INSTITUTE ON TAXATION AND ECONOMIC POLICY

Policy Brief

Informing the debate over tax policy nationwide

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Examining Economic Development Research

State and local lawmakers face enormous pressure to attract and retain business investment—and all too often, anti-tax advocates will argue that tax cuts are the best approach to economic development, usually armed with "research" studies that conclude slashing taxes is necessary for economic development. But all too often, these studies are based on shoddy assumptions that make their results unreliable. This policy brief offers guidance on how to critically examine studies that claim that taxes must be cut in order to spur economic development.

Questions to Ask About Economic Development "Research"

Policymakers are often influenced by claims that businesses will leave their state or choose not to locate to their state because of high taxes or a lack of costly economic development strategies. However, they along with the public have been misled about the impact that some economic policies can have on individual businesses. Over the past decade the number of studies linking economic development with tax reductions have increased, but the findings of such studies deserve careful scrutiny. Fighting against flawed assertions often means analyzing research methodologies.

Economist Dr. Robert Lynch has found that there is wide variation in the quality of the research used to support anti-tax arguments, and shows that the studies that do show strong relationships between tax levels and economic development often have design flaws that invalidate their conclusions. Fortunately, these poor-quality studies tend to share the same design flaws. Below is a list of essential questions to ask when confronted with studies that make a connection between taxes and economic development:

- **Does the study assume that tax changes have no effect on public spending?** One of the most frequent errors made by 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. Of course, the world doesn't work this way. In the real world, tax cuts must be paid for—especially at the state level where there is a requirement to have a balanced budget—and that usually means reducing spending on public services. 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 measure 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" tax level measure—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, according to the Census Bureau, in 2008 Virginia collected $1,298 per capita in personal income tax, while Wisconsin collected $1,180. Yet Virginia's income tax has lower tax rates and higher exemptions than Wisconin'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.

Data Manipulation Tricks to Watch For

- **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 the combined state and local tax level 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 (or profits, in the case of businesses) 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 businesses or non-residents, which may not apply to state residents. As a result, oftentimes studies may claim a tax share on families that is simply unrealistic and too high.

- **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 levelss will disappear once federal deductibility is taken into account.

Conclusion

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. 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 basic questions about the design of the studies.