

Pittsburgh, Pennsylvania



Chapter One
State Winners and Losers

State Winners and Losers

The geographical center of economic and political power in America is shifting right before our very eyes – and in a more dramatic fashion than at any time in a century. Americans are uprooting themselves and moving to places where there is economic vitality, opportunity and a high quality of life. In short, they are going to where the action is. And over the past 25 years, tens of millions of Americans (and immigrants) have voted with their feet against anti-growth policies that reduce economic freedom and opportunity in states mostly located in the Northeast and Midwest.

The big winners in this interstate competition for jobs and growth have generally been the states in the South and West, such as Nevada, Arizona, Texas and Florida, while the big losers have been in the Rust Belt regions of the Northeast and Midwest. The demoralizing symptoms of economic despair in declining states like New York, Michigan, Pennsylvania, Illinois and New Jersey include lost population, falling housing values, a shrinking tax base, business out-migration, capital flight, high unemployment rates, and less money for schools, roads and aging infrastructure.

What’s new is that California has joined the ranks of the “has been” states. Despite all of its natural geographical advantages – ports of entry to the Pacific region, balmy weather, relaxing beaches, idyllic mountains and as the Beach Boys sang, those gorgeous “California Girls” – years of redistributionist economic

policies (liberalism run amok in Sacramento) have resulted in more U.S. residents now leaving California than arriving.

The decline of California is probably the best evidence we can present as to the impact of poor state policy-making on the economic pulse of a state. Table 1 shows that in the 10 years leading up to 2007, California had the second largest domestic population outflow of any state in the nation.

Defenders of the high-tax and high-spending conditions that precipitated this fall into the economic cellar argue that big government policies and taxes on the wealthy are neces-

TABLE 1
NET DOMESTIC MIGRATION, 1998-2007

Top 10		Bottom 10	
State	Inflow	State	Outflow
Florida	+1,579,704	Connecticut	-113,892
Arizona	+817,169	Pennsylvania	-148,979
Texas	+736,903	Massachusetts	-335,391
Georgia	+679,420	Louisiana	-390,998
North Carolina	+646,284	Ohio	-397,899
Nevada	+481,534	Michigan	-419,961
South Carolina	+295,074	New Jersey	-468,024
Tennessee	+278,698	Illinois	-735,768
Colorado	+248,322	California	-1,438,480
Washington	+206,168	New York	-1,936,127

Source: U.S. Census Bureau

sary to protect the poor and the disadvantaged. Yet when flight occurs away from an area, it is always the highest achievers and those with the most wealth, capital and entrepreneurial drive who tend to “get out of Dodge” first, leaving the middle class, and then eventually only the poor and disadvantaged behind. In fact, it is only those individuals with wealth who have the means and thus the ability to choose where they will reside. Consequently, the poor are left victims of the misguided liberal policies that were enacted to assist them. The governmental hand, which sought to lift up the poor, in turn holds them down. The result is fewer taxpayers and a heavier tax burden for those who remain.

There’s an old saying that high taxes don’t redistribute income, they redistribute people. That is precisely what we have found in the research that went into writing this book. When California faced its last deficit in 2003, one of the major causes for the red ink was the stampede of millionaire households out of the state.

The July 2008 survey of 281 corporate executives by Development Counselors International revealed California, New York and Michigan as the three states with the least favorable business climates. Seventy-two percent of executives surveyed listed California as having the worst business climate, followed by New York (42.4 percent), and Michigan (16.8 percent). The most common complaints included high taxes and anti-business regulations.¹

The five least favored states – California, New York, Michigan, New Jersey and Massachusetts – hold combined projected budget deficits of nearly \$65 billion. This figure accounts for approximately 50 percent of the combined deficits that states are facing in fiscal years 2009-2010. In contrast, respondents elected Texas, North Carolina, Georgia, Tennessee and Florida (none of these being extremely high-tax states), as the top five business environments. Texas, Georgia, Tennessee, North Carolina and

Florida face combined deficits of roughly \$15 billion.²

America’s Economic Black Hole: The Northeast

The center of America has grown more fiscally conservative, more dismissive of big government command-and-control policy prescriptions, and more economically prosperous. Meanwhile, the heavily unionized, economically exhausted, industrial Northeast has edged ever further to the left. “In the rest of the country, liberal is a dirty word; in the Northeast it isn’t,” notes Darrel West, a political science professor at Brown University.³

The result: an ever widening ideological Grand Canyon between what truly are now two Americas. Let’s start by defining the geographical boundaries of this “other America.”

Michael Barone, editor of the indispensable *Almanac of American Politics*, calls this peculiar region the “New England-Metro-liner Corridor.”⁴ The issue starts in Washington, D.C., a city with no manufacturing and no industry (outside of influence-peddling), in which one out of every three households receives a government paycheck or a welfare payment. Its aid per capita has surged to among the highest of any metro-area in the United States. For the most part, Washingtonians extract wealth, they don’t create it.

If you were to drive north from Washington, you would travel directly through each of the Northeast corridor states. Welcome to Blue State America.

You would first hit affluent Montgomery County, Md. (eighth richest county in the United States⁵), with its herds of upscale federal employees and “Beltway Bandits.” Then, in succession, you would pass through America’s modern-day Rust Belt: Eastern Pennsylvania, New Jersey and New York. The shared experience of these states is oppressive tax rates, mindless and meddlesome regulation, obese social welfare programs, slumping real estate

markets, and a steady stampede of outward migration. *Wall Street Journal* political writer John Fund best summarized the climate of New York by saying, “I’ve had friends who fled from here to Eastern Europe in search of freedom.”⁶ And this is the politically conservative section of the Northeast. The rest of this “other America” encompasses the New England states of Connecticut, Maine, Massachusetts, Rhode Island and Vermont. These states are systematically anti-free, culturally left-wing enterprises. One of the most popular politicians in the region is Bernie Sanders, the Harvard professor turned Mayor of Burlington, and now Vermont Senator – and an avowed socialist. Enough said.

However, there is a tiny foothold of low taxes and free markets in this sea of statism: New Hampshire. We would add that Delaware is also more free-market oriented than its Northeastern neighbors. Its growth rates in recent years underscore its more business-friendly policies.

Mr. Fund refers to the Live Free or Die state as “the Orange County of the East Coast.”⁷ With no state income tax on wages or state sales tax, and the fifth lowest overall tax burden in the nation, New Hampshire has enjoyed the fastest growth rate in all of New England. New Hampshire is an aberration; its growth in a sea of big government neighbors is a monument to the power of free markets and low taxes. It’s not the cold weather that is causing the Northeast to atrophy. We worry, however, that increasingly New Hampshire is catching the Northeast diseases. As more and more Massachusetts refugees move there, the politics of the state are shifting to the left.

The politics of the region are solidly Democratic, but “there is one conservative issue that plays well in the Northeast these days,” explains political strategist Jeff Bell, the Republican Senate candidate in New Jersey in 1978. Northeastern voters are suffering from severe tax fatigue. For good reason. Six of the 10 states dubbed as

tax hells by *Money Magazine* are in the Northeast: Maryland, Massachusetts, Maine, Rhode Island, Washington, D.C., and New York. A typical family of four living in Maryland, for example, can save close to \$2,500 on its taxes by simply packing the U-Haul trailer and moving across the Potomac River to Virginia. (One of us, Moore, knows this, because he did it.)⁸ The average tax premium for the privilege of living in New England is more than \$4,000 – for schools, police protection, and other state and municipal services that are arguably equal to, or even inferior to those in most other areas.⁹

Yet even on the tax issue, there is a quintessential free-lunch quality to the sentiments of contemporary Northeastern voters. They gripe continuously about over-taxation, but when even modest budget restraint is suggested, the media, unions, and “poverty industry” begin invoking dark visions of the apocalypse. When Gov. Martin O’Malley of Maryland and former Gov. Elliot Spitzer of New York proposed expansive state-run health care systems, “free” child care centers, pay raises for teachers, government-subsidized sports stadiums, or some other gold-plated government scheme, Northeasterners salivated.

The governments in the Northeast are already about one-fifth more expensive than in the rest of America – \$6,400 versus \$5,200 of state spending per resident.¹⁰ Only in recent years has the gap between the New England states and the rest of the nation been narrowing (see Table 2). However, an average-income family of four still saves \$4,000 a year by moving to just an average tax state and more like \$6,000 a year by moving to Florida.¹¹ Because the Northeastern states tend to have highly progressive tax systems, the incentive for wealthy families to relocate is greater.

Meanwhile, the Northeast is becoming increasingly inhospitable for employers. Labor costs are about 30 percent above the national average in this region.¹² Of the 22 right-to-work states, a grand total of zero are in the

TABLE 2
STATE SPENDING PER CAPITA IN THE NORTHEAST

2006	
New England	
Connecticut	\$5,898.93
Maine	\$5,943.43
Massachusetts	\$6,195.30
Rhode Island	\$6,515.36
Vermont	\$7,449.37
Extended Northeast	
Delaware	\$7,639.27
Maryland	\$5,158.01
New Jersey	\$6,197.83
New York	\$7,399.36
Pennsylvania	\$5,218.15
New England Average	\$6,400.48
Extended Northeast Average	\$6,322.52
Rest of United States	\$5,221.06

Source: U.S. Census Bureau

Northeast.¹³ Other than taxes, this is arguably the greatest factor impeding economic competitiveness in the region.

When Ed Rendell became Mayor of Philadelphia in the mid-1990s, city employees received 14 paid holidays a year – compared to eight for most private sector workers. With sick leave and vacation time, some workers got up to 40 paid days off a year. Furthermore, in several school districts in New York, teachers have gone on strike despite salaries and benefits exceeding \$75,000 a year.

In isolation, none of these anti-growth public policies would cripple a state's economic competitiveness. But in the Northeast, each new piece of special-interest-driven legislation is encrusted upon layers and layers of existing anti-business rules, regulations, edicts and laws. The compounding effect has been to convert the entire region into a kind of businessman's purgatory.

For years, Northeastern politicians and academics have responded to critics with a self-delusional mantra: Taxes don't matter. Regulatory costs don't matter. Minimum wage and pro-union laws don't matter. Reminiscent of the pampered nomenclature in the final days of the Soviet Union, Northeastern elites pretend that what they have built is a modern day worker's paradise. That fantasy is losing credibility as workers rush out of the area.

The lesson of the last 50 years, especially from Eastern Europe, is that statism is difficult to sustain without a captive citizenry. There is no Berlin Wall around the Northeast. Workers, businesses and capital have freedom of exit and entry. For three decades now, Americans have been voting with their feet against the high taxes and debilitating policies of the Northeast, creating a massive brain drain from the region.

Over the past 30 years, the domestic flight from the Northeast into the Sun Belt, South-eastern, and Mountain states has begun to resemble a stampede. Rhode Island has experienced negative domestic migration over the last 10 years, which prompted the *Providence Journal* to once quip, "Will the last person in Rhode Island please turn off the lights."

New York, New Jersey, Massachusetts, Connecticut and Pennsylvania have had almost no growth in population – and without an influx of foreign immigrants, they would be suffering population losses as well.¹⁴ The 10 Atlantic states, plus Washington, D.C., have experienced a piddling population gain of less than five million, or just 5.6 percent from 1970 to 1995 (see Table 3). The rest of the nation grew six times faster. The 10 largest cities of the Northeast, once the centers of America's industrial muscle, lost a combined 1.6 million people during that same period.¹⁵

Employers are abandoning the East Coast even faster than workers. A Dunn & Bradstreet study found that, in the 1990s, New York lost more businesses than any other state. In

TABLE 3
POPULATION GROWTH TRENDS AND PROJECTIONS: NORTHEAST VS. THE REST OF THE UNITED STATES

	1970-1995	1990-2007	2000-2030
New England			
Connecticut	8%	7%	8%
Maine	25%	7%	11%
Massachusetts	7%	7%	10%
Rhode Island	4%	5%	10%
Vermont	31%	10%	17%
Extended Northeast			
Delaware	31%	30%	29%
Maryland	28%	18%	33%
New Jersey	11%	12%	16%
New York	0%	7%	3%
Pennsylvania	2%	5%	4%
Washington, D.C.	-26%	-3%	-24%
New England Average	9%	7%	11%
Extended Northeast Average	6%	11%	10%
Rest of United States	38%	25%	29%

Source: U.S. Census Bureau

the '90s, the net employment number in the Northeast decreased by nearly half a million – mostly high-paying manufacturing jobs – while the rest of the states gained 8.5 million jobs.¹⁶ This is a long-term trend. For the past 25 years, the non-Northeastern states have gained new jobs at three times the pace of the Northeastern states.

Northeasterners complain disdainfully of the “war between the states” for jobs and businesses. It’s not surprising. This is a war they cannot win. Southern and Western states are literally cherry picking companies from the North Atlantic states. One Southern governor recently told us that his state had closed its economic development offices in Europe. “Why search for factories overseas when we can plunder high-tax areas like Connecticut and New York?” he reasoned. Why indeed? Forty years ago, the Northeast was the global capital

of manufacturing. Today, manufacturing jobs are still being created in America – but down south in Alabama, North Carolina and even Mississippi.

Other statistics only would add to the depressing tale of regional sclerosis. Incomes in the Northeast grew 20 percent slower than in the rest of the nation in the 1990s. Business start-up and bankruptcy rates in the Northeast reveal less vitality and investment in the region.

Also, despite such punitively high tax rates and overly progressive tax structures, between 1989 and 2004, New England states witnessed the highest increase in income disparity in the nation.¹⁷ This change in income distribution is not only counterintuitive to such redistributive taxation, but is a direct reflection of the above discussion. What was once a thriving manufacturing and industrial center complete

with a strong and prospering middle class is now a hollowed out region whose population is dwindling by the year. What was designed as a “fairer” tax system actually backfired. Its anti-business implications ended up driving good manufacturing jobs from the region.

The Gini coefficient, a commonly used benchmark for gauging income inequality, has increased nationally over the last 15 or so years, but nowhere more dramatically than in New England. But what is even more telling of the negative impacts of a punitive tax system is the change in inequality within the different New England states. Not surprisingly, Vermont, Massachusetts and Connecticut, three states that rank rather low on the ALEC-Laffer State Economic Competitiveness Index, witnessed some of the steepest increases in income inequality. New Hampshire, the one shining star of supply-side policies in New England, maintains the third lowest Gini coefficient in the country.¹⁸

With respect to the economic importance of the Northeast, all the data point to one conclusion: It is dying. The Atlantic states are suffering from a slow-motion version of the economic paralysis now affecting much of Europe, particularly France and Sweden with their state-of-the-art, massive welfare systems.

In 2007, the Northeast was home to a smaller share of the U.S. population than ever before;¹⁹ it had a smaller industrial base and produced a smaller percentage of America’s total value added than at any time in the nation’s history. For the rest of the United States – which has impressively restructured its economy for the challenges of the productivity-driven information age – the Northeast is not so much unnecessary as it is irrelevant. Today, most of America – competitive, capital-

ist and confident – observes the Northeast through its rearview mirror. In the mid-1990s it appeared that the Northeast might have finally awakened to the error of its ways and become ready to heal itself. In New York, Gov. George Pataki and Mayor Rudy Giuliani took some bold steps to stop the bleeding. The crime rate was down by nearly half during Giuliani’s tenure as mayor, and taxes were cut more than 20 times.²⁰ Manhattan is visibly cleaner and safer and more vibrant than 15 years ago. In New Jersey, Christine Todd Whitman was elected governor and slashed income tax rates, which caused a mini-rally in the state.²¹ Tom Ridge did the same in Pennsylvania.

But for the most part, it’s back to big government normalcy in these states. Govs. Jon Corzine of New Jersey, Ed Rendell of Pennsylvania, and Jodi Rell of Connecticut have proposed giant tax increases in the last two years.²² Today, most Northeastern states have a personal income tax rate well above the national average and every

TABLE 4
TOP INCOME TAX RATES IN THE NORTHEAST

	Personal Income Tax	Corporate Income Tax
New England		
Connecticut	5.00%	7.50%
Maine	8.50%	8.93%
Massachusetts	5.30%	9.50%
Rhode Island	9.90%	9.00%
Vermont	9.50%	8.50%
Extended Northeast		
Delaware	5.95%	8.70%
Maryland	6.25%	8.25%
New Jersey	8.97%	9.00%
New York	6.85%	7.10%
Pennsylvania	3.07%	9.99%
Washington, D.C.	8.50%	9.98%
United States Median	6.00%	7.30%

Source: Tax Foundation and Laffer Associates

one of them has a corporate tax rate above the norm (see Table 4).

There is an old Wall Street adage: Sell a falling stock. Economically, the Northeast is exactly that: a falling stock.

Under normal circumstances, domestic migration would be expected to mitigate the economic and ideological distinctions among different regions. But the culturally based migration of the past decade is making the Northeast more rock-solid liberal and the rest of the nation more conservative. The Northeast's political culture is repellent to the very human capital that is the life blood of a prospering region: college graduates, entrepreneurs, conservative-oriented families with children, and the wealthy. What has been left behind in the Northeast has been a residual of welfare recipients, government workers, senior citizens and university professors.²³

State Political Winners and Losers

“At some point, the political balance in New England will tip irretrievably in favor of the redistributionists, business-bashers, anti-growth preservationists, the swelling ranks of government employees and retirees living on tax-exempt bonds,” notes John McClaughry, presi-

dent of the Ethan Allen Institute in Vermont.²⁴ “These people, whose policies have driven out those who create wealth, will be permanently in charge.” The wipeout of Republicans in the Northeast in the 2006 and 2008 elections suggests this process is well under way. Today, Republicans control a grand total of zero U.S. House seats in all of New England.

And what are they in charge of? A region consisting almost solely of tax consumers sows the seeds of its own destruction.

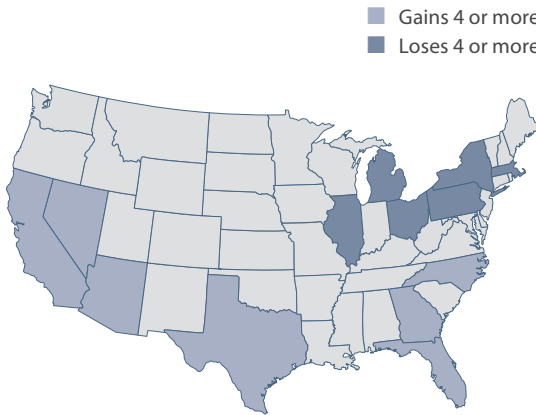
The good news is that the left's monopoly status in this region is almost inconsequential. The political clout of the Northeast hit its high watermark long ago, and with every year it continues to recede. The very demographic trends that are draining the region of economic energy are working against the Yankee states in terms of their political clout as well. In the 1950s, the Northeastern states had 141 House seats.²⁵ Now they are down to 92. They will lose four or five more seats after 2010. This slow drip, drip, drip of lost political power will continue at least through 2030, as Table 5 shows. Between 1970 and 2030, the Northeast will have lost about one-third of its political power and relevance. New York and Pennsylvania will have lost 40 percent of their congressional seats.

TABLE 5
CHANGE IN APPORTIONMENT OF HOUSE SEATS IN THE NORTHEAST

	Apportioned Reps Based on 1970 Census	Apportioned Reps Based on 2000 Census	Apportioned Reps Based on Census Projection 2030	Seat Gain/Loss 1970-2030
New England				
Connecticut	6	5	4	-2
Massachusetts	12	10	8	-4
Rhode Island	2	2	1	-1
Extended Northeast				
New Jersey	15	13	12	-3
New York	39	29	23	-16
Pennsylvania	25	19	15	-10

Source: House of Representatives, Office of the Clerk and the U.S. Census Bureau

FIGURE 1
CONGRESSIONAL SEAT APPORTIONMENT: 1970-2030



Source: House of Representatives, Office of the Clerk and the U.S. Census Bureau

Figure 1 shows the shrinking political influence of the Northeast and Midwest as well. Political power has shifted steadily to the perimeter states in the South and West. The red states are gaining muscle as the Northeast corridor surrenders its command of national politics. As with every failing institution in the world today, the Northeast now confronts a clear choice: Change or die. At the time of this writing, it is not clear that the political class in the region will choose the right course.

The ALEC-Laffer Economic Competitiveness Model

Of course, every state aspires to be a high-octane, high-growth state – a place of destination, not a place where people say with nostalgia that they are “from.” The Economic Performance Rankings in chapter four didn’t just happen by chance. It is not a random occurrence that people move from Connecticut to Florida or from California to Nevada. They are driven by the law of supply and demand: High-growth states supply jobs, high incomes, and opportunities that Americans demand.

In this ALEC book, we investigate what

policy levers state legislators control that can make their state a desired location. Many of the most important factors that make a place attractive – such as the climate, accessibility to beautiful beaches or mountains, or the mineral resources in the ground – are of course, beyond the control of politicians. No one should think that Newark, N.J. will ever compete on equal footing with Malibu, Calif., or that Flint, Mich. will ever be as desirable a destination as Palm Beach, Fla.

But the central premise of this publication is that the economic policy decisions made by state legislators don’t just matter in terms of how a state performs financially, they matter a whole lot. We know that national leaders can impact the desirability of living or investing in a nation. Likewise, state officials can also influence these factors – the economic, fiscal, and social policy legislation that contribute to, or in all too many cases against, the desirability of a state. If you don’t believe that economic policies matter, then why is it that thousands upon thousands of people in East Germany risked their lives and fortunes every year to get through the Berlin Wall to move to West Germany? Or why has the population of South Korea increased four times faster than the population of North Korea? Why is it that Mexicans line up at the U.S. border to get into this nation and live and work here by whatever means they possess, and yet few Americans sneak over the border to get into Mexico?

A logical extension of firms setting up operations in economically friendly countries is that companies based in the United States also place their operations in states within the United States that offer the best business environment. Earlier this year, *Fortune* published the 2008 edition of the Fortune 500, their ranking of the country’s top 500 companies based on gross revenue. While there were no big surprises in terms of winners and losers or entries and exits, we did notice an interesting change in the geographical distribution of this year’s

Fortune 500. Texas posted 58 companies on the Fortune 500, up from 56 last year, overtaking New York, which dropped from 57 to 55, as the state home to the most Fortune 500 headquarters.²⁶ This shift in corporate headquarters is merely the latest example of the pivotal role that fiscal policy, especially tax rates, plays in the economic competitiveness and attractiveness of a state.

When you consider the economic rationale, it comes as no surprise to us that companies are moving to low-tax, right-to-work states like Texas at the expense of high-tax, high-regulation states like New York. Not only does New York state have a corporate income tax of 7.1 percent, but for companies in the New York City metropolitan region there is an additional mass transit surcharge of 17 percent, which brings the overall rate to 8.3 percent. And if that's not enough, New York City imposes its own non-deductible corporate tax rate that brings the rate up to an astounding 17.63 percent! Now it's one thing for people to "vote with their feet" in response to high personal marginal tax rates, but when a Fortune 500 company decides to relocate its headquarters, it takes with it a multitude of resources, hundreds if not thousands of jobs, and millions in tax revenue.

In this study, we have identified 15 policy variables that have a proven impact on the migration of capital – both investment capital and human capital – into and out of states. They are the basic ingredients of our 2009 Economic Competitiveness Rankings of the states. Each of these factors is influenced directly by state lawmakers through the legislative process. Generally speaking, states that spend less – especially on income transfer programs, and states that tax less – particularly on productive activities such as working or investing – experience higher growth rates than states which tax and spend more. The 15 factors are as follows:

- Highest Marginal Personal Income Tax Rate
- Highest Marginal Corporate Income Tax Rate
- Personal Income Tax Progressivity
- Property Tax Burden
- Sales Tax Burden
- Tax Burden From All Remaining Taxes
- Estate Tax/Inheritance Tax (Yes or No)
- Recent Tax Policy Changes 2007-08
- Debt Service as a Share of Tax Revenue
- Public Employees Per 1,000 Residents
- Quality of State Legal System
- State Minimum Wage
- Workers' Compensation Costs
- Right-to-Work State (Yes or No)
- Tax or Expenditure Limit

Based on these factors, we rank the competitiveness of the states in Table 6.

In the following pages, we provide a more in-depth look into the policy variables that make up the ALEC-Laffer State Economic Competitiveness Index. We also will provide a primer on how and why taxation, over-spending, regulation, excessive litigation, and other factors in our index inhibit a state's capability to generate economic growth and jobs. Because taxation is one of the most heavily weighted factors in our index, let's start by reviewing why higher tax rates inhibit the economic performance of states. And also, let us establish some basic rules for state policy-makers to live by regarding the effect of taxes on economic performance. Later, we will address the importance of the remaining policy variables.

The 10 Principles of Effective Taxation

Principle #1:

Tax something and you get less of it.

Tax something less and you get more of it.

Tax policy is all about reward and punishment. Most politicians know instinctively that taxes reduce the activity being taxed – even if they

TABLE 6
2009 STATE ECONOMIC OUTLOOK RANKINGS
 based upon equal-weighting of each state's rank in 15 policy variables

Rank	State	Rank	State
1	Utah	26	Massachusetts
2	Colorado	27	Wisconsin
3	Arizona	28	Maryland
4	Virginia	29	Nebraska
5	South Dakota	30	Montana
6	Wyoming	31	Delaware
7	Nevada	32	Connecticut
8	Georgia	33	West Virginia
9	Tennessee	34	Michigan
10	Texas	35	Iowa
11	Florida	36	Kentucky
12	Arkansas	37	New Hampshire
13	North Dakota	38	Alaska
14	Idaho	39	Oregon
15	Oklahoma	40	Minnesota
16	Alabama	41	Hawaii
17	Indiana	42	Pennsylvania
18	Louisiana	43	California
19	Mississippi	44	Illinois
20	South Carolina	45	Ohio
21	North Carolina	46	New Jersey
22	Washington	47	Maine
23	Missouri	48	Rhode Island
24	Kansas	49	Vermont
25	New Mexico	50	New York

don't care to admit it. Congress and state lawmakers routinely tax things that are "bad" like cigarettes, alcohol consumption and gambling to discourage the activity. We reduce, or in some cases, entirely eliminate taxes on behavior that we want to encourage, such as home buying, going to college, investing in energy efficient appliances and giving money to charity. By lowering the tax rate (in some cases to zero), we lower the after-tax cost, in the hopes that this

will lead more people to engage in that activity.

This is why it is wise to keep taxes on work, savings and investment as low as possible in order not to deter these activities.

Case Study:

The Empire State: Taxed to Death

No state better exemplifies the impact of over taxation on work and investment than New York. New York economist and professor Steve

Kagann found that between 1975 and 2000, there was a clear inverse relationship between New York's job creation and its tax burden. Here is how Kagann describes these results:

“History demonstrates that the ability of the upstate [New York] economy to provide opportunity, prosperity, and stability for New Yorkers is directly and inversely related to the propensity of the state government to spend and tax. More government means fewer jobs and less growth. When government becomes a growth industry, the private sector heads South – in New York's case, figuratively and literally.”

After adjusting for wage and cost-of-living differences, the average New Yorker can expect to keep slightly more than 65 cents of every \$1.00 earned – and this is before the impact of the federal income tax has been calculated. Because of this confiscatory rate, New York has the worst income incentive rate in the country. The state also imposes the largest property tax burdens on its citizens as well as a highly progressive tax code that further discourages innovation and economic activity.

Between 1995 and 1998, New York cut taxes under Gov. George Pataki.²⁷ The result was a temporary revival and the best private economy performance in decades. New York raised more money in the eight years after George Pataki chopped tax rates than did Mario Cuomo in the eight years after he raised taxes. But taxes rose again in the late 1990s and early 2000s, and the upstate region is again one of the most depressed areas in the nation.

Principle #2:

Individuals work, and produce goods and services to earn money for present or future consumption.

Workers save, but they do so for the purpose of husbanding their resources so they or their children can consume in the future. A corollary

of this proposition is that people do not work to pay taxes – though some politicians seem to think they do.

Case Study:

The Supply-Side Version of Robin Hood

Don't believe for a moment that highly progressive tax structures in California or New York help the poor, minorities, or the disenfranchised. They don't. Just on an intuitive level, it should be self-evident that if a government taxes people who work to pay people who don't work, there will be more people who don't work and fewer people who do.

All of us understand the importance of helping those who have difficulty helping themselves. The question is not whether you want to help the poor. The question is, how can you make the poor better off.

If the rich are taxed and the money is given to the poor, do not be surprised if the number of poor people increases and the number of rich subsidies. People respond to incentives; it is the way the world works. If you make an activity less attractive, people will do less of it. If you make an activity more attractive, people will do more of it. Taxes make an activity less attractive and subsidies make an activity more attractive.

Let's retell the story of Robin Hood through the supply-side lens. Robin Hood and his band of merry men would start their days hiding among the trees in Sherwood Forest waiting for hapless travellers on the trans-forest throughway.

If a rich merchant came by, Robin Hood would strip him of all his belongings. Before you feel sorry for the guy, remember he is so rich that by the time he gets back to his castle there will be an abundance of jewels and wealth waiting for him. He'll be just fine, none the worse for the wear.

If just a prosperous merchant came through the forest, Robin Hood would take almost everything the guy had, but not all. Of a nor-

mal, everyday businessman's belongings, Robin Hood would seize just a moderate chunk. And if a poor merchant came through the forest, one who could barely make it, he would be deprived of a little token.

In the vernacular of our modern day society, Robin Hood had a progressive stealing structure. You recognize the model, don't you? Doesn't it sound like the California government to you or other tax systems used in this country?

At the end of the day, Robin Hood and his men would take their contraband back to Nottingham to "help" the poor. They would distribute their treasures to citizens, based on their destituteness.

Using today's words, the more a person makes, the less Robin Hood gives him, and the less a person makes, the more he gives him. You follow the model: He stole from the rich and gave to the poor. The richer you were, the more he'd steal from you, the poorer you were the more he'd give to you. This is the story of Robin Hood.

Now, put on your supply-side economics hat and imagine for a moment you are a merchant back in the ancient days of Nottingham: How long would it take you to learn not to go through the forest?

Those merchants who couldn't afford armed guards would have to go around the forest in order to trade with the neighboring villages. Of course the route around the forest is longer, more treacherous, and as a result, more costly.

Those merchants who could afford armed guards (and by the way, today we call these armed guards lawyers, accountants and lobbyists) would go through the forest and Robin Hood couldn't rip them off. As a result, he had no contraband to give to the poor. All he had succeeded in doing was driving up the cost of doing business, which meant the poor had to pay higher prices and were literally worse off. By stealing from the rich and by giving to the poor, Robin Hood made the poor worse off.

And so it is in high-tax states. The poor who rely on the state for their sustenance are having their benefits cut to the bone. Because of some state's business-unfriendly policies, unemployment rates rise. We could go on, but the point is simple enough and its significance cannot be overstated: progressive tax structures do not benefit the truly needy.

In its attempts to redistribute income, government never, ever succeeds. What it does accomplish is the destruction of the volume of income. Government cannot change the distribution of income with taxes, but it can – and does – lower the volume of income with taxes. As we look across the world at the progressive tax structure of California and other economies, it's amazing to see how the distribution of income, if anything, is made worse.

Principle #3:

Taxes create a wedge between the cost of working and the rewards of working.

To state this in economic terms: the difference between the price paid by people who demand goods and services for consumption, and the price received by people who provide these goods and services – the suppliers – is called the wedge. Income and other payroll taxes, as well as regulations, restrictions and government requirements, separate the wages paid by employers from the wages received by employees. If a worker pays 15 percent of his income in payroll taxes, 25 percent in federal income taxes, and 5 percent in state income taxes, his \$50,000 wage is reduced after-tax to \$27,500. The lost \$22,500 of income is the tax wedge. The wedge is the difference, or some 45 percent. Large as the wedge seems in this example, it is just part of the total wedge. The wedge also includes excise, sales and property taxes plus an assortment of costs such as the market value of the accountants and lawyers hired to maintain compliance with government regulations. As the wedge grows, the total cost to the firm of employing a person goes up, but the net

payment received by the person goes down. Thus, both the quantity of labor demanded and quantity supplied fall to a new, lower equilibrium level, and a lower level of economic activity ensues. This is why all taxes ultimately affect people's incentive to work and invest, though some taxes clearly matter more.

Principle #4:

An increase in tax rates will not lead to a dollar-for-dollar increase in tax revenues, and a reduction in tax rates that encourages production will lead to less than a dollar-for-dollar reduction in tax revenues.

Lower marginal tax rates reduce the wedge and thus lead to an expansion in the production base and improved resource allocation. Thus, while less tax revenue may be collected per unit of tax base, the tax base itself increases. This expansion of the tax base will therefore offset some (and in certain cases, all) of the loss in revenues because of the now lower rates.

Tax rate changes also affect the amount of tax avoidance. It is important to note that legal tax avoidance is differentiated throughout this report from illegal tax evasion. The higher the marginal tax rate, the greater the incentive to reduce taxable income. Tax avoidance takes many forms, from workers electing to take an improvement in nontaxable fringe benefits in lieu of higher gross wages, to investment in tax shelter programs. Business decisions, too, are increasingly based on tax considerations as opposed to market efficiency. For example, at a 40 percent tax rate, which taxes \$40 of every \$100 earned, the incentive to avoid this tax is twice as high as when the tax rate is 20 percent and the worker forfeits \$20 for every \$100 earned.

An obvious way to avoid paying a tax is to eliminate market transactions upon which the tax is applied. This can be accomplished through vertical integration: Manufacturers can establish wholesale outlets, retailers can purchase goods directly from the manufac-

turer, and companies can acquire suppliers or distributors. The number of steps remains the same, but fewer and fewer steps involve market transactions and thereby avoid the tax. If states refrain from applying their sales taxes on business-to-business transactions, they will avoid the numerous economic distortions caused by tax cascading. Michigan, for instance, should not tax the sale of rubber to a tire company, then tax the tire when it is sold to the auto company, then tax the sale of the car from the auto company to the dealer, and then tax the dealer's sale of the car to the final purchaser of the car, or else the rubber and wheels will be taxed multiple times. Additionally, the tax costs embedded in the price of the product would remain hidden to the consumer.

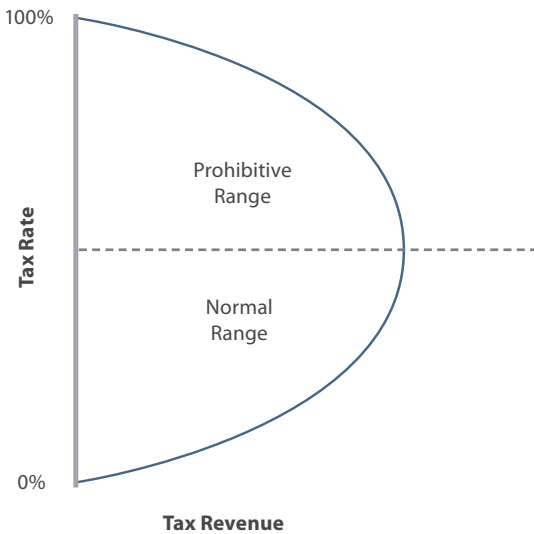
Principle #5:

If tax rates become too high, they may lead to a reduction in tax receipts. The relationship between tax rates and tax receipts is a proposition known as the Laffer Curve.

The Laffer Curve (see Figure 2) summarizes a series of these diagrams. We start this curve with the undeniable fact that there are two tax rates that generate zero tax revenues: a zero tax rate and a 100 percent tax rate. (Remember Principle #2: People don't work for the privilege of paying taxes, so if all their earnings are taken in taxes, they don't work, or at least they don't earn income that the government knows about, and thus the government gets no revenues.)

Now, within what is referred to as the "normal range," an increase in tax rates will lead to an increase in tax revenues. At some point, however, higher tax rates become counterproductive. Above this point, called the "prohibitive range," an increase in tax rates leads to a reduction in tax revenues and vice versa. Over the entire range, with a tax rate reduction, the revenues collected per dollar of tax base falls. This is the arithmetic effect. But the number of units in the tax base expand. Lower tax rates lead to higher levels of personal income,

FIGURE 2
THE LAFFER CURVE



employment, retail sales, investment and general economic activity. This is the economic or incentive effect. Tax avoidance also declines. In the normal range, the arithmetic effect of a tax rate reduction dominates. In the prohibitive range, the economic effect is dominant.

Of course, where a state's tax rate lies along the Laffer Curve depends on many factors, including tax rates in neighboring jurisdictions. If a state with a high employment or payroll tax borders a state with large population centers along that border, businesses will have an incentive to shift their operations from inside the jurisdiction of the high-tax state and into the jurisdiction of the low-tax state.

Economists have observed a clear Laffer Curve effect with respect to cigarette taxes. States with high tobacco taxes that are located next to states with low tobacco taxes have very low retail sales of cigarettes relative to the low-tax states. Illinois smokers buy many cartons of cigarettes when in Indiana, and the retail sales of cigarettes in the two states bear this out. The same is true of high gas taxes. Motorists, especially truckers, "fill 'er up" before they enter the state.

Principle #6:

The more mobile the factors being taxed, the larger the response to a change in tax rates. The less mobile the factor, the smaller the change in the tax base for a given change in tax rates.

Taxes on capital are almost impossible to enforce in the 21st century because capital is instantly transportable.

For example, imagine the behavior of an entrepreneur or corporation that builds a factory at a time when profit taxes are low. Once the factory is built, the low rate is raised substantially without warning. The owners of the factory may feel cheated by the tax bait and switch, but they probably do not shut the factory down because it still earns a positive after-tax profit. The factory will remain in operation for a time even though the rate of return, after tax, has fallen sharply. If the factory were to be shut down, the after-tax return would be zero. After some time has passed, and equipment needs servicing, the lower rate of return will discourage further investment, and the plant will eventually move where tax rates are lower.

One recent study by the American Enterprise Institute found that high corporate income taxes at the national level are associated with lower growth in wages.²⁸ Again, it appears a chain reaction occurs when corporate taxes get too high. Capital moves out of the high-tax area, but wages are a function of the ratio of capital to labor, so the reduction in capital lowers the wage rate.

The distinction between initial impact and burden was perhaps best explained by one of our favorite 20th century economists, Nobel winner Friedrich von Hayek, who makes the point as follows:

"The illusion that by some means of progressive taxation the burden can be shifted substantially onto the shoulders of the wealthy has been the chief reason why taxa-

*tion has increased as fast as it has done and that, under the influence of this illusion, the masses have come to accept a much heavier load than they would have done otherwise. The only major result of the policy has been the severe limitation of the incomes that could be earned by the most successful and thereby gratification of the envy of the less well off.*²⁹

Case Study:

Taxes and Housing Prices

The least mobile factors of production are land and housing. If the tax burden becomes excessive in a state or city, we could expect capital to leave, followed by businesses and families. But it's hard, if not impossible, to take your house and land with you. It is left behind and thus in theory, land values and housing prices will bear the ultimate burden of higher taxes.

Several years ago we tested this proposition with Dr. Richard Vedder of Ohio University.³⁰ We examined the 10 states with the largest increases in state and local tax burden as a percentage of income, 1980-1990, and compared them with the 10 states with the smallest increases – actually, decreases – in tax burden for the same time period. Correcting for inflation, *real housing prices fell significantly – more than 12 percent – in the big tax-increase states, while real housing prices on average rose dramatically – almost 58 percent – in the big tax-reduction states.* For the continental United States as a whole, real housing prices experienced a modest increase of about eight percent.

This conclusion was not some sort of statistical fluke arising from one or two extreme values. Of the 10 states with the biggest percentage increase in tax burdens, nine of them saw a decline in housing values after allowing for inflation (Ohio, Indiana, Washington, West Virginia, Idaho, Texas, Iowa, Oregon and Oklahoma). Only one state with significant tax increases had a rise in housing prices – South Carolina – and even there the increase in hous-

ing prices was in the single digits, and far less than in its neighbors to the north – North Carolina – or south – Georgia.

We also found that it wasn't just higher property taxes that held down housing prices. Changes in all forms of taxation have a negative effect on variations in housing prices. Although property tax changes have the biggest impact on housing price changes, other forms of taxation exhibit the same effects. This negative relationship was observed throughout the '70s, '80s, and '90s.

One example of this tax-substitution effect was the response to the steep increases in income taxes on the rich in New Jersey in the early 1990s. The new tax was only intended to impact the wealthiest families in the Garden State. But taxes were raised so high that many of the tax-targeted families moved out of the state. This outmigration caused a reduction in property values at the high end of the market, but the slump eventually invaded the middle-class housing market. The middle class paid the taxes levied on the rich, in part through depressed home prices. That was one reason the taxes on the rich caused a middle class revolt.

Once known for its high levels of economic growth and low levels of taxation, New Jersey has lost its competitive advantage. Public sector unions have won billions in massive wage and benefit packages, leaving the state with a \$4.5 billion deficit in 2006, despite a national economic boom. This lies in stark contrast to the state's economic history. At one time, New Jersey's tax burden ranked 40th among states, 13 percent below the national average. It was once one of only two states that did not levy a sales or an income tax.³¹

Recently, however, New Jersey has embraced the restrictive tax policies of its Northeastern neighbors at a seemingly ever faster clip. From 2002 to 2004, the state increased taxes and fees more than 30 times to the tune of \$3.6 billion. They implemented an estate tax,

which kicks in at \$675,000 – a threshold significantly lower than the \$3.5 million federal level. Taxes on individuals and corporations have also increased dramatically. New Jersey's anti-growth policies are succeeding in shifting resident behavior. From 1998 to 2007, the state lost 468,000 more residents than it gained.³²

Principle #7:

Raising tax rates on one source of revenue will reduce the tax revenue from other sources. Reducing the tax rate on one activity will raise the taxes generated from other activities.

For example, an increase in the corporate profits tax rate would be expected to lead to a diminution in the amount of corporate activity, and hence profits, within the taxing district. That alone implies less than a proportionate increase in corporate tax revenues. Such a reduction in corporate activity also implies a reduction in employment and personal income. As a result, personal income tax revenues would fall. This decline, too, would offset the increase in corporate tax revenues. Conversely, a reduction in corporate tax rates would lead to a less than expected loss in revenues and an increase in tax receipts from other sources.

Principle #8:

An economically efficient tax system has a sensible, broad tax base and a low tax rate.

Ideally, the tax system of a state, city or nation will minimally distort economic activity. High tax rates alter economic behavior. Ronald Reagan used to tell the story that he would stop making movies during his acting career once he was in the 90 percent tax bracket because the income he received was so low after taxes were taken away. If the tax base is broad, tax rates can be kept as low and nonconfiscatory as possible. This is one reason that we favor a flat tax with minimal deductions and loopholes. It is also why 24 nations now have adopted the flat tax around the world.³³ (We would add that ALEC has great model legislation for

states considering a flat tax.)

Principle #9:

Income transfer payments (welfare) create a de facto “tax” on working and thus have a high impact on the vitality of a state’s economy.

Unemployment benefits, welfare payments, and subsidies represent a redistribution of income. For every transfer recipient, there is an equivalent tax payment or future tax liability. Thus, income effects cancel. In many instances, these payments are given to people only in the absence of work or output. Examples include food stamps (income test), Social Security benefits (retirement test), agricultural subsidies, and of course, unemployment compensation itself. Thus, the wedge on work effort is growing at the same time that subsidies to nonwork are increasing. Transfer payments represent a tax on production and a subsidy to leisure. Their automatic increase in the event of a fall in market income leads to an even sharper drop in output.

In some high-benefit states such as Hawaii, Massachusetts and New York, the entire package of welfare payments can pay people the equivalent of a \$10-an-hour job – and don't forget welfare benefits are not taxed, but wages and salaries are. Because these benefits shrink as income levels from work climb, welfare can impose very high marginal tax rates – 60 percent or more – on low-income Americans. And those tax rates have a deleterious effect. We found a highly significant negative relationship between the level of benefits in a state and the percentage reduction in case-loads.³⁴

The 10 states with the lowest benefit levels slashed their caseloads by 58 percent between 1993 and 1998. The 10 states with the highest benefit levels only trimmed their caseloads by half that much. Hawaii, which offered the most generous welfare benefits of any state, totaling more than \$30,000 a year, recorded the smallest reduction in caseloads in the nation in the 1990s.³⁵ Conversely, Mississippi, whose wel-

fare package provided less than \$11,000 a year, reduced its rolls by an impressive 70 percent. High benefit levels reduce the attractiveness of a normal 40-hour-a-week job.

In sum, high welfare benefits increase the tax wedge between effort and reward. As such, output would be expected to fall as a consequence of making benefits from not working more generous. Thus, an increase in unemployment benefits is expected to lead to a rise in unemployment.

And finally, and most important of all for state legislators to remember:

Principle #10:

If there are two locations, A and B, and if taxes are raised in B and lowered in A, producers and manufacturers will have a greater incentive to move from location B to location A.

Our favorite real life example of this principle comes from Tennessee, which is location A in our example above, and Kentucky, which is location B.

Case Study:

Tennessee vs. Kentucky

Tennessee borders eight states, but Kentucky has the longest border and is probably the state most similar to the Volunteer State in many respects. The two states have similar histories and have comparable economic bases. In 1980, per capita income in the two states was just \$8 (0.1 percent) apart.³⁶

One big way in which Kentucky sets itself apart from Tennessee is tax policy. In 1980, state and local taxes as a percentage of personal income were about 10 percent higher in Kentucky than in Tennessee, with the critical difference being that Kentucky levied a personal income tax, and Tennessee did not. From 1980 to 1996, Tennessee maintained its low-tax climate with taxes as a percentage of personal income actually falling slightly. By contrast, Kentucky went in the opposite direction, raising taxes more than Tennessee

and its eight bordering states. Its income tax burden expanded enormously. By 1996, taxes per \$1,000 in personal income were \$117.29 in Kentucky, but only \$90.42 in Tennessee. The Kentucky tax burden was nearly 30 percent higher than in the Volunteer State.

What happened to the economies of the two states? Both grew, but Tennessee's percentage growth in real output per capita was more than one-third larger than Kentucky's. Whereas Tennessee's income per capita was a minuscule \$16 higher than Kentucky's in 1980 (in 1999 dollars), by 1998 the income disparity had grown 129-fold to \$2,064. It now takes the typical Kentuckian 13 months to make the income that a resident of Tennessee makes in a year.

Kentucky's income tax was a key factor in its relative stagnation for two reasons. First, as stated above, dollar for dollar, income taxes are worse than other taxes since they are a direct burden on production and income. Second, income tax revenues typically rise faster than incomes over time. Therefore, the overall tax burden tends to rise automatically in states relying on income taxes, unlike with states where sales, property and other forms of taxation dominate. Since, dollar for dollar, private sector activity is more efficient and growth-inducing than public sector spending, the effect of income taxes on increasing the size of the public sector also retards economic growth in the long run. If Kentucky hopes to pick up ground lost to Tennessee, it will almost certainly have to lower its income tax, if not eliminate it altogether.

Taxes and Growth: Academic Studies

Now we examine the real world evidence of the impact of taxes on relative state economic performance. Does the evidence match our taxation principles listed above? Do taxes have the "power to destroy?"

Some of the most persuasive studies on the relative economic competitiveness of states ex-

amine a cross section of states to systematically determine the impact of tax policies on growth rates among states. In their analysis of the probable impact of the passage of Proposition 13 in California, Kadlec and Laffer examined the relationship between changes in the level of state and local tax revenues as a percentage of personal income and growth in personal income.³⁷ Observations from the 20 states with the largest property tax revenues in 1965 and 1975 were used. Taxes were disaggregated in property taxes and all other taxes. The results showed a statistically significant negative relationship between increases in each tax burden and the rate of growth in personal income.

A more extensive study by Genetski and Chin (1978) performed a cross sectional analysis on all 50 states and the District of Columbia. Again, changes in relative economic growth were related to changes in relative tax rates, this time between 1969 and 1976. The study concluded that during this time period, economic growth rates of particular states were not associated with relative levels of state and local tax burdens. A weak relationship was found based on changes in the states' relative tax burden. Those states that had above average increases in their tax burdens tended to experience below average economic growth, and vice versa. However, once allowance was made for a three-year period of adjustment, a strong negative relationship was evident between above average increases in tax burdens and economic growth. The study concludes, in part, that "much of the slower than average economic growth experienced in many of the Northeastern states, such as New York, Connecticut, Rhode Island, Vermont, New Jersey and Massachusetts, appears to be related to the sharp increases in relative tax burdens in those states. In contrast, New Hampshire's relative tax burden was lowered during this period, and its economic growth was above the national average. Similarly, the above average economic growth experienced

in many Western and Southern states during this period is associated with decreases in their relative tax burdens."

Newman (1979) analyzed the relative growth rate in employment in the South relative to the non-South in 16 manufacturing industries and six other industries. The impact of three variables – corporate income taxes (changes in the corporate tax rate relative to the national average lagged behind by 10 years), business climate (as indicated by "right-to-work laws") and unionization (union membership as a fraction of nonagricultural work force) – were quantified. Newman's empirical results indicate that changes in relative corporate tax rates over this period, as well as the extent of unionization and the existence of right-to-work laws, were major factors influencing the shift of industry to the South from the non-South. Moreover, the evidence suggests that capital intensive industries are more sensitive to changes in the tax rate differentials, and less sensitive to labor cost differentials than are relatively labor intensive industries.

In a 1982 study, economist Robert Genetski of the Harris Bank in Chicago compared taxes as a percentage of income in a state with income growth in the state between 1963 and 1980. Although he did not find a systematic relationship between average tax burden and income growth, he did uncover "an inverse relationship between changes in state relative tax burdens and state relative economic growth." According to Genetski, "Those states with decreasing relative tax burdens tend to experience subsequent above average income growth. Those states with increasing relative tax burdens tend to experience subsequent below average growth."

The Joint Economic Committee (JEC) of Congress has further substantiated this finding. In a 1982 study, the JEC compared the tax policies in the 16 fastest income-growing states and the slowest income-growing states from 1970 to 1979. The results demonstrated that

income growth in a state is inversely related to 1) the level of state and local tax burdens, 2) the changes in state and local tax burdens, 3) the amount of income taxes levied in the state and 4) the progressivity of the income tax rates in the state. These relationships were found to be statistically significant. The conclusion of the study was as follows:

“The evidence is strong that tax and expenditure policies of state and local governments are important in explaining variations in economic growth between states far more important than other factors frequently cited such as climate, energy costs, the impact of federal fiscal policies, etc. It is clear that high rates of taxation lower the rate of economic growth, and that states that lower their tax burdens are rewarded with an enhancement in their economic growth. Income taxes levied on individuals and corporations are particularly detrimental to growth, more so than consumption based taxes or user charges that do not reduce incentives to work or form capital. Progressive taxation not only lowers the rate of economic growth compared with proportional or regressive taxation, but in the process hurts the very persons that progressive taxes are designed to help: The poor.”

The JEC study determined a special sensitivity of a state’s economy to changes in income taxes. The JEC discovered that the top 10 income-tax-hiking states experienced a loss of 182,000 jobs, a 2.3 percentage point increase in the unemployment rate, and a \$613 real decline in personal income per family of four. The top 10 income-tax-cutting states saw 975,000 new jobs, an increase in the unemployment rate of only 0.3 percentage points, and a \$148 real increase in personal income per family of four.

In a 1985 study, economists Michael Wasylenko and Therese McGuire, found that be-

tween 1973 and 1980, the overall tax effort (taxes as a percentage of income) in a state had “a negative and statistically significant effect on overall employment growth and on employment growth in manufacturing, retail trade and services.” They also found that sales taxes, which are traditionally thought not to impair employment opportunities “had a negative and statistically significant effect on wholesale trade employment.” The single stipulation to this general finding was that when the increased taxes were used to fund education, the effect on growth of taxes was positive.

Economist Robert Newman (1983), examining state employment growth between 1957 and 1973, also concluded that taxes have a significant negative effect. High corporate taxes were found to be particularly important in reducing state employment in “capital intensive industries.”

Businesses flee and avoid states with high relative tax burdens. In 1985, Timothy Bartik of Vanderbilt University reported that the plant location decisions between 1972 and 1978 of Fortune 500 companies were significantly influenced by state tax policies. According to Bartik:

“A 10 percent increase in a state’s corporate income tax rate (for example, from 4.0 percent to 4.4 percent) is estimated to cause a 2-3 percent decline in the number of new plants. A 10 percent increase in a state’s average business property tax rate (for example, from 2.0 percent to 2.2 percent) is estimated to cause a 1-2 percent decline in the number of new plants... These changes in business location patterns put some limitations on the ability of states to redistribute income away from corporate stockholders, both in state and out of state, and toward other state residents.”

In some cases, state and local governments have so appreciably shrunk their corporate tax

base due to high tax burdens that higher taxes have even produced lower – not higher – revenues. The classic case of this was in high-tax New York during the 1970s when more than half-a-million people left the state, causing a loss of state and local tax revenues of \$640 million. According to a 1976 New York State Special Task Force on Taxation to investigate the flight of people and capital:

“There is evidence that the present tax structure is, in many respects, counterproductive, fostering as it has an exodus of business, industry, and individuals, eroding the tax base, and shifting the burden of taxation relentlessly down the income scale. Either New York reduces tax levels now, or New York, by inaction, will suffer an even greater revenue loss through further erosion of its tax base.”

That was a prescient prediction, given the continued decline of New York in the 1970s and '80s.

Progressive Income Taxes: The Worst

One recent study designed to document an inverse relationship between state tax burden and economic performance was published in 1996 by economists at the Federal Reserve Bank of Atlanta.³⁸ The Atlanta Fed study examined personal income growth in the states over the period of 1961-92. The study was pioneering in the sense that it examined the impact of average tax rates and marginal tax rates on income growth. The Fed study concluded that “relative marginal tax rates have a statistically significant negative relationship with relative state growth.” It further found that state and local tax rates “have temporary growth effects that are stronger over shorter intervals and a permanent growth effect that does not die out over time. This finding supports the inference that part of growth is endogenous and susceptible to policy influence.”

As such, states with progressive income taxes that tax productive activity the most will have less economic growth. And furthermore, the power of incentives does not stop at our country’s borders. Because of the relative incentive differences between the United States (especially the most pro-growth states within the country) and the rest of the world, America truly is the only country that is both a developed economy and a growth economy.

Case Study:

What about “Fairness”

Pro-tax income-redistributionists argue that high tax rates on the rich are necessary to help the poor and promote a just and equitable sharing of the tax burden, based on ability to pay. In fact, one liberal think tank in the early 1990s ranked states on the “fairness” of their tax systems. “Fair” was defined as imposing a heavy tax burden on the wealthy, relative to the tax burden on the poor. States with high income tax rates tended to be labeled “fair” and states without income taxes were generally labeled the least fair.

So we used the index created by this liberal group, Citizens for Tax Justice, and we examined the migration patterns in and out of these states. We found that states with the highest tax rates on the richest one percent had much lower population growth than states with no income tax or flat rate income taxes. The highly progressive income tax states had average population growth from 1980 to 1990 that lagged 2.4 percent below the national trend. The non-income tax states had population growth on average nine percent above the U.S. average. It appears that millions of Americans vote with their feet against “tax fairness.”

The Most Recent Evidence on State Taxes and Growth

We recently examined the economic evidence for the most recent 10-year period (1997-2007), for which official government data is available.

TABLE 7

**STATES WITH LOWEST AND HIGHEST PERSONAL INCOME TAX (PIT) RATES:
10-YEAR ECONOMIC PERFORMANCE, 1997-2007** unless otherwise noted

State	Top PIT Rate	Gross State Product Growth	Personal Income Growth	Personal Income Per Capita Growth	Population Growth
Alaska	0.00%	77.9%	66.4%	49.5%	10.7%
Florida	0.00%	87.6%	87.9%	55.0%	18.3%
Nevada	0.00%	112.3%	114.6%	48.4%	40.3%
New Hampshire	0.00%	56.8%	68.2%	50.1%	9.1%
South Dakota	0.00%	71.3%	73.8%	63.9%	7.8%
Tennessee	0.00%	59.0%	64.8%	46.5%	11.6%
Texas	0.00%	90.5%	89.8%	55.8%	20.7%
Washington	0.00%	74.5%	76.9%	55.8%	13.5%
Wyoming	0.00%	111.4%	114.6%	103.4%	8.5%
9 States w/o PIT*	0.00%	82.38%	84.12%	58.70%	15.62%
9 States with Highest Marginal PIT Rate*	9.17%	62.35%	63.82%	52.65%	6.33%
Ohio	8.24%	40.4%	42.3%	38.4%	1.5%
Hawaii	8.25%	63.9%	61.7%	54.4%	6.0%
Maine	8.50%	55.8%	60.7%	52.1%	4.6%
New Jersey	8.97%	54.7%	62.4%	52.5%	4.8%
Oregon	9.00%	63.8%	62.3%	42.9%	13.1%
Maryland	9.30%	74.3%	77.3%	61.1%	8.2%
Vermont	9.50%	61.8%	69.3%	61.2%	3.5%
California	10.30%	77.9%	76.6%	56.0%	11.4%
New York	10.50%	68.5%	61.7%	55.3%	3.9%

*Equally-weighted averages.

Note: Highest marginal state and local personal income tax rate imposed as of 1/1/08 using the tax rate of each state's largest city as a proxy for the local tax. The effect of the deductibility of federal taxes from state tax liability is included where applicable. New Hampshire and Tennessee tax dividend and interest income only.

It revealed that the inverse relationship between state taxes and state economic performance continued to hold true. We compared the economic results of the nine states with the highest income tax rates to the economic results of the nine states without an income tax. The results fully confirm the earlier research: High income tax rates deter economic growth and job creation in states.

Major findings include the following:

- Employment Growth: Business and jobs migrated to low-tax states from 1997 to 2007. The non-income tax states had 21 percent job growth compared to 11 per-

cent job growth in the high income tax states.

- Incomes: Personal income grew by 84 percent in the non-income tax states, versus 64 percent in the high income tax states.
- Population Growth: More than twice as high in the non-income tax states as the high income tax states.

Sales Taxes and Growth

In a static-revenue-estimating world, a higher sales tax rate will simply collect exactly the additional revenue in proportion to the increase in

Net Domestic in-Migration as % of Population	Non-Farm Payroll Employment Growth	Unemployment Rate: 2007
-2.3%	18.1%	6.2%
7.8%	25.5%	4.0%
17.2%	45.0%	4.8%
4.0%	13.8%	3.6%
0.2%	15.2%	3.0%
4.4%	8.3%	4.7%
3.4%	20.3%	4.3%
3.5%	16.6%	4.5%
2.1%	28.3%	3.0%
4.47%	21.23%	4.23%
-2.20%	11.17%	4.41%
-3.5%	0.6%	5.6%
-4.0%	17.3%	2.6%
3.1%	11.5%	4.7%
-5.3%	9.4%	4.2%
4.8%	12.7%	5.2%
-1.5%	15.0%	3.6%
0.1%	10.2%	3.9%
-4.0%	15.5%	5.4%
-9.5%	8.3%	4.5%

the sales tax rate. So, for example, increasing the sales tax from five percent to six percent is a 20 percent increase in the tax rate, and hence static analysis would assume a 20 percent increase in revenues. But we know the higher sales tax rate will lead to lower revenues than the static model predicts for at least four reasons:

1. Higher sales tax rates in one state encourage people to purchase major expenditure items across state borders in lower sales tax states. This effect is especially pronounced for those who live near state borders.
2. Higher sales tax rates encourage more evasion and nonpayment.
3. Higher sales tax rates encourage more internet and catalog sales, which can often be transacted with no sales tax.
4. Higher sales tax rates encourage less consumption and more savings, thus reducing the sales tax base.

A shining example from 2008 of the above-mentioned fiscal folly comes from Chicago. Facing a deficit of some \$238 million, Cook County approved a measure that more than doubles its component of the total sales tax rate from 0.75 percent to 1.75 percent. Coupled with the recent 0.25 percent increase in the Regional Transportation Authority's portion of the county sales tax from 0.75 percent to 1 percent, Chicago's combined sales tax rate jumped to 10.25 percent, effective November 2008 – the highest in the nation. Shockingly, the Cook County Board of Commissioners fell just one vote short of raising the combined sales tax rate to 11.25 percent!

Actively making itself significantly less competitive – especially when the nation's economy is weakening – is precisely the wrong move for Cook County and Chicago to make. Does the Cook County government really believe they'll generate the \$400 million they expect from this tax increase, especially in the current environment? When tax rates on an activity are raised, the volume of that activity shrinks, leading to a revenue offset. Actual revenue will fall far short of government's static revenue estimates as consumers and retailers adjust their behavior. In addition, the tax increase will only serve to worsen the current economic downturn for the county's 5.3 million residents. Piling on more taxes only exacerbates the problems faced by businesses and residents, and in some cases might represent the final straw, leading to layoffs or relocations. Unemployment then rises, along with its associated costs to government. It can quickly become a downward spiral, and it wouldn't be a pretty one.

TABLE 8
STATES WITH LOWEST AND HIGHEST CORPORATE INCOME TAX (CIT) RATES:
10-YEAR ECONOMIC PERFORMANCE, 1997-2007 unless otherwise noted

State	Top CIT Rate	Gross State Product Growth	Personal Income Growth	Personal Income Per Capita Growth	Population Growth
Nevada	0.00%	112.3%	114.6%	48.4%	40.3%
South Dakota	0.00%	71.3%	73.8%	63.9%	7.8%
Washington	0.00%	74.5%	76.9%	55.8%	13.5%
Wyoming	0.00%	111.4%	114.6%	103.4%	8.5%
Alabama	4.23%	61.9%	64.0%	54.6%	5.8%
North Dakota	4.23%	69.9%	71.1%	75.3%	-0.9%
Colorado	4.63%	77.8%	84.9%	52.1%	20.0%
Mississippi	5.00%	52.8%	61.6%	52.8%	4.8%
South Carolina	5.00%	56.9%	68.9%	47.3%	14.3%
Texas*	5.00%	90.5%	89.8%	55.8%	20.7%
10 States with Lowest Marginal CIT Rate**	2.81%	77.95%	82.04%	60.95%	13.48%
10 States with Highest Marginal CIT Rate**	10.92%	56.92%	57.96%	48.03%	5.71%
Michigan***	9.01%	27.7%	39.0%	33.8%	1.6%
New Hampshire	9.25%	56.8%	68.2%	50.1%	9.1%
Alaska	9.40%	77.9%	66.4%	49.5%	10.7%
Massachusetts	9.50%	58.5%	66.9%	61.4%	3.6%
Minnesota	9.80%	63.5%	65.9%	50.7%	8.5%
Iowa	9.90%	57.5%	52.2%	47.5%	3.4%
Oregon	10.25%	63.8%	62.3%	42.9%	13.1%
Ohio	10.50%	40.4%	42.3%	38.4%	1.5%
Pennsylvania	13.97%	54.7%	54.6%	50.9%	1.7%
New York	17.63%	68.5%	61.7%	55.3%	3.9%

* Texas imposes a Franchise Tax, known as the margin tax, of 1.0%, this equates to a CIT rate of 5.0%

** Equally-weighted averages.

*** Michigan imposes the Michigan Business Tax (MBT) which equates to an effective CIT rate of 9.01%.

Note: Highest marginal state and local personal income tax rate imposed as of 1/1/08 using the tax rate of each state's largest city as a proxy for the local tax. The effect of the deductibility of federal taxes from state tax liability is included where applicable.

The best evidence of this is the difference between retail sales in Portland, Ore. and Seattle, Wash. Oregon has no sales tax but does have a 9 percent income tax, while Washington has no income tax but does have a combined state and local sales tax average of 8.26 percent. How does this affect retail sales? According to a famous *Wall Street Journal* investigation a number of years ago, one startling result of Seattle's high sales tax is that residents of Washington voted with their automobiles. Portland ranks

first among all of the top 50 metropolitan areas in the nation in retail sales per capita. Here is how *The Wall Street Journal* put it:

“There is 18 percent more money to spend per person in Seattle than Portland, and yet 69 percent more is spent in Portland than Seattle. It's not that Portland residents are living high; it's that others are coming here to shop. Washington shoppers freely admit they travel to Portland to avoid the sales tax.

Net Domestic in-Migration as % of Population	Non-Farm Payroll Employment Growth	Unemployment Rate: 2007
17.2%	45.0%	4.8%
0.2%	15.2%	3.0%
3.5%	16.6%	4.5%
2.1%	28.3%	3.0%
1.6%	3.0%	3.5%
-5.4%	13.9%	3.2%
4.6%	17.7%	3.8%
-0.9%	4.0%	6.3%
6.9%	13.5%	5.9%
3.4%	20.3%	4.3%
3.32%	17.74%	4.23%
-1.99%	8.08%	4.96%
-4.8%	-4.0%	7.2%
4.0%	13.8%	3.6%
-2.3%	18.1%	6.2%
-5.6%	5.3%	4.5%
-0.3%	10.9%	4.6%
-1.7%	7.8%	3.8%
4.8%	12.7%	5.2%
-3.5%	0.6%	5.6%
-0.9%	7.2%	4.4%
-9.5%	8.3%	4.5%

Portland and Seattle are about two-and-a-half hours apart on I-5. Said one man: ‘The savings on a \$700 television is almost \$60. You bet it’s worth crossing the river.’”

Washington shoppers are blazing a new Oregon Trail.

Arthur Laffer found the same phenomenon to be true when he authored a tax study for Pete du Pont, then-governor of Delaware, in 1978. Delaware had the highest income tax rate in the nation and no sales tax. Delaware also had the highest retail sales per dollar of income in the United States.

Dying to Tax You: The Deadly Estate Tax

The estate tax is an immoral double tax on income that was already taxed when it was earned by the person who leaves an estate for his family. The joke in Washington, D.C., and many state capitals is that there ought to be a policy of “no taxation without respiration.”

But the estate tax is not just wicked; it is a killer of jobs and incomes in states. Many studies indicate that the death tax is so inefficient, so adverse to saving and capital investment, and so complicated, that the states and the federal government would actually recoup much if not all of the revenues lost from this tax with higher tax receipts resulting from long term economic growth. Other studies suggest that the states and federal government will recapture between 30 and 50 percent of the static revenue losses. A recent study for the American Council for Capital Formation in Washington, D.C., co-authored by Douglas Holtz-Eakin and Donald Marples at Syracuse University, highlights the negative impact of the estate tax:

“Entrepreneurs are particularly hard hit by the estate tax as they face higher average estate tax rates and higher capital costs for new investment than do other individuals.”

The estate tax causes distortions in household decision making about work effort, saving and investment (and the loss of economic efficiency) that are even greater in size than those from other taxes on income from capital. This has led ALEC’s Tax and Fiscal Policy Task Force to pass a model resolution asking Congress to permanently kill the death tax.

Case Study:

Yankee Doodle Went to ... Florida

State estate taxes are especially unwise because old people move to avoid them. In 2005, Connecticut Gov. Jodi Rell, a Republican, did a big favor for the state of Florida by enacting a 16 percent estate tax for the privilege of dying in Connecticut. *The Wall Street Journal* joked

that then-Gov. Jeb Bush of Florida “should have sent her a thank-you note with a box of chocolates and a ribbon tied around it.” Why? Because Ms. Rell signed into law an estate tax that might as well be called the Palm Beach Economic Development Act.

The legislators in Hartford hope the tax will raise \$150 million in revenue each year – money that will come in only if the legislators in Hartford are also planning to build a Berlin Wall around the state. If not, high income people will leave for Florida or Texas with constitutional prohibitions against an estate tax. Thanks to the Connecticut death levy, a successful small business owner with a \$10 million estate can save about \$1 million by packing up and heading south. “The Connecticut legislature can’t seem to comprehend that it is taxing away the very wealth-producing people that this state is dependent upon for an economic revival,” says economist Dowd Muska of the state’s Yankee Institute think tank.

Alas, at last count 22 states had estate taxes in hopes of “soaking their rich.” Washington state imposes a 19 percent death tax, the most onerous in the nation.

Since Americans build up estates in part so that their legacies can be left to their children and grandchildren – and definitely not to politicians – seniors with medium and large estates are likely to shop around for low-tax venues.

A 2004 National Bureau of Economic Research study entitled, “Do the Rich Flee from High State Taxes?” found that states lose as many as one of every three dollars from their estate taxes because “wealthy elderly people change their state of residence to avoid high state taxes.” And that was when states imposed effective estate tax rates that were only one-third as high as they are enacting now. Under these new soak-the-rich schemes, some states could lose so many wealthy seniors that they may actually lose revenue over time. Not surprisingly, it is generally the liberal, tax-and-spend blue states that are frantically reinstating puni-

tive taxes on death. Will they ever learn? Over the past 20 years, about 1,000 people every day have been fleeing these high-tax blue states for low-tax red states. It’s one reason the Northeast has suffered economically, and declined politically in terms of electoral votes.

In New York, about one in three tax dollars comes from those with earnings of \$1 million or more, according to the Manhattan Institute. A rational policy out of Albany would be to lay down a red carpet to encourage more rich people to move in, or at least to stay there. Instead, with the current 16 percent estate tax, Albany politicians have effectively declared: “Invest anywhere but in New York.”

Summing Up:

Why and How State Tax Policies Matter

The conclusion, which is getting to be nearly inescapable, is that states with high and rising tax burdens are more likely to suffer through economic decline, while those with lower and falling tax burdens are more likely to enjoy robust economic growth. Here is a quick synopsis of the results:

- The overall level of taxation has an inverse relationship to economic growth in the state;
- The change in the level and rate of taxation impacts state economic performance;
- High tax rates are especially harmful;
- Some state taxes have a more negative impact than others.

Case Study:

Bush Tax Cuts Stimulate the Economy

One of the best contemporary examples of how tax policy can affect economic behavior is the federal tax rate reductions of the last 25 years.

In the 1980s, President Ronald Reagan

TABLE 9: ALEC-LAFFER STATE ECONOMIC PERFORMANCE INDEX: 1997-2007

Rank	State	Absolute Domestic Migration	Per Capita Personal Income	Employment
1	Texas	3	14	8
2	Florida	1	19	6
3	Wyoming	24	1	4
4	Montana	21	5	7
5	Washington	10	13	13
6	Virginia	11	11	14
7	Idaho	13	22	3
8	Arizona	2	36	2
9	Nevada	6	35	1
10	Colorado	9	27	11
11	South Dakota	28	6	16
12	Oklahoma	22	4	26
13	New Mexico	27	16	9
14	North Dakota	35	2	19
15	Arkansas	15	15	33
16	Vermont	26	8	29
17	Maryland	39	9	17
18	South Carolina	7	38	22
19	New Hampshire	17	32	20
20	Georgia	4	48	18
21	Hawaii	38	21	12
22	Utah	23	43	5
23	North Carolina	5	46	21
24	Maine	20	26	27
25	Alaska	31	33	10
26	Alabama	16	20	39
27	California	49	12	15
28	Delaware	19	34	24
29	Oregon	12	45	23
30	Rhode Island	34	17	30
31	Kentucky	14	40	32
32	Tennessee	8	41	37
33	Nebraska	36	28	25
34	Minnesota	30	31	28
35	Louisiana	44	3	47
36	Massachusetts	43	7	44
37	Connecticut	41	10	43
38	West Virginia	29	25	41
39	Mississippi	33	23	46
40	New Jersey	47	24	31
41	Wisconsin	25	42	35
42	Kansas	40	29	34
43	New York	50	18	36
44	Missouri	18	44	42
45	Iowa	37	37	38
46	Pennsylvania	42	30	40
47	Indiana	32	47	45
48	Illinois	48	39	48
49	Ohio	45	49	49
50	Michigan	46	50	50

chopped the highest personal income tax rate from the confiscatory 70 percent rate that he inherited when he entered office to 28 percent when he left office. The resulting economic burst caused federal tax receipts to almost precisely double: from \$517 billion to \$1,032 billion.

In the early 2000s, the U.S. economy was on its back thanks to the stock market collapse after the dot-com bubble burst and the liquidation of some \$6 trillion in wealth.⁴⁰ The jewel of the Bush economic plan was the reduction in tax rates on dividends from 39.6 percent to 15 percent, and on capital gains from 20 percent to 15 percent. These sharp cuts in the double tax on capital investment were intended to reverse the 2000-01 stock market crash and to inspire a revival in business capital investment, which had also collapsed during the recession. The tax cuts were narrowly enacted despite complaints of “tax cuts for the rich.”

The Congressional Budget Office released its Budget and Economic Outlook in January of 2008. The numbers were an eye-popping vindication of the Laffer Curve and the Bush tax cut’s real economic value. Federal tax revenues surged by \$785 billion in the four years after those tax cuts, the largest increase in tax receipts adjusted for inflation in American history. Thanks to strong economic growth from the tax cuts, the federal budget deficit fell from a high of \$413 billion or 3.6 percent of GDP in 2004, to a low of \$163 billion or 1.2 percent of GDP in 2007, a drop of about \$250 billion. From 2003 to 2007, individual income tax receipts soared more than 46 percent. The numbers for corporate income tax receipts are uncanny. Over the same time period, corporate income tax receipts exploded like a cap let off a geyser, up 180 percent. This represents a larger increase in four years than over the previous decade. Once again, tax rate cuts have created a virtuous chain reaction of higher economic growth, more jobs, higher corporate profits and finally more tax receipts.

Other Policy Variables

Which Affect State Competitiveness

Taxes are not the only way state policy determines the economic attractiveness of one state versus another. Our competitiveness index includes seven non-tax variables. To recap, these include:

- Debt Service as Share of Tax Revenue
- Public Employees Per 1,000 Residents
- Quality of State Legal System
- State Minimum Wage
- Workers’ Compensation Costs
- Right-to-Work State (Yes or No)
- Tax or Expenditure Limitations

The Size of the Public Payroll

States and localities have been on a hiring binge of late. Moreover, a Cato Institute study shows that in 2005, public pay rose substantially faster than private pay. States with high government payrolls have a hard time downsizing because of the power of the bureaucracy and the unions behind them. Contracting out and competitive bidding lowers costs and provides greater flexibility in getting key personnel, but only when they are needed. States with big public sector payrolls are often the most inefficient in their spending, so this variable provides us with a government efficiency measure.

During the economic boom in the 1990s, local governments experienced massive increases in revenue. State tax collection rose by 86 percent, or approximately \$250 billion, from 1990 to 2001. At the same time, local property-tax revenue increased by 60 percent. This dramatic rise in government revenue was accompanied by an equally dramatic increase in government spending. From 1990 to 2001, state general-fund spending increased by 85 percent.⁴¹ Unions and social-service groups were thus in a prime position to expand public employee membership.

Over the last 50 years, unions have sought to organize the public sector to the point that, in some states, 60 to 70 percent of public employees

are now union members. Increased union influence is straining government budgets across the country. A prime example is the inflated wage and benefits packages of public employees. The average public sector wage is now 37 percent higher than the average private sector wage. At the same time, local governments spend 128 percent more on average to fund public employee health care benefits than do private employers. Similarly, local government financing of retirement benefits averages 162 percent higher than that of the private sector.⁴²

As a means of financing rising debt burdens, some states are abandoning pro-growth policies. For instance, according to the Rhode Island Public Expenditure Council, Rhode Island ranks fourth in average pay for public sector employees but 23rd in average private-sector wages. To finance public sector wages, Rhode Island has continually raised taxes, achieving the 10th highest total state and local tax burden in the country. As a result, businesses located in the state exhibit low rates of investment, with investment capital per employee dropping to 30 percent below the national average. Coincidentally, Rhode Island has one of the highest rates of public sector unionization, (62 percent), compared to the national average of 37 percent.

The State Legal System

The annual static cost of America's tort system is estimated to be around \$328 billion. The dynamic costs are said to reach \$537 billion, a total annual cost of \$865 billion a year – the equivalent of an annual “tort tax” of about \$9,827 on a family of four.⁴³ The Tillinghast division of consulting firm Towers-Perrin, calculates that the cost of excessive litigation in America is about two cents for every dollar of production. This includes everything from car accident claims, to investor lawsuits, to class-action suits. From 1997 to 2003, the average jury verdict in a medical malpractice case doubled from \$500,000 to over \$1 million, accord-

ing to the Manhattan Institute.⁴⁴ The average small business earning \$1 million per year has to spend \$20,000 each year on legal costs associated with lawsuits. When the legal system becomes a system of jackpot justice, with huge awards not related to the negligence or misbehavior of the company being sued, the biggest winners are trial lawyers. Businesses and citizens hoping to work in the state are the losers. Firms move out of states whose legal systems do not treat businesses fairly.

Mississippi recently enacted meaningful legal reform to ensure that businesses are not punished for appropriate behavior. Immediately following the passage of this legislation, Toyota announced the opening of a new plant in Mississippi. Medical malpractice premiums are already down at least 30 percent. Lawsuits against doctors are down 90 percent. The passage of what some have dubbed the “Mississippi Miracle” was essential to the survival of Mississippi's economy, businesses and health care system.

States that have enacted common sense reforms – such as malpractice insurance limits and proper venue reforms to discourage litigation tourism – have enjoyed greater economic success. A 2002 study by the U.S. Chamber Institute finds that per capita state product rises by about 0.75 percent for every 10 percent improvement in a state's legal climate.⁴⁵ This is why we include the state legal environment in our state ranking system.

Minimum Wage

Study after study shows that states with minimum wage or living wage requirements have fewer employment opportunities for those at the lower rungs of the economic ladder. Service jobs often flow to areas with the least onerous wage requirements. States with high minimum wages also have higher and more enduring unemployment rates. This variable is also a good measure of the relative power and influence of unions in a state. Union boss policies

are generally inimical to growth and bad for business.

Workers' Compensation

Workers' compensation costs vary widely among states. Workers' compensation is a quasi-tax on businesses for hiring workers. Those states that have reformed their workers' compensation system have much lower employer costs, which allows businesses to pay workers more. In the early 2000s, California's workers' comp costs were sometimes three times higher than in states like Arizona and Nevada. States that reduce workers' compensation costs and payouts are generally more economically healthy and independent of union control and trial lawyer control.⁴⁶

Right-to-Work

The Labor Department reported in early 2008 that union membership in America is at near all-time lows. Unions lost 15,000 members between 2006 and 2007, and the percentage of working Americans who belong to a union stands at 12.1 percent – significantly lower than the all time high of 34 percent in the 1950s. Today, only one in 13 private sector workers is a member of a labor union – the tiniest percentage in at least 60 years. There are four Americans who are stock holders for every one American union member.⁴⁷

States are divided into two broad categories with respect to their union organizing laws. They are either right-to-work, which means workers have the right to not join the union, or non-right-to-work which means that workers have to join the union and pay dues if they work in a unionized industry. Ranking far and away at the top of non-right-to-work states are California and New York. Nearly half, (7.8 million) of the 15.7 million union members in the United States live in six states: California (2.5 million), New York (2.1 million), Illinois, Michigan and Pennsylvania (0.8 million each) and New Jersey (0.7 million).⁴⁸ As we have dem-

onstrated and will continue to demonstrate, the evidence points overwhelmingly to the fact that right-to-work states have much greater employment growth than non-right-to-work states.

Case Study:

Union Power Play in Iowa

After the 2006 midterm elections, union bosses were feeling their oats from big Democrat victories in state legislatures. To regain lost power, they sought to overturn right-to-work laws that had been on the books for years in some states. These laws prohibit employers from requiring workers to join a union as a condition of employment. They also protect workers from having to pay the union dues withholding tax extracted from their members' paychecks.

Iowa is one state where unions are flexing their muscles. Iowa has been a right-to-work state for 60 years. Now, for the first time in 40 years, the Democrats control both chambers of the legislature and the governorship. Though neither the new Gov. Chet Culver, nor the legislative candidates, campaigned on overturning right-to-work, the unions are demanding a vote to overturn the popular law. If their scheme succeeds, thousands of Iowa workers, who don't want to pay union dues, would be forced to do so if they work in a union shop. Those union dues can be used for political purposes, so many workers would be required to bank-roll causes they don't believe in.

If the Iowa legislature were intentionally trying to chase jobs and employers out of the state, they couldn't come up with a better plan. Leo Troy, an economist at Rutgers University, finds that "right-to-work laws are strongly correlated with faster growth in jobs and personal income." Many international and domestic companies won't even consider locating a plant in a non-right-to-work state, which is why almost all the new foreign auto plants owned by Mercedes, Nissan, BMW and Honda are locating in southern states like Alabama, South

Carolina, Tennessee and Texas. One survey recently found that between 1986 and 2006, 11 right-to-work states added 104,000 auto manufacturing jobs, a 63 percent increase. The non-right-to-work states *lost* 130,000 auto jobs, or 15 percent of their total, over the same period. One leading plant selection consultant, Bob Goforth, put it this way: “If you’re not a right-to-work state, you’re not in the game.”

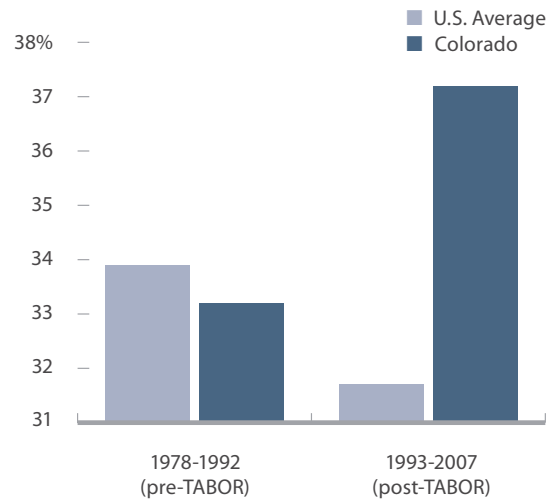
Ironically, for years Iowa politicians have been searching for ways to reverse the state’s population losses and its lethargic economic performance. If Iowa joins Rust Belt states like New Jersey, Pennsylvania, Michigan and Ohio and adopts forced unionism, the politicians might as well ask the last Iowa employer to turn off the lights before leaving.⁴⁹

State Tax or Expenditure Limits

One successful strategy employed by some states to prevent squandering budget surpluses during times of economic expansion is a state Tax or Expenditure Limitation (TEL). One popular form of a TEL is a cap on taxes at some predetermined rate of growth. The most famous TEL was Proposition 13 in California, which capped property taxes in the state and ignited a nationwide tax revolt.

Colorado and Missouri each have constitutional tax limitations that restrict the growth of revenues to the rate of population growth plus inflation. Colorado’s Taxpayers’ Bill of Rights (TABOR) has been a boon to the economy of the state as shown in Figure 3.⁵⁰ Those states generally require that any revenue in excess of that amount be rebated to the people. For example, in 1997, Colorado rebated \$142 million in tax revenues to taxpayers, while Missouri gave back \$318 million in rebate tax credits. The evidence suggests that states with tax and expenditure limitations have done a better job of restraining state government growth than states without such disciplining measures. In 2002, the average per capita savings on taxes would have been \$278 if every state had implemented a

FIGURE 3
PER CAPITA INCOME GROWTH
BEFORE AND AFTER TABOR



Source: National Taxpayers Union

population plus inflation tax cap prior to the post-9/11 expansion. Support for TABOR has been strong in Colorado. In 2008, a proposal to gut TABOR was placed on the ballot, but was defeated by a 55 to 45 percent margin.⁵¹

Another 11 states, including Arizona, California and Nevada, have adopted measures requiring that any tax increase by the legislature must pass by a supermajority vote in both houses.⁵² Most require a two-thirds vote, but others require three-fourths or three-fifths. Those measures have been highly effective at deterring routine tax increases during non-emergencies.⁵³

Supermajority requirements are most effective when they are applied to *all* tax increases and fees – whether income taxes, business taxes, sales taxes or excise taxes. (See ALEC’s model language on supermajority requirements in Appendix C.) We believe supermajority requirements are effective deterrents to runaway taxing authority by the legislature, and recommend that every state adopt one of these constitutional restrictions on taxes.

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