

## Estimates of Factors That Can Affect the Performance of Economic Growth

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### Abstract

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There are many factors that can contribute to economic growth. However, this research will focus on factors that play an important role in the local, community, and state growth. This paper examines how economic determinants will influence the Gross Domestic Product (GDP) by using the generalized least square (GLS) technique. This model examines the investment of education along with the Aggregate Demand and Aggregate Supply models to determine the effects of taxation and trade decisions on economic growth. Thereby, a clearer interpretation can be used to determine their influence on GDP. Further, this analysis (1) identifies the educational importance towards the quality of workforce implementation and (2) reinforces the influence of taxation, job growth and trading of goods and services on GDP. By recognizing the economic influence of each of these variables, policy makers can gain a better understanding towards creating and maintaining economic prosperity.

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**Keywords:** Gross domestic product (GDP), economic growth, business taxes, income taxes, exports, imports, aggregate demand, and aggregate supply

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### 1. Introduction

Economic growth is defined as the increase in the market value of all final goods and services produced by an economy over time. It has been a major topic of discussion for economists for over two centuries and remains just as prevalent in today's economic climate. Adam Smith, the renown, known as the founder of modern economics proposed the question of why some countries are rich and some countries are poor in his famous book entitled, *An Inquiry into the Nature and Causes of the Wealth of Nations*. The same logic can be applied to the current globalization era except in terms of per-capita real GDP to be more relevant. Specifically, why do some countries have a high per-capita real GDP and others have a low per-capita real GDP? Knowing the answer to this question can affect the livelihood of billions of people. It is assumed that economic growth produces not only a greater number of goods, but also produces more efficient goods and services. In fact, Friedman (2005) makes the argument that economic growth can make people happier, more tolerant, more willing to settle disagreements, and more inclined to favor a democratic society. This paper observes these behavioral changes as it analyzes the economic factors that can affect the performance of economic growth, specifically on the state level. Furthermore, the researcher attempts to answer the question; do certain economic factors have a greater impact on the growth of Mississippi's economy? The detailed analysis conducted in this paper will serve as an aid for both local policy officials and national policy makers as they continue to implement programs and policies to increase economic growth.

### 2. Review of Related Literature

The United States continually tries to find ways that will increase the growth of the economy, and still remain competitive with other countries at the same time. The U.S. has been the leader in the global economy for centuries, but has experienced stagnant growth in recent years. The condition of the U.S. economy, often measure by per-capita GDP, is determined first on the state level.

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However, once comprised each state plays an important role in the overall growth of the U.S.'s economy. Specifically, factors such as governmental assistance, business tax, income tax, educational attainment, unemployment, poverty rate, educational spending, imports, and exports play an important role in the generation of state growth. This paper focuses on the theoretical and empirical perspective regarding the relationship between economic growth and these aforementioned economic and social factors. The influence of governmental assistance on the economy has been widely discussed. The belief that increased enrollment in governmental assistance programs contributed to slow growth is consistent with most classical economists' beliefs (Landreth, 2002). Furthermore, evidence from prior studies have shown that when governmental assistance is used to benefit individuals who are truly in need; rather than those who are taking advantage of the program, the local economy will grow. This is evident in a study performed by Richard C. Fording and William D. Berry (2007), who developed a model of poverty rates. They calculated the net impact of increases in welfare benefits on the poverty rate; taking into account both work disincentive and income enhancement effects. Their income enhancement hypothesis contends that public assistance expansion reduced poverty by supplementing the incomes of poor individuals. Another influential factor on state economic growth is tax requirements. Taxes that help to improve the well-being of the community such as parks, community centers, waste management, and safety officials are considered to have a positive impact on the economy. However, taxes can also have an adverse effect on the community. According to L. Jay Helms (1985), tax increase significantly slowed economic growth when revenue is used to fund transfer payments. The study further revealed that states with higher enrollment percentages in governmental assistance programs may suffer from the adverse effects of taxes. In addition, taxes can also deter new businesses from starting in states and local communities when the tax rates are considered high.<sup>3</sup> This was examined by Roland Rathelot and Patrick Sillard (2008) in a study on whether the impact of corporate taxes on business location decisions are significant on a local scale. Their findings indicate, higher local taxes actually tend to deter firms from setting up in a given zone, but the effect is weak. Clearly, the effect of taxation on a state's economy depends crucially on the use of the revenue.

The previous discussion on taxes reveals that economic performance is dependent not only upon state and local taxes, but also upon the types of expenditures the taxes finance. Most of the empirical studies on the correlation between taxes and economic performance have been provided by Alaeddin Mofidi and Joe A. Stone (1990), in which they use a general-equilibrium model of international trade originally developed by Meade (1955) and adapted by Harberger (1962) and McLure (1975). Based on the empirical evidence, Mofidi and Stone's study confirms the importance of controlling for variations in governmental expenditure patterns across states in evaluating the influence of state and local taxes on economic growth. The evidence suggest that state and local taxes have a significantly negative effect on net investment and employment in manufacturing when the revenues are devoted to transfer-payment programs and a significantly positive effect when expenditures are used for programs such as health, education, and highways. Furthermore, the implications that personal income tax has to disposable income is very well documented by Arthur Laffer (1981) in which he focuses on the effects of marginal tax rates on the incentive to work and save. According to Laffer, changes in tax rates affect output in a direct fashion.

By lowering the tax rates, a higher output can be obtained. Carroll et al (2000) proposed to investigate the effect of entrepreneurs' personal income tax situation on the growth rates of their enterprises. By analyzing the personal income tax returns of a number of proprietors before and after the Tax Reform Act of 1986, they were able to establish that individual income taxes exerts statistical and quantitatively significant influence on firm growth rates. According to their findings, as a sole proprietor's marginal tax rate goes up, the rate of growth of his enterprise goes down. This is consistent with the findings of Laffer (1981) and Carroll et. al (2000). Further, Denaux (2007) provided a theoretical and empirical investigation of the simultaneous effects of taxes and government spending on long-run economic growth in an endogenous growth framework. However, Denaux's finding inferred that income tax and economic growth are both positively correlated and proven significant, suggesting state-level fiscal policies affect economic growth. Alm and Rogers (2011) also contributed to the body of literature as to the affect in which income tax influenced economic growth. Their finding suggested that there is a statistically significant correlation between state total tax revenues and economic growth.

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<sup>3</sup> The United States has one of the highest statutory corporate tax rates in the world--35%-- a factor that may reduce business investment (CNN Money September 7, 2012).

However, the correlation is sometimes significantly negative, sometimes significantly positive, and sometimes not significant at all. McCracken (2006) examined the affect of fiscal policy on economic growth. Based on their results, income and property taxes are more harmful to growth than corporate or sales tax.

Moreover, Arnold (2008) and Widmalm (2001) both suggested that there was a negative relationship between the progressivity of personal income taxes and growth. Widmalm (2001) further concluded that labor income taxation may distort the labor-leisure choice and is also progressive in most Western countries. Another factor contributing to state economic growth is educational attainment. A study developed by Jones (2002) revealed that long-run growth is driven by the discovery of new ideas and useful knowledge. In fact, the time period between 1950 and 1993, educational attainment contributed to 0.63 percentage points to growth in output per hour, accounting for just under one-third of growth during this period. Goldin and Katz (2001) also investigated the relationship between educational attainment and economic growth by observing the U.S. growth in education within the 20<sup>th</sup> century. According to their research, the increase in educational attainment allowed the U.S. work force to expand productivity by 0.53 percent annually from 1915 to 1999. Thus, it can be inferred that the ability to retain college graduates will have a positive effect on the economic growth of states and cities. The importance of universities and colleges plays an important role in the economic growth of the States due to their ability to provide the research and training that helps to improve industry conditions. Thus, Hansen and Knowles (1998) used a Cobb Douglas aggregate production function to estimate the impact of formal education. They concluded that when total employment is disaggregated according to educational attainments, aggregate production is characterized by increasing returns to scale. Pritchett (2001) also studied the relationship between educational attainment and economic growth. Unlike other scholarly research which suggested an increase in educational attainment resulted in an increase in economic growth, Pritchett used Cross-national data show no association between increases in human capital attributable to the rising educational attainment of the labor force and the rate of growth of output per worker resulting in statistically strong negative correlation between educational attainment and economic growth. According to Pritchett, this may be due to the institutional environment having been sufficiently bad that the bulk of newly acquired skills has been devoted to privately remunerative but socially wasteful or counterproductive activities, initial individual returns and equal subsequent expansions in the supply of educated labor could have seen the marginal returns to education fall dramatically, stay constant, or rise, or schooling has been enormously effective in transmitting knowledge and skills, while in others, it has been essentially worthless and has created no skills.

It is evident that the unemployment rate has an effect on the growth of the economy, but the extent of this impact seems to be questionable and highly debatable. Clas Eriksson (1997) and Burgen et al (2012) were able to investigate this issue of unemployment and growth. They both were able to conclude that there is a trade-off between successful recovery and growth of an economy and high employment. Moreover, Yusuf et al (2014) and Hoynes (2006) investigated the relationship in which employment and poverty had on economic growth and concluded that the lack of improvement in the poverty rate would reflect a weakened economy. Their findings were inconsistent with Danziger and Gottschalk (1986) which found that in the absence of an unexpected increase in the rate of economic growth, economic growth will unlikely reduce poverty. Furthermore, the link between educational spending and economic growth has been greatly debated among many politicians and academicians. Teles and Andrade (2007), Baldwin et al (2011) and Jorgenson and Fraumeni (1992) found a positive relationship between educational spending and economic growth. In each of their studies, governmental spending on education showed a positive interaction in human capital and was able to show its affect on economic growth. According to Heim (2008), imports were examined to see the affect that rising exchange rate had on them. Further, falling exchange rates reduce the purchasing power of the dollar and increasing import prices. Higher import prices have tow effects: (1) a substitution effect that shifts demand from imported to domestically produced goods and (2) an income effect that reduces the total amount of real income available for spending on domestic goods and foreign goods. As a result of his findings, the estimated decline in the trade deficit of a one index-point decline in the U.S. exchange rate is the sum of the resulting decrease in purchases of imports and the increase in purchases of U.S. exports (Heim 2008). Hack and Vaidya (1996) examined the relationship between the degree of state international export orientation and US state industrial growth rates. They found that state export promotion expenditures were not significant in influencing domestic employment growth, while the variable was negatively correlated with export employment growth. However, a high proportion of exports to total shipments in the initial year, was significant in explaining state industrial growth rates. Fanta and Upadhyay (2009) examined the relationship among economic growth, inequality, and poverty.

Using a data set for 16 African countries, based on household budget surveys, they found strong evidence that poverty decreased in response to economic growth.

In addition to the decrease in poverty, they also concluded that the attainment of a higher level of development allows a country to translate a given growth into greater poverty reduction. Johnson et al. (2011) found long-term effects of growth on poverty either failed to strengthen or actually diminished, concluding comprehensive income estimates of poverty are less sensitive to changes in macroeconomic conditions compared with cash income poverty measures. As the economy grows, the opportunities for work expand and those who capitalize on these job opportunities experience an increase in earnings, which is a component of both cash and comprehensive income. Resulting in growth having a small effect on comprehensive income measures of poverty. In conclusion, as policymakers continue to focus on ways to increase economic growth, the ability to increase the national growth is important also. Although by increasing both local and state economies, the national economy will increase also, but other factors may need to examine to help answer, "How global factors affect both state and national growth?"

### 3. Methodology and Data

The period of study extends from 1982 to 2013. The data used were obtained from secondary sources, including the Bureau of Labor Statistics, United States Census Bureau, the Economic Report of the President, and the Statistical Abstract of the United States. The variables used in the paper are described below:

Mississippi Gross Domestic Product (MSGDP) is the monetary value of all final goods and services produced within Mississippi annually. The data was obtained from the Bureau of Economic Analysis.

State Unemployment Rate (MSunrate) is the percentage of Mississippi civilian labor force that is unemployed. The data was obtained from the U.S. Bureau of Labor Statistics.

State Educational Spending (Eduspending) refers to the allocated governmental spending given to Mississippi for educational growth and development. The data was gathered from the Economic Report of the President.

Mississippi Business Income Tax (MSbustx) refers to the tax collected from Business operating within Mississippi. The data was obtained from the Mississippi Department of Revenue.

Mississippi Income Tax (MSincometx) refers to the tax collected from residents and non-residents within Mississippi. The data was obtained from the Mississippi Department of Revenue.

Mississippi Welfare (MSWelfare) refers to the federal governmental spending given to Mississippi to assist with programs such as family and children services, unemployment, housing, and social protection. The data was obtained from the Economic Report of the President.

Mississippi College Attainment (MSCA) refers to the number of individuals 25 years and older within the State of Mississippi which obtained a college education. The data was obtained from the Statistical Abstract of the United States.

Mississippi Poverty Rate (MSpovrate) refers to percentage of individuals living under the poverty threshold. The data was obtained from the U.S. Census Bureau.

Mississippi Import (MSImp) refers to the percentage of Mississippi imports accounted for in U.S. imports. The data was obtained using the Statistical Abstract of the United States.

Mississippi Export (MSExp) refers to the percentage of Mississippi exports accounted for in U.S. exports. The data was obtained from the Statistical Abstract of the United States.

#### 3.1 The Estimation of Economic Growth in the State of Mississippi

This paper employs a single equation model to examine the factors that can affect the performance of economic growth in the state. In estimating this economic growth model, it is important to use a technique that will yield estimates that are unbiased and efficient. The ordinary least squares (OLS) and the general least squares (GLS) techniques were used to estimate the model. The economic growth model is presented below:  $MSGDP(\text{MS Growth}) = \beta_0 + \beta_1(\text{MSunrate}) + \beta_2(\text{Eduspending}) + \beta_3(\text{MSbustx}) + \beta_4(\text{MSincometx}) + \beta_5(\text{MSwelfare}) + \beta_7(\text{MSCA}) + \beta_7(\text{MSpov rate}) + \beta_8(\text{MSImp}) + \beta_9(\text{MSExp}) + u_i$  The above model takes into account a number of factors that can influence the performance of Mississippi Economic Growth. The definitions are given below in Table 1.

**Table 1: Variable Names, Their Definitions, and Measurements**

Variable	Definition	Measurement
MSGDP	MS Gross Domestic Product	\$ value of all the final goods and services produced within Mississippi annually
MSWelfare	MS Welfare	\$ value of federal government spending given to Mississippi to assist with programs such as Family and Children services, unemployment, housing, and social protection
Eduspending	MS Educational Spending	\$ value of allocated governmental spending given to Mississippi for educational growth and development
Msbustx	MS Business Tax	\$ value of tax collected from Businesses operating within Mississippi
Msunrate	MS unemployment rate	% of Mississippi civilian labor force that is unemployed
Mspovrate	MS Poverty rate	% of individuals living under the poverty threshold in Mississippi
MSCA	MS College Attainment	% of individuals 25 years and older who received a four year college education.
Msincometx	MS income Tax	\$ value of the tax collected from residents within Mississippi
MSImports	MS Imports	% of Mississippi imports accounted for in U.S. imports
MSExports	MS Exports	% of Mississippi exports accounted for in U.S. exports

### 3.1.1 Empirical Results

By evaluating the empirical results used to determine factors of Mississippi's economic growth, a more conceptual understanding of their influence can be established. The model consists of nine explanatory variables and the dependent variable. The estimation of the equation is given below in Table 2.

**Table 2: Factors That Can Affect the Performance of Economic Growth: Results**

Explanatory Variables	B Coefficients	Std. Errors	T Values	Sign. Rates
Intercept Term	<b>22.940</b>	<b>6.670</b>	<b>3.440</b>	<b>0.002</b>
MSWelfare	<b>0.081</b>	<b>3.182</b>	<b>2.130</b>	<b>0.045*</b>
MS Educational Spending	<b>0.657</b>	<b>1.446</b>	<b>5.420</b>	<b>0.000*</b>
MS Business Tax	<b>-0.138</b>	<b>5.092</b>	<b>-2.740</b>	<b>0.012*</b>
MS unemployment rate	<b>-0.046</b>	<b>0.407</b>	<b>-1.380</b>	<b>0.182</b>
MS Poverty rate	<b>-0.021</b>	<b>0.214</b>	<b>-0.880</b>	<b>0.390</b>
MS CA	<b>-0.024</b>	<b>0.229</b>	<b>-0.870</b>	<b>0.391</b>
MS income Tax	<b>0.396</b>	<b>3.833</b>	<b>4.660</b>	<b>0.000*</b>
MS Imports	<b>-0.002</b>	<b>43.363</b>	<b>-0.140</b>	<b>0.891</b>
MS Exports	<b>0.003</b>	<b>5.048</b>	<b>0.170</b>	<b>0.868</b>
AdjustedR <sup>2</sup>	<b>0.996</b>			

\*Statistically significant at .05 or less

Due to the evidence of multicollinearity, which can persist in nonstationary time series regressions, the process of taking the first-order difference of both the dependent variable and independent variables were conducted. The influence of multicollinearity can be recognized by using the Variance-inflating factor (VIF) along with evaluating the extremely high R<sup>2</sup>(Gujarati and Porter 2008).<sup>4</sup> With the F value of 842.031, the model has a good fit and 99.7 percent of the variation of the economic growth is explained by the variations in the independent variables. The variance- inflating factor being 24.69 indicated that multicollinearity existed based on 9 variables and 32 observations (Gujarati, 2008). Given the existence of multicollinearity, the model variables were transformed and re-specified and the transformed variables regressed.

<sup>4</sup> Evidence of multicollinearity was detected with an extremely high R<sup>2</sup> of 0.996 and high t-statistics of partial slope coefficients indicating significance. The use of variance inflation factor further proved multicollinearity to exist between the variables.

### 3.1.2 Extension and Correction of Economic Growth Model

The results obtained after regressing the transformed variables are shown in Table 3 below. The retested model showed that multicollinearity was eliminated by the using the first-difference method. The results obtained from the corrected model are used for the model interpretation and also compared to the current literature where possible. Economic growth was found to be positively related to personal income tax in the state of Mississippi. Thus, income tax is statistically significant in predicting economic growth in the state at the 5 percent level. This finding is consistent with that of Denaux (2007) who found that income tax had a positive impact on economic growth. Business tax was found to be negatively related to economic growth in the state of Mississippi at a 10 percent significance level. This finding is consistent with Carroll et al (2000) who found as proprietor's marginal tax rate goes up; the rate of growth of his enterprise goes down. Mississippi imports was also found to have a positive relationship to economic growth. Imports is statistically significant in predicting economic growth in the state at the 5 percent level. This finding is consistent with that of Heim (2008) who suggested that imports had a positive impact on economic growth. Economic growth was found to be negatively related to unemployment rate in the state of Mississippi, thus unemployment rate is statistically significant in predicting economic growth in the state at the 5 percent level. The finding are consistent with that of Eriksson (1997) and Burgen et al. (2012) who suggested that an increasing unemployment rate had a negative impact on economic growth.

Contrary to Jones (2002) and Goldin and Katz (2001) which suggests educational attainment leads to an increase in economic growth, the findings suggest that college attainment had a negative relationship to economic growth, thus being statistically significant in predicting economic growth in the state at the 5 percent level. This finding may be due to the low number of college educated individuals in Mississippi. The state has a low skill work force and this could have played a role on the impact of this variable. Although educational spending and welfare, were not significant in this study, the findings suggest a positive relationship among these variables to economic growth for Mississippi. This positive relationship is consistent with Baldwin et al (2011), Jorgenson and Fraumeni (1992), and Jorgenson (1981) who suggested educational investment contributed to state economic growth and Landreth (2002) and Angelucci and De Giorgi (2009) who suggested welfare assistance would assist in increasing economic growth. Moreover, economic growth was found to have a negative relationship with poverty in the state of Mississippi, but was not found to be significant. However, this negative relationship is consistent with Fording and Berry (2007) assertion that the reduction in poverty would result in an increase in personal income as well as economic growth of the state. Finally, economic growth was found to have positive relationship with exports, but was not found to be significant. However, this positive relationship is consistent with Heim (2008) assertion that exports would be affected by the decrease in purchase of imports.

**Table 3: Corrected Model using First-Order Difference Coefficients**

Explanatory Variables	B Coefficients	Std. Errors	T Values	Sign. Rates
Intercept Term	2.193	0.379	5.79	0.000
MS Welfare	0.098	1.688	0.659	0.517
MS Educational Spending	0.064	1.381	0.424	0.675
MS income Tax	0.430	2.725	2.586	0.017*
MS Business Tax	-0.241	3.089	-1.746	0.095**
MS unemployment rate	-0.353	0.204	-2.428	0.024*
MS Poverty rate	-0.129	0.169	-0.866	0.396
MS CA	0.315	0.185	-2.298	0.031*
MS IMPORTS	0.336	30.459	2.112	0.046*
MS EXPORTS	0.029	2.718	0.206	0.839
Adjusted R2	0.533			

\*Statistically significant at .05 or less

\*\*Statistically significant at .06 to .10

#### 4. Conclusion and Policy Implications

The basis for this study was to analyze economic variables and social factors which may influence Mississippi's economic growth and shed light as to their impact. This study found that unemployment rate, imports, business taxes, income taxes are factors that can significantly influence economic growth in the State of Mississippi. The statistical findings also suggest that although poverty rate was not a significant deterrent of economic growth, policies which encourage a reduction in poverty rate would lead to an increase in economic growth in the State of Mississippi. Moreover, the statistical findings suggest that welfare although found not to be a significant deterrent of economic growth, continues to be important to economic growth for the State. Therefore, acceptance of welfare policies which improve standard of living within Mississippi should be implemented and utilized. Moreover, the relationship between economic growth and taxation within this study shows that when policies are implemented to decrease business taxes, economic growth for the state of Mississippi will increase. Likewise policies which generate tax revenue from income taxation will also improve Mississippi's economic growth. Mississippi's 2012 Census suggests 20% of individuals age 25 and older have at least a bachelor's degree which would indicate a low skill work force. As a result, the high percentage of low skill work force will stagnate the relationship between economic growth and college attainment within this study due to the large percentage of workers having a high school diploma or less. Moreover, exports were found not to be significant in this study. One possible explanation could be the role of substitution and income effects on real income for spending on domestic and foreign goods. Finally, further research can be conducted to analyze other economic variables that may play a role in economic growth for the state of Mississippi.

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