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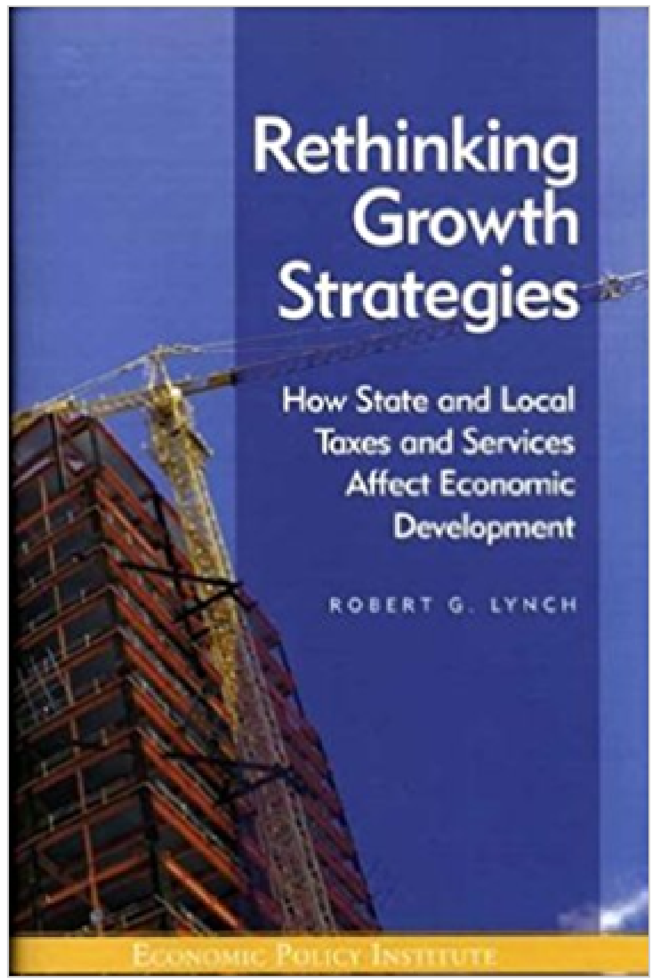
The cost effectiveness of job-creating economic policies

Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development. By Robert G. Lynch. Washington, DC: Economic Policy Institute, 2004, 62 pp., $11.50 paperback.



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Rethinking Growth Strategies, by Robert G. Lynch, is a seven-chapter book that discusses five main arguments supporting the view that cutting taxes and offering tax incentives to businesses boosts economic growth and employment. To critically examine these arguments, the book offers a thorough literature review of relevant statistical and econometric studies. Dr. Lynch, a professor of economics at Washington College, is well versed in the subject, specializing in the areas of public finance, comparative economics, public policy, economic development, and international economics. He has served as a consultant for various organizations, including labor unions, businesses, and governments. His writings have analyzed the effectiveness of job-creating economic policies within state and local governments.

The five arguments assessed by Lynch are (1) the tax-burden argument, (2) the supply-side argument, (3) the demand-side argument, (4) the business-climate argument, and (5) the competitiveness argument. After laying out these arguments, the author follows with an overview of the literature on state and local tax cuts and incentives, presenting results from survey research and statistical and econometric studies. He goes on to discuss the "representative-firm approach" (explained below) and to review the effects of state and local public services on economic development. His account concludes with a section on the policy implications of cutting state and local taxes. Overall, Lynch finds little evidence that tax cuts and incentives stimulate employment. If anything, his findings show that raising taxes and using tax revenues to fund public services prop up economic growth.

The tax-burden argument suggests that business taxes substantially increase the costs of doing business and greatly reduce profits. These effects allegedly prevent additional hiring and, at the same time, incentivize firms to consider relocation. However, Lynch identifies three flaws in this argument: state and local taxes are relatively small, after-tax rates of business profits vary insignificantly across states and localities, and tax revenues support public services that reduce business costs. The supply-side argument posits that tax cuts stimulate the economy by incentivizing businesses and individuals to produce goods and services, thus increasing savings and investment. However, the author points to four weaknesses in this argument: positive effects of tax cuts on savings and work effort are exaggerated, tax cuts may disincentive work, gains from tax cuts do not lower interest rates to increase investment, and the demand-side effects (ignored by supply-side advocates) likely reduce job creation.

The demand-side argument makes a different bet. It suggests that the economy can be stimulated with tax reductions because such reductions increase the amount of spendable income available to businesses and individuals. Once again, Lynch counters this assertion, arguing that state and local tax cuts would reduce government income, thus lowering government spending (including in-state spending). Lower spending, in turn, may be a justifying factor for raising taxes. The business-climate argument proposes that economic development can be promoted by improving the “business climate.” The term business climate often refers to perceptions about infrastructure conditions, economic strength (employment, quality of life, etc.), tax-funds growth, and an area’s favorability to business. However, Lynch notes that savvy decisionmakers make policy choices on the basis of a cost–benefit analysis rather than perceptions about economic conditions. Therefore, attracting firms with tax breaks is not a wise strategy for state and local governments. In addition, tax cuts undermine the provision of public services, which contribute to a positive business climate.

Finally, the competitiveness argument suggests that state and local governments attract businesses by offering tax reductions and incentives, thus compelling jurisdictions to compete for investments. Again, Lynch sees a number of flaws in this argument: (1) gains from tax cuts and incentives may be undermined by a state or local government’s ability to create jobs and retain businesses, (2) incentives that decrease tax burdens provide minimal benefits to firms, (3) tax cuts and incentives are inefficient drivers of growth because the revenue lost by governments surpasses the additional income gained by firms, (4) tax cuts are often provided to firms that would invest regardless of such incentives, (5) there is little evidence that firms relocate on the basis of tax motivations, (6) the negative effects of tax cuts on metropolitan areas are not sufficiently considered, and (7) cooperation among jurisdictions may generate more jobs and faster growth than competition.

The book’s literature review is in line with the foregoing objections raised by Lynch. It suggests that tax incentives are not successful in attracting significant volumes of new business, in creating jobs, or in enhancing economic performance. The review also examines, much to the same end, studies employing the so-called representative-firm approach. This approach involves creating financial statements of a hypothetical business used as a mockup of an actual firm. Different tax scenarios are then simulated, and the results are analyzed to measure the positive or negative effects experienced by the business. While studies of this kind show that there are some differences in tax burdens across states, few of them attempt to determine if these differences substantially affect a firm’s decision to relocate or invest. Likewise, few studies address whether or not providing tax incentives is an efficient use of public funds. Indeed, there is evidence of positive economic effects that come with increasing spending on public services (which are funded with tax revenues). Lynch sums up his analysis with the observation that "state and local tax cuts and incentives are not effective for stimulating economic activity or creating jobs in a cost-efficient manner."

The author does a thorough job in describing the arguments and pointing out their flaws (as he sees them). His conclusion is that promoting economic and job growth is a priority for state and local governments, but that policies of cutting taxes and providing tax incentives may not be as effective as they are commonly believed to be. The layout and terminology used in the book are appropriate for readers untrained in economics. The text also identifies areas for future research. Overall, Lynch offers a compelling read that I highly recommend.