Appendix 3D

Responding to Lynch's Arguments Against the Effectiveness of Lowering Business Taxes

The estimates in this book of the costs of creating jobs through business incentives rely on the research literature on how taxes affect business location. This research literature provides various estimates of the elasticity of business location decisions and related measures (employment, investment, etc.) with respect to various types of state and local taxes. The revenue cost of creating additional business activity through tax reductions will be equal to (total revenue raised by the relevant tax per unit of business activity) / (elasticity of business activity with respect to the relevant tax). (This revenue-cost calculation only looks at the revenue loss on jobs that would have occurred anyway; the fiscal effects of the new jobs include any spending impacts as well as the additional taxes from new jobs.)

In my work, I have generally assumed that the relevant taxes to consider are state and local business taxes. The argument is that even in studies that look at all taxes, it seems likely that the main taxes that affect business location decisions are business taxes. Household taxes only indirectly affect business location decisions by affecting labor supply or other location variables. Therefore, it is assumed that a given percentage effect of all taxes really is proxying for a given percentage effect of state and local business taxes.

This approach is challenged in a 2004 monograph by Robert Lynch. Lynch argues that because many business location studies have been based on broader tax measures, which include nonbusiness taxes, the relevant tax measure should be all state and local taxes. He further argues that business location elasticities for business taxes tend to be smaller than the −0.20 figure

preferred by Wasylenko, which I have sometimes used as well, for example in the research supporting this book. Finally, he argues that household taxes should affect business activity in a state, largely because of the demand-side effects of changing household taxes while holding public spending constant.

The practical implication of Lynch's argument is that the revenue loss per new business activity created will be much greater than I calculate. His proposals imply that the revenue cost per job can, under one alternative, be calculated as all state and local taxes divided by −0.20. This will yield a considerably more negative number than dividing all state and local business taxes by −0.20. Alternatively, if we want to use state and local business taxes in the numerator for this calculation, we should divide these total state and local business taxes by a tax elasticity that is less negative than −0.20.

I disagree with Lynch's argument, for several reasons. First, we are unlikely to get reasonable measures of the revenue cost of creating new business activity unless we recognize the possibility of a given tax measure proxying for other tax measures. For example, it is also true that many business location studies use narrower measures than all state and local business taxes. For instance, these studies may use only state corporate income taxes. If we simply divided state corporate income taxes by one of these studies' tax elasticity, we would get very small costs per job created. However, this is misleading: it is probably the case that states with low corporate income taxes also have low rates on other business taxes. Similarly, I would argue that it is misleading to ignore the possibility that a given percentage variation in overall state and local taxes is proxying for a given percentage variation in state and local business taxes.

Second, I don't think Wasylenko's review of the research evidence, which largely relies on studies from my previous review, really shows that the tax elasticity of business location with

respect to state and local business taxes is less negative than −0.20. In the studies reviewed by Wasylenko, the most relevant studies in looking at business incentives are those that look at how births or other micro measures of individual manufacturing firms respond to business taxes. These include 19 studies, with a median elasticity of −0.20.

Third, the business location literature is relying on the observed variation in tax rates and public services. This observed variation is in a world where state and local governments are generally forbidden by state constitutions and state law from running planned or persistent operating budget deficits. Therefore, lower personal tax rates in a state do not imply a state that is deficit spending. In general, states may be able to have lower tax rates, holding public services constant, because of variation in such factors as tax bases per capita that allow a state to have lower tax rates and yet afford similar public services. If public services are not held constant, then lower tax rates may be due to greater tax bases, or may reflect a preference in that state for lower taxes and lower public services. In any event, if there is any demand-side effect of lower personal taxes, it would take place through a balanced-budget multiplier effect of lower tax rates and lower public spending, which would cause *negative* demand-side effects of lower personal taxes. However, in many cases tax rates may be lower in a state without necessarily implying lower tax collections or public spending per capita. Therefore, I believe that Lynch is incorrect to assert that the natural variation in tax rates and business activity growth across states necessarily reflects demand-side effects.

By this argument, I don't mean to imply that policymakers don't have to pay attention to demand-side effects in changing state and local tax rates. If policymakers lower one type of tax rate in a state, they will have to lower public spending on public services or lower public spending on transfer payments or raise other tax rates, in order to maintain a balanced budget.

These balanced budget shifts may have demand-side consequences. These consequences should be taken into account by policymakers. However, the natural variation in taxes across states is accompanied by other natural variations—in tax bases per capita, for example—that mean that such demand-side effects don't necessarily occur across different states because of "natural" variation in household taxes or business taxes.

If demand-side effects of state and local taxes do not occur, then the effects of state and local household taxes or business taxes on business location decisions must be due to supply-side effects—e.g., effects on the costs of various factors of production in a state. Business taxes directly affect the costs of various factors of production in a state, in particular the cost of capital. Household taxes do not directly affect business costs in a state. They may indirectly affect costs if some of these household taxes are shifted into higher costs of labor or land, or other business inputs. However, many studies of determinants of business location already control for labor costs, and some control for land costs as well. Once these other business costs are controlled, household taxes should not have an independent supply-side effect on business location decisions. As argued above, if household taxes do have some demand-side effect on business location decisions, this demand-side effect will, if anything, be positive, because of the balanced budget multiplier.