Are High Taxes Restricting Indiana's Growth?

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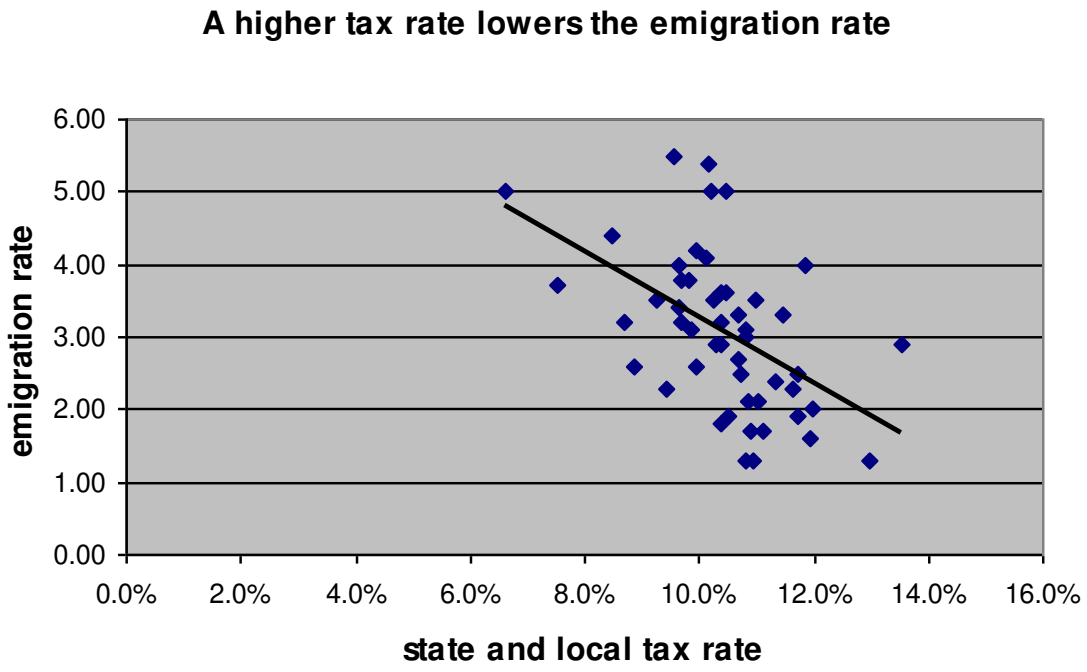
The "Hoosier Comeback" program, sponsored by the Indiana Economic Development Corporation, is part of a strategy to boost economic growth, in this case through increasing the quantity and quality of available human resources. The plan envisions subsidies to encourage the return of former residents. Indiana's population growth has been weak relative to the rest of the country, though not as weak as in the 1970s and 80s. It is set to return to a much weaker pace, however, according the US Census Bureau. In 1972-87, Indiana's population growth rate was only 0.2 percent per year, well below the US pace of one percent per year. In some years, population even fell (1980-83 and 1986). Subsequently, Indiana's population grew at a 0.8 percent average annual rate from 1987 to 2005, closer to, but still below, the national pace of 1.2 percent per year. Over the next 25 years US population growth is expected to slow (0.8 percent per year) and Indiana's is expected to fall back more sharply (to 0.3 percent per year). Such slow growth in population and the workforce will curtail the pace of expansion of overall output and income in the US and all the more so in Indiana.[1]

A broader effort could usefully focus on recruiting others to immigrate to Indiana or on inducing existing residents to stay. Charles Tiebout, in a famous paper published a half-century ago, explained that consumers vote with their feet, sorting themselves into political jurisdictions based on their preferences for public sector goods and services. This "Tiebout hypothesis" has found strong statistical support in a variety of contexts ever since and has become a critical feature of local government expenditure and tax analysis. If people vote with their feet, then governments that reduce government programs or raise taxes would discourage residency and economic activity in their jurisdictions. Indiana could attract back more former residents, or keep those it has, by lowering the tax burden, if people vote with their feet.

Emigration rates are strongly affected by state and local tax rates. The chart below shows the tax rate prepared by the Tax Foundation for the 50 states for 2005 and emigration rates prepared by the US Bureau of the Census for 2005. The emigration rate is measured by the number of residents over one year of age who did not live in a state in the prior year divided by the current population. The tax rate includes all state and local taxes as a percent of net state product. Evidence supporting consumers voting with their feet can be seen in the chart.

Chart
Higher state and local tax rates lower immigration



The emigration rate is very sensitive to the tax rate.[2] In the linear formulation of the data captured by the trend line shown in the figure, each one percentage point rise in the tax rate will reduce the emigration rate by 0.53 percentage points. This effect is statistically significant at a conventional level of significance (t-ratio equals -4.23, which implies that the effect is significantly different from zero at a 99 percent confidence level).

In Indiana, the state and local tax rate rose from 9.9 percent to 11 percent between 2000 and 2005. According to the linear relationship in the data, this tax hike would reduce the emigration rate by 0.6 percentage points. This is slightly larger than the decline in population growth for the 2005-30 period projected by the Census Bureau. Placed on top of the decline already projected, this would bring the population growth rate to below zero from 2005 to 2030. On the other hand, pushing taxes back down by a similar amount could raise the emigration rate enough to boos the population growth rate above the US average rate and keep the state's share of population and income from declining.

The recent increase in the tax rate is unusually large and puts Indiana taxes at a relatively high level. According to Tax Foundation data, Indiana's state and local tax burden rose from 35th in the nation in 2000 to 12th in 2005.[3] This is one of the largest deteriorations among the 50 states since 1970. In 2000 and earlier, Indiana was a moderate tax state, but over a short period climbed to a relatively high-tax state. In particular, in 2000 Indiana had a lower tax rate than all of its neighbors. Since then, all of these states had rising tax rates, but Indiana's tax rate increase was sufficiently large to put it above the rates in Illinois, Kentucky and Michigan. Only Ohio had a higher tax rate in 2005; at 11.9 percent, a full percent higher than in 2000, Ohio's tax rate put the state at the 4th

highest level in the nation. Ohio's emigration rate was only 1.6 percent in 2005, below Indiana's 2.1 percent and higher than the rate in only New York, California, Michigan and California, the other high-tax states with the lowest emigration rates in 2005.

The Tax Foundation also prepares a State Business Tax Index, which assesses the attractiveness of a state based on its tax system. [4] Their index is based on five subcomponents of the tax system: individual income taxes, corporate income taxes, sales taxes, unemployment insurance taxes and property taxes. Somewhat ironically, their index shows Indiana as a very attractive state. With a ranking of 12th in the 2006 and 2007 rankings, Indiana has a tax climate that matches their rank for the level of taxes. How can a state have the 12th highest taxes in the land and yet have the 12th best tax climate? The answer is that the Tax Foundation ranks low individual income taxes with an especially large weight compared with other taxes and Indiana has one of the lowest individual tax rates in the country, ranking eleventh lowest. [5]

Indiana apparently relies more heavily on corporate income taxes and property taxes than other states and while sales taxes are relatively low, these tax rates have increased most rapidly since 2000. It is arguable that a given tax burden arising from an income tax is substantially less onerous than taxes on corporate capital income or property taxes, but this is not reflected in the Tax Foundation's State Business Climate Index. Even the climate index shows deterioration, however. In the first two estimates of the index for 2003 and 2004, Indiana ranked 10th in the country. Some of the deterioration, at least judged by the climb in the tax rate, occurred between 2000 and 2003.

Whether emigration rates could be boosted more by cuts in income tax rates or by cuts in the corporate, sales or property taxes is an open issue, but the taxes that have risen most in recent years have been sales and property taxes. The Tax Foundation's State Business Climate Index suggests that more bang would come from cutting the individual income tax. Economic theory would also suggest that cutting taxes on corporate capital income, or property (structures) would have the largest efficiency gains because the underlying resources are the most mobile.

Recommended reading:

Dubay, Curtis S. and Chris Atkins, "2007 State Business Tax Climate Index," Tax Foundation Background Paper No. 52, October 2006.

Epple, Dennis, Thomas Romer and Holger Sieg, "Interjurisdictional Sorting and Majority Rule: An Empirical Analysis," *Econometrica,* vol. 69(6), November 2001, pages 1437-1465.

Indiana Economic Development Commission, *Accelerating Growth: Indiana's Strategic Economic Development Plan, 2006*, April 2006.

Tiebout, Charles, "A Pure Theory of Local Government Expenditure," *Journal of Political Economy*, 64, (1956), pp. 416-24.

1. See U.S. Census Bureau, Population Division, Interim State Population Projections, 2005.

2. The elasticity of the emigration rate with respect to the tax rate is -1.66, according to the data for 2005, which means that a doubling of the tax rate will cut the emigration rate by more than one-half.

3. The Tax Foundation's Business Climate Index …

4. See Dubay and Atkins (2006) for a description of the index and its latest rankings.

5. In addition, there are other features of the tax system that are ranked; indeed, there are 113 variables that factor in to the five subcomponents of the tax climate index.