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Taxes, Government Services and Jobs

When deciding how to close their budget gaps, cities and states should consider the employment and other economic impacts of various alternatives. Contrary to the pronouncements of some politicians and the pseudo-science of some analysts, cuts in spending on goods and services produced in one's own economy will have a more negative economic impact than increases in taxes. And increases in some kinds of taxes (e.g., consumption taxes) will have a more negative effect on the economy than increases in other kinds of taxes (e.g., increases in the tax rate on the portion of income over some relatively high level). For a clear and simple explanation of the economic reasoning underlying these realities, see ***Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?*** by Peter Orszag, the Joseph A. Pechman Senior Fellow in Tax and Fiscal Policy at the Brookings Institution, and Joseph Stiglitz, Professor of Economics at Columbia University and one of the recipients of the 2001 Nobel Prize in Economics. (http://www.fiscalpolicy.org/10-30-01sfp.pdf)

Contrary to mainstream economic thinking, the Manhattan Institute for Policy Research and other conservative think tanks around the country argue that tax cuts **and** service cuts are always good for the economy, and that tax increases **and** service increases are always bad. To bolster their arguments in this regard the Manhattan Institute and many of those other conservative think tanks have commissioned a conservative think tank based Boston, the Beacon Hill Institute, to produce for it "a computerized method of accounting for the economic effects of tax policy changes." The Beacon Hill Institute initially developed such a model for its own work in Massachusetts.

As opposed to the more legitimate empirical studies in this field (which subject themselves to peer review and make their data available to other researchers for review and analysis), the Beacon Hill Institute's models never consider the economic impact of increases or decreases in government spending on different kinds of public services. The Manhattan Institute then relies on the Beacon Hill model to support its claim that increasing taxes in New York City or State will cost jobs, no matter what the circumstances are.

The research on the effect of taxes and government spending on the economy experienced a great leap forward with the publication in 1985 of the article "The Effect of State and Local Taxes on Economic Growth: A Time Series-Cross Section Approach" by University of California economist Jay Helms.[1] Instead of treating government as a black hole into which funds disappear, Helms included in his study both the taxes paid and the services financed by these taxes. Helms concluded that expenditures on health, highways, schools and higher education cause growth in a state's personal income. The only expenditure that caused a decrease in a state's personal income in Helms' study was welfare. Interestingly, this is also the only result that

[1] L. Jay Helms, "The Effect of State and Local Taxes on Economic Growth: A Time Series-Cross Section Approach," The Review of Economics and Statistics, 1985, pp. 574-582.

did not withstand the test of time. Robert Carroll and Michael Wasylenko (1994) found that the effect of welfare payments on employment was mostly limited to employment in manufacturing and that the effect on manufacturing was present in the 1970s but not in the 1980s.[2] (Helms' data are for the years 1965-1979).

Other researchers have examined more limited issues that are relevant to the effect of taxes and government spending on the economy. For example, in 1990, Alicia Munnell, who late was a member of the President's Council of Economic Advisors, found that tax increases that finance improvements to highways, sewage systems and other infrastructure increase the growth rate of private employment.[3] In 1996, Timothy Bartik found that increased spending on higher education and health, financed by property tax increases, stimulate state manufacturing output.[4] On the other hand, he found that increases in spending on roads, financed by non-property tax increases, reduce manufacturing employment in the long run, and that all of the other kinds of tax increases that he examined had little impact on economic performance.

The Beacon Hill Model

According to its website, the Beacon Hill Institute completed its New York State tax impact model in 2000 for the Heritage Foundation, and its New York City tax model in 2001 for the Manhattan Institute. Economists at the Fiscal Policy Institute have reviewed Beacon Hill's descriptions of their New York City and New York State models but have been denied access to the data used by Beacon Hill to reach the specific conclusions that the Manhattan Institute claims the model produces. FPI has also reviewed another study of the impact of New York City taxes on employment for which the researchers involved made their model and data available for review and analysis. This study was completed by Andrew Haughwout, Robert Inman, Steven Craig and Thomas Luce and published as a working paper by the National Bureau of Economic Research. This model is strikingly similar to the Beacon Hill models and it achieves a similar result.

As FPI's economists have shown in an article in State Tax Notes,[5] the Beacon Hill studies and the study by the NBER researchers are seriously flawed. They do not tell us whether taxes have an effect on employment at all, and if they do what this effect is. The main problems with these studies are:

1. The studies account for taxes in only one jurisdiction. Thus, in the case of New York City, the studies contain information only about the city itself. As the data that these studies use show, between 1989 and 1992 private sector employment in NYC fell by

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[2] Carroll, Robert, and Michael Wasylenko, "Do State Business Climates Still Matter: Evidence of a Structural Change." *National Tax Journal,* Vol. 47 (March), 1994, 19-37.

[3] Munnell, Alicia, 1990. "How Does Public Infrastructure Affect Retinjal Economi Performance?" *New England Economic Review* (September/October), pp. 11-13.

[4] Bartik, Timothy, *Growing State Economies: How Taxes and Public Services Affect Private Sector Performance,* The Economic Policy Institue, 1996.

[5] Moshe Adler, Oliver Cooke and James Parrott, "Do Tax Increases In New York Cause a Loss of Jobs? A Review of the Evidence," *State Tax Notes,* Feb. 4 2002.

10% at the same time that the top personal income tax rate increased by 31%. But these studies completely ignore the fact that New Jersey raised its top rate by 90% and Connecticut instituted its first state income tax during the same period. New Jersey and Connecticut are often described as competing with New York City for jobs, and their inclusion any study of taxes and the economy of New York City and State is critical. It should be noted that Helms' study contains tax data for all the relevant jurisdictions, states in his case, and this is one reason why his results are so different.

2. In the Beacon Hill Institute and the Haughwout et al. studies state and city services play no role. In the Beacon Hill studies the only thing the government does is pay welfare and unemployment, and these are the only expenditures that are included. In the study by Haughwout et al. only transfer payments from the federal government and the state are included. Expenditures on schools, police and roads are missing in all these studies.

3. The Beacon Hill Institute and the Haughwout et al. studies do not adequately control for the business cycle and regional variations in the nature and severity of business cycles. Controls for the differences in the economic performance of central cities vs. suburbs are missing as well.

4. In the Beacon Hill model the effect of tax changes is instantaneous. This makes it impossible to separate cause and effect. Very frequently states and cities raise taxes during downturns in the economy because of the related revenue shortfalls. Taxes are the result of these downturns rather than their cause. But the Beacon Hill model, which uses no lags at all, mistakes effect for cause.

Conclusion

When employment declines, state and local government experience a decline in revenues. In order to avoid damaging service cuts at such times, taxes are frequently raised. The Beacon Hill Institute then interprets the simultaneous occurrence of these phenomena as proof that raising taxes causes a loss of jobs. Moreover, the Beacon Hill models are not faithful even to its own theory. In its studies, Beacon Hill does not control for taxes in any other jurisdiction, not even New Jersey or Connecticut. Nor does Beacon Hill account for the impact of national business cycles let alone for the impact of regional variations in those business cycles.

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