

Increase Spending, Raise Taxes? Been There, Done That

By Richard Vedder, Ph.D.

Summary

If the goal is to restrain economic growth and restrict job creation, the Governor's budget proposal looks like a real winner!

Main text word count: 700

Over the long period 1967-97, the twenty-five states with the highest overall tax burden had 50% per capita income growth adjusting for inflation, while the twenty-five states with the lowest burden had an average 72% growth, which translates into literally thousands of dollars more annual income per family by the end of the period.

Governor Mark Warner has proposed a huge increase in the aggregate tax burden of Virginians. To be sure, the tax hike is disguised in a "tax reform" bill. Governor Warner believes that higher state revenues are necessary to finance important governmental functions and will benefit the people of the state. There is a host of empirical evidence, however, that suggests otherwise.

Literally dozens of studies show that there is an inverse relationship between the overall tax burden and economic growth – higher taxes, lower growth. This relationship holds for different areas, time periods, and ways of measuring growth. It holds using widely differing methodologies. For example, over the long period 1967-97, the twenty-five states with the highest overall tax burden had 50% per capita income growth adjusting for inflation, while the twenty-five states with the lowest burden had an average 72% growth, which translates into literally thousands of dollars more annual income per family by the end of the period. Statistics also indicate that people tend to migrate out of high tax states into low tax ones. For example, from 2000 to 2002, there was net out-migration of native-born Americans from the ten highest tax states of 371,000; by contrast, the ten lowest tax states, including Virginia, had net in-migration of 729,000. Human resources flee high tax jurisdictions for low tax ones.

The nonpartisan Tax Foundation calculates that Virginia had the eleventh lowest state and local tax burden in 2003. It is not coincidental that by all measures Virginia has exceeded the national average in terms of economic growth – higher per capita income growth, greater population growth, more growth in total personal income. A favorable tax climate has been an important contribution to the state's economic health.

One reason high taxes have negative effects on a state's welfare is that they impose what economists call "deadweight losses." Some of the gains to consumer welfare from trades (where both sellers and buyers benefit) are lost when taxes crowd out private exchanges of goods and services. Aggravating the problem is the fact that most private sector activity is produced efficiently in competitive markets, while most governmental activity is produced in a monopolistic non-market environment where there are few incentives to perform efficiently and in an innovative fashion.

The Warner tax “reform” package is bad for other reasons as well. It proposes increasing the progressivity of the state income tax by raising taxes on the “rich” (defined as anyone making \$100,000 or more a year), while lowering them for some lower income people. Research shows that of all major taxes, the individual income tax has the worst impact, dollar for dollar, on economic activity. Moreover, states with flat rate structures tend to do better than states with similar income tax burdens but highly progressive rates. Raising the top rate is absolutely the worse single fiscal policy move that Virginia could make from the standpoint of economic growth. This outmoded and discredited “soak the rich” philosophy would serve to lower income generally for all Virginians, rich and poor alike.

Putting all of these arguments aside, proponents of the tax changes might argue that the state needs the revenues or services to citizens will have to be slashed. As a non-Virginian, I cannot evaluate this argument definitively. Yet I would ask the following questions. Have you moved to a more efficient, market-based approach for providing health care services (e.g., Medicaid)? Have you moved to rationalize public education spending, rewarding the highly productive and efficient districts and staff, while punishing the less efficient providers of education? More generally, have you moved towards a market-based, more competitive schooling environment (school choice)? Have you closely examined staffing changes at your state universities to see if, as I am nearly certain, staff is growing faster than enrollments? Have you privatized activities more efficiently provided by the private sector, including prisons, highway maintenance, and college dormitories? If the answer is mostly “no” to the above questions, increasing tax revenues only encourages the continuation of what are clearly inefficient and wasteful practices.

Virginians should be wary of so-called tax reform, particularly when there is ample reason to believe that it means tax increases that will stifle the spirit of enterprise and growth.

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(Richard Vedder, distinguished professor of economics at Ohio University, is the author of the soon to be released American Enterprise Institute book on higher education *Going Broke By Degree*, and a member of the Board of Scholars of the Virginia Institute for Public Policy, an education and research organization headquartered in Potomac Falls, Virginia. **Permission to reprint in whole or in part is hereby granted, provided the author and his affiliations are cited.**)

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John Taylor
Virginia Institute for Public Policy
20461 Tappahannock Place
Potomac Falls, Virginia
20165-4791

Phone: (703) 421-8635
Fax: (703) 421-8631

www.VirginiaInstitute.org
JTaylor@VirginiaInstitute.org

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