

Virginia Viewpoint

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State and Local Taxes and Economic Growth

Summary

Politicians like to talk about “investing” in the future. Translation? They have become addicted to spending other people’s money and they need more and more of it to maintain their high. If one’s goal is economic growth and a healthy business environment, “investing” in government is betting on the jackass in a horse race.

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The negative correlation between state and local income taxes and economic vitality is breathtakingly striking. For example, from 1990 to 1999, more than 2.8 million native-born Americans moved into the nine states without state and local income taxes from the forty-one states that had such taxes.

By Richard Vedder, Ph.D.

Recent data reveal Virginia has the eleventh highest level of per capita income of the fifty states, and also the eleventh *lowest* tax burden in terms of state and local taxes as a percent of personal income. Those identical ranks are not entirely coincidental, since there is an abundance of evidence that suggests low taxes are associated with high economic growth. Virginia has progressed from being a relatively poor state to a fairly rich state over time for many reasons, but one of them is that it has been more restrained than most states in taxing its citizenry.

Compare Virginia with my adopted state of Ohio. In 1970, Ohio’s per capita income exceeded Virginia’s by about seven percent. Today, Virginia outdistances Ohio on this important measure by more than eleven percent. Why? In part, because Ohio retrogressed from being a relatively low tax state to a relatively high tax state, while Virginia did not. For example, the Tax Foundation (a respected nonpartisan group in our nation’s capital) suggests Ohio went from having the fourth lowest tax burden to having the tenth highest, while Virginia was well below average in both years (going from thirty-sixth to fortieth).

Taxes impact in other ways as well. Consider net migration of Americans. I compared the tax burden for the ten states (including Virginia) with the greatest in-migration from 2000 to 2002, with the ten states with the greatest out-migration. The overall state and local tax burden was more than ten percent higher in the states with the greatest out-migration. People literally “voted with their feet”, fleeing states with high taxes, and moving into states with low ones.

Why is a state’s economic vitality negatively related to its tax burden? While state and local governments do some things well, they suffer from two major disabilities compared with the private sector: they are less competitive, and they are less influenced by the market. While private firms compete vigorously with others for business, forcing them to offer low prices and high product quality, many government activities (e.g., public schools) have little competition, and thus few incentives to offer high quality services in an efficient manner.

Similarly, there is a clear “bottom line” in the private sector - profits.

To be more profitable, a firm must cut costs (becoming more efficient), or increase revenues (by making a more attractive product). The discipline of the market forces efficiency and good service. There is no such “bottom line” with government, no incentives to cut costs or “reinvent” itself. High tax states have bigger governments, which mean they “crowd out” more highly productive private activity.

To be sure, some taxes are worse than others in their economic impact. Consumption taxes seem to have less adverse impact than taxes on productive activity, such as income taxes. The negative correlation between state and local income taxes and economic vitality is breathtakingly striking. For example, from 1990 to 1999, more than 2.8 million native-born Americans moved into the nine states without state and local income taxes from the forty-one states that had such taxes.

What are the implications of all of this for Virginia? First, keep taxes low. To do that, of course, requires keeping government spending down. Given the upward pressures to spend for Medicaid and education, a successful approach to keeping low taxes may mean reforming the way medical and educational assistance is provided by introducing market-based incentives to producers and consumers of educational and medical services. Similar reforms may be required for other areas as well, such as corrections spending.

That means, of course, that Virginia must “just say no” to new taxes, standing up to the special interest groups demanding them. At some point, new constitutional restraints on spending might be useful in assuring that this happens - a supermajority requirement for new taxes, or a required vote of the people.

The empirical evidence showing the debilitating impact of income taxation should also be taken into account. An effort should be made to lower Virginia’s moderately high income tax burden. This perhaps cannot be done overnight, but the growth in inflation-adjusted state tax revenues over time provides a fund that can be used to finance sustained tax reduction.

Virginia is better than a majority of states in terms of its tax policy, but very far from perfect. A recent Tax Foundation ranking of states on their business climate ranked Virginia twenty-first, a bit above average, but well below that of such leading economic growth states as Colorado. If the prosperity of the past generation is to be maintained and enhanced, Virginia governments need to constrain their spending growth, allowing for some needed tax reduction and an improvement in the state’s tax climate.

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