Since Nevada has a very small government, and was the fastest-growing state for decades, did the former cause the latter?

Actually, it’s not likely. Examine the statistics comparing the real growth of a state’s GDP (gross domestic product) to the share of GDP provided by state and local governments for all states over the last 45 years, and you will find no correlation. States with relatively smaller governments have not tended to grow any faster than other states.

There is, however, a strong statistical relationship between a state’s real GDP growth rate and the lagged growth rate of its state and local government. A fall in state and local government spending in one year tends to be followed by lower economic growth in the next year.

Why is this? One way to look at it is that state and local governments provide essential public goods that cannot be adequately provided by the private sector, such as roads and education. While higher taxes may create some disincentives for private investment and growth, many of these public goods are necessary investments for the private sector to function.

For example, interstate and state highways increase productivity by making it possible for retailers such as Wal-Mart to incorporate just-in-time inventory management. Otherwise, stores would have to hold large inventories, decreasing profits while increasing consumer prices. Similarly, without good public education, the private sector lacks the educated workforce it needs.

You can also consider what economists call spending multipliers, which are particularly important in a recession. If the state spends less to fix a bridge, this means less revenue for a construction company, fewer jobs and fewer purchases of material from other companies and subcontractors, so they also have fewer jobs. Firing an elementary school teacher means less money is spent by that teacher on rent, food and other goods.

In Nevada, good estimates are that a $100 reduction in state and local spending reduces Nevada’s GDP by $162, and reduces household income by $136. Firing 100 state or local employees reduces Nevada’s total employment by 153 workers.

Meanwhile, an increase in taxes to fix that bridge or keep that teacher reduces the money firms can pay to their workers or to their stockholders, and taxpayers have less to spend on purchases in restaurants, furniture stores and the like. Increasing state and local taxes by $100, however, reduces Nevada’s GDP by much less than $100, though it depends on the type of tax.

In short, the multipliers for state and local government spending cuts are larger than the multipliers for tax increases. Economists teach this to every first-year student in macroeconomics, and estimates from real data consistently find it to be true.

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