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Taxes, Government and Prosperity

Virginia can't tax its way to prosperity, but starving critical assets like roads and schools won't create wealth either. The solution: Demand productivity and innovation from state and municipal government.

By James A. Bacon

Back in 2004 when Virginians were debating the merits of higher taxes, a prominent politician coaxed chuckles from a business-friendly crowd at an event I attended when someone asked, wouldn't higher taxes hurt Virginia's economic growth?

Low taxes were OK, he retorted -- if you wanted to be like Mississippi.

Badda bing!

There were two assumptions embedded in that quip. First, that Mississippi had significantly lower than average taxes. Second, that the state's unenviable economic performance was no endorsement of low taxes.

It's often illuminating to refer to the facts. Back in 2004, according to Tax Foundation data, the Magnolia state ranked 31st among the 50 states in terms of state and local tax burden per capita -- five notches *higher* than Virginia. Virginia would hardly look to Mississippi as an example of a low-tax state.

Mississippi was indeed the poorest state in the country, but it wasn't as poor as it once was. In 1970, its per capita income was a pitiful 64 percent of the national average. By 2005, it had clawed its way up to 73 percent of the national average -- overcoming the legacy of Jim Crow segregation, an ill-educated workforce and a century of under-investment in knowledge-creating institutions. Mississippi's lower-than-average tax burden, higher than Virginia's though it was in 2000, was one of its few competitive advantages and arguably accounted for much of its slow but steady progress toward national norms.

I don't mean to dwell on Mississippi. The point of the story is this: A lot of what Virginia's political elites think they know about taxes and regional economic growth is driven by ideology and partisanship, and a lot of it is just plain wrong. The complex reality doesn't support the position of either those who think taxes are no big deal, or those who would oppose taxes blindly without offering alternatives for accomplishing core missions of state and municipal government.

Allow me to submit two propositions:

- All other things being equal, lower taxes create a business climate more favorable to growth and prosperity than higher taxes.
- But all things are rarely equal. The economic performance of states and regions is strongly influenced by their local industry mix -- regional economies rise and fall along with their leading industries -- as well as the level of public investment in productivity-enhancing, wealth-creating assets like schools, universities, research centers, transportation systems and other infrastructure.

As I hope to demonstrate, taxes and public investment *both* matter. *The central challenge for Virginia government is to keep taxes as low as possible while also delivering core public services needed to sustain prosperity and a high standard of living*.

Many of those who editorialize about state-local government posit a one-to-one trade-off between taxes and services: In the absence of borrowing, tax cuts can be paid for only by cuts in services. That notion, I maintain, is intellectually bankrupt and a sure-fire recipe for stagnation. Virginia cannot afford such a blinkered approach to governance.

Instead, Virginia should follow a third path: working diligently to make government more efficient... in effect, to do more with less. We need to replace a governmental culture of "good enough" with the zealous pursuit of productivity and innovation. That's what successful private companies do, even if it requires painful change, and it's what the enterprise known as the Commonwealth of Virginia must do as well.

Economists have debated the impact of state/local taxes on economic performance for years. You can hop onto the Internet and find any number of studies to fit your preconceived notions. Here's *my* quick-and-dirty analysis.

In the chart to the right (and continued on the next page), I've ranked the states by 2000 tax burden, as calculated by the Tax Foundation.

As I argued earlier in the "Economy 4.0" series, per capita income is the single best metric for economic prosperity. Accordingly, using Bureau of Economic Analysis figures, I have expressed each state's per capita income as a ratio of the national average in 2000 and 2005. (A score of 100 equals the national average. A score of 95 indicates per capita income five percent lower than the national average; 102 indicates two percent above average.)

Then I calculated the percentage-point gain or loss in relative standing over that five-year period. Virginia, for instance, rose from 104 to 109, meaning that its income gained five percentage points relative to the national average.

Next, I broke down the 50 states by quintiles and calculated the average tax burden and average income gains for each quintile, as seen in the chart of the bottom of page three.*

Overall, it is clear to see, lower tax burdens are associated with higher rates of relative income growth.

It's not difficult to explain why this might be the case. Lower business taxes improve the return on capital that businesses invest. While taxes may be only one factor influencing the investment decisions of large corporationswhose playing field is the entire globe, they are particularly significant for small and midsized businesses that reinvest profits to fuel their enterprise's growth.

Tax Burden and Income Growth
(2000 to 2005)

Rank	State	Relative Income 2000	Relative Income 2005	Gain	2000 Tax Burden
1	Maine	87	89	2	13.2%
2	New York	117	116	-1	12.9%
3	Hawaii	95	100	5	12.2%
4	Wisconsin	96	97	1	12.1%
5	Rhode Island	98	102	4	11.7%
6	Minnesota	107	108	1	11.6%
7	Vermont	93	95	2	11.6%
8	Utah	80	79	-1	11.3%
9	Connecticut	139	137	-2	11.2%
10	California	109	107	-2	11.2%
	1st quintile		**Average:**	**0.9**	**11.9%**
11	Illinois	108	105	-3	11.1%
12	New Mexico	74	81	7	11.1%
13	Idaho	81	83	2	11.0%
14	Nebraska	93	96	3	11.0%
15	Ohio	95	92	-3	11.0%
16	Iowa	89	92	3	10.8%
17	West Virginia	73	77	4	10.7%
18	Georgia	94	90	-4	10.5%
19	Louisiana*	77	72	5	10.5%
20	Maryland	115	122	7	10.5%
	2nd quintile		**Average:**	**2.1**	**10.8%**
21	Washington	106	103	-3	10.5%
22	Mississippi	70	73	3	10.5%
23	Kansas	93	95	2	10.5%
24	Arkansas	73	77	4	10.5%
25	New Jersey	129	127	-2	10.5%
26	Arizona	86	87	1	10.4%
27	Michigan	99	95	-4	10.3%
28	Massachusetts	127	126	-1	10.3%
29	Kentucky	82	82	0	10.3%
	3rd quintile		**Average:**	**0**	**10.4%**

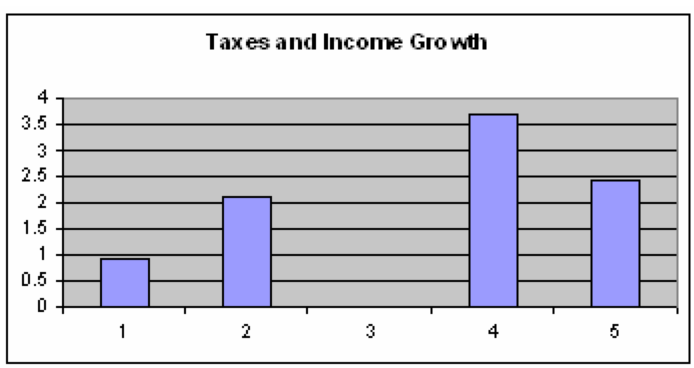
Chart continued on next page...

30	North Dakota	84	91	7	10.1%
31	South Carolina	82	82	0	10.1%
32	Montana	77	84	7	10.1%
33	Virginia	104	109	5	10.1%
34	Oregon	94	94	0	10.0%
35	Indiana	91	90	-1	10.0%
36	North Carolina	91	90	-1	10.0%
37	Pennsylvania	99	101	2	10.0%
38	Missouri	91	91	0	9.9%
39	Wyoming	95	108	13	9.9%
40	Oklahoma	82	87	5	9.8%
	4th quintile		**Average:**	**3.0**	**10.0%**
41	Colorado	112	109	-3	9.7%
42	Florida	96	99	3	9.5%
43	South Dakota	86	94	8	9.4%
44	Nevada	102	104	2	9.4%
45	Alabama	80	86	6	9.2%
46	Texas	95	94	-1	9.1%
47	Tennessee	87	90	3	8.3%
48	Delaware	103	108	5	8.2%
49	New Hampshire	112	110	-2	7.8%
50	Alaska	100	103	3	6.8%
	5th quintile		**Average:**	**2.4**	**8.7%**

* I used 1994 data for Louisiana. The 1995 data, which reflected the devastating effects of Hurricane Katrina, showed a such a precipitous decline in per capita income that it would have skewed the numbers significantly.

Lower personal taxes also create a hospitable climate for foot-loose members of the creative class who have the means to live anywhere they want. As Richard Florida has famously argued, the "creatives" are drawn to communities marked by openness, diversity and tolerance. But an examination of internal migration patterns in the U.S. also shows a consistent flow of well-off citizens from high-tax states to low-tax states. It appears that many members of the creative class like to keep the money they earn rather than have it taxed away.

However, there are plenty of exceptions to the low-tax rule: The middle quintile** of states was the worst performer of all between 2000 and 2005 (see the chart below), showing no gains compared to the national average at all. Thus, it is equally clear that taxes are not the only factor that contribute to income growth.



What are some of those other factors? One is industry mix. If you dredge through the details of the per capita income data over the years, you'll see that many smaller states move up and down with changes in the price of energy and agricultural commodities that play a large role in their economies. Similarly, the decline of certain industries can drag a state down, as automobiles have done to Michigan, while the rise of other industries, such as information technology in Virginia, has propelled per capita income growth.

Another factor may be the large-scale immigration (legal or otherwise) of poor, unskilled Latin Americans into the border states. Undoubtedly that was a factor behind the under-performance of California and Texas between 2000 and 2005. However, one shouldn't make too much of this phenomenon: Arizona and New Mexico, which also share the border with Mexico, showed relative income gains over the same period.

Finally, as some economists have noted, higher levels of state spending (and the taxes to pay for it) can be associated with higher incomes if that spending is used to boost productivity and innovation. One can argue, for instance, that investing in education and transportation infrastructure yields benefits that outweigh the cost in higher taxes.

In "Rethinking Growth Strategies," Robert G. Lynch with the Economic Policy Institute, a left-leaning think tank, writes:

> The evidence fails to support the claim that growing the economy requires shrinking the public sector and reducing taxes. In particular, there is little evidence that state and local tax cuts — when paid for by reducing public services — stimulate economic activity or create jobs. There is evidence, however, that increases in taxes, when used to expand the quantity and quality of public services, can promote economic development and employment growth.

Please note Lynch's key qualifier: Higher taxes "*when used to expand the quantity and quality of public services*" can increase growth. What he doesn't say is that higher taxes often flow to bloated bureaucracy, pork barrel projects, public sector unions and wealth transfers to constituencies with the biggest, strongest lobbyists -- not to bolster productivity, innovation or growth.

Most Virginians would agree, I trust, that not all state/local spending is created equal. Some government spending contributes to economic growth, other spending does not. Some government spending contributes to the wealth-creating capacity of its citizens, some does not.

To maximize Virginia's long-term prosperity, then, our vision should be to balance the drive for low taxes with a commitment to bolster the wealth-creating capacity of the state. As a generality, that means:

- Developing human capital (through K-12 education, college, and training programs);
- Investing in infrastructure (especially the transportation system);
- Providing public services and amenities (including clean air and water) that contribute to a high quality of life and make Virginia regions attractive to members of the creative class;
- Designing a social safety net that moves poor people from dependency to self sufficiency;
- Curtailing wealth transfers to favored special interests.

One way to keep spending and taxes under control is to cut "waste, fraud and abuse" in state and municipal government. That's easier said than done, of course, but the potential exists in Virginia to save hundreds of millions of dollars a year.

In one positive development, Republican legislators in the General Assembly and the Kaine administration have joined to create operational review teams to root out costs in such areas as travel, printing and receivables from state government. Also, reforms are afoot to rationalize the state's vast real estate holdings and lease obligations. There is potential, too, to reduce the cost of medical insurance for the state workforce. On the downside, a ballyhooed initiative to control information-technology costs appears to be sputtering, and no one is willing to go to bat for civil service reform.

Finding such efficiencies is crucial, but administrative overhead accounts for only a fraction of total state spending. The really big savings will come from transportation, Medicaid and education.

For instance, Virginia could save tens of millions of dollars annually by instituting a state-of-the-art methodology for managing road and highway assets. The state could save potentially hundreds of millions of dollars in Medicaid program expenses by rationalizing the system for medical records and setting up incentives for recipients to seek care at the most appropriate venues -- the doctors office as opposed to the emergency room. As for K-12 schools, Virginia's bureaucratic and unaccountable system stifles innovation. The solution is not more money, I would contend, but less centralized control.

Finally, at the level of municipal government, dysfunctional human settlement patterns -- the scattered, disconnected, low-density pattern of growth commonly known as "suburban sprawl" -- aggravates traffic congestion, increasing pressure to build more roads, and runs up the cost of municipal services. We will address these issues in more depth in future sections of the "Economy 4.0" series.

I'm not under any illusion that achieving these gains will be easy. Many of these issues are highly complex, and an array of special interests will defend the status quo ferociously. Working for Fundamental Change in governance and land use is a challenge that could well consume Virginia for a generation or more. But the fact that change comes hard is no excuse for failing to take up the challenge. If

Virginia wants to set the global standard for prosperous and livable communities, we need lower taxes *and* we need institutions that provide core services efficiently. We should settle for no less.

-- October 15, 2007

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* Sharp-eyed observers will notice that more states gained ground relatively speaking than lost ground. How is that possible? Because the losers tended to be the most populous states. Thus, a handful of large states with disproportionate weight -- California, New York, Texas, New Jersey, Illinois and Michigan -- dragged down the national average.

If that's the case, one might ask, shouldn't we also give comparable weight to these states when weighting the average gains and losses of relative per capita income? Doing so would bolster my case that taxes harm growth -- all but one of the states cited above have moderate or high tax burdens. But I chose not to: Each of the 50 states as an independent laboratory for taxes and growth, so each should be given equal weight.

**Sharp-eyed observers also might note that the second quintile contains only nine states, while the third quintile contains eleven. I shifted North Dakota from the second to the third because it had the same tax burden -- 10.1 percent -- as three other states in the third bracket. The whole purpose of the exercise is to compare the performance of states with differing tax rates.