The Beacon Hill Institute

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Information and Updates on Current Issues

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The Beacon Hill Institute's Analysis of Pennsylvania Tax Policy: STAMPing Out the Nonsense from Our Critics

An organization called the "Pennsylvania Tax and Budget Center" has issued a statement attacking a release of June 15, 2009 in which the Commonwealth Foundation used certain results of the Beacon Hill Institute's State Tax Analysis Modeling Program (PA-STAMP) in commenting on Pennsylvania tax and budget issues. The purpose of the comments released here is to identify the numerous flaws in the Center's attack. We proceed by breaking the Center's criticism into major topics. Then, for each topic, we provide, first, the Center's summary of the Commonwealth Foundation's original statement, second, the Center's criticism of that statement, and, third, the Beacon Hill Institute's (BHI's) rebuttal.

BHI's PA-STAMP Model

The Center's Summary of the Commonwealth Foundation's Statement

"Using the Pennsylvania State Tax Analysis Modeling Program (PA-STAMP), an economic modeling program developed by the Beacon Hill Institute at Suffolk University, the Commonwealth Foundation projects that a 1-percentage point increase in the PIT (from the current rate of 3.07%) would result in a net loss of 47,633 jobs next year. A 2-percentage point PIT increase would cost Pennsylvania 94,491 jobs."

The Center's Criticism

"The Commonwealth Foundation provided no information about its model or methodology, only results. However, the Beacon Hill model employed by the Commonwealth Foundation, known as STAMP, has been criticized by reputable researchers. According to an October 2003 analysis of modeling practices and their ability to assess tax/expenditure economic impacts, prepared by the University of Arizona, 'the STAMP model is not useful for forecasting.' *Strike One*. The report further states, 'Its use is very limited for impact analysis.' *Strike Two*. Also noting, 'it will be extremely difficult to accurately represent a change in Arizona's tax structure with a change in STAMP's tax variables.' *Strike Three.*"

"Tax/Expenditure models are only as good as the data and assumptions that go into them. The STAMP model excludes the economic impact of public sector spending, which is considerable. Reports using the PA-STAMP model, issued with little transparency regarding methods and data, and questionable assumptions, should be used cautiously at best."

BHI's Rebuttal

Had it asked, we would have been happy to provide the Center with documentation of our PA-STAMP methodology, which we have made available online at http://www.beaconhill.org/BHIStudies/PA-STAMP2009/PA-STAMP2009.pdf. (This report is similar to dozens of other STAMP reports we have issued over the last several years.) Indeed, a more careful critic would have requested this documentation before charging ahead with criticisms that turn out to be wrong and, in at least several instances, predicated on a thorough misunderstanding of how PA-STAMP works.

Most notably, the comments by University of Arizona researchers cited by the Center have no bearing on PA-STAMP. The Arizona researchers were commenting on a model that BHI built nine years ago for a different state using an entirely different methodology from that employed in building PA-STAMP. The AZ-STAMP model that the Arizona researchers criticize was an *econometric* model. PA-STAMP is a *computable general equilibrium* (CGE) model. We switched to the CGE methodology shortly after completing the Arizona model.

There are arguments for and against both the econometric and the CGE approach to tax modeling. For several years, and in building AZ-STAMP, we used the econometric approach because it allows us to estimate the model's elasticities directly. Shortly after building AZ-STAMP, we switched because, although it sacrifices that advantage, the CGE approach offers greater flexibility in modeling tax changes. That rationale reflects some of the criticisms of econometric models – not just our AZ-STAMP model, but *all* econometric models – made by the Arizona researchers.

While we do not accept all of the Arizona researchers' criticisms of AZ-STAMP, the fact that we switched to a CGE approach overcomes some of the criticism made of that model and, co-incidentally, the second and third complaints leveled by the Center. The CGE methodology has a number of advantages over the econometric methodology, among which, to quote the Arizona researchers in their discussion of the CGE methodology, are:

1. "the specifications are extremely flexible, so that the model builder can include any production function, any 'closure rules,' or any government-economic interaction," and
2. "[CGE] models incorporate price effects into the models, which is important in assessing tax impacts."

The inability of the STAMP model to provide forecasts would be legitimate if STAMP were designed to provide forecasts. However, STAMP was never designed to provide forecasts. Rather, it was designed to provide policy simulations. A forecast is an attempt to estimate various economic indicators based on historical trends and hunches about turning points in the economy, given fixed assumptions about tax and budget policy. A simulation attempts to show how changes in tax and budget policy would affect the economy, given whatever path the economy is forecasted to follow absent those changes.

Finally, the accusation that we do not account for the effects of government spending is dead wrong. The Commonwealth Foundation reports "net" job and income effects. A STAMP model simulation of a tax increase accounts for the positive effects on public sector employment, income and wages as well as the negative effects on private sector employment, income and wages. In the Pennsylvania income tax simulation, the private sector job losses simply outweigh the public sector gains.

Taxes and Recessions

The Center's Summary of the Commonwealth Foundation's Statement

"As every economist knows, a recession is the worst time to increase taxes, and doing so now would add thousands more Pennsylvanians to the ranks of the unemployed."

The Center's Criticism

"No such agreement exists. Economists have differing opinions on this subject, particularly when the other choice is budget cuts. Economists Joseph Stiglitz, a recipient of the Nobel Prize, and Peter Orszag, now the Director of the Office of Management and Budget, wrote during the last recession that 'economic analysis suggests that tax increases would not in general be more harmful to the economy than spending reductions.'"

BHI's Rebuttal

Stiglitz and Orszag are entitled to their opinion as to whether tax increases are no more harmful than spending cuts during a recession. In either case, they clearly view tax increases as harmful, just as the Commonwealth Foundation suggests.

Tax Increases and Economic Recovery

The Center's Summary of the Commonwealth Foundation's Statement

"Tax increases will harm our economic recovery as Harrisburg politically allocates spending rather than allowing the private sector to spend, invest, and save in the most productive manner."

The Center's Criticism

"When worried about financial markets and dropping consumer demand, wealthy individuals are more likely to save during a recession than spend and invest. While saving is good, it does very little to help the economy recover. Maintaining public spending during an economic downturn on such things as transportation systems and higher education helps our businesses be more competitive when the economy recovers."

BHI's Rebuttal

These statements betray an ignorance of elementary macroeconomic accounting principles. There are three kinds of spending, all of which "stimulate" the economy: personal consumption spending, government purchases and private investment spending. Private investment spending is financed by saving. Thus, if, as the Center implies, the "rich" are an important source of private saving, they are also an important source of private investment spending. Thus, when the rich "worry" about a downturn and save more, the additional investment made possible by their saving is exactly as "stimulative" as the consumption they forgo.

The statement "while saving is good, it does very little to help the economy recover" is also wrong. Whereas public spending on infrastructure and education can increase productivity, it can also crowd out more productive private investment spending. The history of the Great Depression and of World War II provides evidence that a temporary surge in government spending crowds out private investment, thus reducing the hoped-for "stimulus" to the economy.

The Growth of Government

The Center's Summary of the Commonwealth Foundation's Statement

"The failure of the Rendell, Bush, and Obama agendas to stimulate jobs with higher levels of government spending is evident," noted Brouillette. "The only thing they have 'stimulated' is government."

The Center's Criticism

"According to the data included in the press release, state government employment has decreased by 200 employees since April 2008. Federal jobs have increased during that same time by 2,900, but that is likely due to the ramp up for the 2010 Census."

BHI's Rebuttal

Every dollar of new tax revenue represents one dollar more of public-sector spending and one dollar less of private-sector spending. The only reason that Pennsylvania might have shed some jobs, even as the federal government created other jobs, is that the underlying economy has reduced the amount of revenue collected from existing taxes. As for whether Pennsylvania government is growing or not, the governor's Fiscal Year 2010 budget projects spending from general fund revenues to grow by 5% annually from 2010 to 2014.

The Stimulus and Economic Recovery

The Center's Summary of the Commonwealth Foundation's Statement

"While President Obama and Governor Rendell claimed the economic stimulus would 'create or retain' 130,000 jobs in Pennsylvania, **the state has only lost jobs since passage of the stimulus legislation, and unemployment rates are higher today than the Obama administration claimed they would be with passing the stimulus bill.** In fact, Pennsylvania has lost 217,000 private sector jobs since the start of the current recession, while adding 13,500 government employees."

The Center's Criticism

"On Monday, June 15, economist Paul Krugman noted the irony of the claims that the economic stimulus is failing after four months, when in comparison, jobless rates continued to increase for 16 months following the 1981 Reagan tax cuts. As only a small fraction of the funds from the multi-year federal stimulus program have been spent, no one should expect to see a radical downgrade in unemployment rates, particularly when the scope of the world-wide recession is still growing."

"As the figure below from the Economic Policy Institute (EPI) illustrates, the unemployment rate expected by economic forecasters increased by more than two percentage points between October and March with each new forecast revised upward as new data accumulated about the depth of the recession. As the forecasts became progressively more grim the projected size of the stimulus expected by these same forecasters was revised upward. The final stimulus package although sizable was not sufficiently large to return the economy to full employment but it will limit the depth and length of the current downturn."

"Pennsylvania has the second-lowest top income tax rate of the 42 states with individual income taxes. This means that for the wealthiest among us, those who hold the majority of capital used to make business decisions, even with a rate increase, Pennsylvania will still have among the lowest rates in the nation and a rate well below our economic competitors. If tax rates were the most important criteria for business decisions, jobs and wealthy people should be storming Pennsylvania. Location decisions are complex and vary by industry and by business. A well-developed transportation system, skilled workforce, proximity to important markets, and emerging technologies can far outweigh tax rates in such decisions."

BHI's Rebuttal

The reason that the predicted unemployment rate for the fourth quarter of 2009 continues to rise is the growing pessimism over the effectiveness of the already-massive stimulus. As for Krugman, he conveniently forgets that the 1981 Reagan tax cuts were not fully implemented until 1985 and that they were implemented against a backdrop of severe monetary tightening. In any case, the Reagan tax cuts were conceived not just as a recovery measure but as a permanent expansion in the growth potential of the economy. Conversely, a tax increase now in Pennsylvania sets the stage for a permanent reduction in that state's economic growth.

As for the comment on Pennsylvania's top income tax rate, it's not the top rate that matters but the overall rate structure. Any upward movement in the average marginal tax rate diminishes Pennsylvania's competitiveness, irrespective of where it stands relative to other states.

According to BHI's State Competitiveness Index, Pennsylvania already ranks low in terms of its competitiveness – 39th of the 50 states. The Index places Pennsylvania below New York and only slightly higher than New Jersey. Thus, even if its tax rates are relatively low, compared to its competitors, there are other factors that drag down its competitiveness. Notably, for example, Pennsylvania ranks 43rd for its ability to incubate new business. Raising taxes only worsens its competitiveness, measured in terms of this factor.

The Beacon Hill Institute at Suffolk University in Boston focuses on federal, state and local economic policies as they affect citizens and businesses. The institute conducts research and educational programs to provide timely, concise and readable analyses that help voters, policymakers and opinion leaders understand today's leading public policy issues.

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