

CHAPTER EIGHT

TAXES AND ECONOMIC DEVELOPMENT

One of the main concerns of state policymakers is how to lure jobs to their state—and too often, policymakers assume that tax cuts make the best bait. It's not hard to understand why they might believe this: tax-cut advocates frequently assert that cutting tax rates will spur economic growth by attracting more jobs and employers to the state, and businesses are constantly threatening to relocate to other jurisdictions if state governments won't pony up lavish tax breaks. But there is growing evidence that tax cuts and incentives are not an effective growth strategy for states—and that investing in public infrastructure such as schools, roads and hospitals can be a better approach to encouraging economic development. This chapter discusses the relationship between state fiscal policies and a state's economic climate.

Assessing Claims that Taxes Affect State Economies

When state policymakers discuss proposed tax increases, the debate inevitably turns to the impact of these proposals on the state's business climate. Business lobbyists usually argue that tax increases will hurt a state's business climate and drive away industries and jobs. And if tax increases aren't on a state's agenda, the same lobbyists will push for special tax breaks to encourage new business investment—or to prevent a company from leaving the state—and will tell apocalyptic tales about what will happen if these business demands are not met.

But there is little hard evidence to support the assertions of those who see tax cuts as a panacea for a state's economy. A comprehensive survey of the literature on the relationship between taxes and economic development by economist Robert Lynch found little evidence that state and local taxes are important factors in determining business location decisions or in affecting state economic growth.¹

Lynch's survey suggests that there is a wide variation in the quality of the "research" used to support these anti-tax arguments, and suggests that the studies that do claim a strong relationship between tax levels and economic growth usually have design flaws that invalidate their conclusions. Here's a quick review of some important questions to ask in evaluating these studies:

- **Does the study assume that tax changes have no effect on public spending?** One of the most frequent errors made by these studies is to simply ignore the linkage between taxes and public spending. This is equivalent to saying that when taxes are hiked, the resulting revenues will simply be thrown away rather than being used to fund education and other public services—and that when taxes are cut, there will be no reduction in the state's ability to fund these services. In the real world, of course, tax cuts must be paid for—and that usually means spending cuts. In contrast, when taxes are increased, the new revenue is used to preserve state services that are important to residents, as well as businesses and the economy.

Studies that ignore this basic linkage and look only at the impact of tax cuts are merely stating the obvious: state economies would be stronger if they could maintain the current package of public services while paying less for them. In the best of all possible worlds, state and local governments would provide all of our public services for free. Of course, that's unrealistic—but that's the implication of studies that don't factor in the impact of tax cuts on public services.

- **Does the study measure the impact of any other possible explanations for economic growth?** There are many plausible explanations for the difference between

fast-growing and slow-growing state economies. These differences could result from tax law changes, government spending behavior, regional and national economic changes, demographic changes, or even the weather. The simplest “studies” often measure the linkage between only one explanation—tax levels—and an economic outcome. But if the study doesn’t at least try to test for the impact of these other factors, its findings shouldn’t be taken seriously.

- **Does the study measure tax levels correctly?** Anti-tax advocates frequently resort to manipulating data in arcane ways to back up their assertions. For example, some studies use the “per capita” measure of tax levels—that is, the total amount of taxes collected in a state divided by the state’s population—to identify high-tax states. The problem with this is that “per capita” tax measures tell us more about how rich a state is than how high its taxes are.

For example, in 2007 Virginia collected \$1,330 per capita in personal income tax, while Wisconsin collected \$1,131. Yet the Virginia income tax has lower tax rates than Wisconsin’s income tax. Virtually anyone moving from Wisconsin to Virginia (and keeping the same salary) would, in fact, see their income taxes go down. Simply put, tax collections are higher overall because Virginia has more wealthy taxpayers, not higher taxes. This approach to measuring tax levels is simply misleading—but anti-tax advocates rely on it simply because the average taxpayer won’t know the inherent flaws in per capita measures.

Other data manipulation tricks to watch for include:

- Making assertions about how total taxes affect growth—but backing these assertions up using only state tax data. State tax hikes are often enacted to reduce local taxes, so it is important to use combined state and local tax data in evaluating these assertions.
- Using legal or nominal tax rates as a measure of true tax levels. This trick is frequently used in states that combine high income tax rates with generous deductions, exemptions and other tax breaks. Effective tax rates—that is, taxes as a share of income—are a far more accurate approach to measuring tax levels.
- Using aggregate tax collection data to measure state tax levels instead of measuring the incidence of these taxes on state residents. Aggregate measures based on total tax collections tell us little about whether specific groups of taxpayers experience the state as a high-tax or low-tax place

to live. Some nominally “high-tax” states rely heavily on taxes paid by large multi-state businesses or non-residents, which may not apply to state residents.

- Not factoring in the deductibility of state and local income and property taxes when comparing tax levels across states. The ability to write off these taxes means that the difference in tax levels between “high tax” and “low tax” states is never as large as it may seem. For the wealthiest taxpayers (and for profitable corporations), up to 35 percent of the difference between any two states’ tax levels will disappear once federal deductibility is taken into account.

Much of the research that is commonly cited by anti-tax advocates is based on research methods that are dubious at best—and the tricks outlined above tend to get recycled in different states by anti-tax lobbyists and researchers. So whenever lawmakers or the media are presented with a study purporting to show that high taxes hurt economic development, it’s a good idea to ask these basic questions about the design of the studies.

Low-Tax Strategies Aren’t Effective

So why is it that there’s no observable relationship between tax levels and economic growth? One sensible reason is that taxes are levied for a very important purpose: to help fund the public services that make a state more attractive to businesses. Good roads and bridges, a well-educated workforce and other government services are essential to business productivity and profitability. And on the other side of the coin, low taxes generally lead to low-quality public services. Moreover, compared to other costs of doing business, state and local taxes are rather insignificant: Lynch’s 2004 survey estimated that the state and local taxes paid by businesses represented just 0.8 percent of the costs they face. Usually the decision on where to locate is based on more important economic factors than taxes, such as proximity to suppliers and markets, and the availability of skilled workers. That’s why heads of major corporations will candidly admit that taxes are not very important in their location decisions.

As Paul O’Neill, a former executive at Alcoa and President George W. Bush’s Treasury Secretary put it: “I never made an investment decision based on the tax code...If you are giving money away I will take it. If you want to give me inducements for something I am going to do anyway, I will take it. But good business people do not do things because of inducements.”⁷²

Other corporate leaders have echoed these thoughts. Oklahoma billionaire George Kaiser recently testified to the ineffectiveness of tax incentives in that state by noting that “the tax rebates

we are considering cause almost no wells to be drilled in Oklahoma that would not otherwise be drilled. As an oil and gas producer myself... I can say unequivocally that the rebates in this legislation have never influenced our decision to drill or rework or restore any well in this state or the many other states in which we operate. And the reason isn't that we do not understand the benefit from the rebate; we are happy to file for and receive the gift, and we do."³

Similarly, long-time business leader Michael Bloomberg has bluntly said that "any company that makes a decision as to where

they are going to be based on the tax rate is a company that won't be around very long. If you're down to that incremental margin you don't have a business."⁴

The Corporation for Enterprise Development (CFED) has issued a series of reports grading states on the characteristics that are likely to attract high-wage, high-value-added industry—and these reports' findings echo the explanations of these corporate leaders. Level of taxation has consistently been found to be of little significance. The factors that businesses look for include the quality of life in the community, a good supply of highly skilled and educated men and women to fill demanding technical and management positions, good roads and adequate transportation, public safety, and the quality of health care.

When corporations raise the "business climate" issue, it's often just a ruse to try to keep their taxes low. For example, research from New Jersey Policy Perspective and Good Jobs New York found that Citigroup regularly plays New York, New Jersey, Kentucky and Texas against each other by threatening to move their operations from one state to another.⁵ The study found that "Citigroup appears to have taken advantage of rivalry among states, exploiting the 'prisoners' dilemma' dynamic to mislead one government that it is competing against another, when no rival offers actually have been made." Between 1989 and 2007, Citigroup received nearly \$286 million in state and local economic development subsidies.

It's also worth noting that the few businesses that might actually be attracted by low taxes are likely to be low-paying industries with little loyalty to the community and its long-term well-being.

Finally, it's important to remember that tax breaks don't buy loyalty from companies. Many states and communities have given huge tax breaks to large companies for years, only to have the company shut down the local plant for reasons unrelated to taxes. Massachusetts lawmakers enacted a special corporate income tax break largely in response to threats from the Raytheon Corporation that it would reduce its employment in the state unless this break was enacted—and after they got their way, the company cut thousands of Massachusetts jobs.

The Millionaire Migration Myth

Some anti-tax advocates and lawmakers have recently generated a lot of publicity by attacking state income tax increases targeted at high-income earners—so-called "millionaires' taxes." One of the most obviously false claims made about these types of tax increases is that they inevitably lead to a mass exodus of high-income earners from the states that enact them.

Claims of this sort overlook the fact that high-income earners, like all Americans, care about a lot more than their tax bill when deciding where to put down their roots, and whether or not to move. These claims also often overlook—or even distort—available empirical evidence.

In 2009 and 2010, for example, anti-tax groups in Maryland repeatedly referenced data from the Maryland Comptroller's office indicating that the number of individuals with over a million dollars in income had recently declined. These groups enthusiastically cited this finding as evidence of a "millionaire migration." A more careful analysis of the data by ITEP, however, showed that the decline was in fact a result of wealthy Marylanders seeing their incomes decline in the wake of the 2008-2010 recession.^a

These same groups also pointed toward New Jersey as an example of a state where an income tax increase caused high-income individuals to flee the state. In order to make this claim, anti-tax groups were forced to ignore a contrary study from Princeton University, and to instead distort the findings of a study out of Boston College with no real relevance to Maryland's situation.^b

Ultimately, the erroneous claims by anti-taxers in Maryland played a key role in the state's decision not to extend the temporary income tax increase on Maryland's millionaires. Other states debating the creation or continuation of a "millionaires' tax" should expect to confront similar, misleading arguments.

Types of Tax Breaks Offered

The types of tax breaks offered to companies under the guise of economic development vary widely, but they can be categorized into three groups:

- **Broad changes in tax rates or apportionment rules.**

Some states choose to pursue general reductions in corporate taxes, either by cutting the legal tax rate on all

[a] "Where Have All of Maryland's Millionaires Gone?" Institute on Taxation and Economic Policy, May 2009. http://www.itepnet.org/pdf/MD_Millionaires.pdf

[b] "Maryland's Millionaire Migration Debate: Understanding the Relevance of the New Jersey Migration Studies." Institute on Taxation and Economic Policy, March 2010. http://www.itepnet.org/pdf/md_migrationstudies_0310.pdf

corporations or by providing special apportionment rules, such as the “single sales factor,” that will provide benefits to large groups of companies (although, as noted in Chapter Six, such rules may create as many losers as they create winners).

■ **Abatements, credits, exemptions, and TIFs.** States also offer tax breaks that apply to specific companies, or companies doing business in a specific area. One example of this approach is **tax increment financing** or TIF.⁶ TIF districts are usually established in areas that are considered to be blighted. When property values rise because of development in a TIF district, a portion of the property taxes generated are set aside from their normal use (usually funding schools) and instead are used to improve infrastructure used by businesses in the district. TIFs deserve greater scrutiny because many of the areas designated as TIF districts aren’t actually blighted, and because studies have shown that development in many of these areas would likely have happened even without the use of TIFs.⁷

■ **Tax packages offered by states to lure investment.** States and local governments often put together entire packages of tax subsidies including a mix of exemptions and credits designed to reduced taxes. For example, North Carolina gave away almost \$300 million in tax incentives to Dell in 2004 to lure it to build a manufacturing plant in the state while the closest competitor state offered only \$30 million. The company promised to invest at least \$100 million in the plant and create at least 1,500 jobs by 2010. But instead, after only four years in operation, Dell announced plans to shut its North Carolina plant in 2010. While most of the incentives were never paid out to Dell, the company left more than 900 people in an economically distressed area without work and its actions raise doubts about the role of tax incentives to spur economic development. Incentive packages of this kind too often result in bidding wars between the states— and these costly and ambitious tax breaks bring no guarantees that a company will remain in the state over the long term.

Ensuring Accountability in Economic Development

Even if there is little evidence that tax policy affects economic growth, state lawmakers continue to pursue potentially damaging tax breaks in an effort to spur economic growth in their state. How can lawmakers limit the damage of these tax breaks and ensure that companies receiving these breaks won’t take them to the cleaners? The Washington-based

nonprofit watchdog group Good Jobs First focuses on issues of economic development accountability, and has recommended a variety of best practices for lawmakers enacting tax breaks, including:

- **Disclosure** of how much tax breaks cost state and local governments and what public benefits resulted from the tax breaks. For example, lawmakers and the public should be able to determine how many jobs were created as a result of the tax breaks and whether the jobs created are “good jobs” in terms of the wages and benefits provided. This information should be made publicly available online and frequently updated. For example, according to Good Job First’s The State of State Disclosure report, Iowa’s Department of Economic Development releases annual disclosure reports on a variety of state business development programs that detail the number of jobs produced and the wages paid. The reports are searchable and available online.⁸
- **Strict job quality standards** should be applied to any tax break designed to increase in-state employment. Requiring these new jobs to provide a basic “living wage” along with health care benefits helps to avoid imposing hidden taxpayer costs on state government. If a tax break results in a company hiring employees who are paid so little that they qualify for food stamps, Medicaid, or other taxpayer-funded safety nets, the cost of the tax break may exceed its benefits to the state. For example, in Montana companies receiving federal Workforce Investment Act training monies must pay wages and benefits of at least 110 percent of the state’s median wage.
- **Money-back guarantees** that companies receiving tax breaks to create new jobs will actually create these jobs—and that the jobs will remain in the state for some specified period of time. These guarantees, known as “clawbacks,” are now used in at least twenty states to ensure that lawmakers get enough “bang for the buck” for the tax breaks they offer. For example, Minnesota’s clawback statute states that if a company receiving benefits doesn’t fulfill the subsidy’s requirements, the company is banned from getting more aid for five years or until they have repaid the subsidy amount.
- **Location-efficient incentives** should encourage economic development in areas that are accessible to public transportation. This creates more opportunity for low-income families who cannot afford cars, and reduces traffic congestion.
- **Automatic review of giveaways** should be mandatory. Corporate tax breaks are often given without regard for

how long the tax break will remain on the books. Regularly reviewing tax breaks is essential to ensuring that subsidies that aren't working are removed from state law. For example, a 2006 Washington State law requires regular review of tax preferences with the goal of evaluating their effectiveness and making reform recommendations to the state legislature.⁹

- **Establishing an economic development policy** that outlines goals, objectives, and strategies for state economic development is one way to ensure that reasonable and responsible questions about tax incentive packages are asked. A coherent policy can ensure that each decision on tax incentives will be analyzed in terms of how the incentive package helps to achieve larger economic development goals.

Businesses Are a Vital Partner in Tax Fairness Efforts

Business owners and fair tax advocates fully understand the importance of a healthy economic climate for jobs and incomes. Good roads and bridges, a well-educated workforce and other government services are essential to both business productivity and community prosperity. There is a clear linkage between taxes and a state's ability to provide important public services. Governments must have the resources to provide the education, the roads, the sewer systems and other services that allow businesses to prosper.

Unless those with the most ability to pay contribute their fair share, it will be virtually impossible for governments to provide essential programs. Precisely for this reason, not all corporations fight against progressive tax changes. Especially in states with low taxes, businesses may support progressive tax increases in order to improve the quality of government services. When Virginia lawmakers passed a billion-dollar tax hike in 2004, for example, it was with the blessing of the state Chamber of

Commerce. In 2005 many Colorado business owners came out in favor of a five year time-out from a restrictive spending cap called TABOR (the Taxpayers Bill of Rights) because of the horrific impact that state spending caps had on the state's schools, infrastructure, and even businesses' own ability to function.

There are some sectors of the business community that favor progressive tax reform. Often the organized business lobby is dominated by a few large corporations that may have very different interests than do small- and medium-sized businesses. Small businesses typically are left holding the bag when larger multi-state corporations carve out special tax breaks for themselves, and for this reason small businesses can be an essential partner to progressive coalitions seeking to achieve tax reform. The importance of working in coalition with businesses is discussed more in Chapter Ten.

Conclusion

Improving living and working conditions for residents and businesses is among the most basic tasks facing state policymakers. But all too often, the simple economic development recommendations made by anti-tax advocates can actively work against these goals by starving the ability of state governments to adequately fund needed infrastructure, and when these advocates present "research" purporting to prove that low taxes encourage economic growth, it's important to ask the basic research design questions outlined in this chapter. When policymakers do decide to provide targeted tax incentives to businesses, it's imperative that the breaks come with sufficient strings to rein in companies who aren't hiring well-paid workers or fulfilling the requirements for receiving special treatment. After all, business owners and nonbusiness owners alike thrive when communities prosper and government is able to provide adequate infrastructure and a healthy, educated workforce. 

¹ Lynch, Robert G., *Rethinking Growth Strategies: How State and Local Taxes Affect Economic Development*. Washington, DC: Economic Policy Institute, March 2004.

² O'Neill, Paul. Statement to the U.S. Senate Finance Committee. Confirmation of the US Treasury Secretary, Hearing, January 17, 2001.

³ Kaiser, George. Statement to Oklahoma's House Appropriations and Budget Committee. Oil and Gas Tax Rebates, Hearing, January 22, 2009. http://www.gkff.org/userfiles/file/1_22_09%20Oklahoma%20oil%20and%20gas%20rebate%20hearing.pdf

⁴ Tierney, John, "The Big City: An Outsider Comes Inside to Run Things." *The New York Times*, November 8, 2001. http://www.nytimes.com/2001/11/08/nyregion/the-big-city-an-outsider-comes-inside-to-run-things.html?ref=michael_r_bloomberg

⁵ Stecker, Sarah and Dan Steinman, "Pay or We (Might) Go: How Citigroup Games the State and Cities." *New Jersey Policy Perspective and Good Jobs New York*, June 2007. http://www.njpp.org/rpt_games.html

⁶ For more on tax increment financing, visit Good Jobs First at www.goodjobsfirst.org

⁷ Dye, Richard and David Merriman, "Tax Increment Financing: A Tool for Local Economic Development." *Land Lines: Vol. 18, Number 1*. The Lincoln Land Institute, January 2006.

⁸ See Mattera, Phillip, Karla Walter, Julie Farb Bain and Michelle Lee, "The State of State Disclosure: An Evaluation of Online Public Information About Economic Development Subsidies, Procurement Contracts and Lobbying Activities." *Good Jobs First*, November 2007. <http://www.goodjobsfirst.org/news/article.cfm?id=375> and The Iowa Department of Economic Development's Legal and Compliance Project Portfolio- Searchable database: <http://www.iowalifechanging.com/AnnualReport/2009/asp/search.aspx>

⁹ Washington State House of Representatives, Final Bill Report EHB 1069, <http://www.leg.wa.gov/pub/billinfo/2005-06/Pdf/Bill%20Reports/House%20Final/1069.FBR.pdf>