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Income Taxes and Economic Growth

Despite the widespread belief held by politicians that the level of income taxation affects economic growth, most studies have found little or no connection. While there is still much discussion on the issue, the majority of the evidence points toward the limited role of income taxes in business location decisions. "It is political salience, rather than economic consequence, that emerges most clearly and consistently. . . Given this asymmetry between political and economic forces, it appears that state tax choices are nested more in exaggerated beliefs and political fears than based in real economic consequences" (Brace, forthcoming). Most studies cite a plethora of other uncontrollable factors, such as "labor costs, availability of appropriately skilled labor, energy costs, climate, and the availability of natural resources" (Bradbury et al., 1997). In addition, many studies note the importance of the public services provided (Helms, 1985; and Dye, 1980). Helms explains,

> A state's ability to attract, retain, and encourage business activity is significantly affected by its pattern of taxation; however, taxes cannot be studied in isolation. To the extent that tax revenues are devoted to the provision of public services which are valued by businesses and their employees, a state may encourage economic activity within its borders with appropriate expenditures. Our results indicate that the effects of taxation on a state's economy depend crucially on the use to which the revenues are put. (1985)

In addition, Romans and Sabrahmanyan showed that personal income taxes negatively affect employment growth, and "employment growth is reduced by high transfer payments and high tax progressivity" (cited in Blair and Premus, 1987).

It is also interesting to note that a large number of studies have looked at the effect of taxes in general on economic growth. Dye found it noteworthy that:

> state spending is more influential in explaining variance in economic growth rates than state taxing. Despite the general popularity of the view that state tax rates and tax burdens directly affect economic growth, we were unable to discover *independent* linkage between variation in state taxing and variation in economic growth rates (1980).

The aforementioned studies show a small but significant relationship. Bradbury et al. find the average tax elasticity to be a -0.2, meaning that a 10% reduction in taxes would lead to approximately a 2% increase in economic activity. (See also, Bartik, 1991; Wasylenko, in Bradbury et al. 1997). In a study covering the years 1957 to 1984, Dye found a negative association between increases in the tax burden and economic growth in 20 of 50 states (Dye 1990). In other words, for 20 states, increases in taxes were followed by lower growth over this time period.

Blair and Premus, in their review of studies on industrial location factors discovered that conventional factors, such as access to markets, labor, raw materials, and transportation are becoming less important, while other factors, such as productivity, education, taxes, community attitudes toward business, etc. have been influential (1987).

The Boston branch of the Federal Reserve Bank held a symposium in November 1996, entitled "The Effects of State and Local Public Policies on Economic Development: An Overview." While this does not discuss personal income tax, it does feature articles and discussion on how tax policies affect economic growth. A full transcript of the articles and discussions are available in the *New England Economic Review* (cited below, under Bradbury et al., 1997).

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