

Virginia Viewpoint

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Economic Realities to Recognize and Accept

By Gary Wolfram, Ph.D.

Summary

Virginia's politicians like to talk about "investing" in the future. However, "investment" decisions that ignore the realities of our market economy can eliminate tens of thousands of jobs in Virginia. We should learn from California that it is better for one Gray Davis to be unemployed than many of our friends and neighbors.

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We must understand that economic realities dictate that private sector investment flows to where it will receive the highest return, and that both employers and employees vote with their feet.

Empirical literature demonstrates that high taxes, or taxes that are increasing, dampen economic growth. Dr. Richard Vedder, a professor of economics at Ohio University, is well-published in this area and most recently showed that not only is business activity slower in high-tax states, but that individuals tend to move from high-tax states into low-tax states. Given the budget difficulties in which state governments find themselves today, it may be useful to present the common sense explanation for the empirical results we observe.

Sherlock Holmes once told Dr. Watson that the problem with Watson's attempts to solve mysteries was that he saw, but he did not observe. To understand the effects of taxes on economic activity, we only need to follow Holmes' advice. We see businesses providing jobs, and without thinking about it, we begin to believe that the object of business is to hire workers. Yet, the object of business is to produce goods and services. In a market economy a business exists to produce something that people are willing to buy. That business can only continue to exist if it produces something at a cost that is less than, or equal to, what consumers are willing to pay to purchase the product.

If it costs ACME Hat Company \$15 to produce a hat, then it will go out of business if its customers are not willing to pay at least \$15 for that hat. Its customers will not be willing to pay \$15 for the hat if BEST Hat Company is selling the same hat for \$10. Thus we have to observe that businesses in Virginia must be able to produce products at least as cheaply as those products can be produced elsewhere, including the cost of transporting the goods or services.

Taxes are part of the cost of producing. If the commonwealth taxes businesses directly, then this will make it more expensive to produce in Virginia than would be the case without the taxes. If the state government taxes the income or wages of workers, then those workers will find it more attractive to live and work somewhere else, and thus Virginia's businesses will have to offer higher wages to keep their employees. If the commonwealth taxes the purchases of consumers, then the price at which businesses must sell their products will have to be lower, since the consumer does not care if the \$10 she pays for the hat is made up of \$9 in payment to the ACME Hat Company and \$1 to Virginia, or \$10 to the ACME Hat Company. She still is only willing to pay \$10 for the hat. If the state

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government taxes the property used to produce hats, then this cost has to be covered in what ACME charges for its hats just as if its electricity costs were higher.

Virginians are well aware, as are the rest of Americans, that if ACME finds it less expensive to produce hats in Delaware or Indonesia, it will be forced to locate there. If ACME does not produce where it is the least expensive, then its competitors will. In this scenario we can expect consumers to buy BEST hats for \$10 while the \$15 ACME hats sit on the shelves until ACME ultimately goes out of business. This is how the market system works, and while I may wish it to be otherwise, particularly if I work for ACME Hats in Richmond, the reality is that consumers benefit from this system and we have no choice but to recognize and accept how the system works.

No reasonable person would suggest that Virginia should refrain from levying any taxes, because there are government activities that make it cheaper to produce. A court system and police departments make contracts enforceable which reduces the cost of production. Fire departments reduce the insurance costs for buildings and equipment. Admittedly, these government services require taxes.

Nevertheless, we must understand that economic realities dictate that private sector investment flows to where it will receive the highest return, and that both employers and employees vote with their feet. (See California) If the Commonwealth of Virginia can control its urge to tax, spend, and incur debt, economic growth and job creation will be the result.

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(Gary Wolfram is the George Munson Professor of Political Economy at Hillsdale College 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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