

State and Local Business Taxes are Not Significant Determinants of Growth

State and local business taxes don't significantly affect the cost of doing business, but the state rankings examined on this website embrace the faulty belief that by lowering taxes on businesses and the wealthy, states can entice firms to relocate to their state or expand their operations.

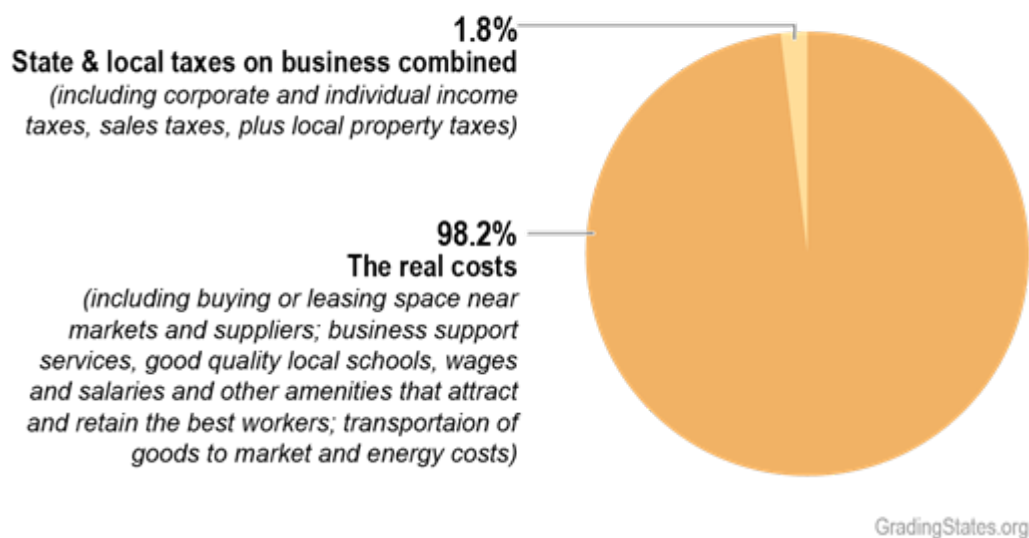
State and Local Taxes are a Small Part of Business Costs

The reason this strategy doesn't work is that it focuses on a very small component of business costs, while businesses take many factors into account when making location decisions. All state and local taxes on businesses combined (including corporate and individual income taxes, sales taxes, plus local property taxes) represent only about 1.8 percent of total business costs on average for all states.¹ Corporate income taxes, in turn, are only about 9.5 percent of that 1.8 percent, or 0.17 percent, according to one estimate.² Put another way, a large corporate tax break that reduces a company's corporate income tax bill by half represents a cost savings to the average firm of just 0.09 percent.³

Businesses weigh most heavily the business basics that comprise the other 98 percent of their cost structure, and which vary greatly depending upon what the company makes or does; which part of the company is being sited; where the company and industry are in their life cycle; where the company and its competitors already have facilities, and other factors. Common key variables include: proximity to markets and to suppliers; transportation infrastructure; supply of labor with appropriate education and skills; wage and salary rates; energy costs; occupancy costs (to buy or lease space); access to supporting business services; the quality of local schools, recreation amenities, climate and other amenities important in attracting and retaining skilled labor; and proximity to university research facilities. For service-sector companies, labor is the biggest cost; for manufacturing or warehousing, physical plant space is also a major expense.

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All state and local taxes on businesses as a share of total business costs, on average



The tiny change in the cost calculus from tax cuts does not change any meaningful share of site location choices as the differences in big-ticket cost items such labor, occupancy, energy, or raw materials, would dwarf anything a company could gain via tax breaks. As a result, nearly all of an across-the-board tax cut will be wasted on corporations that would have chosen or remained in a state anyway.

If tax rates do affect business location decisions to any degree, then states with lower taxes should experience more rapid growth, other things held equal. But that last phrase, “other things held equal,” is crucial. If a state lowers corporate taxes, it must deal with the loss of revenue by raising taxes on individuals and/or other businesses or by lowering the quality of public services, or some of both. Either action could make a state less attractive for private investment.

Research Shows Mixed Results, Little Evidence of Significant Tax Effects

As stated above, many factors influence business location decisions. To discern the effect of tax levels, researchers must use statistical techniques to hold all other relevant factors constant. The question is: if two states are similar in their business basics (labor skills and wages, access to markets and materials, occupancy and energy costs, etc.), will a difference in business taxes be associated with a difference in growth rates? Statistical techniques have become increasingly sophisticated over the past 25 years, enabling better ways to control for other location determinants and thereby generate more reliable answers to this question. While even the most sophisticated statistical analysis cannot *prove* causality, the more carefully a study controls for the whole range of factors reasonably believed to affect business decisions, and the more often such studies are replicated, the more confidence we gain in evidence of a causal relation.

Fortunately for those interested in how taxes interact with economic growth, there has been a large volume of research investigating this question over the past 40 years. Three summaries of the research, in 1988 by Robert Newman and Dennis Sullivan, 1991 by Timothy Bartik, and in 1998 by Michael Wasylenko, produced something of a consensus that the independent effect of state taxes on state growth is either not statistically significant or is very small.⁴ Subsequent literature reviews report continued mixed results, with several studies finding no significant effect of business taxes on state growth, and others finding statistically significant but small effects.⁵ Most recently, Gale, Krupkin and Rueben reviewed the literature and found the results remarkably “fragile”; research results often could not be replicated for other time periods, and the effects of taxes on growth in some studies disappeared or reversed in sign when models were specified differently.⁶ The same authors also conclude that “examination of recent state experiences with changing tax structures reveals little evidence of tax cuts driving growth.”⁷

The preponderance of the evidence, then, from many dozens of peer-reviewed studies over several decades is that business tax cuts, if they could be enacted without cutting public spending, may or may not have some positive effect on state economic growth, but that any positive effect is likely to be quite small.

Tax Cuts Can Hurt State Services to Business

States’ balanced budget requirements mean that tax cuts often result in cuts to public services, which hurt growth as these services are essential to the economy. As Bartik has said: “[A]n economic development policy of business tax cuts may fail to increase jobs in a state or metropolitan area if it leads to a deterioration of public services to business. An economic development policy of tax increases may succeed in increasing jobs if it significantly improves public services to business.”⁸

Business tax breaks could be financed, alternatively, by increases in taxes on households, but such a strategy will likely *decrease* consumer spending within the state, which hurts local retailers and other in-state businesses and the state economy.⁹

1.□ This is based on data averaged over three years 2005-2007 from two sources: U.S. Internal Revenue Service, Statistics of Income, Integrated Business Data for all U.S. Corporations, partnerships, and non-farm proprietorships, showing total deductions for business costs on tax returns, at <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data>; and a 2009 report by the Council on State Taxation, which estimates total state and local taxes paid by businesses, available at <http://www.cost.org/Page.aspx?id=69654>.

2.□ Council on State Taxation (see note 3). This is the average proportion over the three non-recessionary years 2005 to 2007; the fraction is lower in recession years.

3.□ 50 percent times 9.5 percent times 1.8 percent equals .09 percent. This is the average over all types of business, which is the relevant figure for considering the impact of a particular tax cut on overall business activity. The impact of a corporate

income tax cut on corporations only would be somewhat larger; however, considering corporations only, state and local taxes are only 2.3 percent of total corporate business expenses at most (see Michael Mazerov and Mark Enriques, "Vast Majority of Large Maryland Corporations Are Already Subject to Combined Reporting in Other States," Center on Budget and Policy Priorities, November 9, 2010, Note 4), while the state and local corporate income tax represents about 19 percent of corporate state and local tax payments, according to IRS data, so the impact of a 50 percent corporate income tax cut is still very small: 50 percent times 19 percent times 2.3 percent equals 0.22 percent.

4. □ Robert Newman and Dennis Sullivan, "Econometric Analysis of Business Tax Impacts on Industrial Location: What Do We Know, and How Do We Know it?" *Journal of Urban Economics*, vol. 23, 1988, pp. 215-34; Timothy Bartik, *Who Benefits from State and Local Economic Development Policy?* Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1991; Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review*, March/April 1997, pp. 37-52. Bartik's review of 59 studies completed prior to 1991, including 34 studies that attempted to measure the effects of business taxes on state output, led him to conclude that the bulk of the credible research indicated an elasticity somewhere between -.1 and -.6, and probably about -.3. This means that a 10 percent reduction in taxes will lead eventually to an increase in the state GDP of 3 percent (+3 percent divided by -10 percent is equal to the elasticity of -.3).

5. □ See, among others, Alan Peters and Peter Fisher. "The Failures of Economic Development Incentives." *Journal of the American Planning Association*, vol. 70, no. 1: Winter 2004, pp. 27-38; J. William Harden and William H. Hoyt, "Do States Choose Their Mix of Taxes to Minimize Employment Losses?" *National Tax Journal*, March 2003, pp. 7-26; James Alm and Janet Rogers, "Do State Fiscal Policies Affect State Economic Growth?" *Public Finance Review*, July 2011; Daphne Kenyon, Adam Langley, and Bethany Paquin. *Rethinking Property Tax Incentives for Business*. Cambridge, MA: Lincoln Institute for Land Policy, 2012; Richard Funderburg, Timothy J. Bartik, Alan H. Peters, and Peter S. Fisher. "The Impact of Marginal Business Taxes on State Manufacturing." Forthcoming in the *Journal of Regional Science*, December, 2013.

6. William Gale, Aaron Krupkin, and Kim Rueben. "The Relationship Between Taxes and Growth at the State Level: new Evidence." *National Tax Journal*, vol. 68, no. 4, December 2015, pp. 919-941.

7. William Gale, Aaron Krupkin, and Kim Rueben. "The Growth Mirage: State Tax Cuts Do Not Automatically Lead to Economic Growth." Tax Policy Center, September 8, 2015. <http://www.taxpolicycenter.org/UploadedPDF/2000377-the-growth-mirage.pdf>

8. □ Timothy Bartik, *Who Benefits from State and Local Economic Development Policy?* Kalamazoo, MI: W.E. Upjohn Institute for Employment Research, 1991, p. 8.

9. □ See Michael Mazerov, "Cutting State Corporate Income Taxes is Unlikely to Create More Jobs," Center on Budget and Policy Priorities, Sept. 14, 2010, at <http://www.cbpp.org/cms/index.cfm?fa=view&id=3290> .