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TAXES, ECONOMIC GROWTH, AND BUDGET DEFICITS: WHAT WASHINGTON CAN LEARN FROM THE STATES

INTRODUCTION

For more than two decades, America's state governments regularly have been achieving the goal that continues to elude the federal government – balancing their budgets. In fact, while the federal government has run a budget deficit in each of the last twenty years, the states always have finished the fiscal year with a cumulative net surplus.

Despite this impressive record at the state level, federal policy makers continue to ignore the lessons to be drawn from state budgeting practices. For instance, most states have adopted powerful tools to check spending. These include balanced budget requirements (49 states), line-item veto power for the governor (43 states), and tax and expenditure limitations (26 states).[1] Explains a study by the Advisory Commission on Intergovernmental Relations, "...the states have long had a good record of fiscal discipline, in large part because of [these] constitutionally and statutorily imposed limits on legislative and executive behavior."[2] Yet Congress refuses to enact similar restraints, despite their proved effectiveness.

Powerful Arguments. Of all the lessons to be learned by looking beyond the Capital Beltway, perhaps the most important is that raising taxes to balance the budget is rarely successful, and it undermines the economy. In Washington, the chorus for higher federal taxes simply presumes that hiking taxes somehow will improve the economy by reducing the deficit, so

1 *The Book of the States* (Lexington, Kentucky: Council of State Governments, 1988).
2 Advisory Commission on Intergovernmental Relations, "Fiscal Discipline in the States," 1988.

lawmakers today are determined to force George Bush to abandon his "no new taxes" pledge. Yet the experience of the states over the last twenty years argues powerfully against raising taxes. Those states that have kept taxes down have achieved more rapid rates of income growth, job creation, and business investment than their high-tax neighbors. The economies of Arizona, California, and until recently, Massachusetts surged during the 1980s; each cut taxes sharply in the late 1970s or early 1980s. Conversely, three of the slowest growing states – Iowa, West Virginia, and Wyoming – substantially raised the tax burden on residents during the same period.

This should be sobering economic news for the Washington pro-tax lobby. Just as high-tax states have lost jobs, businesses, and skilled labor to low-tax states, so the U.S. runs the risk of surrendering economic competitiveness to foreign rivals if Congress increases the tax burden. This danger is heightened by recent developments in Europe and the Pacific Rim, where many of America's competitors have cut tax rates to sharpen their competitive edge.[3]

Encouraging More Government Spending. Lawmakers have sought to defuse public criticism of tax increase proposals by pledging to use any new revenues to reduce the federal deficit. But once again, the track record of the states demonstrates that such pledges mean little. Over the past two decades, actions by states to raise taxes have resulted in higher spending, not lower levels of debt. States raising taxes have not improved their overall fiscal condition in the long run; rather, higher revenues simply have encouraged state legislators to vote for more government spending. The highly publicized fiscal crisis now confronting the Northeastern states is a dramatic case in point: Connecticut, Massachusetts, New Hampshire, New Jersey, and New York are struggling to avoid sinking deeper into debt. Yet the rise in tax collections in the region has outpaced the rest of the states by almost 25 percent during the last four years.[4]

Federal lawmakers thus should pay close attention to the experience of the states. If they do, they will learn two things. First, the federal budget deficit crisis is unlikely to be resolved by further increases in taxes. And second – even more important – they will recognize that raising taxes could sound the death knell to America's seven-year economic expansion.

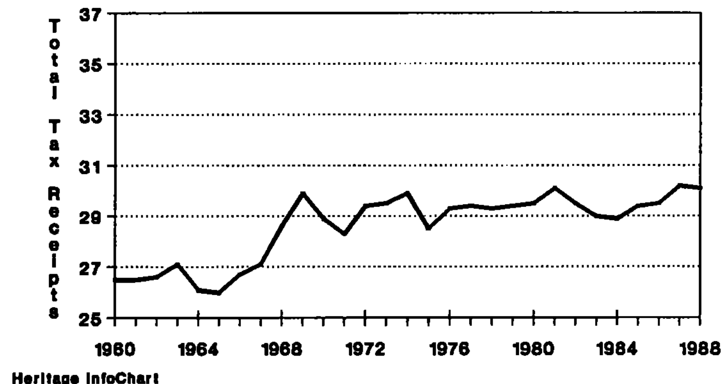
3 Stephen Moore, "Why America Does Not Need New Taxes," Heritage Foundation *Backgrounder* No. 680, November 22, 1988.

4 U.S. Bureau of the Census, Bureau of Economic Analysis, August 1988.

HOW TAX HIKES IGNITE NEW SPENDING AND DEBT

Ever since the early 1980s, when the nationwide tax revolt movement began to lose steam, federal legislators increasingly have argued that the U.S. is undertaxed. A common public perception encouraged by lawmakers in Washington is that Americans pay lower taxes today than they did in the 1970s and early 1980s, and that the federal deficit is rising because tax revenues have declined. The truth is that taxes have been edging upward at all levels of government, and by 1988, virtually all of the tax relief granted in the 1978-1982 period had been taken back by government.[5]

One-Third of GNP in Taxes. The figure below shows that the percentage of the American paycheck that is diverted to the coffers of government is back to the peak level of 1981. Thirteen separate federal tax hikes have been enacted since 1982,[6] while tax revenues at the state level have been growing for the last three years at roughly twice the rate of inflation.[7] As a result, tax receipts at all levels of government this year will exceed $1.5 trillion – or about one-third of gross national product (GNP). According to the nonpartisan Tax Foundation, a moderate income ($45,000 a year) two-worker family this year will pay an estimated $14,000 in federal taxes.[8] When



*National Income and Product Account basis; excludes nontax receipts.
Source: Department of Commerce, Bureau of Economic Analysis; and Tax Foundation computations.

5 The National Conference of State Legislatures reports: "In 1987 the overall [State/Local] tax burden in relation to personal income was close to what it had been 17 years earlier." National Conference of State Legislatures, *The Fiscal Letter*, November/December 1988, p. 1.

6 "1989 Tax Increases Have Arrived!" Tax Foundation, *Tax Features*, March 1989, p. 4.

7 U.S. Bureau of The Census, Data on State Government Balances, 1988.

8 "Moderate Income Family Will Pay Total Federal Taxes of $14,068 in Fiscal 1989," Tax Foundation, *Tax Features*, March 1989, p. 2.

state and local taxes are included, this family's total 1989 tax bill rises to about $20,000 a year.

As these data indicate, the tax revolt movement had only temporary success. The tax cuts of the late 1970s and early 1980s were only a brief interruption in the upward trend in taxation and the size of government.

Legislators in Washington and the states have built support for the recent wave of tax increases by insisting that the revenues would reduce government red ink. Several studies indicate, however, that a jump in federal revenues tends to be associated with higher, not lower, subsequent budget deficits. This is because Congress tends to regard higher revenues as an open invitation to spend more. A 1986 study in *Public Finance Quarterly* examined the relationship between taxes and deficits over more than a half century (1929-1982). Its chief finding: "...the causality tests leave no doubt that revenue increases lead to spending increases and not to smaller deficits."[9]

The Evidence from the States

At the state level, it could be assumed that tax hikes would be more likely to achieve deficit reduction, since many states have constitutional expenditure limitations and almost all have balanced budget requirements. These constitutional constraints limit the ability of legislators to spend away increased revenue flows resulting from economic growth or legislated tax increases.[10]

Nonetheless, on balance, the experience of the states refutes the claim that higher taxes lead to lower levels of government debt (or higher year-end reserves). Examining state budget data between the 1952 and 1982, former U.S. Treasury Department economists Michael L. Marlow and Neela Manage conclude: "The results of our tests indicate similarities between the expenditure-tax receipt relations of state governments to those previously reported for the federal government....Tax receipts cause expenditures at the state level of government."[11]

Tax Hikes and the Fiscal Crisis in the Northeast

The states have learned just how damaging a tax hike can be. The national economic expansion since 1983 has yielded unprecedented revenue windfalls

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9 Paul R. Blackley, "Causality between Revenues and Expenditures and the Size of the Federal Budget," *Public Finance Quarterly*, April 1986, pp. 139-156.

10 Although states with tax and expenditure limitations are generally more effective in controlling spending than states without them, state policy makers have discovered methods of evading statutory spending restraints. These include increased reliance on "off-budget spending" and providing benefits through credit programs rather than direct spending. See James T. Bennett and Thomas J. DiLorenzo, "Off-Budget Activities of Local Government: The Bane of the Tax Revolt," *Public Choice*, 1982, pp. 333-342.

11 Michael Marlow and Neela Manage, "Expenditures and Receipts: Testing for Causality in State and Local Government Balances," *Public Choice*, 1987, pp. 243-255.

for the treasuries of most state governments. The decline in the unemployment rate from its peak of 9.7 percent in 1982 to the current rate of just over 5 percent alone has pumped between $15 billion and $20 billion each year into state coffers in boosted income tax receipts. The states benefiting most from the burgeoning national economy have been those in the Northeast. Personal income in the region grew about four times faster than in the nation as a whole between 1978 and 1987, and unemployment at the end of 1988 stood at just 2.5 percent. With such healthy economic growth, the Northeastern states should be among the most fiscally sound in the nation.

Shrinking Reserves. Yet the Northeastern states are facing a severe fiscal crisis. Next year several may be wallowing in red ink. Table 1 shows the expected deterioration for the eight Northeastern states between 1987 and 1990, based on forecasts by the National Association of State Budget Officers. Contrary to the widely held assumption that higher taxes bring fiscal balance, the experience in the region is that tax hikes are associated with budgets plunging into the red. By 1990, revenues in these states will have grown roughly between 20 percent and 25 percent faster than those in the rest of the country. But while year-end balances in other states are rising, reserves in each of the revenue-rich states are shrinking.

State policy makers in the Northeast region blame the crisis on a variety of factors beyond their control. Among them: the loss of federal aid; the impact of the 1986 Tax Reform Act on state revenue projections; and a cooling in the regional economy. These are lame excuses. As *The Washington Post* reports, the real culprit is easy to pinpoint: "The main reason for budget shortfalls from Concord to Trenton has been...mushrooming spending programs that doubled and tripled many outlays in these prosperous states."[12] Indeed, in the last two years alone, outlays escalated 37.3 percent in New Hampshire, 30.5 percent in Connecticut, 20 percent in New Jersey, 18 percent in New York, and 12.5 percent in Massachusetts.

Boom Won't Last Forever. The plight of the Northeast is a classic case of the ratcheting effect of government. Higher revenues trigger new spending, which quickly becomes a politically indispensable fixture of the government. As the budget balance deteriorates, pressures mount for higher taxes. Explains New Hampshire State Representative Donna P. Sytek, the Republican chairman of the state's Ways and Means Committee, "We did a lot of good things in the years we had the money. [But] there's a constituency that now perceives these programs as essential, and we can't take them away. We should have known [the boom] wouldn't last forever."[13]

It is precisely because of this universal ratcheting effect of government spending that higher taxes cannot be counted on to provide long-term deficit

12 "Northeast Scrambling to Pay the Bills," *The Washington Post*, April 16, 1989, p. A-30.
13 *Ibid.*

reduction solutions – either by members of state legislatures or by lawmakers in the U.S. Congress.

Table 1
Taxes and Reserves of Eight Northeastern States Compared with all Other States, 1987-1990

State	General Tax Revenues (millions $)		
	1987	1990	Percentage Change 1987-1990
Connecticut	4,742	6,315	33
Maine	1,118	1,495	34
Massachusetts	6,964	8,877	27
New Hampshire	538	602	11
New Jersey	9,339	11,711	25
New York	24,688	29,406	19
Rhode Island	1,187	1,472	24
Vermont	482	588	22
Total Northeast	–	–	23
All Other States	–	–	19

State	Budget Year-End Reserves* (Percentage of State Expenditures)	
	1987	1990
Connecticut	4.9	2.1
Maine	8.1	4.7
Massachusetts	1.1	0.3
New Hampshire	9.8	4.5
New Jersey	7.9	2.1
New York	0.7	0.0
Rhode Island	12.5	2.8
Vermont	14.0	1.8
Total Northeast	3.0	0.9
All Other States	3.0	3.5

*Budget Stabilization and General Fund Balance.
Source: National Association of State Budget Officers, *Fiscal Survey of the States*, 1988 and 1989 issues.

TAXES AND ECONOMIC GROWTH RATES IN THE STATES

Many proponents of large tax increases to balance the budget also assume that such measures have little adverse impact on the condition of the economy. Others, while acknowledging that progressive income taxes have negative economic effects, contend that taxes on consumption restrain consumer spending, promote national savings, and provide a convenient and relatively painless method by which the federal government can raise revenues. This reasoning has helped boost support for a wide range of consumption taxes, such as versions of a value-added tax, new gasoline taxes, and higher "sin" taxes on beer, liquor, and cigarettes.

Because of the diversity in their tax policies, the fifty states offer a fertile testing ground for examining the impact of taxes on economic growth. Much of the early research on state tax policy concluded that taxes were not a significant determinant of economic progress. Concluded one prominent study, for instance, "...empirical evidence that taxes affect interregional business location decisions is almost nonexistent."[14] Yet more than a dozen studies conducted during the past ten years have produced very different results. The overwhelming consensus of these more recent studies is that the high-tax states have performed less well than low-tax states during the last three decades. This research has yielded a number of important conclusions. Among them:

1) Incomes have grown fastest in low-tax states.

In a 1982 study, economist Robert Genetski of the Harris Bank in Chicago compared taxes as a percentage of personal income in each state with income growth in the state.[15] Genetski examined this relationship for the period 1963 to 1980. Although he did not find a systematic relationship between average tax burden and income growth, he did uncover "an inverse relationship between *changes* in state relative tax burdens and state relative economic growth." According to Genetski, "Those states with decreasing relative tax burdens tend to experience subsequent above average income growth. Those states with increasing relative tax burdens tend to experience subsequent below average growth."

The Joint Economic Committee (JEC) confirmed this finding.[16] In a 1981 study, the JEC compared tax policies in the sixteen fastest growing states from 1970 to 1979 with those states experiencing the slowest economic

14 Michael Wasylenko, "The Location of Firms: The Role of Taxes and Fiscal Incentives," In R. Bahl, ed., *Urban Government Finance: Emerging Trends* (Beverly Hills, California: Sage, 1981), pp. 155-1960. See also, Joseph E. Pluta, "Taxes and Industrial Location," *Texas Business Review*, January/February 1980, pp. 1-6.
15 Robert J. Genetski, "The Impact of State and Local Taxes on Economic Growth: 1963-1980," Harris Bank, Chicago, Illinois, December 17, 1982.
16 "State and Local Economic Development Strategy: A Supply Side Perspective," staff study, Joint Economic Committee, October 26, 1981.

growth. The results, shown in Table 2, indicate that income growth in a state is inversely related to:

- ♦ ♦ The *level* of state and local tax burdens (including all taxes).
- ♦ ♦ The *changes* in state and local tax burdens.
- ♦ ♦ The amount of *income taxes* levied in the state.
- ♦ ♦ The *progressivity* of the income tax rates in the state.

Table 2
Differing Tax Policies of High and Low Growth States

Tax Measure	High Growth States 1970-1979	Low Growth States 1970-1979
Change in State/Local Taxes Per $1,000 Income, 1970-1979	+$0.80	+$7.51
State/Local Personal Income Taxes Per $1,000 Income, 1970	$7.10	$14.90
Change in State/Local Personal Income Taxes Per $1,000 Income, 1970-1979	$4.89	$8.08
State/Local Corporate Income Taxes Per $1,000 Income, 1970	$2.90	$6.26
State Income Tax Progressivity, 1970*	3.30 percent	5.40 percent

*Highest marginal tax rate minus lowest marginal tax rate. The higher the percentage, the more progressive a state's tax code.
Source: Richard K. Vedder, "State and Local Economic Development Strategy: A Supply Side Perspective," Joint Economic Committee, October 1981.

These relationships were found to be statistically significant. Concluded the study:

> The evidence is strong that tax and expenditure policies of state and local governments are important in explaining variations in economic growth between states – far more important than other factors frequently cited such as climate, energy costs, the impact of federal fiscal policies, etc. It is clear that high rates of taxation lower the rate of economic growth, and that states that lower their tax burdens are rewarded with an enhancement in their economic growth. Income taxes levied on individuals and corporations are particularly detrimental to growth, more so than consumption-based taxes or user charges that do not reduce incentives to work or form capital. Progressive

> taxation not only lowers the rate of economic growth compared with proportional or regressive taxation, but in the process hurts the very persons that progressive taxes are designed to help: the poor.[17]

A 1988 study by A.B. Laffer Associates shows similar results for the 1980s, "...during the 1980-1986 period," the Laffer study concludes, "a negative and significant relation [emerged] between changes in states' relative tax burdens and their rates of economic growth."[18] Laffer Associates notes that as much as one-third of "a state's economic performance is associated with changes in the average tax rates relative to the national average."[19]

2) Employment has grown fastest in low-tax states.

States with low and declining tax burdens have created most jobs — particularly jobs in manufacturing and high technology industries. In a 1985 study, economists Michael Wasylenko of Pennsylvania State University and Therese McGuire of the State University of New York at Stony Brook concluded that between 1973 and 1980 the overall "tax effort" (taxes as a percentage of income) in a state had "a negative and statistically significant effect on overall employment growth and on employment growth in manufacturing, retail trade and services."[20] In addition, the study found that sales taxes, which are widely assumed to have no effect on employment opportunities, in fact "had a negative and statistically significant effect on wholesale trade employment."[21] The single exception to this general finding was where increased taxes were used to fund education; then the effect of taxes on economic growth was positive.

This negative relationship between taxes and employment applies to cities as well as states. Princeton economist Robert Grieson investigated employment growth during the 1960s and early 1970s in New York and

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17 *Ibid.*, p. 340.

18 Victor A. Canto, "The State Competitive Environment: 1987-88 Update," A.B. Laffer Associates, February 1988.

19 Victor A. Canto, *et al.*, "The State Competitive Environment," A.B. Laffer Associates, August 1984.

20 Michael Wasylenko and Therese McGuire, "Jobs and Taxes: The Effect of Business Climate on States' Employment Growth Rates," *National Tax Journal*, Vol. 38, 1985, pp. 497-511.

21 *The Wall Street Journal* has provided anecdotal evidence to support the claim that sales taxes affect employment. It reports that Seattle has an 8.1 percent sales tax, while Portland, Oregon, has no sales tax. General merchandise sales are 69 percent higher in Portland than in Seattle even though income is 18 percent higher in Seattle. Forty percent of all new jobs in Portland are in the retail trade sector. See Gary Eisler, "Portland, Oregon: Washington's Bargain Basement," *The Wall Street Journal*, January 25, 1989.

Philadelphia.[22] He found that every 30 percent increase in city income taxes during the period resulted in a drop in manufacturing employment of 11 percent in Philadelphia and 10 percent in New York City. Similarly, a New York City commission study estimated that, in the 1970s, every one percentage point rise in the city income tax led to a loss of 44,500 manufacturing jobs.[23]

3) Rising state taxes deter business investment.

Businesses tend to avoid states with relatively high tax burdens. In a 1985 study examining the period 1972-1978, Timothy Bartik of Vanderbilt University found that the plant location decisions of *Fortune 500* companies were significantly influenced by state tax policies.[24] According to Bartik:

> A 10 percent increase in a state's corporate income tax rate (for example, from 4.0 percent to 4.4 percent) is estimated to cause a 2-3 percent decline in the number of new plants. A 10 percent increase in a state's average business property tax rate (for example, from 2.0 percent o 2.2 percent) is estimated to cause a 1-2 percent decline in the number of new plants....These changes in business location patterns put some limitations on the ability of states to redistribute income away from corporate stockholders, both in state and out of state, and toward other state residents.[25]

Important to Businessmen. A 1982 survey of corporate executives of high technology firms, conducted for the Joint Economic Committee, similarly found that businesses are attracted to low-tax areas.[26] Table 3 shows that more than two out of three executives considered the level of taxes in a region and the taxes imposed in states within a region to be "very important" or "important" determinants in choosing plant location. The study also revealed that the issue of whether taxes fall directly on workers or on businesses is less important than the overall level of taxes in the state. Explained the report:

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22 Robert Grieson, *et al.*, "The Effects of Business Taxation on the Location of Industry," *Journal of Urban Economics*, April 1977, pp. 170-185; Robert Grieson, "Theoretical Analysis and Empirical Measurement of the Effects of the Philadelphia Income Tax," *Journal of Urban Economics*, July 1980, pp. 123-137.

23 Temporary Commission on New York City Finances, "The Effects of Taxation on Manufacturing in New York," 9th Interim Report, December 1976.

24 Timothy Bartik, "Business Location Decisions in the United States: Estimates of the Effects of Unionization, Taxes, and Other Characteristics of States," *Journal of Business and Economic Statistics*, January 1985, pp. 14-22.

25 *Ibid.*, pp. 19-20.

26 Robert Premus, "Location of High Technology Firms and Regional Economic Development," Joint Economic Committee, 1982.

State and local taxes influence the willingness of high technology companies to invest in a region for two interrelated reasons. First, the portion of the tax bill that falls directly on business will result in a reduction in the rate of return on investment in new technologies. Second, the portion of the tax that falls on workers will result in a reduction in real after-tax income and make it more difficult for high technology companies to attract and hold skilled labor. As a result, in a tight labor market, state and local taxes are likely to be forced onto the businesses in the form of tax-compensated wage increases, reducing further the rate of return on investment in the region.[27]

Table 3
Taxes and State/Regional Business Investment
Survey of 691 Executives of High Technology Firms

Rank	Factor	Percent Responding "Important" or "Very Important"
Top Five Factors that Influence Regional Plant Locations		
1	Labor Skills/Availability	89
2	Labor Costs	72
3	Tax Climate Within Region	67
4	Academic Institutions	59
5	Cost of Living	58
Top Five Factors that Influence Plant Locations within Region		
1	Availability of Workers	96
2	State and/or Local Taxes	85
3	Local Attitudes Toward Business	82
4	Property and Construction Costs	79
5	Transportation for Workers	76

Source: Robert Premus, "Location of High Technology Firms and Regional Economic Development," Joint Economic Committee, 1982.

27 *Ibid.*, p. 370.

HOW TAX HIKES ENDED THE "MASSACHUSETTS MIRACLE"

The relationship between taxes and economic growth is underlined by comparing the economic performance of states that raise taxes with that of states that cut the tax burden. Table 4 compares the real per capita income in the five states that raised taxes most rapidly between 1978 and 1987 to the five states that made the deepest tax cuts. The "tax-cut" states saw per capita income rise by an average of 8.5 percent over the period, while in the five "tax-increase" states it fell by 1.1 percent. The average unemployment rate in the "tax-cut" states fell by 0.5 percentage points, while joblessness rose by 2.6 percentage points in the "tax-increase" states.

Table 4
Taxes and State Economic Development in the 1980s:
Five Highest Tax-Increase States and the Five Highest Tax-Cut States

	Percentage Change Between 1978-1987 in:		
	State/Local Tax Revenue Per $1,000 Income	Real Per Capita Income	Unemployment Rate* (percentage points)
Ohio	+14.1	+3.6	+1.6
Wyoming	+13.4	-19.6	+5.3
Utah	+4.9	-3.5	+2.6
North Carolina	+4.2	+15.4	+0.2
Iowa	+3.8	-1.3	+1.5
Average 5 Highest Tax-Increase States**		-1.1	+2.6
California	-20.1	+8.8	-1.3
Massachusetts	-17.5	+30.1	-2.9
North Dakota	-12.5	-2.9	+0.4
Montana	-11.7	-5.1	+1.2
Arizona	-11.6	+11.7	+0.1
Average 5 Highest Tax-Cut States		+8.5	-0.5

*State Unemployment rate in 1987 minus state unemployment rate in 1978.
**Excluding Alaska.
Source: National Conference of State Legislatures, "Interstate Tax Comparisons and How They Have Changed Over Time," Legislative Finance Paper No. 66, 1989; U.S. Department of Commerce, Bureau of Economic Analysis, unpublished data on state income growth; and U.S. Department of Labor, Bureau of Labor Statistics, unpublished data, 1989.

"Miracle" Running Out of Gas. Massachusetts is a microcosm of how changes in tax burdens can have a dramatic effect on the economic fortunes of a state. Between 1970 and 1978, the state's tax burden as a percentage of personal income rose by one-fifth – the third largest tax rise in the nation. Per capita income plummeted. The state earned the derisive nickname "Taxachusetts" and was quickly "on its way to becoming a banana republic," recalls University of Massachusetts Professor Ralph Whitehead, Jr.[28] Then in 1980 the state passed Proposition 2 1/2, modeled after California's 1978 Proposition 13 tax cut, and shortly thereafter it cut capital gains taxes substantially. The passage of these two tax cuts slashed the state's relative tax burden by almost 20 percent. The economy surged, and with it, state tax revenues. By 1986, per capita income had risen by almost 30 percent – five times faster than the national average. This economic success was quickly touted as the "Massachusetts Miracle."

Beginning in 1986, however, the tax-cut strategy was put into reverse in an attempt to pay for surging state government spending that had followed the growth in revenues. The result: growth has stalled. The state's budget reserves have evaporated, it had to issue $2 billion in short-term debt just to meet its payroll obligations this year, and its financial bond rating has been lowered twice in the past twelve months by Standard and Poor's. With the state now battling declining employment the "Massachusetts Miracle" has run out of gas.[29]

THE IMPLICATIONS FOR FEDERAL POLICY MAKERS

These studies of state taxes and economic growth show clearly that raising taxes threatens a state's finances and undermines its economy. Still, many economists question the relevance of these studies to federal tax policy decisions. A common assertion is that federal taxes have a relatively minor effect on the national economy, compared with the adverse economic impact within a given state of higher state and local taxes. According to this thesis, workers and businesses will flee burdensome state taxes easily by moving across state borders, but they find that relocating abroad to escape federal taxes is much less practicable. Some analysts have even used this line of reasoning to argue that the federal government should take the lead in raising taxes, because the lower levels of government are constrained by the propensity of taxpayers to migrate to cities and states with lower taxes.

This thesis is plausible, but it is seriously flawed. There is mounting evidence that on the international level, as on the state level, taxes influence

28 Quoted in: Warren Brookes, "Top Growth States Have Tax Sense," *Insight*, October 27, 1986, p. 51.
29 Foundation for Economic Research, "New Massachusetts Reserves: A History and Analysis 1983-1988," Needham, Massachusetts, October 1988.

economic growth. In an increasingly integrated economy, multinational corporations frequently do move their plants abroad to capture the benefit from lower taxes. Indeed, the U.S. has been a notable and recent beneficiary of this phenomenon. By slashing top marginal tax rates from 70 percent to 28 percent, the U.S. became one of the world's most attractive investment opportunities – luring tens of billions of dollars of capital investment from abroad.[30] According to a recent report by *Fortune* magazine, this has prompted many of U.S. foreign competitors, including Japan, West Germany, Britain, and France, to begin "chopping tax rates to keep their best brains at home."[31]

Extraordinary Success. Several studies show that the relationship between taxes and growth at the state level can also be seen at the international level: Low-tax countries are growing faster than high-tax countries.[32] For example, a 1987 study by Stanford economist Alvin Rabushka examined economic growth in four of the world's most rapidly growing nations – Hong Kong, South Korea, Malaysia, and Singapore. Rabushka found that tax policy has been critically important to the extraordinary success of these economies.[33] The governments in these four countries adopted "either the model of a neutral, broad-based, low tax rate system (Hong Kong), or that of selective incentives coupled with light taxation of capital (Korea, Malaysia, Singapore) to propel their nations to upper middle-income advanced status in the short span of one generation."

State and international experience also suggests that federal consumer taxes would imperil national economic growth. While it is true that progressive income taxes have by far the most destructive impact on growth, the overall tax burden (measured as the percentage of income paid in taxes of all kinds) imposed by a country or state has enormous consequences for the rate of economic growth. This suggests that the most dangerous taxes are the so-called money machines. These are the widely based consumption taxes that raise substantial amounts of revenue with only small changes in the tax rate. They include value-added taxes and gasoline taxes.

30 Christopher Whalen, "Should Americans Be Worried About Foreign Investment in the U.S.?" Heritage Foundation *Backgrounder* No. 720, July 20, 1989.

31 Quoted in Andrew Tobias, "New York's Tax Burdens May Drive People Out, " *The New York Times*, January 30, 1987, op ed page.

32 Michael Marlow, "Private Sector Shrinkage and the Growth of Industrialist Economies," *Public Choice*, Vol. 44, 1986, pp. 143-154; Alan Reynolds, "The Urgency of International Tax Relief," In *Supply Side Analysis*, 1985.

33 Alvin Rabushka, *Tax Policy and Economic Growth in Advanced Developing Countries*, study prepared for the U.S. Agency for International Development, 1987.

CONCLUSION

A 1985 report of the Advisory Commission on Intergovernmental Relations concludes that "similarities between the states and the national government argue for the general relevance of state experiences to the national deficit problem."[34] Regrettably, Congress continues to bury its head in the sand by insisting that higher taxes are necessary to reduce the deficit and spur economic growth. Yet more than two decades of analysis of state fiscal policies shows that raising taxes slows long-term economic growth, encourages higher levels of government spending, and leaves the overall fiscal condition unchanged or worse.

Critical Point. It now appears that the availability of tax revenues is the only budget constraint limiting the size of government.[35] With government now consuming more than one-third of gross national product, and taxes back up to their pre-tax revolt levels, the U.S. is at a critical point. The state experience shows not only that raising federal taxes further is likely to make the budget deficit picture worse, but also that it could derail nearly seven years of economic expansion.

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34 Advisory Commission on Intergovernmental Relations, 1985.
35 This view is expressed in: Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (New York: Cambridge University Press, 1980); and Michael L. Marlow and William Orzechisky, "Controlling Leviathan Through Tax Reduction," *Public Choice*, forthcoming.