

# State and Local Fiscal Policy and Economic Growth and Development

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By

State and Local Fiscal Policy Research Program

George Washington Institute of Public Policy

George Washington University

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# Study Objectives: What Do We Know About

- The factors that drive local economic development and growth
- The impact of state and local fiscal policies on local economic development and growth
- Is there a balanced tax system that supports growth and development without over burdening any one sector

# Defining Local Economic Development and Growth

- ***Economic growth*** implies growth in various measures of economic output – income, jobs, etc
- ***Economic development*** implies more than just increases in measures of economic outputs. It implies that the welfare of citizens is improving – poverty rate, infant mortality rate, etc
- Relation between incomes and achievements, commodities and human capabilities, economic wealth and our ability to live



# Factors Affecting Area Growth and Development and Firm Location Decisions

- Primary engine for strong state and local economies is a strong private sector
- Agglomeration economies: size matters
- Human capital and labor costs
- Access to markets and raw materials
- Natural endowments/amenities
- Strong educational system
- State and local fiscal policies

# State and Local Policy Affecting Local Economic Growth and Development

- State and local policy makers have limited direct control over most factors affecting local economic growth and development. Policies over which they do have control include:
  - Public services that are fundamental to the private sector, including education, transportation, and local infrastructure
  - State and local tax and expenditure decisions that create an environment conducive to entrepreneurial activity
  - Targeted assistance either spatially or to specific firms
- Traditional fiscal policies targeted at attracting new firms and expanding existing businesses – targeted tax credits, job training, and other targeted assistance programs

# Economic Development Policies and Interjurisdictional Competition: Helpful or Harmful

- Helpful: Interjurisdictional competition serves to reduce cost and enhance efficiency
- Harmful: Encourages zero-sum competition and reduces public sector's ability to provide services
- State and local competition for economic activity through spatial and firm-specific incentives is type of competition most deserving of criticism
- Such competition reinforces predisposition toward cutting taxes as a way of stimulating private economic activity



# Overall Effect of State and Local Fiscal Policies on Local Economic Development

- Increases in taxes negatively affect employment and economic activity, *holding constant the level and quality of public services*
- Increases in public services positively affect employment and economic activity, *holding constant the level of taxes*
- Both of these effects are greater within a metropolitan area than among metropolitan areas
- There is disagreement on the magnitude of these effects

# Taxes and Economic Activity

- Several studies find that taxes, at the margin, may have a negative impact on economic activity
- In this view, cutting taxes can promote economic activity
- But the empirical results assume everything else remains the same – no cut in services, no changes in fiscal behavior of other state or local governments
- Effect of taxes varies according to type of tax, type of industry, and the extent to which firms face an elastic demand for their products, thus preventing shifting of taxes to consumers

# Spending and Economic Activity

- Several studies conclude that the level and quality of public services available is a major influence on promoting economic activity – especially infrastructure services
- Evidence on the effect of educational and public safety *spending* on economic development is less consistent.
- If cutting taxes reduces the level and quality of services available it may have a detrimental impact on economic activity
- Research suggests that spending on specific projects such as sports stadiums or convention centers rarely has significant positive economic impacts

# Taxes and Spending and Housing Values

- Strong economies usually have vibrant real estate markets with high housing prices – e.g. San Francisco, New York, Washington D.C.
- In addition, however, state and local policies impact housing prices
- Capitalization literature reveals that both taxes and spending impact housing values



# People get the Government Services that they Pay for

- Many suburban jurisdictions have
  - High property taxes
  - High quality services
  - Seems to attract households
- But some older core inner areas have
  - Low property tax revenues (despite high rates)
  - Poor schools and basic services
  - This can be devastating

# Direct Impact of Property Taxes on Values

- Tax gets capitalized into value
  - Full capitalization means the entire burden of the tax is passed through to property values
  - This happens when supply of housing is completely fixed, or *inelastic*
  - Usually, because housing supply is somewhat elastic, the impact on values is less extreme

# Tax-Service Mix

- If taxes and services both increase, the impact on values is ambiguous
- Mayer and Hilbert show that it is possible that increased taxes that fund superior schools can be associated with increases in property values
- If people are allowed to sort themselves into the sort of communities they prefer, the tax-service mix for a particular community should be optimal for those living in that community—people vote with their feet



# A Balanced Tax System

- What does it mean to have a balanced tax system?
  - Advisory Commission on Intergovernmental Relations has put forward one view of the characteristics of a balanced revenue system
  - Balance among characteristics of a sound tax system is important

# Movement of 50 State-Local Revenue Systems Toward More Balanced Use of the Big Three Taxes between 1957 and 1984, but has Trend Reversed?

<b>Year</b>	<b>Strongly Balanced</b>	<b>Fairly Balanced</b>	<b>Poorly Balanced</b>	<b>Imbalanced</b>
1957	--	--	19	31
1967	2	2	26	20
1977	4	10	23	13
1984	12	11	14	13
2002	4	14	22	11

# Strengths and Weaknesses of Individual Revenue Sources

<b>Feature</b>	<b>Property</b>	<b>Sales</b>	<b>Income</b>
Revenue Raising Potential	Strong	Weak	Strong
Revenue Growth Stability	Revenue growth in line with income growth and is relatively stable as income declines	Revenue growth slower than income sensitive to declines in income	Revenue growth faster than income but sensitive to declines in income
Fairness	Consistent with ability-to-pay and benefits-received principle of taxation. Regressive at low income levels then proportional and a bit progressive at high income levels	To a limited extent it is most consistent with ability-to-pay principle. It is generally regressive	Consistent with ability-to-pay principle of taxation and can introduce progressivity into the tax system
Behavioral Distortions	Tax on land does not affect behavior	Distorts economic behavior	Distorts economic behavior