THE GOVERNOR AND THE ECONOMY

by Kevin J. Murphy

Prior to the election in November, I was asked by a reporter from the *Detroit News* to assess Governor Granholm's performance on the economy. In a state described by Republicans as in the throes of a "single-state recession," you would think that the answer to this question would be simple enough (certainly the reporter thought so!). I gave my stock, public-finance expert's type of answer to the reporter, however—state governors in general lack the discretionary fiscal and monetary policy tools necessary to affect the basic macroeconomic indicators that we use to judge and measure the economic health of a state. Under the circumstances, then, Governor Granholm has done the best that could have been done in a state which has always ridden the roller coaster of the business cycle and in a state whose chief industry is under severe structural pressure exerted both by the global economy and by steady technological advancement in production methods.

I don't think many economists would disagree with my assessment—it's really a point of logic or perhaps even basic arithmetic. But surely the governor must have *some* role to play in the state's economy. So what can our governor, or any governor for that matter, do about the state economy?

The Optimal Amount of State Government

The basic premise from which you must proceed in order to answer this question is that most states, Michigan included, impose the constraint that the state budget be balanced on an annual basis (known in the public finance literature as a Balanced Budget Requirement (BBR)). In other words, whatever amount the state chooses to spend on goods and services must be offset by state tax revenues and fees and by transfers from the federal government.

Higher taxes permit more spending on government services; lower taxes necessarily imply less spending on government services. Unlike the federal government, taxes and spending are inextricably bound together in a state. You shouldn't think about one without thinking about the other. Any politician who promises to cut your taxes is, implicitly, also promising a cut in your services. A politician who promises to provide more government services is implicitly promising to raise your taxes. The disconnect in the minds of voters between state taxes and state spending is remarkable, and it is this disconnect that opens the door to public opinion manipulation via slick political ads that attempt to convince the voter that one can somehow have the proverbial cake and eat it too.

Viewed in this light, the choice in November was not so much a question of which person would make the better governor, but rather what the optimal amount of state government is. Dick DeVos and the Republicans offered lower taxes (plus fewer government services). Jennifer Granholm and the Democrats offer more government services (but higher taxes than would exist under the Republicans). Hard-nosed BBR logic precludes any other options.

So what *is* the right amount of state government? This is obviously a subjective question, but economists have long recognized that the private sector cannot provide (or cannot provide enough of) *certain* goods and services. The private sector cannot provide for law and order and enforcement of property rights on its own. The private sector cannot encourage enough provision of goods (e.g., education) which have beneficial effects on third parties nor can it curtail production and consumption of goods that have adverse consequences for third parties (e.g., pollution). The private sector has no natural inclination to prevent monopolistic forces from coming to dominate certain industries. The private sector has no natural inclination to care for those unable to take care of themselves (e.g., children or the indigent). A certain amount of government is both necessary and desirable for a well-functioning society.

Perusal of Michigan's budget reveals that our state government engages in the very basic activities I have listed as falling within the proper purview of government. About 45% of state expenditures go to fund or subsidize education, about 20% of state expenditures go to help those down on their luck, about 10% of what the state spends goes to public health, about 6.5% is spent on the roads, and about 5% of expenditure goes for law and order.

Starving the Beast

My punch line is that the electorate in deciding who will be Governor is in essence deciding who a majority of voters believe can lead the state to the optimal amount of government services (which must be paid for by a corresponding amount of taxes). This of course is not how the discussion was framed during the campaign. Dick DeVos fired the opening volley attacking Governor Granholm for her jobs record and promising major cuts in taxes to make the economic environment more "friendly" to business.

Over the summer, as if on cue, the Michigan legislature did away with the much vilified single business tax (SBT). The SBT provided $2 billion dollars per year in revenue, equal to about what the state spends annually on say hospitals, or on higher education, or on the criminal justice system. The single business tax accumulated a lot of warts over the years, no question about it. This is ironic because when it came into being in the 1970s, it was ballyhooed as innovative. It eliminated a number of other inefficient business taxes (hence the moniker *single* business tax), it reduced the marginal tax rate on new business investment to zero, and it stabilized business tax revenues which are notoriously volatile and sensitive to the business cycle. Politics being politics, however, the SBT was reformed and revised over the years (mostly by a Republican Governor and a Republican dominated state legislature) to the point where it had become burdensome and failed to treat equals equally. Though Dick DeVos did not personally eliminate the SBT, its elimination was clearly part of his overall game plan.

The notion of luring voters with the promise of lower taxes is not new. It's been a major part of the Republican mantra since Ronald Reagan. Tax cuts, so the argument goes, will be good for business and will be job creating. When folks in this camp really get their mojo working (and DeVos definitely had his mojo working) they wrap the argument up in a bow of supply-side economics and claim that the additional economic activity induced by the tax cut will more than pay for itself in the form of actually *higher* tax revenues. It's the ultimate feel good policy—more money in our pockets to spend and more money for public services to boot, a veritable free lunch. It is this extreme point of view that Dick DeVos pressed during the campaign.

The problem with the supply-side proposition is that careful analyses of the effect of such tax cuts on economic activity reveal the impact on the supply side to be small (if not non-existent). Optimistic estimates suggest that a 10 percent cut in business taxes spur a 2 percent increase in economic activity. Pessimistic estimates find no effect at all.

The take-away points here are that a cut in business taxes will, at best, have a small positive impact on economic activity. More importantly, from the point of view of government finances, the extra economic activity will not pay for the tax cut. For that to occur, a 10 percent tax cut would have to spur at least a 10 percent increase in economic activity. If economic activity grows by only the 2 percent that the consensus estimates suggest, then tax revenues will fall by 8 percent. If no net additional economic activity is generated by the tax cut, then tax revenues would fall by the full 10 percent. Given the state's BBR, therefore, a given cut in business taxes will necessitate a cut in government services of approximately the same order of magnitude as the tax cut regardless of whether the optimistic estimate or the pessimistic estimate is correct.

With respect to the SBT itself the non-partisan and highly respected Upjohn Institute for Employment Research released its report on Michigan's economic competitiveness in August. The report's authors, using a regional econometric model, predict that elimination of the single business tax will likely *reduce* employment growth in our state over the next ten years. The study's authors explain that despite the positive impact of reduced business production costs and of higher after-tax incomes for owners of capital, elimination of the SBT also reduces incomes of public service providers (think laid off teachers, policemen, firemen, hospital workers) and reduces the quantity and quality of public services (think roads, education, public health). The Upjohn study's authors conclude, basing their judgment on rigorous, non-ideological, economic analysis, that the negative demand and supply-side effects of elimination of the SBT will outweigh its positive effects, adding up to poorer economic performance for the state in the years to come.

It's hard to believe that the Republican Party of this generation is unfamiliar with the findings in the research literature on this issue, so why persist with the supply-side rhetoric regarding business taxes? The more cynical in my profession have pegged this discussion as really being all about "starving the beast." In other words, savvy proponents of lower taxes are well aware that the supply side effects of such cuts are marginal. The trick is to convince the voting public that lower business taxes are in their best interest. Once taxes are cut, the BBR will then in turn force a commensurate downsizing of government (the beast), which is the hidden agenda of starve-the-beast proponents.

Less government, on the surface, may sound like a good thing. Who, after all, is not for less bureaucracy? In reality, however, state government is the institutional euphemism for spending on education, on public health, on poverty reduction, on roads, on the justice system, on clean water and air. If we do starve the beast, then we are really starving ourselves of consumption of these basic types of public goods. The legislature has not proposed any plan to replace the lost revenue from the SBT. Given the balanced budget requirement, the implication is that government services will have to shrink commensurately once elimination of the SBT goes into effect. Elimination of the SBT by the legislature definitely has the look and feel of a starve-the-beast gambit. So what's your pleasure then? More homeless, worse roads than we already have, higher college tuition, more kids per teacher in K-12 classrooms? These are the hard choices we face with elimination of the SBT.

Why DeVos Lost the Election

Why did Dick DeVos lose the election? The Michigan economy is in miserable shape and he was promising to cut taxes and shrink government. Did the voters see through his supply-side con? Perhaps. I think it at least equally likely, however, that in the end Jennifer Granholm simply beat DeVos at his jobs game. She said, "Okay, you want to make this campaign about jobs, let's make it about jobs." She painted DeVos as a jobs outsourcer at Amway. She relentlessly touted the record of her economic development office on bringing new jobs to the state. On this latter score, her biggest success was in getting Google to locate a thousand new jobs in Ann Arbor. Now 1,000 jobs sounds like a lot, but in a state with 4.5 million employed people those thousand jobs aren't going to budge the major macro indicators. Moreover, what they don't tell you is that the economic research shows that about 80 percent of new jobs resulting from a business re-locating to a state actually go to out-of-state residents. One of Granholm's most impressive TV ads ran late in the campaign. On the screen, a variety of company names flashed by that had located new jobs in the state. A thousand here, two hundred and fifty there, six hundred and fifty there, and so on. To the untrained eye, I'm sure the numbers looked impressive, but again the point stands that 1000 + 250 + 650 and so forth just doesn't add up to much in comparison to the overall size of Michigan's labor market.

In watching the debates closely, I don't think the Governor was drinking her own Kool-Aid. She went with the jobs angle because DeVos left her no choice but to wage the battle in that arena. To her great credit, she thumped DeVos with his own stick. Between the lines, however, you could almost hear her muttering under her breath that John Engler had caused that part of Michigan's economic mess that is truly attributable to state government. Engler, benefited greatly from the BBR. The late '90s were very good to John Engler due to the surging national economy. Tax revenues exploded as a result of the strong economy and the BBR gave Engler the enviable choice of cutting taxes or increasing spending. He cut taxes, but either way the Clinton economy was going to make him look like a genius. With the Bush recession of 2001, the bottom fell out and tax revenues crashed. Just as John Engler was a beneficiary of the BBR, Jennifer Granholm was its victim. Engler's tax cuts during the good times were so severe that Michigan has been left in a perpetual state of structural deficit, a situation where tax revenues are not sufficient to sustain the desired level of services. I think Governor Granholm really wanted to convey this point to the public and sometimes, quietly, she did. But being a good politician, I think she mostly chose not to play the blame game with the ghost of Christmas past and instead wisely chose to concentrate on the foe before her.

The campaign's rhetoric, aside from being shrill and contentious, was far off the mark. Both candidates claimed job creating ability that they do not have. If you're unwilling to believe the serious research on this point, then simply ask yourself why neither the Republican-dominated State legislature nor the Governor had made *any* headway on the jobs situation up until the election. After all, it has been five years since the economy went into its dive. No, both candidates huffed and puffed about jobs because we in Michigan are justifiably worried about jobs. The unfortunate reality is that there's not much that a state's governor can actually do about employment and employment growth. State employment and employment growth are driven by much larger national and international forces outside of the Governor's control.

Did the candidates know better? In Granholm's case the answer must surely be yes, but she had to play the jobs game since DeVos had the first mover advantage on her. Did DeVos know better? I guess we'll never know. Given his fundamentalist leanings, he actually may have been drinking his own Kool Aid, but certainly intelligent and well-informed strategists in the state's Republican Party *must* have known better. They must have cynically decided as strategy to lay the blame for the floundering economy at the Governor's feet in order to pursue their starve-the-beast agenda.

So what *can* the governor do about the economy? The governor ultimately represents a package of tax and spend policies. Whether most people got this point or not, the election really was a referendum on what kind of state we want to have. The election's outcome is a victory of sensible government over forces that would have us starve the beast. Does this mean we'll have *big* government? I don't think so. If anything, John Engler's legacy is that he left our state government under-funded. Looking at the tax side of the ledger, Michigan is below the national average (even including the single business tax) when measured against other states in terms of the tax bite of business taxes and Michigan is about at the national average when measured against other states in terms of total tax bill. With Governor Granholm in office, there is at least the chance that the revenues from the SBT will be replaced in a responsible fashion and that we can maintain a sensible level of public goods provision over the next four years.