states are in the southern and western US, where warm weather and low home prices have contributed to in-migration. Several of these states also have significantly higher birth rates than the high-tax states.[6]

The authors conclude, "The findings of this report do not suggest that higher state income tax rates are causing faster growth, but they do cast serious doubt on claims that cutting or eliminating income taxes will lead to dramatic, measurable differences in states' economic trajectories."[7]

Tax cuts failed to spur state economies

The Center on Budget and Policy Priorities (CBPP) takes a different approach, assessing the impact of cuts in state personal income taxes in the 1990s, 2000s, and 2010s.[8]

In the 1990s, six states (Colorado, Connecticut, Delaware, Massachusetts, New Jersey, and New York) cut taxes in excess of 10 percent of state revenue. In the next economic cycle (2000-2007), jobs in these states grew at just 30 percent of the national rate, on average, and income growth trailed the US average in all states but Delaware.

Similarly, six states significantly cut taxes in the early 2000s (Arizona, Louisiana, New Mexico, Ohio, Oklahoma, and Rhode Island). By 2014, job growth in four of them significantly trailed the US average. According to the report, the two states that experienced higher growth – New Mexico and Oklahoma – were likely bolstered by growth in their uniquely large energy sectors.[9]

In the aftermath of the Great Recession of 2007-2009, more states turned to tax cuts to boost economic growth. Five states with the largest cuts were Kansas, Maine, North Carolina, Ohio, and Wisconsin. In the years following these cuts, four of the five states, including Maine, experienced job growth that trailed the US average. The exception was North Carolina.

Entrepreneurship unaffected by state personal income taxes

Researchers at Wake Forest University and the Federal Reserve Board tested the responsiveness of new business starts to changes in state taxes.[10] Using detailed, county-level data, they found that corporate income tax increases (which are levied on c-corporations but not on sole-proprietors or "pass-through" entities like LLCs) have a small negative impact on entrepreneurship.

After the Great Recession, many states cut taxes to promote growth. Four of five states with the largest tax cuts, including Maine, trailed US job growth in subsequent years.

However, "Personal tax rates have no detectable effect on startup activity, and state sales tax rates have negative but typically statistically insignificant effects."[11] A study in the academic journal Small Business Economics also found that "state tax policies generally do not appear to have quantitatively important effects on entrepreneurial activity."[12]

These results point to the complexities involved with a decision to start a company and affirm that business location decisions, particularly for start-ups, often have little to do with tax policy.

Data on patent origination reinforce this finding as many states with relatively high tax rates also have disproportionately higher rates of entrepreneurial activity, and vice-versa. Some examples:

- In 2019, California ranked first in patent origination, with roughly a quarter of all US patents and the 2nd highest number of patents per capita,[13] but had the 9th highest personal income tax incidence rate according to the Federation of Tax Administrators.[14]

- Also in 2019, Alaska had the lowest tax incidence rate of all states[15] but generated just 0.03 percent of patents, the lowest among states in absolute number and patents per capita.[16]

- Since 2009, Hawaii saw the second highest growth rate of entrepreneurs[17] but had among the highest tax incidence rates of all states.[18]

"Millionaire taxes" have little impact on millionaire migration

Proponents of tax cuts often claim that high taxes will deter high-wealth individuals from living in a state. A large, longitudinal study of these individuals found little evidence of this effect.

Researchers from Stanford University and the US Treasury examined all federal income tax filers who earned $1,000,000 or more in any year from 1999 to 2011.[19] This included 3.7 million filers in all fifty states. They compared the migration patterns of these high-wealth filers to a random sample of all filers during this period.

The study's authors found that "millionaires" were slightly more likely than others to move from a high-tax state to a low-tax state, but the effect is small, and entirely explained by movement to Florida, which does not have a state income tax.

According to the researchers, "Other low-tax states, such as Texas, Tennessee, and New Hampshire, do not draw away millionaires from high-tax states… [W]hen Florida is excluded, there is virtually no tax migration."[20] They explain,

Florida has no state income tax, but it is also attractive in other unique ways—for example, it is the only state with coastal access to the Caribbean Sea. It is difficult to know whether the Florida effect is driven by tax avoidance, unique geography, or some especially appealing combination of the two.[21]

MECEP's analysis of migration patterns specific to Maine are consistent with these findings across all income groups.[22] Between 2000 and 2016, Maine gained more migrants from New Hampshire than it lost. During the same time period, more New Hampshirites moved to Florida than Mainers, despite the fact that both New Hampshire and Florida claim no income taxes.

Between 2000 and 2016, Maine gained migrants from New Hampshire and New Hampshire lost more population to Florida than Maine did.

In a more targeted analysis, CBPP compares the growth of states that increased personal income tax rates on the highest income earners (sometimes called a "millionaire tax") to neighboring states.[23]

Once rare, twelve states have passed this type of tax since 2000, according to CBPP. Eight of them have neighboring states with characteristics that are similar enough to allow for comparison.[24] Of these eight, six outperformed or equaled their neighbors in GDP growth in the years following the new tax.

Two states, Connecticut and New Jersey, underperformed their neighbors. However, these states were both hit hard by the financial crisis, which occurred during the research period.

Similarly, seven of the eight states (all but Connecticut) outperformed their neighbors in per capital personal income growth. Five of the eight states matched or outperformed their neighbors in job growth, with Connecticut, New Jersey, and California, trailing their neighbors by this measure.

Based on these results, the authors conclude, "real-world experience suggests that raising top income tax rates is unlikely to harm state economies in the short run, contrary to some claims."[25]

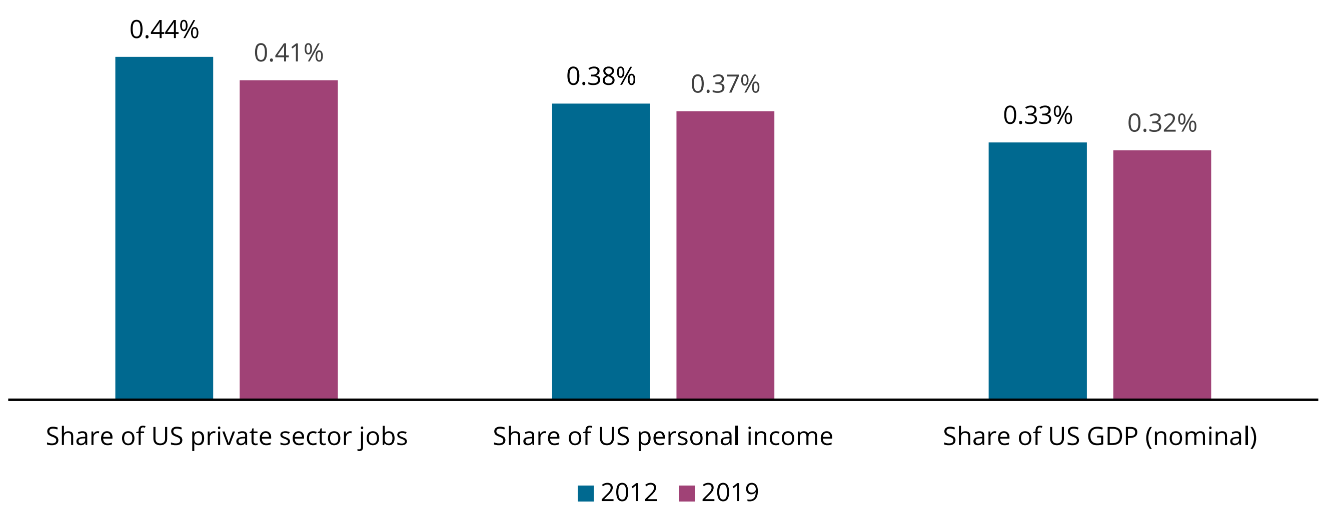
Recent Maine tax cuts have not generated growth

Maine's recent experience with income tax cuts proves the veracity of the academic research. From 2012 to 2016, Maine lowered its top marginal personal income tax rate from 8.5 percent to 7.15 percent. This reduction, celebrated as the "largest tax cut in Maine history,"[26] has not generated any noticeable changes in Maine's economy.

Since the 2012 tax cuts, Maine has fallen further behind the rest of the nation. In 2019, Maine's share of US private-sector jobs,[27] personal income, and gross domestic product (GDP) was lower than 2012, meaning Maine failed to keep pace with growth in other states during this period.

Maine gained ground on wages, but this is likely due in large part to legislated increases in the minimum wage. The minimum hourly wage, which had been $7.50 since 2009, rose incrementally from $9.00 in 2017 to $11.00 in 2019. Concurrently, Maine's average weekly wage increased from 78.3 percent of the national average in 2012 to 79.7 percent in 2019.[28]

Maine's share of US economic activity fell from 2012 to 2019 as income tax rates dropped



Sources: US Bureau of Economic Analysis and US Bureau of Labor Statistics

Cutting public services detracts from economic growth

The failure of tax cuts to spur economic activity draws attention to the two-sided nature of public finances: taxes fund public services that help businesses and the economy grow. Prof. Gabe reminds readers of this in Pursuit: "If high taxes, in fact, go hand-in-hand with better quality public services (and if these services are valued by businesses and the workers they are trying to attract), then a strategy of cutting taxes – along with the services that they support – could be counterproductive in the pursuit of economic development."[29]

When state and local governments cut spending, either because of a recession or tax cuts, the resulting loss of employment and spending multiply through the economy. A Harvard economist estimates that for every one dollar of spending that states cut during the recession, overall economic activity was reduced by between $1.50 and $2.00.[30] The Hutchins Center on Fiscal and Monetary Policy finds that during the Great Recession years of 2009-2012, spending cuts by state and local government subtracted an estimated 1.2 percentage points from real GDP.[31]

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Budget cuts impact public schools and harm students

Because public education is often one of the largest components of state and local budgets, when public services are cut, by necessity they often include significant funding reductions to schools. During the Great Recession, CBPP found that 34 states and the District of Columbia cut funding to K-12 education and 43 states cut funding to higher education.[32] Several examples:

- Colorado cut public school spending by $260 million, nearly a 5 percent decline from fiscal year 2010. The cut amounts to more than $400 per student.[33]
- Virginia's $700 million in K-12 education cuts for the current biennium include the state's share of an array of school district operating and capital expenses and funding for class-size reduction in Kindergarten through third grade.[34]
- Kansas, which cut school funding repeatedly starting in 2009, found an array of budget-induced challenges in K-12 schools, including fewer teachers, overcrowded classrooms, "insufficient and declining" per-student funding, fewer dollars to help at-risk students, less training for teachers, fewer extracurricular programs, and higher property taxes.[35]
- Florida's 11 public universities raised tuition by 15 percent for the 2010-11 academic year. This tuition hike, combined with a similar increase in 2009-10, resulted in a total two-year increase of 32 percent.[36]
- In Minnesota, as a result of higher education funding cuts, approximately 9,400 students lost their state financial aid grants entirely, and the remaining state financial aid recipients will see their grants cut by 19 percent.[37]

How are students affected by budget cuts to public education? A 2019 exhaustive review of several decades of rigorous academic research on K-12 schools finds definitively and quite simply that student achievement increases with higher spending per-student.

Further, they find that “resources that cost money, including smaller class sizes, additional supports, early childhood programs and more competitive teacher compensation (permitting schools and districts to recruit and retain a higher-quality teacher workforce), are positively associated with student outcomes.”[38]

In regards to higher education, a study by economists at Harvard and Berkeley found that budget cuts to public colleges and universities directly led to lower enrollment and lower degree attainment.They find “a causal connection between budget cuts, higher education dropout rates, and slowdown in the growth of postsecondary attainment.”[39]

Budget cuts widen income inequality and health inequities

A longitudinal review of state spending and income since 1987 and across three recessions found that “income inequality increases when states respond to economic crisis by relying on unexpected spending cuts” and that these inequalities continue even during subsequent economic recoveries.[40]

Poor, minority, and female-headed households are more likely to qualify for state government assistance, and are therefore more likely to be directly affected by lower government spending.[41]

Further, while the relationship between household income and personal health is well known, a recent exhaustive study by the RAND Corporation found a positive correlation between state spending on social assistance and health outcomes like life expectancy and infant mortality rates.[42]

Exacerbating this dynamic, when state policy leaders cut budgets, they often do so by reducing spending on public health services. For example, during the last recession roughly 30 states made cuts to spending in healthcare and services to the elderly.[43]

Inequality increases when states respond to economic crisis by relying on unexpected spending cuts. These inequalities persist through subsequent economic cycles.

In Maine, Governor LePage’s tenure included a halving of public health nurses, reductions in appropriations to the Drugs for the Elderly program, and the failure to expand Medicaid as allowed by the Affordable Care Act.

Conclusion

A vast body of academic research, and Maine’s recent history, reveal the inability of tax cuts to reliably generate economic growth. Furthermore, real-world comparisons of low-tax states show that many are underperforming their neighbors. Conversely, many higher-tax states are doing well.

Budget cuts, whether necessitated because of tax cuts or recession-induced revenue losses, ripple through the economy in ways that detract from economic growth, harm students, and worsen health outcomes and inequality.

About MECEP

The Maine Center for Economic Policy is a nonprofit research and policy organization dedicated to economic justice and shared prosperity by improving the well-being of low- and moderate-income Mainers. Since its founding in 1994, MECEP has provided policymakers, advocates, media organizations, and the public with credible, rigorous research and analysis. MECEP is an independent, nonpartisan organization.

Endnotes

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