State Fiscal Policies and State Economic Growth

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Managing Economic Development in Times of Fiscal Uncertainty

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Road Map

- Evidence for and against the effect of the level of state taxes on state economic growth
- Another angle: the effect of fiscal policy uncertainty on economic growth
- The case of Illinois

What's the systematic evidence?

Are taxes a significant factor in the economic fortunes of states?

- This question was a major impetus for the creation of the Minnesota Tax Study Commission of the mid 1980s
  - In late 1983, Burlington Northern decided to relocate its headquarters out of the Twin Cities and move to the south. BN claimed that Minnesota's high taxes were a major factor in its decision to move. There was a sense that Minnesota's taxes had gotten out of line.

- Michael Wasylenko and I undertook an empirical study of the 48 contiguous states to seek systematic evidence
  - Dependent variable: job growth between 1973 and 1980.
  - Independent variables: average manufacturing wage, electricity costs, income per capita, **public spending on education**, **individual income tax burden**, other factors.
  - Estimated equations for total employment and six major industries.
  - Found
    - education spending had a positive, significant effect on job growth for total employment and two industries,
    - the individual income tax burden had a negative effect on job growth in three industries.
  - Of the 28 possible tax coefficients, eight were significant.

A selection from the voluminous literature

- Helms (1985) – taxes significant determinant of employment growth
  - Carroll could not replicate the results with more recent data
- McGuire and Wasylenko again (1987) for NJ tax study commission
  - Unable to replicate their earlier results
- Carroll and Wasylenko (1991) for AZ tax study commission
  - Taxes were not a significant factor
- Bartik survey (1991) – concludes the 'consensus' is that taxes have a small but significant effect
- Papke (1987, 1991) – state corporate income taxes matter to investment
  - Tannenwald unable to replicate Papke's 1987 results with more recent data
- Hines (1996) – state taxes mattered for foreign direct investment
- Wasylenko and Fisher surveys (1997) – basically inconclusive
- Goolsbee and Maydew (2000) – reducing the payroll weight in the formula for apportioning corporate income boosts manufacturing employment
  - Merriman found results sensitive to changes in sample and specification

The Economic Effects of TABOR

An empirical study by T. McGuire and K. Rueben
State Tax Notes (2006)

- In 1992, by passing the Taxpayers' Bill of Rights (TABOR), the voters of Colorado amended their constitution to **limit the annual growth rate of revenues to the sum of population growth and inflation**
  - Many states have limits of one kind or another on revenues or expenditures; this limit is one of the more stringent:
    - It is not tied to personal income growth, so taxes as a share of income can fall if income grows more quickly than inflation plus population growth
    - It does not take into account that many components of state expenditures can grow at higher rates than inflation (health care expenditures) or the overall rate of population growth (education expenditures)
    - It is based on the prior year's *actual* revenues rather than the prior year's TABOR limit, which can result in a permanent ratcheting down of revenues after a recession

- Why pass such a limit?
  - **Proponents** argued that the limit was needed to rein in the growth of government, thereby providing **a boost to the economy of Colorado**
  - **Opponents** argued that necessary and desirable services would be cut, thereby **harming the economy of Colorado**

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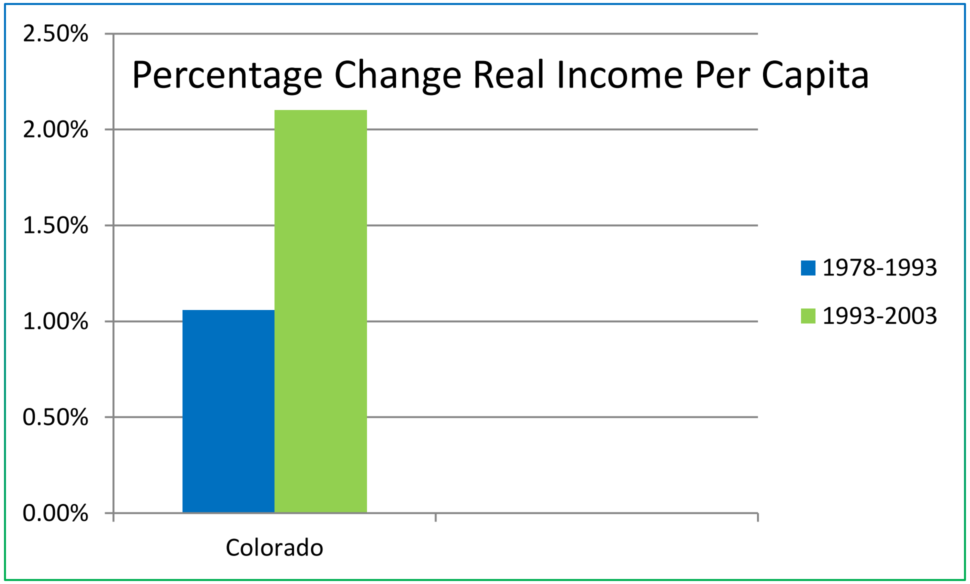
Who was right? What happened to Colorado's economy after the passage of TABOR?



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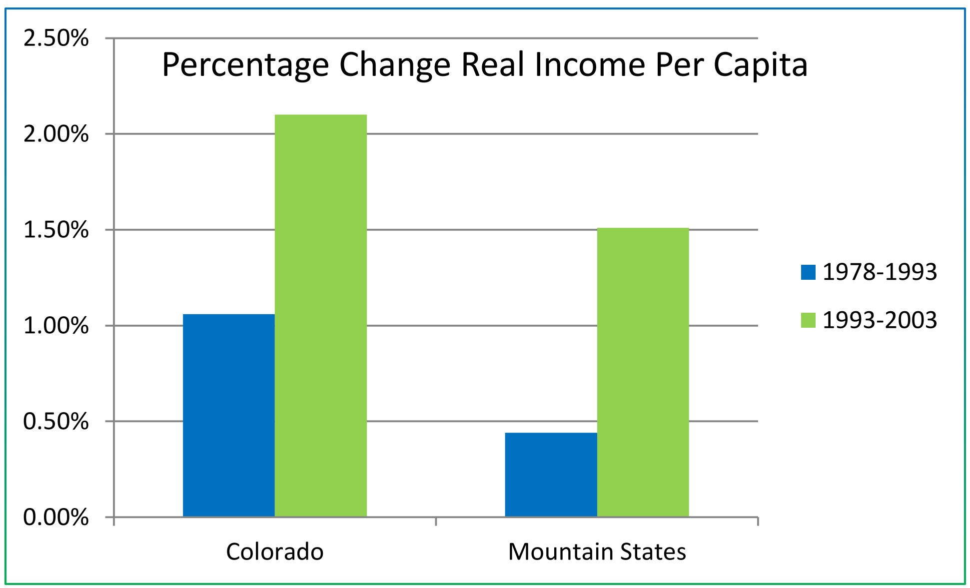
But the change in trend growth rates in other mountain states, which did not enact a TABOR-like law in 1992, was similar to the change in Colorado.



Could TABOR have been one factor among many that boosted Colorado's economy?

The Economic Effects of TABOR

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- Using a panel data set covering all states from 1978 through 2003, we estimated a regression with a measure of economic growth as the dependent variable and several factors expected to influence growth as independent variables (industrial mix of the economy, education level of the population, etc.) and we included two key hypothesis variables:
  - "TABOR passed" – an indicator variable that turns on in 1993 for Colorado only
  - "TABOR-out-years" – an indicator variable that turns on in 1998 – five years after passage of the act – for Colorado only
    - For a number of reasons, including the design of TABOR's formula, which benchmarks to actual revenues rather than the TABOR limit, the act could be more restrictive over time. This variable allows us to separate the long-term effect of the limit from the short-term effect.
- We estimated three different specifications that differed in terms of the indicator variables we included (for states, for regions, for neither)

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- What did we find?
  - When we examined the effect on the grow rate of **real per capita income**, we found **no effect of TABOR** – not in the short run; not in the long run
  - When we examined the effect on the grow rate of **employment**, in two specifications we found
    - a positive effect of TABOR in the first five-year period,
    - but a negative and much stronger effect of TABOR in the second five-year period, implying that **any short-term gain correlated with TABOR was offset by losses in employment in the long term**
- We concluded that **TABOR did not significantly boost Colorado's economy**

Bottom line on the evidence of the effect of state taxes on economic growth

- The jury is still out and may always be out
  - We do not have a good model of regional economic growth
  - Inter-regional studies are fraught with too many econometric difficulties
  - We need a “natural experiment” but so far none has been granted
    - TABOR passage comes close, but one could argue that the same forces that caused TABOR also caused changes in Colorado’s economic fortunes
    - What we would like is random assignment of TABOR-like laws to a set of ‘treatment’ states that we could then compare to neighboring ‘control’ states

- <u>McGuire’s bottom line</u>: the evidence of a link between the levels of state taxes and state economic growth is weak; too weak for me to believe that cutting taxes with the goal of boosting economic growth is likely to be an effective policy play

Sidebar: Firm-specific Tax Incentives

- None of the systematic evidence speaks to the effectiveness of firm-specific tax incentives

- Many qualms about the practice:
  - Is it a zero-sum game?
  - Is the government simply being held up? I.e., is it a waste of taxpayers' money?
  - Does it make for an uneven playing field?
  - Does it signal desperation on the part of the government or the firm?

- Despite (perhaps because of) the current tough fiscal times, the practice is alive and well
  - Illinois and CME, CBOE and Sears
  - Kansas and AMC Entertainment
  - Alabama and Airbus

Another angle: tax (and spending) policy uncertainty

- Perhaps it is not current tax levels but uncertainty about future tax levels – uncertainty in Illinois' case stemming from its mountain of unfunded liabilities – that is a deterrent to economic growth

- A new line of macroeconomic research – are there lessons for state governments?
  - This portion of the presentation draws heavily upon a paper by and conversation with Nick Bloom of Stanford University

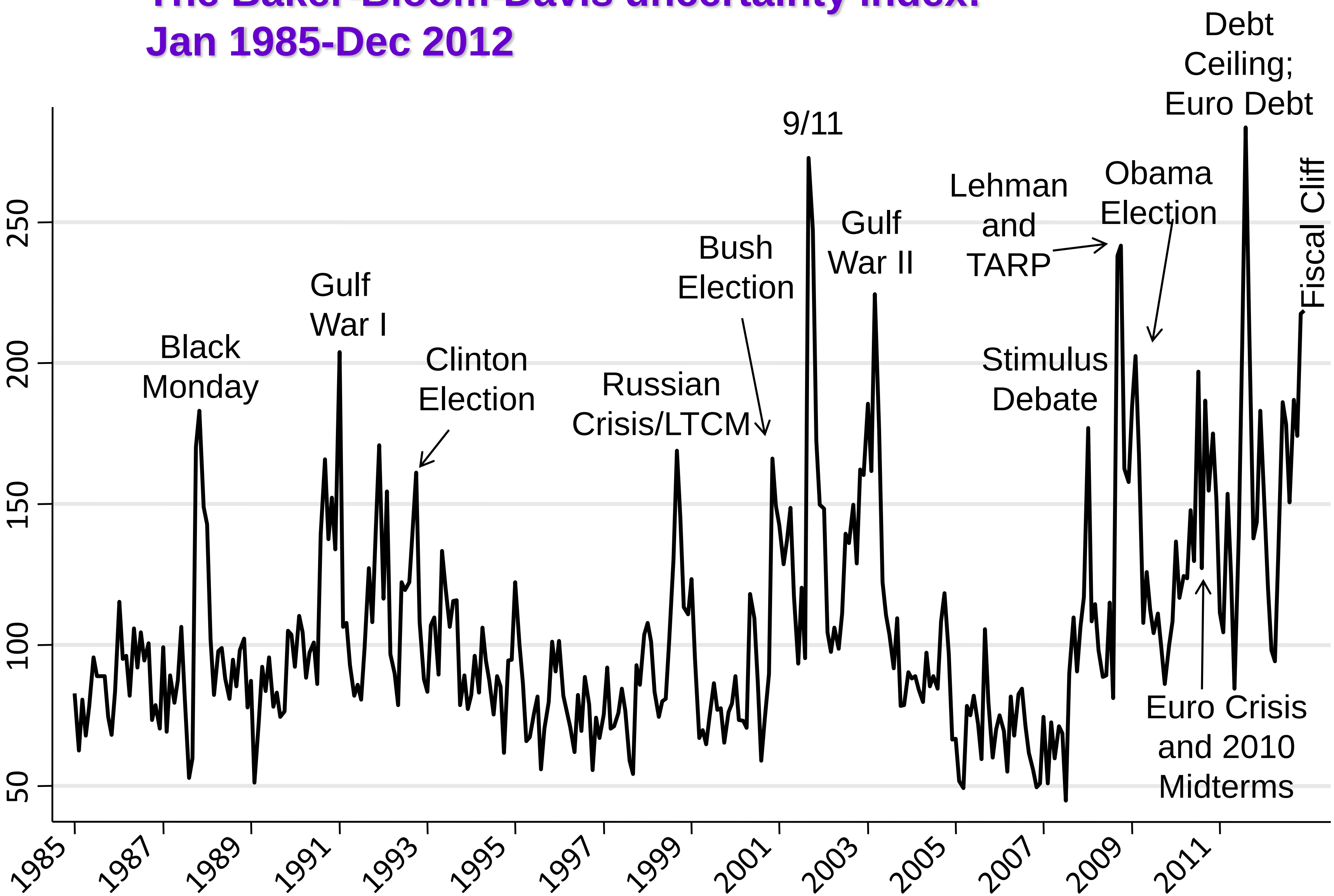
- My conversation with the executives at 3M during my stint as senior economist for the 1984 Minnesota Tax Study Commission
  - What were they worried about?

Uncertainty and the Economy

- In a recent line of research, macroeconomists are trying to understand the impact of increased policy uncertainty on the economy

- In a 2013 working paper, Baker, Bloom, and Davis create an economic policy uncertainty index
  - count newspaper references to economic policy uncertainty (weight = 1/2)
  - number of federal tax code provisions set to expire (weight = 1/6)
  - forecaster disagreement over expected inflation (weight = 1/6)
  - forecaster disagreement about expected government purchases (weight = 1/6)

The Baker-Bloom-Davis uncertainty index: Jan 1985-Dec 2012



Source: "Measuring Economic Policy Uncertainty" by Scott Baker, Nicholas Bloom and Steven J. Davis, all data at www.policyuncertainty.com. Data normalized to 100 prior to 2010.

Results: the impact of uncertainty

- An innovation in policy uncertainty equal to the increase from 2006 to 2011
  - Leads to a decrease of up to 2.3% in GDP
  - Leads to a decrease of 2.3 million in employment

- Uncertainty (a combination of tax code expirations, newspaper mentions of economic policy uncertainty, and forecaster disagreement about macro variables) appears to predict changes in GDP and employment

Why might uncertainty impact the real economy?

- Economics literature has mainly focused on three channels
  - Real-options effects: Uncertainty can make firms cautious about investing and hiring
    - "Wait and see effect"
    - Notion introduced by Ben Bernanke in 1983
  - Financing costs: Uncertainty can increase risk premiums
    - Hurts small firms the most
  - Precautionary savings: Uncertainty can reduce consumption

The most important channel seems to be real-options (caution) effects

Dave Cote, chairman and CEO of Honeywell, a Fortune 500 firm that employs 130,000 people worldwide stated "*Right now we're holding back on all but the most necessary [illegible]nal hiring. And on capital expenditures, if I can make the decision now or six months from now, I'll make the decision six months from now and see what develops*".

November 5th 2012

Do these results matter at the state level?

- FOMC Beige Book (March 6, 2013): "Contacts in the Cleveland, Richmond, Chicago, and Kansas City Districts cited concerns over government regulation and fiscal uncertainty as a reason for slow growth."

- My conversation with 3M executives when I was a working for the 1984 Minnesota Tax Study Commission. They made two points that impressed this then 20-something "senior" economist:
  - Certainty/predictability in state taxes is much more important in business location and hiring decisions than is the level of state taxes
  - Firm-specific tax breaks are viewed as not only unfair but also a signal of a weak, if not desperate, government

Did Illinois shoot itself in the foot by raising income taxes in January of 2011?

- No one can know for sure; the systematic evidence provided by the voluminous academic literature is simply not definitive

- Politicians in other states seemed to think so; quotes from "Illinois Raises Taxes – NJ Hopes to Lure Its Businesses," *The New York Times*, January 13, 2011.
  - "Escape to Wisconsin," chortled Scott Walker, the state's Republican governor.
  - Mitch Daniels, the Republican who runs Indiana, compared Illinois to the Simpsons — "you know, the dysfunctional family down the block?"
  - "I'm going to Illinois," Mr. Christie said in an interview on Wednesday. "I mean soon. I'm going to Illinois, personally, and going to start talking to businesses in Illinois and get them to come to New Jersey."

Top marginal tax rate	Illinois	Indiana	New Jersey	Wisconsin
Individual	5.0%	3.4%	8.97%	7.75%
Corporate	9.5%	8.5%	9.0%	7.9%

Did Illinois shoot itself in the foot by raising income taxes in January of 2011?

Not necessarily, according to commentary in *The Chicago Tribune*, January 21, 2011, that pitted op-eds by the governors of Wisconsin and Illinois against one another and gave the win to Quinn

- "Frankly, our state's unstable finances have stood in the way of business investment," Quinn explained in his commentary. Therefore, "We are putting our financial house in order, which will only make Illinois a stronger competitor."

Perhaps yes, according to commentary in *The Wall Street Journal*, January 19, 2011, review & outlook online.

- "Our overriding goal was to get the income tax rate as low as possible, because the evidence is so clear that this is the biggest driver of growth and jobs," says Georgia state bipartisan tax commission member Christine Ries.

Who was right? Following the tax increase, S&P removed Illinois from its watch list for a potential downgrade and Fitch lifted its outlook on Illinois from negative to stable.

Is Illinois shooting itself in the foot by allowing unfunded liabilities to mount?

- The systematic evidence is very new, but the evidence appears to be mounting that fiscal policy uncertainty can be harmful to the economy by making businesses cautious to invest, consumers unwilling to make purchases, and financial institutions unwilling to lend

- Unfunded liabilities will come to roost in the future – that is a certainty

- How the state will pay for those unfunded liabilities is anyone's guess and until the state reveals a path to solvency, business owners, consumers, workers, and employers will have to make important economic choices under a cloud of uncertainty

What is likely to be the most effective economic-development play for Illinois?

Based on my experience interpreting the academic evidence for state policymakers, working with tax study commissions, and talking with business executives, my answer is that Illinois should

- Devise a clear and immutable path to paying off its debt
- Devise a clear and credible plan for not taking on new debt unless it is associated with capital projects
- Reform its tax system so that it can adequately support the functions of government that are most important to a vibrant economy
  - Development of human capital (education, healthcare, public safety, etc.)
  - Provision of infrastructure (effective transportation, protection of the environment, etc.)