Joint Committee Hearing
Revenue & Finance Committee and State Government Administration Committee
Illinois House of Representatives
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Testimony of
Therese J. McGuire, Kellogg School of Management, Northwestern University

I have organized my remarks around three points.

The academic evidence on the effect of state taxes on state economic growth is inconclusive.

My reading of the voluminous literature

Dozens of academic studies have been conducted over the past several decades that ask one variant or another of the question: Does the level of state taxes affect state economic growth and business-location decisions? Some find that higher taxes are a deterrent to economic growth, while others find no effect of taxes on economic growth. When studies do find an effect, the effect tends to be small. The findings tend not to be robust to changes in the modeling strategy (the time period studied, the factors included, etc.). My reading is that the evidence is too weak to support a conclusion that a sure way to boost a state's economy is to cut state taxes—particularly if such tax cuts would result in cuts to publicly provided services that are vital to the state economy.

A summary of one academic study

Kim Rueben and I studied the effects of TABOR, Colorado's Taxpayers' Bill of Rights (passed in 1992), on the growth of Colorado's economy. TABOR limits the annual growth rate of revenues to the sum of population growth and the rate of inflation. Proponents argued that by reining in the growth rate of government, the economy would grow faster. Opponents argued that by reining in the growth rate of revenues, vital services would need to be cut and the economy would be harmed.

We compared the growth rate of Colorado's economy before and after the implementation of TABOR with the growth rates of other states' economies before and after the implementation of TABOR; if TABOR had an effect in Colorado, it would be evident there but not in other states because they did not pass a similar law. The time period we analyzed was 1978–2003: 15 years before TABOR through 10 years after TABOR. We controlled for other factors that might affect a state's economy (e.g., the industrial mix of the economy, the age distribution of the population, the average education level of the population). We examined two different measures of state economic growth: the growth rate of real per capita income and the growth rate of employment.

We found some evidence of a short-run positive effect of TABOR on employment growth, but the short-run effect was swamped by a stronger, long-run negative effect. We found no evidence of an effect of TABOR on the growth of real per capita income. We concluded that TABOR did not significantly boost Colorado's economy.

There is new (so caution is warranted), but compelling, evidence that fiscal and economic policy uncertainty can be harmful to the economy.

A summary of one academic study

In a recent working paper, Baker, Bloom and Davis develop an index of fiscal, monetary and regulatory policy uncertainty in the U.S. Their economic policy uncertainty index is based on newspaper mentions of economic policy uncertainty, a count of federal tax code provisions set to expire, and forecaster disagreement over expected inflation and expected government purchases. Their index varies widely over the last several decades with spikes near tight presidential elections, after the initiation of the Gulf wars, on 9/11, at the time of the Lehman Brothers bankruptcy, and at the time of the 2011 debt-ceiling debate.

The authors find that an increase in policy uncertainty equal to the increase experienced from 2006 (a relatively stable time for economic policy) to 2011 (a time of great uncertainty due to the debt-ceiling debate in the U.S. and worries about sovereign debt in Europe) could be associated with a 2.5 percent decrease in industrial production and a loss of 2.3 million in employment. There are three channels for economic policy uncertainty to have a deleterious effect on the real economy:

- Uncertainty can make firms cautious about investing and hiring.
- Uncertainty can cause banks to require higher risk premiums, making financing more costly.
- Uncertainty can make consumers more likely to save and more cautious about spending.

The view of business executives

- A quote by David M. Cote, Chairman and CEO of Honeywell, in *USA Today* on November 5, 2012: "Right now we're holding back on all but the most necessary hiring. And on capital expenditures, if I can make the decision now or six months from now, I'll make the decision six months from now and see what develops."
- When working for the 1984 Minnesota Tax Study Commission, I interviewed executives at 3M. They told me that certainty and predictability in state taxes are much more important in business-location and hiring decisions than is the level of state taxes.

My interpretation of the academic evidence and the insights from business executives for the policy debate in Illinois

Fiscal policy uncertainty in Illinois stems largely, if not exclusively, from its mountain of unfunded liabilities, both unfunded pension liability and unpaid bills for the General Funds. I believe it would likely be an effective economic-development play for Illinois to:

- devise a clear and immutable path to addressing its unfunded liabilities;
- make a credible commitment not to take on new debt unless it is associated with capital projects;
- reform its tax system to raise revenues in a predictable, fair manner and use the revenues to support the functions of government that are most important to a vibrant economy.

Company-specific tax breaks are difficult to justify from a public-policy perspective.

- They make for an uneven playing field and can be viewed as unfair.
- They can be viewed as an inappropriate use of public funds.
- They can be a waste of taxpayers' money.
- They can be a sign of a desperate or weak government.
- They can be a sign of a desperate or weak firm.

Still, while company-specific tax breaks may be a zero-sum game for the nation as a whole, it is difficult and arguably unwise for one state unilaterally to stop the practice. The challenging question facing Illinois' lawmakers is how to reform—indeed, rein in—the practice of granting company-specific tax breaks to achieve the goals of fair treatment of companies and appropriate use of taxpayers' money.