

Economic Summit IV

Using Tax and Budget Policy to Lead Economic Development

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I want to argue this afternoon that **no** reform of tax policy is likely to have much impact on the rate of growth of the state's economy.

There exists a substantial amount of evidence that taxes have very limited impact on the rate of state economic growth. Specifically, reducing taxes, or giving certain industries or groups of individuals tax breaks, is likely to be a highly ineffective strategy for encouraging economic development.

Let me provide two main reasons why tax policy is a poor economic development tool, and then say a few words about the nature of the evidence that supports this contention.

The first reason. Businesses obviously care about profit. Current businesses will stay and expand in Wisconsin and new business will be attracted to our state, if they can earn a good profit in Wisconsin. The fact is that state and local taxes are a very small part of the cost of doing business. Thus, for most businesses, tax policies won't have a big influence on profits and are unlikely to play a large role in influencing inter-state location decisions.

Much more important to profitability are:

- a well-trained and ample labor force,
- physical access to markets and to inputs, in other words a good transportation system,
- relatively inexpensive sources of energy,
- a networks of both suppliers and customers (and these are often carefully developed and nurtured over a long period of time). Disrupting these connections to reap a little tax savings can be very costly indeed.

The bottom line is that taxes have a very small impact on the after-tax rate of return of businesses. Other factors are much more important determinants of business profitability. Thus, it is not surprising that the level of state and local taxes play a minor role in influencing the inter-state location decisions of businesses.

The second reason that tax policy has limited influence on economic growth is that even in cases where taxes have a big impact on costs, any reduction in taxes for one set of taxpayers means that taxes have to be increased on other taxpayers, or public services have to be cut.

There is ample statistical evidence that businesses (and individuals) value good public services. So, a narrow focus on tax breaks that benefits just one part of the economy, ignores the fact that tax increases and cuts in public services will have a negative effect on economic growth elsewhere in the economy.

Now a word about the nature of the *evidence* that taxes have a limited impact on economic growth. Economists have studied the effects of fiscal policy on economic growth for a long time. The general approach is to gather data on taxes and government spending, and on the wide range of other factors that have a potential influence on the location decisions of businesses. Using various statistical techniques, the analyst then attempt to determine whether higher taxes result in slower economic growth, when account is taken of all the other factors that influence growth. The results of literally hundreds of studies suggest very strongly that taxes, *per se*, have at most a very limited negative influence on economic growth.

If tax policy is not likely to be a successful tool for spurring economic growth, what should be the focus of state government economic development policies?

Let me focus on one factor that will be very critical in ensuring Wisconsin's long-term economic prosperity—the availability of an adequate and appropriately-skilled **labor force**.

Wisconsin, like other states, will soon be facing the retirement of the baby boom generation. The result will be potentially large labor shortages. Where is the replacement labor, so important for economic growth, going to come from?

For the most part, Wisconsin is not an obvious destination for foreign immigrants. Also, we have to overcome one disadvantage relative to many of our competitors—namely, our long, cold winters.

What this reality means to me is that Wisconsin will have to work very hard to attract (and retain) a well-educated labor force. To achieve this goal it is imperative that we create (or rather, maintain) an attractive environment for both labor and business. This means we need to provide the things that attract workers to this state. This certainly includes high quality public services—good public schools, an excellent public university system, an attractive environment, safe and clean streets, etc.

In the end, maintaining high quality services will be a much more important element in encouraging economic growth than reductions in state and local taxes.

We have recently heard lots of complaints about high property taxes in Wisconsin. And, indeed some residents and businesses are facing high burdens. (And I think there are policies that could

be put in place to reduce some of the hardship caused by excessive property tax burdens).

But, in talking about the attractiveness of Wisconsin, I think it is important to put the property tax discussion in proper perspective. Let's say that an engineer is considering job offers in Cambridge, MA and in Madison. While the property tax rate is certainly lower in Cambridge than Madison, the engineer will probably have to pay at least twice as much for a house in Cambridge compared to a similar house in Madison. The lesson I draw from this comparison is that even with high property taxes, housing-related costs are generally lower in Wisconsin than in much of the rest of the country. And for most families, housing costs are the most important component of their over cost of living. And on top of that, Wisconsin residents generally receive very high quality local government services relative to services provided in other states—a key element in attracting and retaining an educated labor force.

Secretary Morgan asked us to propose a single reform to state fiscal policy. As a public finance economist, you would not be surprised to learn that I have a long list of policies that I believe could make our tax system fairer and more efficient.

However, as a pre-condition for developing new fiscal policies, I think that it is essential that we in Wisconsin conduct a tax incidence or tax burden study. Such a study would indicate the true burden of state and local taxes on various groups of Wisconsin taxpayers. We can't develop effective, efficient, and equitable tax policy without first knowing about the distribution of tax burdens among us.

Wisconsin made history by conducting one of the very first state tax incidence studies. But, that study was completed 25 years ago and used data from 1974. Obviously, much has changed since then. To make good tax policy it is essential to have good up-to-date analysis of our existing tax system.

I understand that the Department of Revenue is planning to conduct just such a study. I would like to end by commending the Secretary and urging him to devote whatever resources are necessary to complete a high-quality tax study.