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The Reality of Tax Cuts:

A Primer on the Failings of Tax Cuts as Economic Development Strategy

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Introduction

Proponents of tax cuts continue to push a mantra of low-income taxes being a major driver of state economic growth. Research and past experience, however, has proven this approach unlikely to deliver promised economic results. Instead it can be counterproductive. Investing in K-12 education and colleges, infrastructure projects across the state, and more targeted support for main street and neighborhood revitalization initiatives presents a much better economic development strategy that helps drive the state forward.

States that have enacted large income tax cuts in recent years are not seeing a boost to their economies, adding to evidence that tax cuts that primarily benefit the wealthy and profitable corporations are not an effective strategy for promoting broadly shared economic growth. These ineffective tax cuts do, however, reduce revenue, which create and deepen revenue and budget shortfalls. Consequently, state support for core public services erodes and low- and middle- income households are often left to pick up the slack by paying even more in state and local taxes as a share of their income than their wealthy neighbors.

North Carolina's experience is unlikely to prove an exception to the mounting evidence that broad-based tax cuts do not drive economic growth. For years, the underlying theory supporting this idea has been questioned. This warranted questioning combined with recent experiences of other states points to the need for an alternative strategy that can deliver on promoting widespread economic prosperity.

Tax cuts based on flawed economic theory

Proponents of tax cuts have presented economic theories that have taken many names over the years to promote their claim that income tax cuts boost economic performance. From *trickle-down* (or *"voodoo"*) *economics* to the more generous label of *supply-side economics*, supporters of large income tax cuts often offer up three arguments when they make their case:

- **Personal income tax cuts attract new residents, encourage more work, and create more jobs:** Supply-side economic theory suggests that taxes reduce dollars available to individuals who are best able to use those dollars in support of job creation, greater investment, and economic growth. The idea behind the theory is that individuals make decisions about whether to work more and earn additional income based on the taxes they must pay on the additional income earned. The additional income earned becomes available to make investments or directly create jobs. Another aspect of this idea is that taxpayers will pursue the lowest tax rate possible, moving to new states to find that lowest tax rate, regardless of other factors.
- **Corporate tax cuts will encourage businesses to hire more workers and entice companies to locate to the state:** Proponents contend that taxes play a significant role to the financial performance of businesses and that failure to lower corporate income tax rates makes states unattractive and less competitive as a place to do business. The idea is that state-level corporate tax cuts will attract businesses to the state that otherwise wouldn't come or that the tax cut would make an otherwise unprofitable business activity profitable in the state.

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- **Income tax cuts will lead to more revenue for state budgets:** Supply-side economic theory purports that income tax cuts can lead to increased overall tax revenue as a result of increased economic growth. The underlying theory is based on what has been coined the "Laffer curve," created by economist Arthur Laffer, as a way to suggest that at some optimal tax rate, economic activity and the amount of tax revenue raised from such activity is maximized. Accordingly, raising the marginal tax rate above this optimal level will reduce economic activity and in turn lower tax revenue (see points above).

No consensus in academic literature that income tax cuts spur state economic growth

Academic literature suggests that tax cuts are not a good strategy for promoting broad economic growth and provides no support for claims that tax cuts will always and automatically lead to economic growth.[1] A review of academic literature on tax cuts and economic growth by the Center on Budget & Policy Priorities highlights the following:

"Looking only at the eight major studies published in academic journals since 2000 that have examined the effect of state personal income tax levels on broad measures of state economic growth, six have found no significant effects and one of the others produced internally inconsistent results."[2]

A more recent analysis replicates methods used in a previous analysis, which tax-cut proponents often cite as supports for their claim, but extends the time horizon of analysis by 10 years.[3] Findings show that taxes do not have an impact on growth. In fact, when the study looked at a more recent time period of 1992 to 2006, stronger economic growth was associated with *higher* taxes, a direct contrast to claims from proponents of tax cuts.[4]

Here are key reasons why claims that pursuing tax cuts will spur economic development are problematic.

Claim #1: Personal income tax cuts attract new residents, encourage more work, and create more jobs.

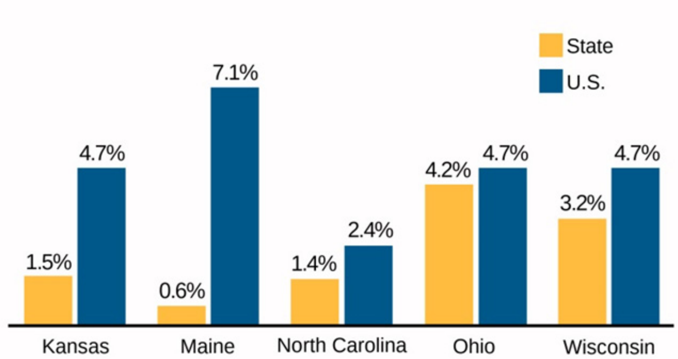
Taxes play a negligible role in decisions about where individuals and families choose to locate. Several recent studies on interstate migration highlights that income taxes do not drive decisions by households about where to locate.[5] People are more likely, however, to move because of family

IN PRACTICE: *Cutting taxes has not strengthened the economic recovery for states*

Economic performance for recent tax-cutting states has not been more robust than that experienced by their region overall. In Kansas, where tax cuts have been in place the longest, not only are tax cuts not delivering stronger job growth but wage growth has also been underwhelming. Wisconsin has also seen slower than expected job growth, falling behind the region in year over year employment growth. Louisiana faces a huge budget gap as a result of costly tax cuts in recent years. Finally, more recent data on economic output shows that tax-cutting states are underperforming the nation.

FIGURE 1: **Biggest Tax-Cutting States Not Seeing Boom**

Growth in gross domestic product adjusted for inflation, since tax cuts took effect, through 2014



NOTE: Effective dates for tax cuts are Jan.2012 for Maine; Jan. 2013 for Kansas, Ohio, and Wisconsin; and Jan. 2014 for North Carolina. The cuts in Ohio and Wisconsin were enacted in June 2013 and made retroactive to January.

Source: Commerce Department

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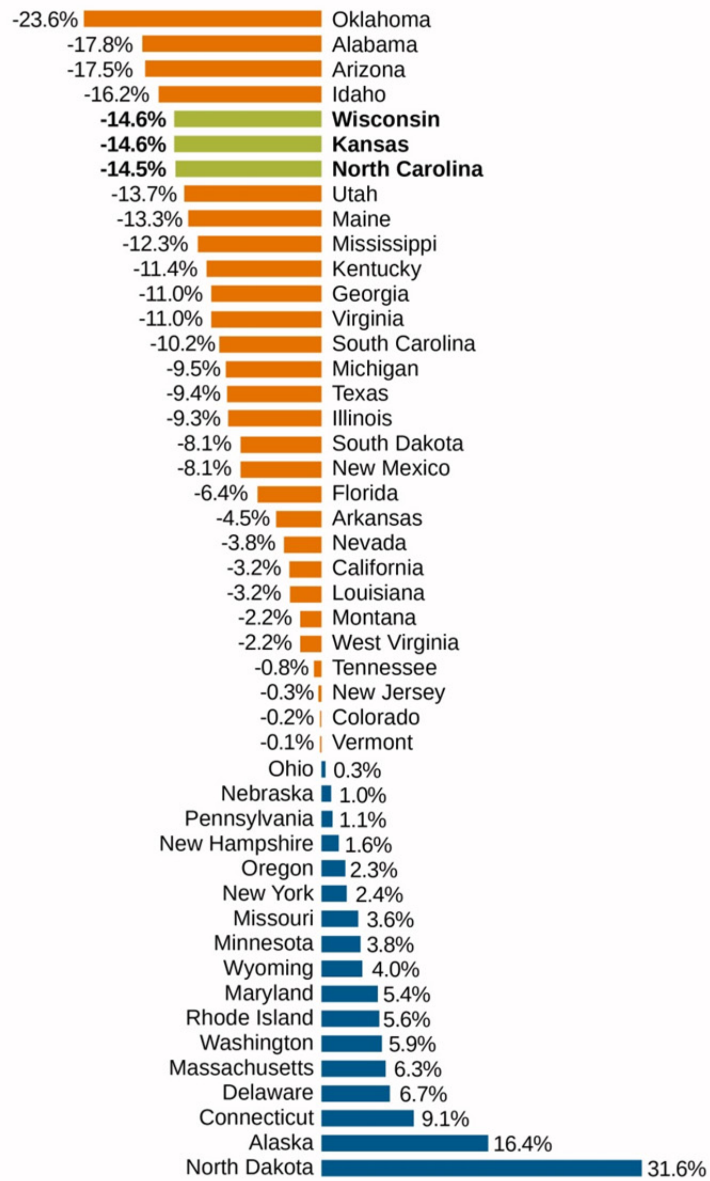
IN PRACTICE: ***Cutting taxes has reduced the quality and effectiveness of public services, undermining states' economic growth prospects***

In Kansas, financial support for K-12 spending is already down 15 percent since 2008 and cuts to higher education have forced an average annual tuition increase of nearly $1,000 at our public universities.[14] In North Carolina, tax cuts in 2013 resulted in ongoing cuts to classrooms, higher education, the courts, and other pillars of a strong economy.[15] Compared to 2008, more than 7,000 fewer teacher assistants are in classrooms and state funding cuts to the Pre-K programs has resulted in thousands of fewer slots available for at-risk 4-year olds. Since 2008, steady cuts in recent to higher education have been accompanied by a 38 percent increase in tuition and mandatory fee at public universities and a more than 70 percent increase in tuition at community colleges, when adjusted for inflation.

FIGURE 2: **Per-Student Spending Remains More than 10% Lower than 2008 in 14 States**

Percent change in spending per student, inflation-adjusted, FY08 to FY15



Note: Hawaii, Indiana, and Iowa are excluded because the necessary data to make a valid comparison are not available.

Sources: CBPP budget analysis and National Center for Education Statistics enrollment estimates.

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considerations, weather, job opportunities, and cost of housing. This finding mirrors North Carolina's experience, where the number of wealthy households moving into the state increased significantly after the state added a new top marginal income-tax bracket in 2001.[6]

The impact of tax cuts on labor supply is also inconclusive and more likely to make a difference for workers earning low wages. These workers are more likely to make decisions regarding work hours based on taxes than a higher income worker.[7] Moreover, the claim that tax cuts put more dollars into the paychecks of taxpayers ignores the unaddressed reality of falling wages for workers. Contrary to small changes in state taxes, trends in wages either declining or growing have the potential to play a much larger role in driving economic growth. Furthermore, personal income tax rates do not significantly affect decisions regarding job-creation, as relatively few households are in a position to create jobs.[8] Nearly half of the businesses filing personal income taxes are sole proprietors and 9 out 10 of those do not have any employees.[9]

Claim #2: **Corporate income tax cuts will encourage businesses to hire more workers and entice companies to locate to the state.**

The most significant problem with this theory is that state and local taxes are typically only 2 to 3 percent or less of business costs, meaning tax cuts rarely cover the cost of hiring new workers.[10] Expenses for labor, property, equipment, and transportation are much more substantial cost for businesses.

Far more important to businesses' decisions about hiring is whether adequate customer demand exists for their products or services. With low consumer demand in recent years, companies across the nation have held onto record profits rather than deploy those profits into additional investments.[11] To the contrary, when sufficient consumer demand exists, businesses will hire and expand regardless of whether they receive a tax cut or not.

Research also finds that the impact of tax cuts on business investment would not only be small but also require years to fully take effect. In general, a 10 percent reduction in total state and local taxes paid by businesses is likely to boost economic output and jobs by only about 2 percent.[12] Additionally, as emerging research highlights, many small businesses are not in a position to significantly grow their operations due in part to the nature of their respective industry and the owner's motivations for owning their small business.[13]

Finally, a portion of tax cuts to large, profitable corporations is likely to flow outside of North Carolina, as many shareholders and managers of large companies live outside of the state. Furthermore, an additional portion, around a third of the tax cut, would go to the federal government, as corporations would have to include the additional income from the state tax when determining the amount of federal income tax owed.

Claim #3: **Income tax cuts will lead to more revenue for the state's budget**.

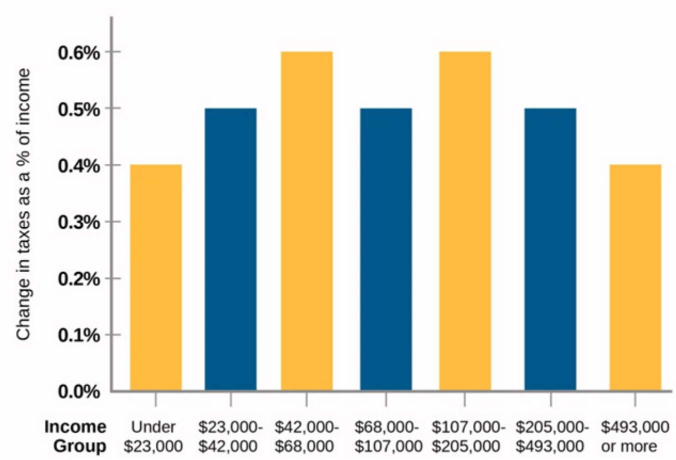
The reality of this claim is that reducing tax rates results in a loss of revenue for the state. Absent lower tax rates, states would be collecting more revenue under the same economic conditions.

IN PRACTICE: *Cutting taxes has made it harder for North Carolina to ensure equal access to opportunity and create thriving communities statewide because of inadequate revenue.*

Public policy at the state level is supposed to ensure that access to economic opportunity and economic well-being is limited due largely to where someone lives. When state policy fails to promote and access to opportunity in less privileged communities, economic well-being can vary wildly from place to place. Georgia's local governments have found that the lack of state revenue to support their public schools and economic development efforts is taking a serious toll on the economic health of their communities.[18] States that have passed huge tax cuts in recent years, such as Louisiana, Kansas, and Wisconsin, currently face significant state budget challenges that impact the quality of life in local communities and have often turned to raising taxes on middle- and low-income taxpayers.

FIGURE 3: **End of Session to Address Kansas Budget Crisis Brought on By Tax Cuts, Raises Taxes**

Even with the 'low-income exclusion,' low-income Kansans still see **$60 hike**



SOURCE: Institute for Taxation and Economic Policy Microsimulation Model, June 2015

Lowering tax rates, and adopting flat income tax rate structures, reduce revenues through two mechanisms. As already mentioned, lowering tax rates means fewer dollars are available to make investments in public services and goods, like public schools and universities, that support the state economies. And yet, for example, the greatest driver of per capita income growth in a state, one study finds, is its stock of educated workers and research institutions.[i6] Second, a tax code that reflects low and flat rates is less able to grow as the economy grows thus leading to an erosion in revenue to meet changing and growing needs in communities over time.

One final point on the connection between tax rates and revenue: in many so-called low-tax states, the majority of residents actually pay a relatively high share of their income in state and local taxes, making these state in fact high-tax states.[17] This is in part due to these states relaying more on the sales tax, which hits those with the lowest income the hardest, to raise revenue to support public services that all taxpayers in their respective states utilize and rely on.

Failure of tax cut experiments to deliver promised results shouldn't be a surprise

The experiences of states that have passed large tax cuts, the country as a whole, as well as academic literature on the issue show a lacking connection between tax cuts and economic growth.

States that cut taxes the most in the 1990s did not see as robust economic growth in the next business cycle, according to analysis by the Center on Budget & Policy Priorities.[19] Another study that compared all 50 states found that tax rates do not harm economic growth, job creation, or income growth.[20]

Analyses of federal tax policy find that income tax cuts that primarily benefit the wealthy and profitable corporations have contributed to growing income inequality and failed to deliver stronger economic growth or improved incomes for the average American. Over the last 65 years, changes in tax rates have had virtually no impact on economic growth nationally. The top income and capital gains tax rates were found to have had no discernible impact on economic growth, accordingly to analysis by the Congressional Research Service.[21] Cuts in the top tax rates in 2001 and 2003 at the federal level failed to generate more savings, investment or productivity, and in fact were followed by the weakest economic expansion since the end of World War II.[22]

Alternatives for an Economy that Creates Broad Prosperity

Alternatives to tax cuts exist that can support a stronger economy that works for all North Carolinians. Researchers have documented how key state investments can strengthen the economy and ensure that the benefits of growth are broadly shared across all income groups.[23]

- **Open up opportunity for communities of color, immigrants and women.** Removing barriers to higher earning for communities of color—such as increasing affordability of skills training, developing pipelines into work and reducing discrimination in the workplace – would generate significant economic returns for North Carolina. In 2012, North Carolina's overall economy would have been $63.5 billion larger if gaps in income by race or ethnicity hadn't existed.[24]

- **Increase educational attainment.** States with higher educational attainment not only have higher productivity but also higher median wages. In these states, higher levels of education have led to producing more goods and services, and the new income from that greater productivity and economic growth is returned to workers in the form of higher wages.[25]

- **Build infrastructure in underserved communities.** Just like efforts to bring electricity to all Americans at the turn of the last century, efforts to build out the physical infrastructure that supports businesses and households alike are critical to making all communities competitive. Investments in broadband, wireless internet access in schools and city centers, transportation networks and thriving main streets have supported revitalization efforts in traditionally underserved communities.[26]

- **Finance small business development and expansion.** No clear relationship exists between state business taxes and entrepreneurial activity. Access to capital is key, however. Financing through a targeted loan fund and community development finance institutions can reach many small business owners.[27] In addition, factors such as mentoring, business networking support, and proximity to markets and intellectual capital are important to growing the number of small businesses in the state.

- **Fund research & development at state public universities.** North Carolina's public universities not only help support educational attainment, but they also serve as hubs of research and development that have sparked profitable commercial ventures in the state and globally and improved the quality of life of residents here and across the country.[28]

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