Testimony presented before the Missouri House Special Interim Committee on the Earnings Tax

# "If You Tax Something, You Get Less of It: The Effects of Earnings Taxes on Economic Growth"

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I believe that each committee member has received a copy of a research report I produced estimating the effects of earnings taxes on the economies of St. Louis and Kansas City. I would like to provide a brief summary of what I found.

City governments provide many important services to their residents, including police, roads, streetlights, parks, and more. To provide these services, cities raise revenue through taxes and fees. Taxes and fees do not just transfer money from citizens to their government, however, they also alter the decisions of consumers, homeowners, and businesses. Simply put, "If you tax something, you get less of it." Property taxes will mean less-valuable property, sales taxes will mean reduced sales, and income taxes will mean less income. These distortions are unavoidable, and effective city governments try to minimize them relative to the benefits that residents receive from the services the taxes finance.

Because of the relative ease of tax avoidance in cities as opposed to states or the country as a whole, most cities tend to levy taxes on relatively immobile things. In particular, they tend to rely much more heavily on property taxes rather than sales taxes and income taxes. Property won't move when it is taxed, unlike people who can be taxed as residents, employees, and/or customers.

Localities in the U.S. collect about 15 times as much revenue from property taxes as they do from taxes on individual income, and about four times as much as they do from sales taxes. St. Louis City and Kansas City, on the other hand, do the complete opposite of this. In each city, government revenue from property taxes is about half the amount of government revenue from taxes on individual income.

There are several direct ways that taxes on income--such as the St. Louis earnings tax--can affect individual decisions and, therefore, city and metro growth. Most obviously, because of the earnings tax, the metro area's natural population growth will be distorted away from the city to elsewhere in the metro area. And, just like any tax, the earning tax means there is more incentive for residents to move out of the metro area altogether and less incentive for others to move into it.

Admittedly, given that the earnings tax rate in St. Louis is not very high, we shouldn't expect massive numbers of people making their job and housing decisions based on them in any given year. But even fewer than a hundred such decisions per year can mean thousands of mislocated people over a decade.

Earnings taxes also can have indirect effects that result from the misallocation of people and jobs. For example, efficient metro areas tend to have people and jobs concentrated in the central areas, with employment and population density decreasing the further you get from the center. Earnings taxes in the central city flatten the distribution of people and employment away from the center. This reduction in geographic efficiency means lower employment and population across the metro area. In other words, an earnings tax does not simply reallocate people and employment between cities within a metro area, it also can lead people and employment to leave the metro area altogether by weakening the local economy.

**Estimates**

To pin down the magnitudes of the effects of earnings taxes, I compared growth rates for over 500 cities and their metro areas across the country between 2010 and 2019. Thirty-nine of the cities impose earnings taxes, with rates that range from Philadelphia's 3.8809 percent to San Francisco's 0.19 percent. To capture the effects of earnings taxes, I considered each city's earnings tax rate, the differences in earnings tax rates within metro areas, and the sizes of taxing cities relative to their metro areas. I also controlled for differences across cities in their size, density, industry mix, and region.

As expected, I found that earnings taxes tended to reduce growth in employment and population in the cities that imposed them, and that this harm was greater for cities that were small relative to their metro area. That is, the earnings tax is more distortive in St. Louis City than in Kansas City because Kansas City because there are more options to live and work outside the city of St. Louis. I also found that, despite not imposing earnings taxes, the rest of the metro area also tends to see lower growth because the tax in the central city suppresses the local economy generally.

For St. Louis, the results indicate that the city's earnings tax reduced population growth for the city itself by 10,800 (about 58 percent of the actual decline) and for the metro area as a whole by 58,500 (about 81 percent of the growth that otherwise would have occurred).

I find also that the earnings tax affected employment growth, reducing it in the city of St. Louis by 5,000 (or by about 29 percent) and in the metro area as a whole by 24,100 (or by about 19 percent). The estimates for Kansas City were of the same order of magnitude. Keep in mind that these results are for the pre-pandemic period when work-from-home was not nearly as much of an option as it is today. We should expect that earnings taxes will be even more distortive over the next few years than they have been in the past.

These metro area results might not be the end of the story because what happens in the St. Louis economy doesn't stay in the St. Louis economy. In separate research, I found that extra employment of 1,000 in the St. Louis metro area has tended to mean extra employment of about 300 in outstate Missouri. This rule of thumb suggests a decrease of 7,200 in outstate Missouri employment growth and a 16,000 reduction in outstate population growth because of the earnings tax in St. Louis.

For a relatively slow-growing state like Missouri, the numbers presented in my study indicate significant declines in growth from a single policy in the state's two largest cities. All tolled, between 2010 and 2019 the taxes probably reduced Missouri-wide population growth by about 95,400 (or 40 percent) and employment growth by about 39,800 (or 15 percent).

Finally, it is worth noting that my study is not about changing the amounts that St. Louis and Kansas City spend. It is about how to best collect taxes to support given levels of spending. In other words, if the cities had spent the same amounts, but had collected revenue with the types of taxes used in the rest of the country, the cities, their metro areas, and the state would have seen a good deal more growth in employment and population.

Further, with more growth and more-efficient ways of collecting taxes St. Louis and Kansas City would be in better positions to provide even more services to their residents and their visitors.