

# Tax Cuts Undermine State Investments in Productivity

Taxes cuts do not pay for themselves; rather they cost states revenue that could boost economic growth by being invested in critical services, like schools, roads, and building safer communities.

## Tax Cuts Produce Revenue Losses

The false assertion that tax cuts increase revenue is often traced to the Laffer Curve, supposedly sketched out on a napkin by Arthur Laffer for the benefit of Dick Cheney in a Washington, D.C. bar in 1974. The curve is based on an alleged truism: If you tax a particular thing at 100 percent, you will generate zero revenue (e.g., if wages were taxed at 100 percent, no one would work). Therefore, at some point, as the tax rate approaches 100 percent, any increases to the tax rate will decrease revenue, rather than increase revenue. According to the theory, once past this point, a state can increase revenue by cutting taxes. The curve—which is shown as a sketchy graphic, not a precise chart—is drawn so that it appears that this prohibitive point is reached at about a 50 percent tax rate.

There are so many things wrong with this depiction and the conclusions drawn from it that it is difficult to know where to begin. First, Laffer provides no empirical evidence showing at what tax rate the curve starts to turn downward, though in his writings he often implies that the United State is already there. In reality, it is doubtful that any state or local tax rates are anywhere near the “prohibitive” level as effective state tax rates on corporate and individual income, for example, are in the single digits.<sup>1</sup>

Second, the point at which a tax rate increase leads to a reduction in revenue instead of an increase in revenue—if there is such a point at all—will vary dramatically depending on which commodity or activity is taxed and by which jurisdictions.

Finally, the fundamental premise may not apply to sales to excise taxes; a tax equal to 100 percent of the price of, say, cigarettes, is quite feasible, and would generate a great deal of revenue. Those addicted to cigarettes would still buy them, even if the tax effectively doubles the price.

These facts do not deter Laffer and company from making this statement in the 2011 edition of *Rich States, Poor States*: “Economists have observed a clear Laffer Curve effect with respect to cigarette taxes.” As evidence, they point to the fact that states with higher cigarette taxes sell fewer cigarettes than neighboring states with lower taxes. But a reduction in number of units sold is not a demonstration of the Laffer curve at all, which is about a *reduction in total revenue*. All respected research on the effect of taxes on cigarette consumption shows that cigarettes are well within what Laffer calls the “normal

range,” where an increase in the state tax rate *increases* revenue.

We need only look at the large accumulation of empirical evidence on [the effect of taxes on state economic growth](#) to realize that states overall are well within the so-called “normal range” where tax cuts reduce revenue. Research shows that **state economic growth is not very responsive to changes in state and local taxes**: a 10 percent tax cut leads to *perhaps* a 3 percent increase in growth, if all else (including state spending on education and infrastructure) could be held constant. But such a tax cut would have to produce at least a 10 percent gain in growth to actually pay for itself, over three times the degree of effectiveness researchers have found.<sup>2</sup> That leaves states that cut taxes grappling with revenue loss, which begs the issue of how to keep the budget balanced and sustain the same level of public services.<sup>3</sup>

## Tax Cutting Has Led to Under-investment in Education and Infrastructure

Most importantly, the effect of tax rate increases on revenue depends crucially on what government does with the revenue.<sup>4</sup> In the Laffer model, the implicit assumption is that revenue is simply frittered away when in fact **government spending can have a substantial positive effect on economic activity and the tax base if used to fund education, job training, or infrastructure improvements that stimulate economic growth**. Therefore tax increases will increase revenue, especially if the revenue is devoted to investments that enhance the prospects for long term growth. And tax cuts reduce revenue, and reduce it even more to the extent that the revenue loss results in cuts to investments needed for long-term growth. **The bottom line is tax cuts have a real and substantial cost to states.**

A recent report has documented the troubling decline in infrastructure investment at all levels of government.<sup>5</sup> State and local spending on infrastructure as a percent of GDP is at a 30-year low, and a huge gap remains between transportation and education infrastructure needs and actual capital spending by the states. The majority of states in 2015 had still not restored K-12 education funding to the level that prevailed before the great recession of 2008, and key education reforms aimed at improving student performance have been cut or under-funded.<sup>6</sup> As of 2015, the average state was spending 20 percent less per pupil on higher education than it did in 2007-08, leading to rising tuition and reduced access to post-secondary education.<sup>7</sup> These funding cuts will have harmful long-term consequences for the nation’s growth and prosperity if not reversed.

1.□ The Institute on Taxation and Economic Policy has documented that the most profitable Fortune 500 corporations pay an average of just 3.0 percent of their profits in income tax to the states. “Corporate Tax Dodging in the 50 States, 2008-2010.” Institute on Taxation and Economic Policy, December 2011.  
<http://www.itep.org/pdf/CorporateTaxDodgers50StatesReport.pdf>

2.□ Because research invariably finds that economic activity is inelastic with respect to changes in state and local taxes, an

increase in taxes will always yield an increase in revenue, and a cut in taxes will always produce a loss of revenue.

3. To use a simple example of how a tax cut reduces revenue when demand is inelastic, consider that a tax of \$1 on 100 packs of cigarettes raises \$100; a tax of 90 cents (a 10 percent cut) applied to 103 packs (a 3 percent increase in sales) produces \$93.

4. See Zsolt Becsi, "The Shifty Laffer Curve." *Economic Review*, vol. 85, no. 3, 2000.

5. Elizabeth McNichol. *It's Time for States to Invest in Infrastructure*. Washington, D.C.: Center on Budget and Policy Priorities. February 23, 2016. <http://www.cbpp.org/research/state-budget-and-tax/its-time-for-states-to-invest-in-infrastructure>

6. Michael Leachman, Nick Albares, Kathleen Masterson and Marlana Wallace. *Most States Have Cut School Funding, and Some Continue Cutting*. Washington, D.C.: Center on Budget and Policy Priorities. January 25, 2016. <http://www.cbpp.org/research/state-budget-and-tax/most-states-have-cut-school-funding-and-some-continue-cutting>

7. Michael Mitchell and Michael Leachman. *Years of Cuts Threaten to Put College Out of Reach for More Students*. Washington, D.C.: Center on Budget and Policy Priorities. May 13, 2015. <http://www.cbpp.org/research/state-budget-and-tax/years-of-cuts-threaten-to-put-college-out-of-reach-for-more-students>