Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

March 21, 2013

State Personal Income Tax Cuts: A Poor Strategy for Economic Growth

By Michael Leachman, Michael Mazerov, Vincent Palacios, and Chris Mai

Policymakers in a number of states including Arkansas, Kansas, Missouri, North Carolina, Ohio, and Wisconsin are promoting deep cuts in personal income taxes as a prescription for economic growth — an approach that has not worked particularly well in the past and is not supported by the preponderance of the relevant academic literature.

States that enacted major personal income tax cuts in the 2000s, before the most recent recession hit, were as likely to lose economic ground as to gain it.

- Of the six states that enacted large personal income tax cuts in the years before the recession, three states saw their economies grow more slowly than the nation's in subsequent years, and the other three saw their economies grow more quickly.

- The three that grew quickly are all major oil-producing states that benefitted from a sharp rise in oil prices in the years after they implemented their tax cuts. In other words, *all* of the lesser- and non-oil-producing states that enacted big personal income tax cuts in the 2000s grew more slowly than the national average.

Similarly, the biggest tax cutting states of the 1990s — all of which enacted substantial personal income tax cuts — also did not perform particularly well in later years.

- States with the biggest 1990s tax cuts grew jobs during the next economic cycle at an average rate one-third the rate of states that were more cautious.

- The biggest tax-cutting states also had slower income growth. In *none* of these states did personal income growth in the next economic cycle exceed inflation.

These anecdotes illustrate an important finding from a multiplicity of empirical academic studies conducted by economists over the last 40 years. The vast majority of these studies find that interstate differences in tax levels, including differences in personal income taxes, have little if any effect on relative rates of state economic growth. Of the eight major studies published in academic journals since 2000 that have examined the broad economic effect of state personal income tax

Good Reasons to Believe Personal Income Tax Cuts Are a Poor Strategy for Growing State Economies

There are a number of good reasons why the real-world results and the academic literature lend little support for personal income tax cuts as a strategy for boosting state economies. For example:

- **It's a zero-sum game.** Because states must balance their budgets, tax cuts must be paid for by cutting state services, raising other taxes, or both, and those actions slow the economy and offset any economic benefit of the tax cuts.

- **Higher state and local taxes help pay for services that households and businesses want and need.** State and local taxes are often higher in some locations than others because they are financing higher-quality public services: better schools, universities, roads and mass transit, more public recreational facilities, better police protection, etc. When higher taxes pay for better services, they may have no adverse impacts on location decisions whatsoever and may even have positive impacts (when, for example, the reduction in other business costs exceeds the taxes themselves).

- **Other factors are much more important to a state's economic growth.** Trends in the national and international economy, a state's natural resources, the education of its workforce, the proximity to major markets, and the mix of industries in a state — these are among the major factors that determine the growth of state economies. Differences among states in state personal income taxes, by contrast, are a very minor issue.

levels, six have found no significant effects and one of the others produced internally inconsistent results.

Despite the evidence that cutting personal income taxes does little to boost state economies, states may still be tempted to take the risk. That would be a mistake. With their revenues still deeply damaged by the recession and their reserve funds depleted, states have little margin for error right now. Gambling on a personal income tax cut would put fundamental public services, which in most states are heavily dependent on personal income tax revenue, at risk. (Personal income taxes account for 24 percent of the general revenues states raise to pay for public services.) And with the federal government on track to impose deep reductions in funding for schools and other services states provide, states have an additional reason to protect their own revenue to limit the damage being done to their public services.

Past Personal Income Tax Cuts: No Panacea

The idea that cutting personal income taxes might boost the economy is not a new one. In the 1990s and 2000s, a significant number of states tried this approach.

The results make clear that deep personal income tax cuts are no panacea for state economies. States that followed this prescription for growth did not do particularly well in later years, with the exception of major oil-producing states benefiting from a boom in oil prices.

The Experience of States That Cut Taxes in the 2000's

In the years before the recent recession hit in late 2007, six states — Arizona, Louisiana, New Mexico, Ohio, Oklahoma, and Rhode Island — enacted significant personal income tax cuts. In every case, proponents claimed the tax cuts would improve the state's economic standing, just as proponents of similar cuts today are claiming. For example, the House Majority Leader in Rhode Island said, "This new tax rate. . . is certain to create new jobs, spur economic development, put money back in taxpayers' pockets, and otherwise bring Rhode Island to a position of twenty-first century economic leadership in the region and, indeed, in the country."[1]

After enacting the tax cuts, Arizona, Ohio, and Rhode Island saw their economies fall *behind* the rest of the country on three important measures — job creation, production growth, and income growth (see Table 1). On average, after enacting the cuts, these states saw their share of the nation's jobs and personal income fall by 4 percent and their share of the nation's economic output fall by 6 percent.

The other three states — Louisiana, New Mexico, and Oklahoma — have outperformed the nation so far, but probably not because of the tax cuts. All three states are major oil and natural gas producers[2] whose economies benefited from the tripling of oil prices since the mid-2000s and the rapidly growing use of a new technique for extracting oil and gas that combines horizontal drilling with hydraulic fracturing, or "fracking." Half or more of the relative job gains in New Mexico and Oklahoma can be accounted for by very rapid job growth in just two parts of the oil industry — mining and pipeline transportation.[3] Louisiana's economy benefited both from the oil and gas boom and also from billions in federal disaster aid that have flowed into the state in the years following Hurricane Katrina.[4]

---

[1] Steve Stanek, "Rhode Island Democrats Seek Flat Tax," Heartland Institute, April 1, 2006, http://news.heartland.org/newspaper-article/2006/04/01/rhode-island-democrats-seek-flat-tax.

[2] Each of the three states ranks among the top seven states for oil production, and in the top six for natural gas production Rankings based on information from the U.S. Energy Information Administration: for oil production rankings as of October 2012, see: http://www.eia.gov/beta/state/rankings/?sid=US#/series/46. For state-by-state natural gas production data as of 2011, see: http://www.eia.gov/naturalgas/annual/pdf/table_002.pdf.

[3] In Oklahoma, growth in mining and pipeline transportation jobs account for 58 percent of the state's relative job gains from 2004 — the year before the state started cutting income taxes — through 2011. In New Mexico, they account for 50 percent of the relative jobs gains from 2002 — the year before that state cut income taxes — through 2011.

[4] The Federal Emergency Management Agency has provided nearly $14 billion in disaster assistance to Louisiana since the state implemented major personal income tax cuts in 2007. Other federal agencies including the U.S. Department of Housing and Urban Development and the U.S. Department of Transportation also have provided disaster relief funds for a range of disaster-related projects in Louisiana since 2007. For an overview of the impact of federal aid on Louisiana's economy, see Adam Nossiter, "Louisiana: A Test Case for Federal Aid," *New York Times*, April 4, 2009, http://www.nytimes.com/2009/04/05/us/05louisiana.html?_r=0.

Table 1			
States That Cut Taxes in 2000s Have Performed Poorly Since, Unless They Have Oil			
	Change in Share of National Personal Income Between Year Before Tax Cut and 2011	**Change in Share of National Employment Between Year Before Tax Cut and 2011**	**Change in Share of National GDP Between Year Before Tax Cut and 2011**
Minor oil producing states			
Arizona*	-2.1%	-1.3%	-2.6%
Ohio	-7.4%	-6.1%	-11.2%
Rhode Island*	-2.4%	-3.7%	-3.9%
Major oil producing states			
Louisiana	7.0%	6.7%	7.5%
New Mexico	7.2%	2.1%	4.4%
Oklahoma	7.4%	4.7%	7.6%

* The Arizona analysis runs from year before the tax cut was implemented through mid-2010, when the state raised its sales tax, boosting revenue by more than the state was losing from the earlier income tax cut. The Rhode Island analysis runs from year before the tax cut was implemented through 2010 because the state increased income taxes in 2011, offsetting the revenue loss from the earlier tax cut beginning that year.
Source: CBPP analysis of data from Bureau of Economic Analysis.

The Experience of States That Cut Taxes in the 1990's

Like states that cut personal income tax cuts in the 2000s, states that experimented with this approach in the 1990s did not perform particularly well.

As the economy emerged from the recession of the early 1990s and entered the remarkable boom period of the middle and late 1990s, many states enacted tax cuts. The deepest occurred in the six states — Colorado, Connecticut, Delaware, Massachusetts, New Jersey, and New York — that reduced state taxes by more than 10 percent of revenue.[5] Each of these state's tax cutting included major personal income tax cuts.

As they do today, proponents of tax cuts in the 1990s often asserted that tax cuts necessarily result in stronger state economies. For example, Governor John Rowland in Connecticut claimed that the "key to economic growth is cutting taxes and cutting spending to create jobs…By returning more money back to people's purses and pockets, we will stimulate the economy, create jobs, and expand our tax base."[6]

But after enacting the cuts, Connecticut and the other biggest tax-cutting states saw their economies grow *more slowly* than the economies of more cautious states. Between 2000 and 2007 —

---

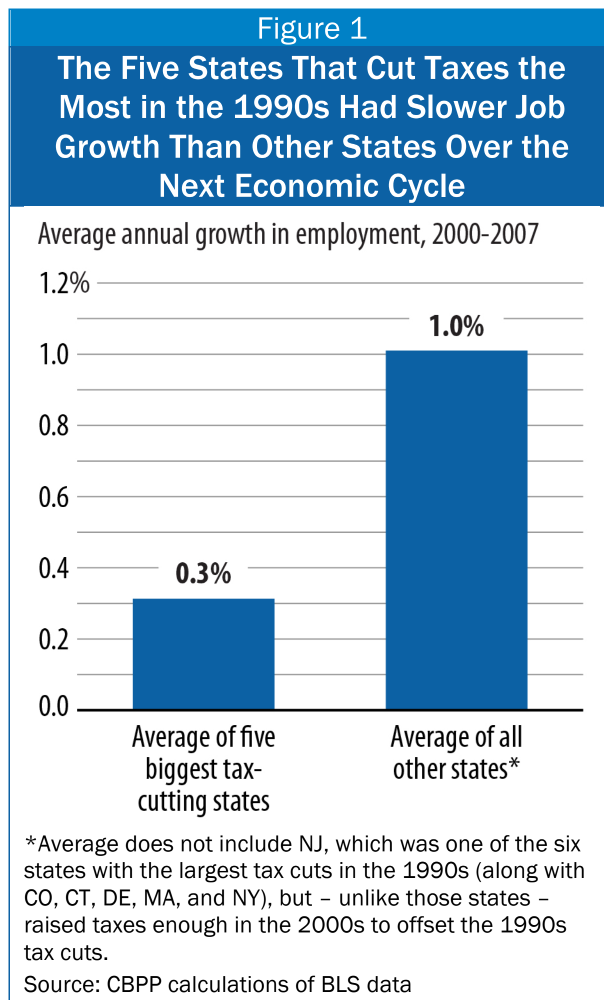
[5] These tax cuts are described in more detail in other papers by the Center on Budget and Policy Priorities. See, for instance, *The State Tax Cuts of the 1990s, the Current Revenue Crisis and Implications for State Services*, November 2002, at http://www.cbpp.org/11-14-02sfp.htm.

[6] *The Redding Pilot*, "Four Who Would Be Governor Offer Answers On State Issues," November 3, 1994, p. 13.

the period containing the first full economic cycle following the implementation of the tax cuts[7] — the states that had cut taxes most:

- *Created fewer jobs*. The top five tax-cutting states saw job growth of less than 0.3 percent per year, on average, compared to 1.0 percent for the other 44 states. (New Jersey is excluded because — unlike any of the other big tax-cutting states — that state raised taxes by enough in the 2000s to offset fully the 1990s tax cuts.)

- *Had slower income growth*. In four of the five biggest tax-cutting states — excepting only Delaware — personal income grew more slowly than it did on average in the other 44 states. In *none* of the biggest tax cutting states did personal income growth exceed inflation.



*Average does not include NJ, which was one of the six states with the largest tax cuts in the 1990s (along with CO, CT, DE, MA, and NY), but – unlike those states – raised taxes enough in the 2000s to offset the 1990s tax cuts.

Source: CBPP calculations of BLS data

Experiences of Past Tax-Cutting States Consistent With Academic Literature

The lackluster results from states that cut personal income taxes over the last two decades are consistent with the strong consensus from a large number of empirical studies conducted by economists over the last 40 years. The vast majority of these studies find that interstate differences in tax levels — which increase when a state cuts taxes and other states don't — have little if any effect on relative rates of state economic growth.

Studies of the impact of *state personal income tax* levels on economic growth are particularly likely to find no economic benefit from lower taxes. 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

[7] An economic cycle lasts from one peak in the economy to the next peak. The 1990s economic cycle lasted from July 1990 through March 2001, when the economy fell into recession. The next economic cycle ran from March 2001 through December 2007, when the economy again fell into recession. Here we start the analysis in 2000 because that's the last full year before the economy tipped into recession, and data for state personal income are available only in annual segments. We also looked at jobs growth from March 2001 through December 2007, since those data are available monthly, and got essentially the same results as when we looked at the 2000-07 period.

Table 2		
Most Major Studies Published in Academic Journals Since 2000 Find That State Personal Income Tax Levels Do Not Affect Economic Growth		
Citation	**Do Personal Income Tax Levels Affect Economic Growth?**	**Key Quotes**
James Alm and Janet Rogers, “Do State Fiscal Policies Affect State Economic Growth?” Public Finance Review, July 2011.	No	“Similar results are found for the individual income tax variable. . . The estimated coefficient is never [statistically] significantly negative. . . but its coefficient is often significantly positive [i.e., indicates that higher state personal income taxes are associated with *higher* state economic growth].”
Howard Chernick, “Redistribution at the State and Local Level: Consequences for Economic Growth,” Public Finance Review, 2010.	No	“The progressivity of a state’s tax structure does not have a statistically significant effect on the rate of growth of personal income. …Income tax burdens do not have a [statistically] significant effect on growth. … The most striking policy implication of this study is that tax cuts for high-income taxpayers cannot be justified in terms of growth in state income. Although such cuts may benefit current taxpayers, there is no evidence of a spillover or trickle-down effect to the overall state economy.”
Brian Goff, Alex Lebedinsky, Stephen Lile, “A Matched Pairs Analysis of State Growth Differences,” Contemporary Economic Policy, 2011.	Yes and No	“Taken as a unit, our results provide strong support for the idea that lower tax burdens tend to lead to higher levels of economic growth. Among tax variables, individual income taxes matter most. …In terms of the matching exercise, this restrictive sample comes the closest to producing a comparison of "twin" states, such as Kentucky and Tennessee and New Hampshire and Vermont. Policy analysis based on these states would indicate that higher tax burdens and, in particular, higher individual income-tax rates. . . promote higher growth. . .”
J. William Harden and William H. Hoyt, “Do States Choose Their Mix of Taxes to Minimize Employment Losses,” National Tax Journal, March 2003.	No	“We find the corporate income tax has a [statistically] significant negative impact on employment while the sales and individual income taxes do not. . . .”
Randall G. Holcombe and Donald J. Lacombe, “The Effect of State Income Taxation on Per Capita Income Growth,” Public Finance Review, May 2004.	Yes	“The results show that over the 30-year period from 1960 to 1990, states that raised their income tax rates more than their neighbors had slower income growth and, on average, a 3.4% reduction in per capita income.”

Table 2 (cont'd)		
Do State Personal Income Tax Levels Affect Economic Growth?		
Andrew Leigh, "Do Redistributive State Taxes Reduce Inequality?" National Tax Journal, March 2008.	No	"Regarding the efficiency cost of taxation, I find no evidence that states with more redistributive taxes experience slower growth in per capita personal income. (If anything, states with redistributive taxes grow faster.)" [Note: although this quotation refers to "redistributive taxes" in general terms, the specific measure of redistribution used is state personal income taxes.]
W. Robert Reed and Cynthia L. Rogers, "Tax Cuts and Employment Growth in New Jersey: Lessons from a Regional Analysis," Public Finance Review, May 2004.	No	"This study's analysis does not support the hypothesis that [personal income] tax cuts stimulated employment growth in New Jersey."
Marc Tomljanovich, "The Role of State Fiscal Policy in State Economic Growth," Contemporary Economic Policy, July 2004.	No	"The coefficients on [personal] income tax rate and property tax rate are statistically insignificant. ... Subsidying state revenues and expenditures into individual components therefore reinforces the lack of impact of individual [income] tax rates on long-run state economic growth. . . ."

broad measures of state economic growth, six have found no significant effects and one of the others produced internally inconsistent results (see Table 2).

Other studies focused on more narrow aspects of the impact of personal income tax levels on state economies   the impact on interstate migration and entrepreneurship   also have found little or no impact. For instance, a carefully designed study by two Princeton University researchers of the impact of personal income tax increases on interstate migration concluded that a tax increase on high-income earners in New Jersey "raises nearly $1 billion per year, and tangibly reduces income inequality, with little cost in terms of tax flight."[8] And a rigorous 2012 study commissioned by the U.S. Small Business Administration found "no evidence of an economically significant effect of state tax portfolios on entrepreneurial activity."[9]

The Dangers of Experimenting with an Income Tax Cut

Even though the academic evidence supporting income tax cuts as an economic growth strategy is meager at best, policymakers may be tempted to take the risk. This would be a mistake. The potential downsides of an ill-advised income tax cut for families, communities, and the state are likely to outweigh the advantages for a number of reasons, including:

---

[8] Cristobal Young and Charles Varner, "Millionaire Migration and State Taxation of Top Incomes: Evidence from a Natural Experiment," *National Tax Journal,* June 2011.

[9] Donald Bruce and John Deskins, "Can State Tax Policies Be Used to Promote Entrepreneurial Activity?," *Small Business Economics*, 2012.

- **States right now have very little margin for error.** States have yet to recover from the severe 2007-09 recession, which caused budget shortfalls totaling well over half a trillion dollars.[10] Revenues have improved lately but remain about 6 percent below where they were five years ago, even as the number of people needing state services has grown. State "rainy day funds" and budget reserves were largely drained during the recession and have yet to be replenished. Enacting tax cuts now, when state finances are so fragile, would make it even harder for states to recover from the recession and prepare for the next one.

- **Fundamental state services depend on income tax revenue.** In most states, K-12 schools, universities, health care services, public safety, and other public services rely heavily on funding from the personal income tax. Because states must balance their budgets, personal income tax cuts that fail to produce the promised economic gains almost certainly will lead to deep funding cuts for schools and other public services that serve as fundamental building blocks of future economic growth.

- **The federal government is on track to cut funding for states.** The 2011 Budget Control Act already has caused cuts in grant programs to states and will push federal funding for a wide range of state and local services — schools, water treatment, law enforcement, and other areas — to its lowest level in four decades as a share of the economy.[11] The additional, automatic cuts ("sequestration") that began March 1 are projected to cause over $6 billion in further cuts in funding for states this year, and more over the next several years. And there is substantial risk that future deficit-reduction legislation could impose still more cuts, especially if that legislation doesn't include substantial revenues. States need to be preparing to limit the damage from these federal funding cuts, not exacerbating the problem by reducing their own revenue as well.

Conclusion

States considering personal income tax cuts this legislative session should be skeptical of claims that these tax cuts will improve the state's economic performance. In the last two decades, a number of states have cut taxes deeply in hopes of spurring economic gains, with unimpressive results. That's not surprising given that the preponderance of the peer-reviewed academic studies indicate that state and local personal income tax levels do not affect economic performance.

Rather than bet their futures on a tax-cutting approach that has not worked particularly well in the past, states would do better to concern themselves with improving their schools, transportation networks, and other public services that act as building blocks of economic growth.

---

[10] Phil Oliff, Chris Mai, and Vincent Palacios, "States Continue to Feel Recession's Impact," Center on Budget and Policy Priorities, updated June 27, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=711.

[11] The Budget Control Act caps apply to all non-defense discretionary state aid programs, except for federal funding for transportation projects.