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TAX MYTHS DEBUNKED

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LIMITED GOVERNMENT • FREE MARKETS • FEDERALISM

Eric Fruits, Ph.D., and Randall Pozdena, Ph.D.

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CENTER FOR STATE FISCAL REFORM

TAX AND BUDGET SOLUTIONS FOR ECONOMIC GROWTH

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About the Authors

Eric Fruits, Ph.D., is president of Economics International Corp., an Oregon-based consulting firm specializing in economics, finance and statistics. He is also an adjunct professor at Portland State University and Pacific Northwest College of Art. Fruits has been engaged by private and public sector clients, including state and local governments, to evaluate the economic and fiscal impacts of business activities and government policies. His economic analyses have been widely cited and have been published in *The Economist*, *The Wall Street Journal* and *USA Today*. Fruits has been invited to provide analysis to the Oregon legislature regarding the state's tax and spending policies. His testimony regarding the economics of Oregon public employee pension reforms was heard by a special session of the Oregon Supreme Court. His statistical analyses have been published in top-tier economics journals, and his testimony regarding statistical analysis has been accepted by international criminal courts.

Contact Information:

Eric Fruits, Ph.D., Economics International Corp.,
Portland, OR 97213
Phone: 503.928.6635
E-mail: info@econinternational.com

Randall Pozdena Ph.D., is president of QuantEcon Inc., an Oregon-based consultancy. He received his B.A. in economics, with honors, from Dartmouth College and his Ph.D. in economics from the University of California, Berkeley. Former positions held by the author include professor of economics and finance, senior economist at the Stanford Research Institute (SRI International) and research vice president of the Federal Reserve Bank of San Francisco. He also served on numerous public, non-profit and private boards and investment committees. He is a member of the CFA Institute and a member and former officer of the Portland Society of Financial Analysts. He has written more than 50 refereed articles and books and has been cited in *The Wall Street Journal, USA Today* and numerous other national and regional publications. He has served for more than a decade on the Oregon Governor's Council of Economic Advisors.

Contact information:

Randall J. Pozdena, Ph.D., QuantEcon Inc.,
P.O. Box 280, Manzanita, OR 97130
Phone: 503.368.4604
E-Fax: 866.307.2466
E-mail: pozdena@quantecon.com

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Executive Summary

The U.S. economy has recently suffered its deepest and most prolonged recession since the Great Depression. The fundamental causes of the recession and the slow recovery are the result of two decades of poorly conceived housing credit and other policies and the adoption of long-ago discarded Keynesian policies. The latter policies have failed to rejuvenate the economy and have left behind a massive accumulation of national debt. This accumulation has significantly constrained the policy options of the Federal Reserve, Congress and state and local governments.

State fiscal policy reform therefore needs to include policies that will support economic growth and break with the long tradition of high levels of taxation, government spending and intervention at the state level. The states must do this alone because the federal government will be in no position to provide financial assistance.

In this setting, defenders of the status quo and advocates for the so-called "progressive" reforms of higher taxes and greater government involvement have sought to discredit legitimate and research-based state fiscal policy reforms. The purpose of this paper is to set the record straight regarding recent pro-growth reform proposals, as well as illustrate the theoretical and empirical mythology that is used to discredit reform efforts.

After first providing an introduction and background to the current challenges that states face in reforming tax and spending strategies, the study provides an analysis of reform proposals that will reduce tax system impediments to economic growth.

Several scholarly articles and papers are referenced throughout this report, and detailed citations are available in the report's bibliography.

Review of Reform Proposals: Primary Findings

The report's primary findings are as follows:

> Well-respected economics authorities have advanced tax reform proposals that offer the prospect of helping states grow their way out of their weak economies and the legacy of fiscal excess. These proposals are referred to herein as "free-market" proposals because their intent is to remove impediments to real recovery of the private economy. This is necessary not only to advance the economic well-being of the states' residents, but also to provide an economy with enough vigor to support key public activities and services. The analyses reviewed include:
>
> Laffer, A. B., Moore and Jonathan Williams, *Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index*, (2012) for American Legislative Exchange Council, 5th edition.
>
> Arduin, Laffer and Moore Econometrics (2011). "Eliminating the State Income Tax in Oklahoma: An Economic Assessment," Oklahoma Council of Public Affairs.
>
> Arduin, Laffer and Moore Econometrics (2009). "Enhancing Texas' economic growth through tax

reform: Repealing property taxes and replacing the revenues with a revised sales tax." Texas Public Policy Foundation.

Laffer, A. B. and Winegarden, W. H. (2012). "The economic consequences of Tennessee's gift and estate tax." The Laffer Center for Supply-Side Economics and Beacon Center of Tennessee.

We found these proposals to be well-founded in widely accepted theory and empirical work. Where appropriate and available, we have brought our own or others' research to bear on theoretical or measurement issues raised by critics of these works. In all cases, we concluded that the opinions, analyses and measurements offered in these works to be valuable resources for state policymakers facing tough fiscal choices.

We reviewed "progressive" critiques of the aforementioned works to the extent they were suitable for review. In general:

Broad and inaccurate statements about the state of the literature are made, but, in general, the critiques make sparse or no reference to the extensive literature that exists in the public finance field.

The critiques, coming primarily from affiliated progressive organizations and networks, came across as "sound-byte" public relations campaigns.

There is virtually no part of the record of the critics that can be construed as having contributed in a meaningful way to the theory, measurement and analysis of the tax reform debate. Yet, they have been distributed widely as if they are research products.

The authors of the critiques do not display economics expertise or modern analytical skills in the documents, Web sites or promulgating organizations. They appear to labor under mythological or, at best, ambiguous appreciation of what the professional literature has to say about the issues relevant to the work of Laffer et al. or their critiques of those works.

The Laffer-ALEC *Rich States, Poor States* ranking of states' pro-market policies have been subject to a particularly disingenuous critique by Peter Fisher, an economist on the Iowa Policy Project.

We find that Fisher's findings–though widely distributed as authoritative–in fact are the result of amateurish and incorrect analysis and misinterpretation of data. When analyzed properly, the Laffer-ALEC rankings are proven to be strongly predictive of states' relative economic health.

"Our goal is not to deny that legitimate debate remains, but rather to demonstrate the strength of the evidence available on certain key issues."

A Public Finance Mythology Review

Given the state of the critics' misunderstanding of the analyses crucial to the tax reform debate, this paper attempts to address that broader issue. We offer a brief review of what we consider the key myths that circulate as accepted truth in the debate about tax reform.

Our goal is not to deny that legitimate debate remains, but rather to demonstrate the strength of the evidence available on certain key issues. We present this

discussion with references to the literature and our own prior or current research. We address seven strongly held propositions that we believe are mostly mythological or, at a minimum, are open to serious debate.

Myth #1

Increased government spending stimulates the economy during recessions.

In this discussion, we present theory and evidence that strongly disputes this supposition. In fact, there is a solid theoretical and empirical basis for concluding that increased government spending and "printing press" liquidity will delay economic recovery.

Myth #2

Lower tax rates are bad for the economy in a recession.

This addresses the oft-heard charge that lowering tax rates slows economic growth because it necessitates reduction in public spending. In our view, the evidence and the literature support the notion that lower tax rates are associated with more rapid growth—both during normal periods and during recovery from a recessionary condition.

Myth #3

Raising tax rates will not harm economic growth.

In this discussion, we review the large body of evidence that higher tax rates depress income and output.

Myth #4

Austerity in the form of spending cuts will harm growth and employment.

Empirical data supports the notion that a heavily indebted economy exhibits slow growth. "Austerity programs" are focused on reducing the burden of public spending on the economy so that the debt burden can be reduced as rapidly as possible. These abrupt measures are seen (incorrectly, in our view) as necessarily harmful. In fact, a growing amount of literature supports the notion that properly configured austerity programs can be expansionary.

Myth #5

Real household income has not grown in the past 20 years.

Reliance on incomplete statistics of various income methods and the number and type of actual taxpayers conceals significant real growth in incomes. Although the recession has slowed this growth, it is clear that the economy itself is capable of providing broad-based growth in real income, even under adverse policy conditions.

Myth #6

The distribution of income is increasingly inequitable.

To distract the public from the problems that public policy has created for the economy, the "fairness" of income distribution has become a major feature of progressive tax reform. In this discussion, we present the measurement tools progressives use to exaggerate the extent and direction of income distribution, along with the philosophical and economic efficiency arguments that weigh against policy to alter the distribution of income.

Myth #7

Raising tax rates on the rich will not harm the economy.

Regardless of whether the distribution of income is "too concentrated" or not, it is a separate issue as to whether it is good policy to more aggressively tax high income earners. We conclude that the U.S. tax system is already too progressive and discuss the implications of impairing the incomes, savings and investment behavior of higher income individuals.

I. Introduction

More than five years after the recession began in 2007, the U.S. economy continues to be plagued by weak economic growth. Keynesian deficit spending remedies have not only failed to stimulate economic growth, but also have left the country with a huge overhang of debt. This debt, in total, now exceeds the entire annual gross domestic product (GDP) of the nation. At this debt-to-GDP ratio, economic growth slows, and we risk an extended period of unparalleled economic malaise. Weakening conditions in the European Union and China further reduce the likelihood of significant recovery.

This situation poses a particularly challenging problem for the 50 states. They cannot realistically expect to receive any significant increase in aid from the federal government. Many state economies remain weak, while economic conditions and demographics put greater service responsibility in their hands.

Put simply, states must engineer their own economic and fiscal recovery policies. Against this background, prominent economists are counseling the states to move away from high tax policies that discourage growth and instead consider policies that stimulate business, investment and job growth.

So-called progressives have sought to discredit these reform efforts and advocate for increases in tax rates and spending. Despite the fact that these regimens are the genesis of today's fiscal problems, the political left continues to advance policies that expand a state's role, while punishing those who are the sources of most production, investment and job creation.

A key tactic of progressive policymakers is to attack the reform efforts and analyses of economists who advance increased focus on invigorating the private sector. The purpose of this publication is to identify the dangerous fallacies that are promulgated by progressive advocates for return to high tax rate policies and greater reliance on government sector activity and control. In our view, the progressive agenda risks exposing the United States to the same calamitous declines revealed by Europe's romance with social-democratic policy.

"The purpose of this publication is to identify the dangerous fallacies that are promulgated by progressive advocates for return to high tax rate policies and greater reliance on government sector activity and control."

We begin with a brief review of the missteps that have sapped the strength of the U.S. economy. We then turn to a review of the proposals that have been advanced by market-oriented economists and the war that has been declared on these ideas by progressive policy advocates. As we demonstrate in our findings, opposition to market-friendly reform is clearly a web of misrepresentation and out-of-date economic thinking.

II. Background: The State Fiscal Policy Challenge

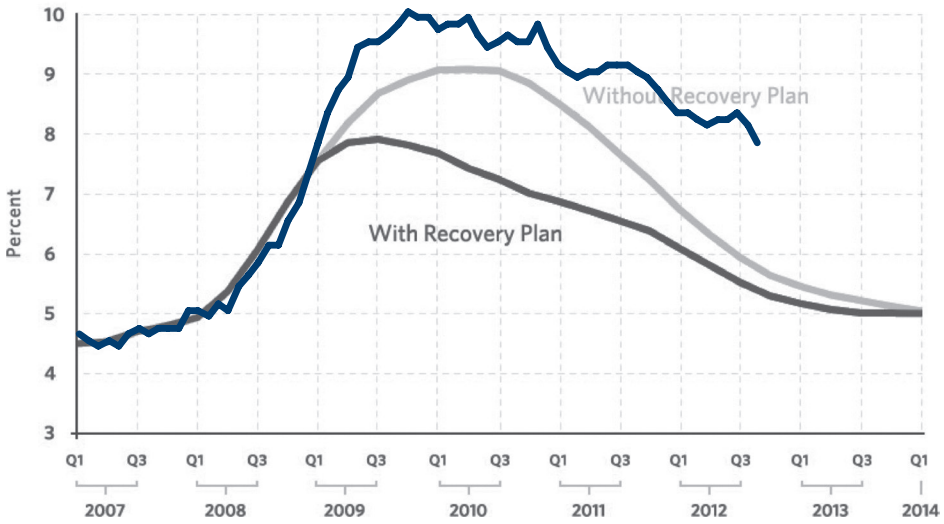
Economic conditions deteriorated for both the nation and for most states with the onset of the 2007-2008 recession. The resulting job and income loss created fiscal problems for states as revenues declined faster than changes in public services and costs. The Obama administration and its liberal allies in Congress forgot the dismal performance of Keynesian-type deficit spending as a stimulus of growth in the 1960s and 1970s and embarked on an aggressive deficit spending policy anyway.

Specifically, in the weeks before President Barack Obama's inauguration, his economic team began pushing a stimulus program that eventually became the *American Recovery and Reinvestment Act* of 2009. The heads of the economics team—Berkeley economist Christina Romer and social welfare specialist Jared Bernstein—used Keynesian multipliers to project the impact of the proposed stimulus program's economic growth. Many states followed the stimulus route as well by issuing bonds, raising taxes and/or exhausting contingency funds to boost state spending.

The Obama administration's projections were widely off the mark. The president's economists predicted that by the fourth quarter of 2010 the stimulus would have led to employment of 137.5 million. Instead, actual employment was 7.3 million lower than the administration's projections, and unemployment rates reached 10 percent. They projected that 2012 unemployment would be only 5.75 percent. Instead, unemployment is hovering around 8 percent, with much of that "improvement" coming from individuals leaving the labor force unable to find employment.[1]

As Figure 1 makes clear, we would have been better off–by the administration's own modeling–to not embrace this (and many other) market-interventionist policies and, instead, let the market work and redress the private sector credit and housing market distortions that were created by the last, great intervention by the Department of Housing and Urban Development, Fanny Mae, Freddie

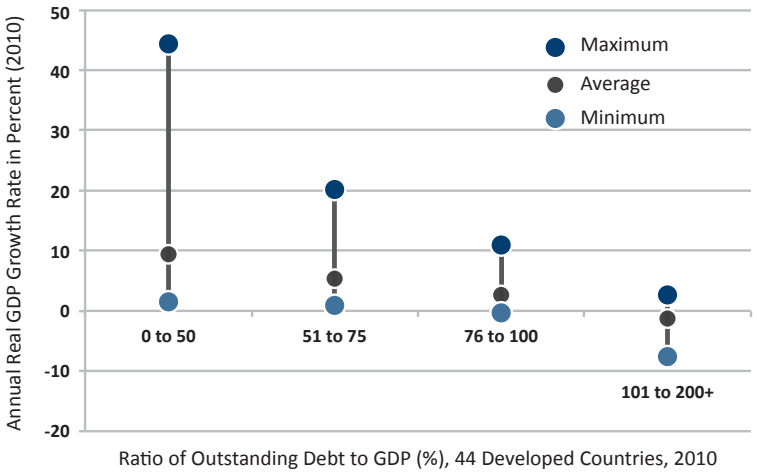
Figure 1: The High Cost in Lost Jobs of Obama's Keynesian "Recovery Plan"



Mac and others into the doomed policy of "democratization of credit" and housing access.

The "hands off" policy that German Chancellor Ludwig Erhardt pursued so successfully after the World War II devastation of Germany yielded what is known as an "economic miracle" of rapid recovery under conditions much worse than we faced in 2008. Instead, we borrowed heavily to create supposedly "shovel-ready jobs" and deluded ourselves that "smart" spending by government can bring the private economy back to life without offsetting reactions by the private sector. The sorry legacy of that hubris is:

Figure 2: High Debt-to-GDP Ratios Slow Future Growth Prospects



- Gross federal debt increased by approximately $1 trillion.
- The federal debt-to-GDP-ratio rose to 100 percent.
- The giant U.S. economy entered the same club as the unraveling, profligate social democracies of Europe.

This leaves a durable legacy of fiscal challenges. In particular, a sufficiently high debt-to-GDP ratio creates the risk of entering a death spiral of slower growth and increasing difficulty to meet interest payments and principal of the outstanding debt. Specifically, when the ratio of outstanding debt–to-GDP exceeds 70 percent, it becomes difficult to grow fast enough for the economy to work its way out of the debt. Indeed, if interest rates on the outstanding debt exceed the rate of economic growth, it becomes impossible to grow one's way out of the problem, as illustrated in Figure 2.

For state governments, this means:

- For the foreseeable future, the federal government will be in no position to provide significant financial support to the states.

- States must find their own solutions to economic and fiscal stimulus and support compatible reforms at the federal level.

Indeed, it is likely that the federal government will cut back on current levels of state program support and/or subvert additional federal responsibilities to states. The states thus face the challenge of maintaining budgetary balance using their own tools.

III. Promoting State Economic Growth: Free-Market vs. Status Quo Policies

States must increasingly devise their own methods of balancing service demands and revenue realities. At the same time, they are faced with a range of competing policy tools. In choosing the correct tool, state policymakers must recognize several inescapable facts:

- Economic growth—especially employment growth—is the key metric by which the electorate grades its policymakers. Elected leaders must evaluate revenue raising schemes and spending programs with an eye toward how the policies would stimulate or stifle economic growth.

- Fiscally speaking, it's much easier to balance a budget with reduced spending than with increased revenues.

- Private sector spending and investment has a much greater impact on economic growth than public-sector spending.

- Public sector spending forces out private sector spending and investment.

The debate is between free-market economists and those who would preserve or enlarge the role of government as a growth strategy. At one end of the range are those who advocate free-market approaches. Free market economists demonstrate that greater economic freedom fosters economic growth and that government intervention stifles that growth. Policies that liberate the private sector from onerous taxes and regulations will spur economic growth. Greater economic growth simultaneously will reduce the demand for costly government services and increase government revenue.

At the other end of the range are those who advocate for a large and growing role for government and the public sector. This approach is born out of a belief that the free market is fundamentally flawed and subject to numerous market failures. The implicit belief system of such advocates is that regulations can mitigate market failures without any economic cost. This belief system supports the notion that public enterprise can replace private firms and that taxes serve the dual progressive role of raising revenue to support the public enterprises while redistributing wealth to those who are deemed to deserve it more, whether earned or not.

"The debate is between free-market economists and those who would preserve or enlarge the role of government as a growth strategy."

To avoid pejorative labels, we will simply refer to these two positions as the free-market and status quo/progressive positions, respectively.

IV. Myth vs. Reality: Setting the Record Straight

Unfortunately, the fiscal policy debate will become more strident as the United States navigates the "fiscal cliff" and states find themselves facing the fallout of what may be another global recession.

The political rhetoric is already crystallizing around broader issues than have been raised by recent tax reform proposals in Oklahoma, Texas and Tennessee, which are analyzed at length later in this publication.

ALEC's annual *Rich States, Poor States* publication has generated many policy debates across the states. *Rich States, Poor States* ranks the 50 states based on fifteen policy indicators that theory suggests should influence the economic health and growth of the states.

The political rhetoric speaks to a set of broad assumptions and reform notions, including:

- Increased government spending stimulates the economy during recessions.
- Lower tax rates are bad for the economy.
- Austerity programs impair economic output and employment.
- Income is becoming less "fairly" distributed.
- Higher tax rates on the rich will not harm the economy.

When examined closely, progressive arguments against fiscal reform are not supported by the evidence. In this section, we address the central factual premises of the progressive arguments for higher taxes and larger government.

Myth #1

Increased government spending stimulates the economy during recessions.

In the popular media, it is widely accepted that reducing the current size of the public sector in a recession would be harmful to the economy. This myth is driven by the incorrect belief that public spending is equivalent to private spending, provides stimulus and stability in a recession and has no offsetting adverse effects on savings and investments. Therefore, many incorrectly argue that if government sector spending or wages are reduced, this translates into a Keynesian reduction in aggregate demand, diminishing the size of the economy.

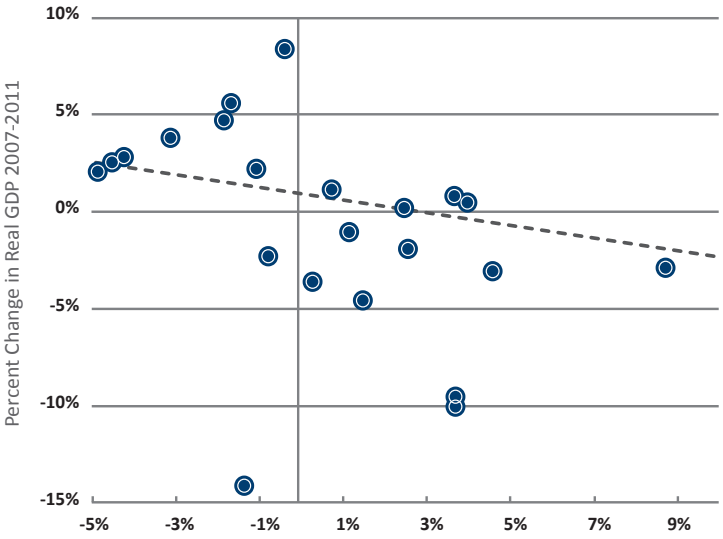
This myth, unfortunately, has deep roots in economic literature. The notion of deficit spending as an offset to weak private demand was advanced by John Maynard Keynes in the 1930s. Keynesian-type fiscal policy was credited (we now know, incorrectly) with the ultimate recovery from the Great Depression. Worse yet, it prevailed over the Austrian view that counseled for private saving and "no-use-of-the-printing-press" (deficit spending) to stimulate recovery.

The Austrian School dismissed the notion that deficit spending could stimulate the economy and saw it as illogical as a policy of trying to overcome a hangover by

drinking even more.[2] By the Austrian logic, taking resources from the private sector in a recession for public spending further depresses the economy and stifles its recovery.

Also, greater public spending today means higher taxes at some point down the line. The result is that the private sector reduces its activity in anticipation of having to bear future burdens of taxation or has less to save and invest due to current taxation. Tax policies that discourage investment and spending result in businesses and households looking elsewhere to locate or expand and can contribute to delayed investment and hiring. Such effects tend to persist over time. Most studies confirm that greater government spending during recession is associated with slower economic growth:

Figure 3: National GDP Growth is Lower when Prior Government Spending Growth is Rapid



National and Cross-Country Studies

A large and long-standing body of literature finds that increased or higher government spending tends to reduce economic growth rather than increase it. This negative relationship between prior levels of high spending and growth is apparent in the data from developed nations (See Figure 3).

- Some 45 years ago, Baumol (1967) warned that shifting resources from high productivity-growth private sectors to low-productivity sectors—for example, government services--will cause the growth rate of overall output to decline.

- Barro (1991) argued that government consumption has no direct effect on private productivity. Instead, he finds that increased government consumption lowers saving and growth through the distorting effects of taxation or government-expenditure programs.

- Hseih, E. and K. Lai (1994), using data from the G-7 countries, found no evidence that increased government spending increases the rate of growth of per capita GDP. Barro (1996), for example, concluded that most government spending does not enhance productivity. Indeed, the ratio of government consumption expenditure to economic output has a negative association with growth and investment.

- Alesina, A. et al. (1999), using a cross-country analysis of Organization for Economic Co-operation and Development (OECD) studies found that reducing the share of public spending in the economy would increase economic growth by increasing investment. Specifically, they find that a 1 percent decrease in the share of public spending in GDP leads to an immediate increase in the investment/GDP ratio by .16 percentage points. Also, a cut in public sector costs of 1 percent of GDP leads to an immediate increase in the investment/GDP ratio by .51 percentage points, by 1.83 percentage points after two years and 2.77 percentage points after five years.

- Mueller (2003) documented dozens of articles that empirically demonstrate that decision-making and operational efficiency are much poorer in the public sector than in the private sector. Hence, the diversion of activity from the private sector to the public sector is inherently at high risk of being counter-productive.

- More recently, in a wide-ranging review of recession history, Alesina et al. (2002) determined that spending cuts are the most stimulative of economic growth in a recession. This comports with the Hayekian notion that the private sector needs to gather increased resources to re-activate investment after a "bust."

In addition to these formal analyses of major spending stimulus programs, there is a wealth of informal observations of more modest efforts. These, too, are consistent with the notion that stimulus spending is often a zero-sum game (or worse) without any positive effect on market recovery momentum:

- In 2008, the Bush administration authorized a one-time tax rebate. "Economists from the Brookings Institution estimated that each dollar of revenue loss from the rebates would increase real GDP by more than a dollar if households consumed at least 50 cents of each rebate dollar." According to Martin Feldstein, who was initially an advocate of a small test program, consumers spent only one dollar out of every five received by the rebates, effectively causing a decline in GDP.[3]

- The Obama administration's 2009 Car Allowance Rebate System—the so-called "cash for clunkers" automobile stimulus program–simply cannibalized later car purchases through its offer of a $4,000 rebate, according to Edmonds.com auto analysts.[4] Of the 690,000 vehicles that were purchased under the program, at most, 125,000 would not have been sold under existing market conditions anyway. That means that the program cost taxpayers a subsidy of $24,000 per car and raised car prices 10.3 percent just to move the purchase ahead slightly in time. In essence, the program was a tax with negative benefits.
- The First-Time Homebuyers Tax Credit Program leads to a similar conclusion. The program offered an $8,000 tax credit to first-time homebuyers in 2009 or the first half of 2010. It was expected that the demand for homes would plummet after the expiration of the tax credit. Indeed, home sales fell by almost 40 percent in the months after the program expired and home prices at the end of 2011 were more than 7 percent lower than they had been at the peak reached with the tax credit.[5]

State-Level Studies

Studies comparing the growth rates of various states with different levels of public sector spending also fail to identify consistent evidence that demonstrates how public spending increases a state's rate of economic growth. This is particularly the case when the spending is on transfer payments, but it is ambiguous even when spending is on more productive items, such as education, health and infrastructure.

Figure 4 shows that states that have a history of high rates of total government spending growth (per dollar of Gross State Product [GSP]) subsequently display much lower rates of GDP growth. This is suggestive of a causal relationship between fiscal profligacy and subsequent slow growth.[6]

Figure 4: State GSP Growth is Slower when Prior Government Spending Growth is Rapid

Myth #2

Lower tax rates are bad for the economy in a recession.

Progressive advocates of higher tax rates are fond of asserting that "tax cuts do not pay for themselves," and tax cuts during a recession compound the problem of weak aggregate demand by making it more difficult to finance public spending.[7] Depending on the shape of the Laffer Curve (Figure 5), whether one takes a long run vs. short run view, this is possible. Before taking that discussion further, however, it is important to ask why it is important for tax cuts to pay for themselves. Shouldn't policymakers ultimately be more interested in maximizing total private income?

- Economist Feldstein makes this point cogently: "Why look for the rate that maximizes revenue? As the tax rate rises, the 'deadweight loss' (real loss to the economy) rises so as the rate gets close to maximizing revenue the loss to the economy exceeds the gain in revenue. ... [W]ould I really want to give up say $1 billion of GDP in order to reduce the deficit by $100 million? No. National income is a goal in itself. That is what drives consumption and our standard of living."[8] Brad de Long, an advocate of higher marginal tax rates agrees: "Marty and Bruce are, of course, correct: you don't want to be at the peak of the curve: *you want to be way down on the left side.*"[9] [Emphasis added.]

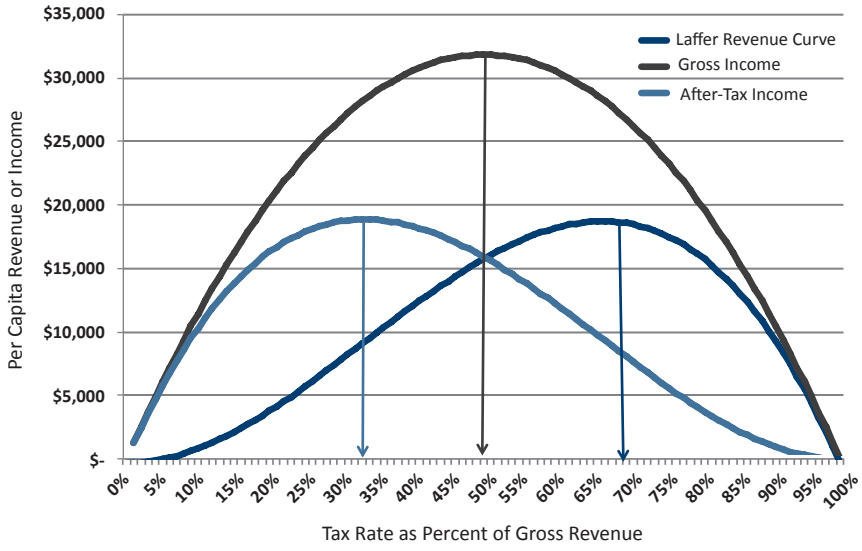
Let us accept, for the sake of argument, that the empirical evidence argues for a Laffer Curve revenue maximizing point at combined total of all tax rates of 70 percent of income as argued by Saez and de Long. This yields the right-leaning Laffer Curve depicted in Figure 5.[10] If the Laffer Curve is, indeed, shaped this way and the tax rate is a flat tax rate, then one can calculate the associated gross income (and after-tax income) that is associated with this Laffer Curve. Figure 5 presents the Laffer Curve and also the gross income and after-tax income curves that are consistent with it.

This simplified example illustrates an important point: Advocates of high tax rates cannot have it both ways. If they levy high tax rates and are successful in gaining higher revenues, then they are condemning the economy to be smaller. Indeed, at the hypothetical Saez/deLong rate of 70 percent and the arithmetic of Figure 5, we find:

- Gross private income is maximized at a tax rate of only 50 percent.
- After-tax private income is maximized at a lower rate, still of only 33 percent.
- At the tax rate (70 percent) that is assumed to maximize revenue, after-tax income is only 43 percent of what it would be at a 33 percent rate, and gross income is only 84 percent of what it would be at a rate of 50 percent.

In other words, shifting resources to the government sector does not dynamically improve the income performance of the economy; it degrades it.

Figure 5: The Laffer Curve: It is not only Revenue that Matters



Do Revenues Really Rise when Tax Rates are Increased?

It is important to evaluate the implicit premise of progressive tax policy advocates—namely, that higher tax rates and/or progressivity generate more revenue over a useful timeframe. A long-standing empirical challenge to this view is the fact that for 60 years, despite wide swings in federal tax rate levels and structures, the share of GDP collected by the federal government in tax receipts has been relatively stable (Hauser's Law).[11] Indeed, the federal government has never been able to collect more than about 19.5 percent of GDP as a revenue share (see Figure 6). Spending in excess of this share has been funded with borrowing.

There have been many debates about why the receipts-to-GDP ratio is stable.[12] In our view, the phenomenon can be traced to both marketplace and political-economic behavioral reactions stimulated by raising rates. Statistical analysis by the authors suggests that, in fact, efforts to increase federal government receipts by raising maximum marginal tax rates are neutralized by other behavioral reactions. Specifically:

- Raising the maximum marginal tax rate (causally) elevates the share of federal receipts relative to GDP, but only by a small amount and only briefly (less than three years).

- The higher marginal tax rate reduces the long-term growth rate of GDP. This, in turn, appears to stimulate an offsetting restoration of lower statutory rates via political-economic processes.

- On balance, over the period depicted in Figure 6, there is a negative correlation (of about .33) between marginal tax rates or progressivity and the share of revenue in GDP.

Interestingly, Hauser's Law seems to operate for states, too. This is demonstrated graphically in Figure 7. (The marginal tax rate series likely appears more stable than it is because of the difficulty of computing a properly weighted, precise, all-state marginal tax rate.[13])

Figure 6: Federal Tax Receipts are a Fairly Constant Share of GDP (Hauser's Law)

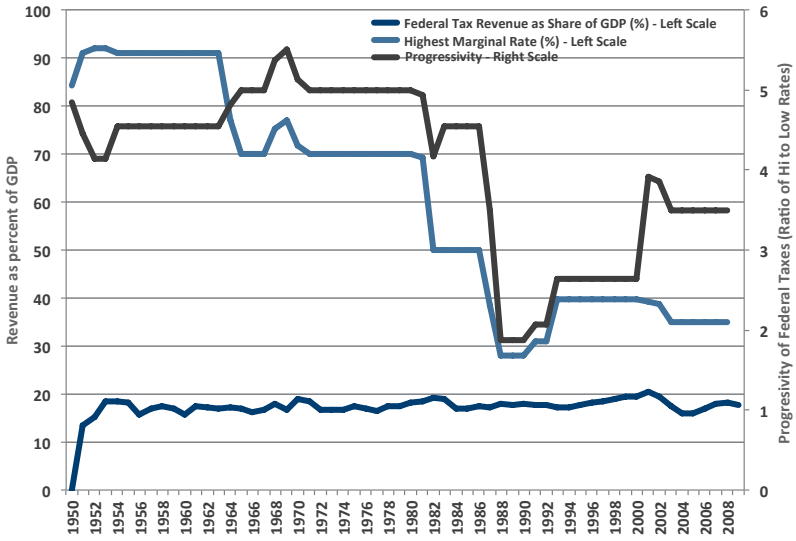


Figure 7: A State Version of Hauser's Law?

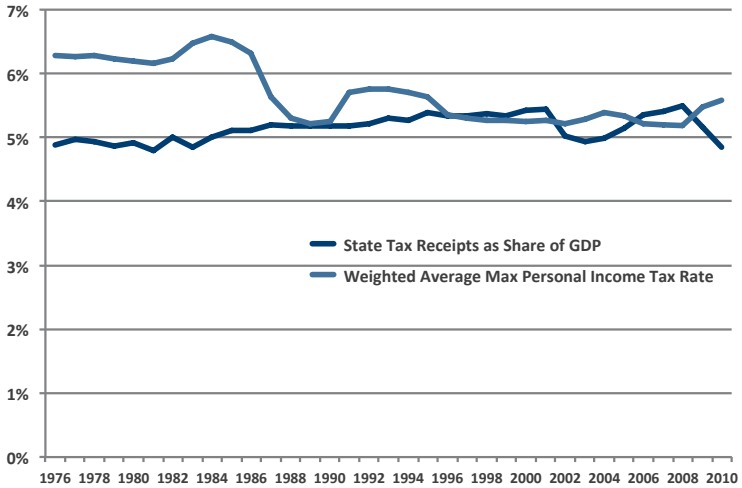


Figure 7 suggests that total state tax receipts, as a share of GDP, have also been mostly stable in the 5 percent range, despite changes in the computed top marginal tax rate. The state tax receipts-to-GDP ratio has varied by less than one-half of 1 percent for almost 40 years. Although there is insufficient data to apply comprehensive statistical modeling, the data suggests that at both the federal and state level, increases in marginal tax rates may not yield the anticipated increase in receipts relative to GDP.

This myth is a corollary of the notion that public spending is stimulative and stabilizing in periods of weak private spending. The expectation of future, higher tax rates leads to an offsetting retrenchment in private consumption and investment that neutralizes any effect of deficit spending.

Myth #3

Raising tax rates will not harm economic growth.

Progressives are fond of arguing that the rate of economic growth is not harmed by increased taxation. The evidence they offer is that marginal tax rates were very high in the 1950s, yet the economy enjoyed reasonable growth. Unfortunately, the multifactorial nature of the causes of economic growth make such simple-minded logic—apart from additional evidence—treacherous. Anything that encourages economic growth will likely make the economy and the collection of tax revenues more resilient to tax rate levels.

To formulate policy properly, one must isolate the effect of a change in tax policy from other confounding factors. Modern statistical procedures allow economists to isolate the effects of taxation from the multitude of other factors that influence economic growth.

National and Cross-Country Studies

Ironically, Professor Christina Romer, Obama's own head of his Council of Economic Advisors, has provided (along with her husband David Romer) some of the strongest and most current evidence to the contrary. Specifically, their recent study concludes that:

- Each 1 percent increase in taxation lowers real GDP by 2 to 3 percent.
- These damaging effects on the economy are persistent and are not diminished by offsetting changes in prices.
- Investment falls sharply in response to tax increases. It is very likely that this strong retreat of investment is part of the reason the declines in output are so large and persistent.

Romer and Romer are not the only ones to measure effects this large. A recent comprehensive study of tax policy effects across many modern economies by the OECD confirms the depressing effect of taxation. In addition, it offers interesting insights into the effect of various methods of taxation. This study finds that:

- Corporate taxes are found to be most harmful for growth, followed by personal income taxes and then consumption taxes.
- A revenue-neutral growth-oriented tax reform would shift the revenue base from income taxes to less distortionary taxes, such as those on consumption.
- High top marginal rates of personal income tax can reduce productivity growth by reducing entrepreneurial activity.

The findings of the OECD research highlight the foolishness of the current, progressive agenda that is aimed at making businesses and high-income individuals "pay their fair share." The OECD findings imply that pursuit of these policies would have a doubly-damaging effect on the growth of the economy: Raising corporate rates and rates on high-income individuals would sap the strength of the investment engine that produces jobs, income and revenues for government.

State-Level Studies

Research at the state level is consistent with these findings. States compete with each other for businesses and hard-working individuals. Thus, it is not surprising that the depressing effects of high rates and certain types of taxation show up in migration data. Households and businesses can relatively easily react to differences in taxation among the states by migrating. Data from the Internal Revenue Service (IRS) on 20 years of interstate taxpayer migration among all pairs of the 50 states provide approximately 25,000 migration activity measures that can be linked to tax differences among the various state pairs.

Using the IRS taxpayer migration statistics, we have been able to isolate the influence on migration of tax policy and related factors. Tax rates matter in making important decisions about where to locate one's family or business.

It is therefore no surprise that we also find effects of the rates of taxation on the rate of growth of state economies. Although the effects are numerically modest on an annual basis, they accumulate over time as the higher rate of growth is applied to a larger economic base.

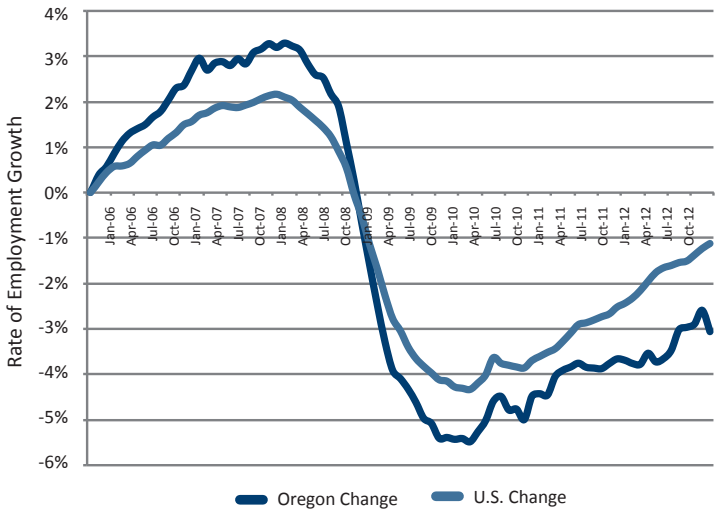
The prevalence of the progressive myth that public spending is stimulative, of course, means that policymakers turn to that remedy first rather than considering permanent changes in tax rate policy as a stimulus technique. Unlike Keynesian policy, which alleges to work at the "macro" level of the economy, tax rate cuts have their effects at the "micro" level of behavior of participants in the economy. Namely, tax rate cutting as a policy has the potential to increase the supply of labor, entrepreneurship and capital. This is because low marginal tax rates, in effect, raise the after-tax returns to labor and capital. The quantity of labor and the quantity of investment are both directly linked to industry productivity potential.

Proponents of big government, however, see tax rate cuts as a subterfuge to cut spending. Thus, few states implemented rate cuts to stimulate their economy during the 2007 recession and its subsequent slow recovery. In fact, most states increased marginal tax rates in a quixotic effort to preserve the government spending status quo.

The evidence that lowering marginal tax rates grows the economy is voluminous and, because individual states vary so much in the level and type of taxes levied against the backdrop of federal policy, it is relatively easy to demonstrate a causal relationship between lower marginal tax rates and greater employment overall and migration to those states with preferable, low income tax rates. Thus, instead of states cutting taxes—the most theoretically and empirically promising means of stimulating the economy—a standard prescription for them is to raise tax rates to preserve or increase public spending during a business cycle downturn. The irony is that both halves of this policy are, in fact, depressive, so there is a negative net effect on economic activity.

In 2008, for example, Oregon raised its highest marginal tax rates on both personal and corporate income to the first and second highest rates in the country. The net effect was to slow employment growth in Oregon significantly relative to U.S. employment growth on the back side of the 2007 recession, as illustrated in Figure 8.

Figure 8: Oregon's Income Tax Hike Slowed Oregon's Employment Growth Rate



Myth #4

Austerity in the form of spending cuts will harm growth and employment.

Austerity or "fiscal consolidation" is a process by which the excess of government expenditures over revenues are brought abruptly into line by spending cuts. Austerity strategies are most often thought of in the national context, where the ability to push today's deficits on future generations is easier than it is in a state context. In these cases, austerity is a last resort when the accelerated level of debt-to-GDP is so high that the borrowing strategy is no longer tolerated in the marketplace. However, at any time of fiscal crisis—including the current economic landscape of U.S. states, austerity measures are a viable policy alternative.[14]

Evidence that Austerity Can Stimulate Growth

The conventional wisdom is that austerity measures that do not include revenue increases will cause the economy's growth to slow abruptly and unemployment to rise. However, this appears to be a myth. There is growing evidence that an austerity program need not have these consequences *if the program is carefully designed*.[15] This is a particularly important consideration for individual U.S. states, since most cannot borrow significantly to defer resolution of the excess of spending over revenue, and there appears to be no positive relationship between tax rate increases and state growth rates.[16]

The literature suggests that the secret to successful austerity measures is to combine spending cuts with tax cuts, *not tax increases*. The reason is that, if both cuts are credible, then consumers and investors will have more confidence that expansionary monetary policy will lower interest rates and that future taxation will be less onerous. The resulting reduction in taxes, interest rates and the increased resources in private hands is then more likely to stimulate added investment and work effort. Unless the public sector labor that is initially idled by the spending cuts is completely unproductive, they will be drawn quickly into the expanded and more productive private sector.

The result is that:

- The fiscal consolidation is more likely to lead to a more stable budget.
- By redeploying resources previously managed by the public sector and reducing tax distortions in the economy, an adverse effect in terms of lost output will be smaller.
- Any stumble by the economy as it adjusts to austerity is likely to be of shorter or even zero duration.

All of these effects are more likely, of course, when other policy is also supportive. Any policy that creates uncertainty about the commitment to the policy, or that provides disincentives for labor and capital to aggressively seek deployment will hamper the prospects and pace of recovery.

> "...the secret to successful austerity measures is to combine spending cuts with tax cuts, not tax increases."

It is interesting to contemplate whether a well-designed austerity program might well have helped the states recover faster. However, between 2009 and 2011, 40 states raised taxes and only eight states lowered tax rates.[17] Moreover, although many states did cut spending, the $140 billion the states received from the State Stabilization Fund features of the stimulus buffered a significant proportion of 2009-2011 projected deficits.

Because of the nature of the services provided by state and local governments and the political and contractual rigidity built into the provision of these services, there was never any widespread movement to use the

opportunity of the recession to make *structural* changes to reign in the size of the state public sector. In fact, according to a recent Brookings Institution report, states that raised revenues the most (in percentage terms) generally remain those with largest remaining budget imbalances, as they chose to maintain or enlarge programs.[18]

Is Europe Really Practicing Austerity?

Unfortunately, the austerity programs being implemented in Europe also involve significant increases in tax rates and relatively modest spending cuts by most accounts. Europe's austerity legacy may prove to be giving the policy a bad name.

Greece is a good example of a government that is relying significantly on tax increases and less-aggressive changes in public spending. For example, a special set of progressive "solidarity levies" will be added to existing income tax rates, raising the latter by 1 to 5 percentage points, the value added tax will rise from 13 percent to 23 percent, and higher luxury and property taxes will be levied. Spending cuts consist of reductions in public sector wages (by 15 percent), reduction of 150,000 public sector jobs through attrition, some defense spending cuts and changes in the national pension retirement age. It is hard to see how such high marginal tax rates will not adversely affect work effort and investment.

In the United Kingdom during 2011 and 2012, under Prime Minister David Cameron's austerity program, spending increased from $1.15 trillion to $1.2 trillion, and public pensions have yet to be reformed. The government has increased the capital gains tax, national insurance tax and value-added tax along with other taxes masquerading as fees. Only 5 percent of public spending cuts thus far appear to have come from reductions in the public workforce.

In Spain, the government austerity proposal to reduce the deficit by $35.2 billion uses a combination of tax increases ($16 billion) and spending cuts ($19.2 billion). They have increased the corporate income tax and will *increase* public pension and unemployment benefits in the course of cutting spending.

In France, where public spending already is close to 60 percent of GDP, the new socialist president, Francois Hollande, also appears to misunderstand the economics of austerity. He expects to increase revenues by 4 percent in the first year and plans to impose a 75 percent marginal income tax rate for those earning more than $1.3 million, in addition to increasing the corporate income tax rate.

Italy may prove to be an exception. Former Italian Prime Minister Mario Monti attempted to reform the pension system and promised to make $5.5 billion in spending cuts to avoid a looming increase in the national sales tax from 21 percent to 23 percent.

For those who believe that a larger public sector is preferable to a smaller one, raising revenues to preserve current or higher levels of public spending is greatly favored over lowering tax rates to stimulate growth instead. In the United States this is especially true at the state level, since current public spending levels are, in effect, capped at the rate of growth of current tax revenues, since budgets theoretically need to be balanced even in the short run (in most states).[19] Hence, there is a tendency for public spending to ratchet upward during periods of high revenue and to seek means of *increasing revenues*, rather than reducing spending, in periods of low revenue.

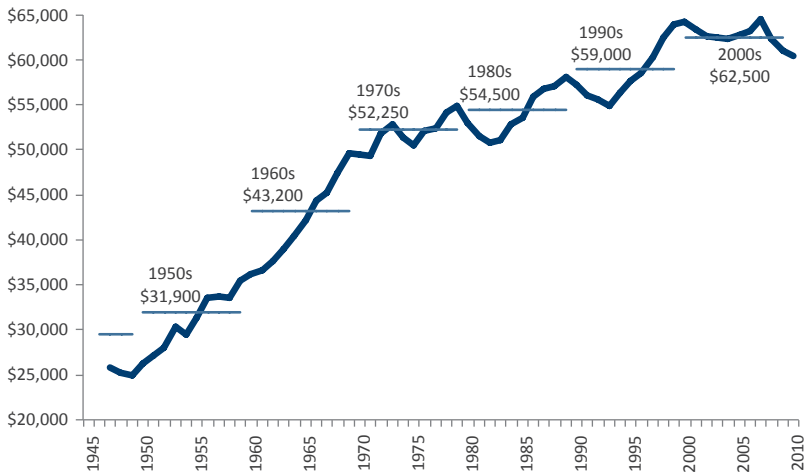
This mentality adds to the bias against cutting taxes to raise employment and incomes. It also causes policymakers to be skeptical of the possibility that lowering tax rates might, in fact, increase revenues in the long run, if not also the short run.

Myth #5

Real household income has not grown in the past 20 years.

It is popular to assert that the incomes of average Americans have stagnated or fallen for the last three decades. Indeed, data from the Current Population Survey of the Bureau of Labor Statistics began reporting an abrupt "flattening" in cash incomes adjusted for inflation in 1975 in its July 1986 Monthly Labor Review. The popular press has attempted to connect the dots to argue

Figure 9: Median Family Income and Decade Averages in 2010 Dollars



that deregulation, free trade and free-market policies ultimately lead to languishing of household incomes.

This blame-game logic, of course, evaporates if the premise that incomes have been stagnant is incorrect. A more careful review of the data shows that the premise is, indeed, false. First, even using unadjusted U.S. census data, the median family income in the United States has been on a fairly stable increase since the end of World War II—despite ups and downs. Indeed, every decade saw an average median income that was higher than the decade before. In real terms, family incomes were twice as high in the 2000s as they were in the 1950s (See Figure 9).

Second, over the decades, there have been significant changes in several other factors that affect the correct measurement of the trend in incomes:

- Many more households receive their income in some form of transfer, from pension plans, Social Security and various income assistance programs.

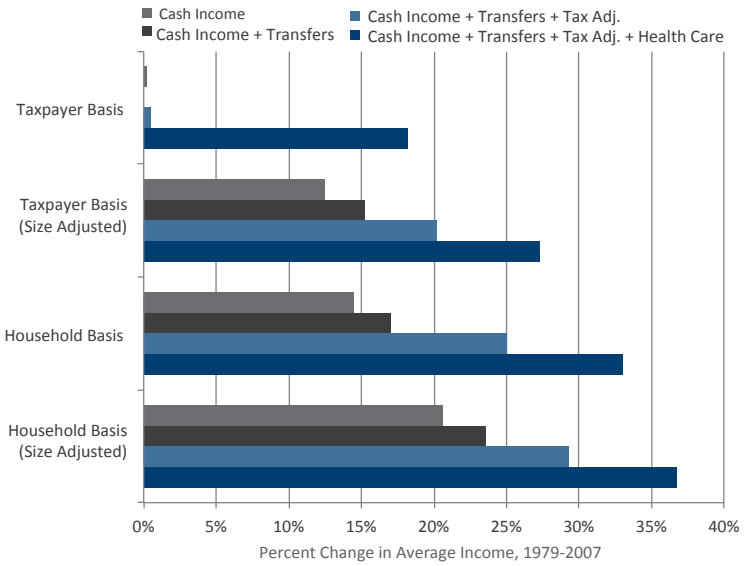
- Tax policy has changed significantly and is more highly redistributive today than it was in the past. The Earned Income Tax Credit (EITC), for example, uses the income tax system to supplement the income of low-earning households with direct cash subsidies in the form of an income tax credit.

- Americans are receiving more of their compensation in the form of benefits, especially prepaid health care insurance coverage.

- Finally, the trend in income depends upon whether one focuses on individuals or households as the relevant unit for measuring economic well-being. Co-habitation, changes in family demographics and sizes have all influenced this trend.

Burkhauser et al. (2011) have reconstructed the path of real average income changes from 1979 to 2007 to account for these changes in compensation, tax practice and social demographics. In Figure 10, the flat (near-zero) growth in real income during this period becomes approximately 37 percent when all of the adjustments are incorporated. This is tantamount to a continuously compounding growth rate per annum of approximately 1.2 percent.

Figure 10: Adjusted Real Income Growth, 1979 to 2007



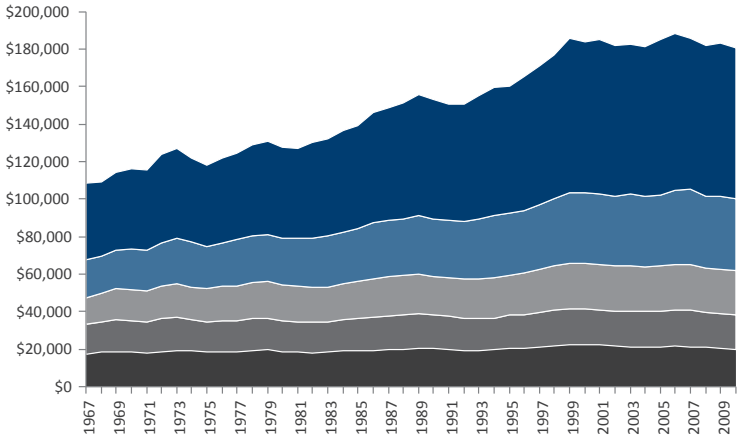
It is unlikely that those who wish to find fault with the outcomes of our economy will be satisfied by correction of the prevailing mythology. However, it is important for policymakers not to tolerate propagation of the myth by progressive organizations who are eager to find a premise for social democratic remedies.

Myth #6

The distribution of income is increasingly inequitable.

Progressive advocates also allege that the country is quickly becoming one of "haves" and "have-nots" in terms of equality of outcome. As Figure 11 illustrates, if one examines the income trends of the various income quintiles over time, one can be left with the impression that certain groups of people are enjoying higher rates of income growth than others.

Figure 11: Percentile Cutoffs for Household Income Distributions, by Year, in 2010 dollars



Although it should be noted that all quintiles have enjoyed some income growth over the period displayed in Figure 11, the highest quintile appears to have enjoyed nearly a doubling of its income. Indeed, as one moves progressively down the quintiles, this appearance of a regressive shifting of income shares persists even though the percentile cutoffs (in real dollar terms) have risen for all quintiles. For example, using other data, we know that the real income of the wealthiest 5 percent of households rose by 14 percent between 1996 and 2006, while the income of the poorest 20 percent of households rose by just 6 percent. This, in turn, means that the income of the wealthiest 5 percent of households grew (relative to the lowest quintile) from 8.1 times the latter's income to 8.7 times the latter's income by 2006.[20]

The problem with this interpretation, of course, is that individuals who occupy these quintiles are not the same individuals from one year to another. Indeed, in a market economy where upward mobility is possible for many people, one would expect the highest quintile to be selectively occupied by individuals who have progressed, in a life-cycle sense, through their careers to occupy ever-higher quintiles.

The level of performance, human capital accumulation and risks of failure likely increase as one rises through the ranks, so we would expect:

- It is easiest to exit the lowest quintile.
- It is progressively more difficult to exit higher quintiles to the next highest level as requirements of experience and capability (human capital) become sharper.
- It is hardest to stay in the highest income categories because of high levels of competition and risk.
- It is easier to stay in somewhat lower income categories where competition and risk may be less significant.

This is precisely what we find, in fact, when we examine dynamic panel data that allow us to track individuals year by year as they transition from one income bracket to another. Figure 12 was constructed from a special U.S. Treasury data collection effort on the movement of taxpayers of various income classes from one year to the next.[21]

- The lowest quintile workers have the highest probability (56 percent) of being in a higher quintile in 2005 than in 1995.

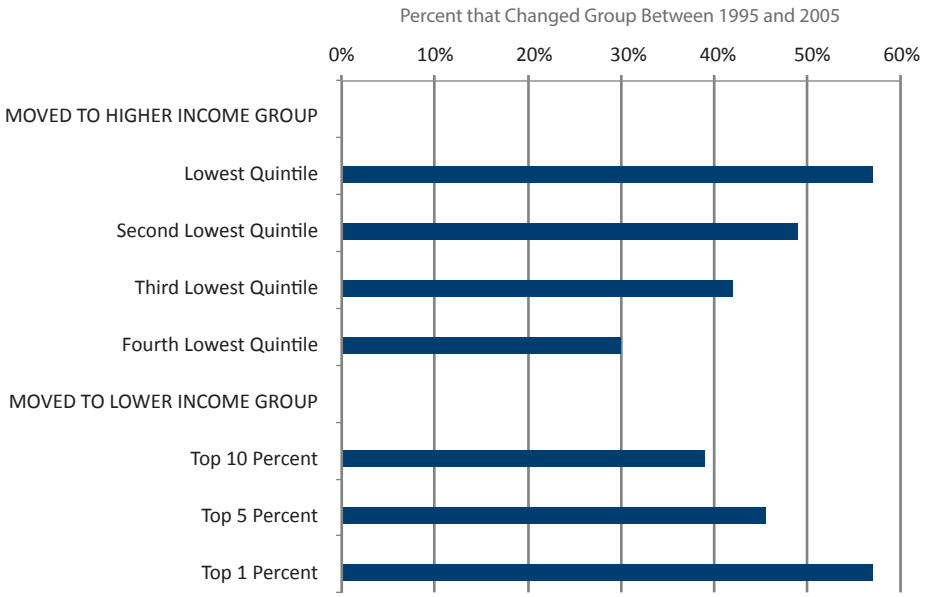
- The probability of moving to a higher quintile declines as one achieves higher quintile status. For example, the probability of being in a higher quintile if one is already in the fourth-lowest quintile (second highest) is about 30 percent.

- The probability of falling from the highest income levels is correspondingly high. Those already in the top one percentile of income in 1995, for example, had a probability of 58 percent of being in a lower income category in 2005.

- The probability of falling even from the top 10 percent is almost 40 percent.

It is clear, therefore, that the U.S. economy offers significant upward and downward mobility. No given status is guaranteed. Put differently, the economy offers relatively ready opportunity to rise or fall in economic status, but it does not guarantee outcomes, only opportunity. Progressives, of course, would prefer to see equalization of outcomes, rather than opportunity. Ironically, however, the tax and redistribution policies necessary to move toward equalized outcomes unwittingly risk damaging the very engine of competition and opportunity that creates wealth in the first place. Competition and efforts to avoid risk generate entrepreneurship, hard work, motivation to obtain education and the many other behaviors that are crucial to providing superior standards of living for all of our citizens.

Figure 12: The High Rates of Economic Mobility of U.S. Workers, 1995-2005



Myth #7

Raising tax rates on the rich will not harm the economy.

During the 2001 recession, the Center on Budget and Policy Priorities circulated a three-page memorandum arguing that when recessions reduce state revenues, legislatures would be better served by selectively raising taxes on the state's highest income households rather than by cutting spending on social programs.[22]

Their conclusion is that, if anything, tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run. Reductions in government spending on goods and services or reductions in transfer payments to lower-income families are likely to be more damaging to the economy in the short run than tax increases focused on higher-income families.

A thorough reading of Orszag and Stiglitz (2001) reveals, however, that even they recognize this advice is counter-productive to a prompt recovery:

> *"In any case, in terms of how counter-productive they are, there is no automatic preference for spending reductions rather than tax increases.*
>
> *It is worth emphasizing that any state spending reductions or tax increases are counter-productive at this time: they restrain the economy at a time when it is already slowing."*

While Orszag and Stiglitz examined studies of consumption and saving by income level, they did not study the effect of taxes on economic recovery. Moreover, the memo does not address the relationship between saving and investment and the role investments play to fuel future production and consumption. Thus, they make a far from compelling case for sacrificing private expenditures and investments for the preservation and expansion of government employment and programs.

At almost every level of government—federal, state and local—politicians have painted themselves into a fiscal corner. They dismiss cuts in entitlement benefits as touching the "third rail" of politics. They dismiss broad-based taxation out of fear of losing crucial middle-class votes. In doing so, they are eliminating useful alternatives and are left with one alternative: tax the rich.

Taxing the rich is politically attractive. It's relatively easy to get 99 percent of the voters to turn against the other 1 percent, no matter who the 1 percent are. However, even if one puts aside the counterproductive behavioral reaction that higher rates of taxation might engender in the rich, there are other serious problems with relying on taxation of the rich to address U.S. budgetary woes.

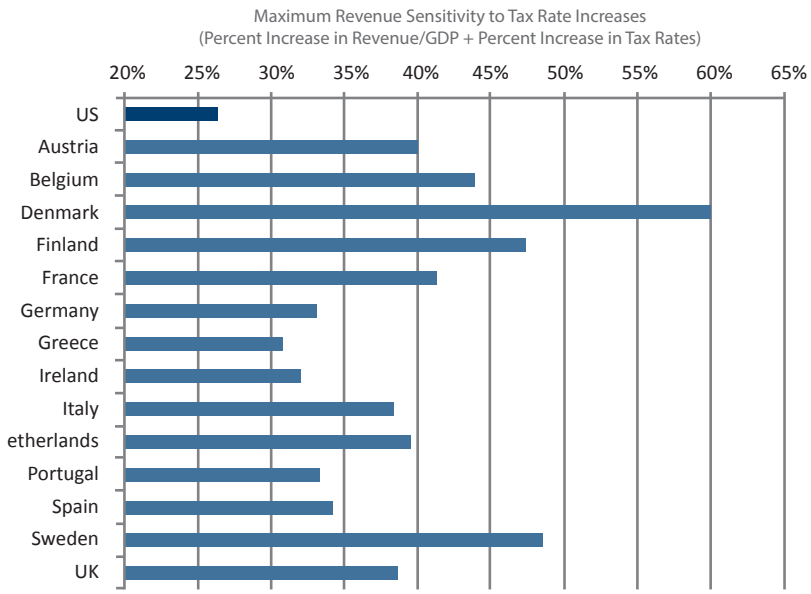
Does it Generate Enough Revenue?

Taxing the rich does not generate as much revenue as one might expect. Assume that there is no offsetting behavioral response and one could find support for a 10 percentage point increment to be applied to the incomes of the "rich."

- Taxing the incomes of the top 1 percent of taxpayers at this rate would yield only $93.8 billion. These are all taxpayers with incomes above $380,000 or so.
- Taxing the incomes of the top 5 percent of taxpayers would yield about $180 billion. This would require a tax on all incomes over about $150,000 per year.
- Taxing those in the top 10 percent of the income distribution at the same rate would raise only $340 billion. This would require bringing the taxable income threshold to about $110,000.

Even the most aggressive of these policies would barely cover one fiscal year's interest on the outstanding debt, assuming debt holders remain happy holding debt at

Figure 13: The U.S. Laffer Curve Implies Low Revenue Productivity of Tax Rate increases



today's interest rates. Strictly from a fiscal sufficiency standpoint, a selectively high tax rate on the rich would leave a very large problem to be solved by other means.

Where are we on the Laffer Curve?

A recent, multi-country attempt to characterize the Laffer Curve found that the responsiveness of revenues to tax increases is the lowest in the United States of any of the OECD countries studied by Trabant and Uhlig (2012, see Figure 13). The maximum revenue potential is approximately 7 percent of GDP. Since our current debt-to-GDP ratio is roughly 100 percent, it would take eight to 10 years at the revenue-maximizing tax rate on both labor and capital to bring the current U.S. debt-to-GDP ratio down to a level closer to the historical norm. Or, put differently, the total revenue generated by the revenue-maximizing tax increase is approximately equal to the annual deficit expected under the Obama administration's budget for the next 10 years.

> "The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business and invest it in tax-exempt securities or to find other lawful methods of avoiding the realization of taxable income."

The history of taxation shows that taxes that are inherently excessive are not paid. The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business and invest it in tax-exempt securities or to find other lawful methods of avoiding the realization of taxable income. The result is that the sources of taxation are drying up; wealth is failing to carry its share of the tax burden; and capital is being consumed rather than accrued.

V. The Conundrum for States

For states, raising taxes on the wealthy is particularly challenging. States like Oregon and Maryland have raised the tax rates on higher income households only to find themselves with what has been called in Oregon the "Mystery of the Missing Millionaires." Neither Oregon's nor Maryland's tax increases have raised the revenues promised by the states' official revenue forecasts.

> "Capital is very likely more mobile between states than between countries, and imposition of selective taxes needs to be approached with trepidation."

Capital is very likely more mobile between states than between countries, and imposition of selective taxes needs to be approached with trepidation. The relationship between taxation and migration dates back at least as far as Adam Smith's *Wealth of Nations* (1776), when he warned of stifling industry with taxes:

> *"The proprietor of stock is properly a citizen of the world and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a ... burdensome tax and would remove his stock to some other country. ... By removing his stock he would put an end to all the industry which it had maintained in the country which he left."*

Smith's observations rang true in 2012 when one of Facebook's co-founders, renounced the American citizenship he gained as a teenager and become a permanent resident of Singapore, which levies no capital gains taxes. This anecdote, however, highlights a relationship that has long been found in the economics literature.

VI. Recent Research Supporting Free-Market Approaches

In this section we review the recent work of the key, free-market advocates and the critiques promulgated by progressive groups. In our view, the critiques are weak and offer opinions rather than useful research counterpoints to the professional research efforts of the free-market advocates.

We begin by summarizing the data and methods used to support the free-market position as expressed in certain key, recent publications. We then evaluate the critiques published by their opponents.

Rich States, Poor States

Laffer, Moore and Jonathan Williams recently released the 5th edition of *Rich States, Poor States*.[23] ALEC has published *Rich States, Poor States* for five consecutive years to examine what makes the economies of some states rich and others poor. *Rich States, Poor States* is a compendium, state-by-state, of tax and regulatory indicators that theory suggests should influence the economic health and growth prospects of the respective states. The study measures 15 factors and presents the comparative measures comprehensively on a state-by-state basis.

This comprehensive report does what is rare among political-economic treatises:

- It lays out clearly the underlying economic principles and logic for its policy focus on tax and fiscal policy.
- It develops consistent measures of indicators of these policies on a state-by-state basis.
- It provides clear and concise state rankings for each of the 15 policy dimensions, as well as a consolidated ranking for each state referred to as the "ALEC-Laffer Economic Competitiveness Index."[24]

The authors of *Rich States, Poor States* use an equal weighing method for developing their state scores from the 15 factors. However, the raw state scores are presented so that those who would weigh the factors differentially can do so if they wish. This facilitates individual states bringing their own weights and preferences to the debate. In our view, the *Rich States, Poor States* report is an informative source of comparative market-oriented state characteristics.

The rankings give state officials a useful starting point in thinking about how they might improve their state's economic and fiscal prospects. *Rich States, Poor States* gives practical guidance to citizens and legislators sympathetic to ALEC's principles of free markets, limited government and tax burdens.

The Progressives' Critiques

The publication of the 2012 edition unavoidably coincided with the kick-off of the 2012 presidential campaign season, and its implied policy direction—and ALEC itself—have been under very aggressive attack this year as a result. The Institute on Taxation and Economic Policy

(ITEP) and its sister organization, Citizens for Tax Justice (CTJ), have seemingly led the policy attack on Laffer and ALEC. However, their critique is short on analysis but long on innuendo.[25] To wit:

- "[T]he most laughable thing about the *[Rich States, Poor States]* index is the way it claims to provide a look at the important "policy variables" under the control of state lawmakers but then ignores the ones that actually matter" (e.g., public spending, in ITEP's view).

  Of course, if the ALEC-Laffer Competitiveness Index were missing key elements, it would do a poor job of explaining the comparative economic performance of the states. An index constructed agnostically of "bad" things will prove a terrible indicator of economic vigor if it the omitted "good" things. Indeed, including missing "good" things would only improve its performance. Also, in a multifactorial economic world, one would expect exceptions to the general case.

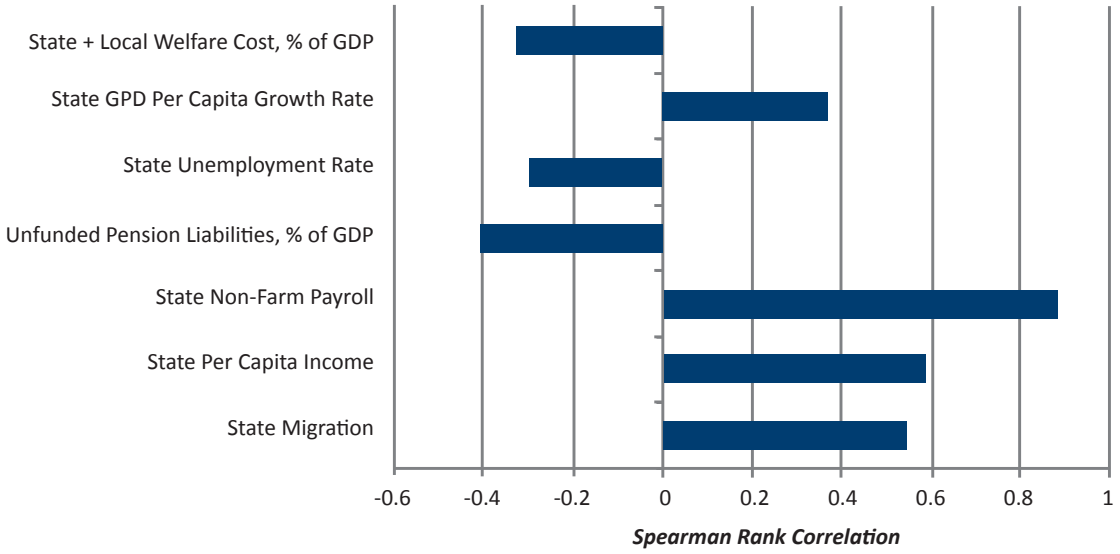
  More important, we have examined the relationship between the ALEC-Laffer State Economic Competitiveness Index and found it, in fact, to be usefully correlated with important economic performance measures and not "missing" the influence of the "expenditure side" of the fiscal equation. For example, the rank correlation of the index with median household income rank of a state was measured at 88 percent.[26] Other efforts failed to detect a significant, positive influence of state and local spending, in the aggregate or by major spending category.[27]

Figure 14 reveals that a higher state competitiveness ranking is associated with superior economic performance ranking among the 50 states. Specifically, a higher competitiveness score is associated with:

- Lower state and local welfare expenditures.
- Higher growth rate of GDP per capita.
- A lower unemployment rate.
- Lower unfunded pension liabilities.
- Higher non-farm employment.
- Higher per capita income.
- A higher rate of migration.

  These are all positive effects for an economy. They are exactly what one would expect if market-oriented fiscal and labor policies (which is the heart of the Laffer ranking system) were in place in a state.

Figure 14: The U.S. Laffer Curve Implies Low Revenue Productivity of Tax Rate increases



VII. What do the Critics have to Offer?

The studies by Laffer and ALEC have become targets for criticism by progressives who see them as a threat to high tax rates and government involvement schemes that they favor. The distinguishing feature of the Laffer and ALEC studies is that they make their case in an academic-style manner. The theoretical underpinnings of the analysis are presented in the documents, their appendices or in companion documents.[28] The analysis is strongly empirical, usually with the support of statistical modeling.

In contrast, it is important to consider what progressives are offering as alternatives.

Dubious Analysis

The progressives' analyses are frequently simplistic, unprofessional and technically flawed—but well promoted. A recent example is the critique of the ALEC-Laffer state policy rankings in *Rich States, Poor States* by Peter Fisher of the Iowa Policy Project. It has the provocative title, "The Doctor is Out to Lunch."[29] It has been widely disseminated by a network of progressive organizations and friends in the liberal press who have no interest in the quality of the work, only the conclusions. The quality of Fisher's "analysis" is a case in point of the dubious quality of progressive analytical claims.

Specifically, Fisher's analysis consists of inaccurate regressions of selected ALEC-Laffer policy factors (tax revenues and right-to-work indicators or the ALEC-Laffer state rankings) on selected economic growth measures of the states. As we will reveal, the approach used by Fisher to evaluate ALEC-Laffer indicators has no hope of identifying effects of individual policy variables or the ALEC ranking with state economic health. Yet Fisher makes much, for example, of his finding that tax revenues or right-to-work statuses are not positively associated with measures of state economic activity.[30,31]

First, he includes *shares* of total employment enjoyed in a state by certain industries in his regression studies. This is to control (presumably) for other, non-policy sources of growth. But shares of employment in these sectors are themselves an outcome of growth—meaning that he is effectively trying to explain one measure of growth with another measure with no attempt to demonstrate which one is the cause of the other. It is a bit like explaining a person's height by the length of his legs–two correlated measures of the same thing. More important, however, the use of shares in the first place is theoretically incorrect, since the total of all shares obviously cannot exceed 100 percent. Thus, if Fisher's selected industries keep growing until they represent 100 percent of all employment, one can only conclude that Fisher expects a state's growth to cease–an obviously absurd implication of his approach.

Second, work by widely respected economists such as Reed (2008) and Ohanian, Raffo and Rogerson (2008), find strong relationships between tax policy and economic health by properly measuring tax policy[32] and using proper controls for other factors that might be affecting economic activity.[33] Neither ALEC nor Laffer would ever claim that only policy factors matter to the economic prospects of states.

Third, Fisher's findings that the ALEC–Laffer state rankings bear no relationship to state economic health is contrary to the data. But, once again, it is the oversimplification of the analysis that leads him to the wrong conclusion. He fails to recognize that the *Rich States, Poor States* analysis consists of *rankings*, not predictions of growth *rates*. Hence, the obvious appropriate comparison is between ALEC-Laffer policy *rankings* and *rankings* of state economic performance. Fisher could have done this very simply by using well-known, consistent measures of comparative state performance.

We present the analysis Fisher easily could have done in the following discussion.

The Federal Reserve Bank of Philadelphia has prepared comparable indices of state economic health (for all months since 1979).[34] Because the indices are single measures (comprised of multiple factors[35]), they are easily ranked.

Those rankings can then be compared with ALEC-Laffer rankings of the pro-market policy postures by the 50 states.

Figure 15 and Table 1 present the results. They demonstrate clearly that, contrary to Fisher and his progressive colleagues, there is a positive relationship between the ALEC-Laffer rankings and state economic health rankings. Figure 15 shows the association graphically between the policy rankings presented in the 2008 *Rich States, Poor States* publication and the actual performance of the 50 states in 2008, 2009, 2010, 2011 and 2012 (as of June).[36] The positive association is obvious from the graphic.

Table 1 performs a more statistically-sophisticated test, measuring a special type of correlation when one is studying ranks (the so-called Spearman Rank Correlation). This properly measures the correlation between the ALEC-Laffer state policy rankings and the Philadelphia Federal Reserve's state performance rankings.[37] In this case, the correlation is presented for years contemporaneous with the *Rich States, Poor States* publication as well as one, two, three and four years afterwards (to the extent the future years have occurred).

Figure 15: Higher ALEC-Laffer Ranks are Associated with Higher State Performance Ranks

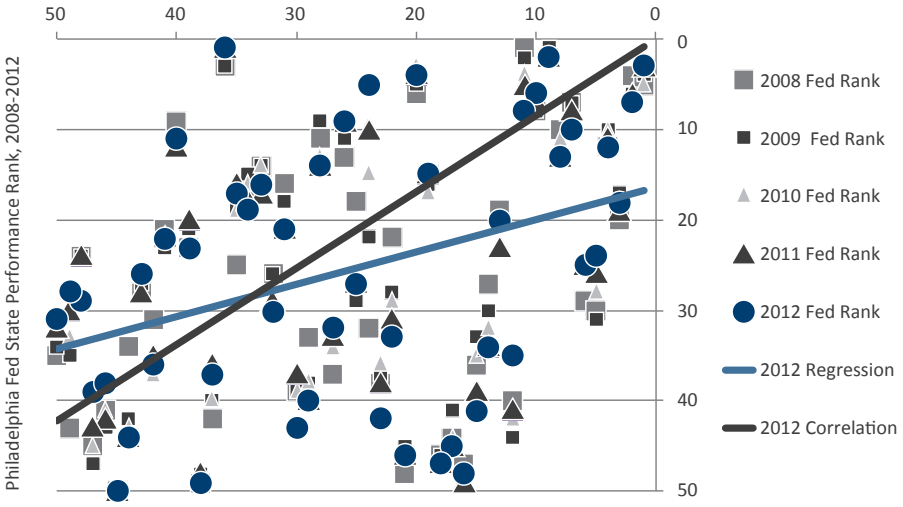


Table 1: The Correlation of ALEC-Laffer State Policy Ranks and State Economic Performance

	ALEC-Laffer State Policy Rank Year				
	2008	***2009***	***2010***	***2011***	***2012***
Spearman Rank Order Correlation: ALEC-Laffer Ranks vs. FRB- State Performance Ranks					
Contemporaneous	38.9%	40.7%	28.7%	26.4%	27.1%
1 Year Ahead	39.6%	38.6%	27.5%	27.4%	
2 Years Ahead	37.2%	37.0%	27.0%		
3 Years Ahead	35.8%	36.7%			
4 Years Ahead	35.7%				

The findings are completely contrary to Fisher:

- There is a distinctly *positive* relationship between the *Rich States, Poor States*' economic outlook rankings and current and subsequent state economic health.

- The formal correlation is not perfect (i.e., it is not equal to 100 percent) because there are other factors that affect a state's economic prospects. All economists would concede this obvious point. However, the ALEC-Laffer rankings alone have a 25 to 40 percent correlation with state performance rankings. This is a very high percentage for a single variable considering the multiplicity of idiosyncratic factors that affect growth in each state—resource endowments, access to transportation, ports and other marketplaces, etc.

  We encourage all policymakers to read the professional literature on the effects of public policy factors, such as tax rates and right-to-work policy and not fall prey to flawed demonstrations. Earlier in this paper, we further debunked the notion that factors like tax rates don't matter.

Oklahoma: Lower Income Taxes Fuel Faster Economic Growth[38]

For the Oklahoma Council of Public Affairs, Arduin, Laffer and Moore Econometrics analyzed the effect of the gradual elimination of Oklahoma's individual income tax. Currently, Oklahoma's top marginal tax rate on individuals is 5.25 percent. The phase-out would drop the top rate to 2.25 percent in 2013 and completely phase it out by 2022.

- Personal income growth would be an average of 1.9 percentage points higher, adding $47.4 billion in personal income in 2022.

- In 2022, state GDP would be $53.4 billion, or 21.7 percent higher than if the current taxes remain in place.

- State employment growth would be an average of 1.5 percentage points higher, with 312,200 more people working in Oklahoma after the phase out of individual income taxes.

  The proposed tax reform would lower revenues relative to the no-reform case by $365 million in 2013 to $2.1 billion by 2022. However, the increased growth in GDP and personal income would buoy revenues from other sources, such as sales taxes, excise taxes, business taxes and local tax sources.[39]

- On balance, the share of total taxes relative to personal income is anticipated to decline from its current 8.7 percent to approximately 6.8 percent by 2022.

> "...increased growth in GDP and personal income would buoy revenues from other revenue sources, such as sales taxes, excise taxes, business taxes, and local tax sources"

Data and Methodology used by Arduin, Laffer and Moore Econometrics

Many of the study's conclusions are supported with empirical evidence. The key impact predictions, however, are derived from regression analysis provided in the report's appendix. The statistical model calculates the relationship between statutory marginal tax rates on individual income with the rate of growth of personal income at the state level, using actual historical data.

The statistical model tests the supply-side proposition that the top marginal tax rate influences state economic growth. It also examines the extent to which total state and local expenditure burden relative to personal income affect economic growth. In addition, the study includes the state population growth as a control variable. The analysis spans 50 states and eight years (2001 through 2008).

It is noteworthy that the revenue relationship to tax rates is not established directly by the original Laffer Curve itself, but rather by Laffer measuring the revenue impacts of tax policy through the historical linkages for Oklahoma, specifically between personal income and the various (non-income) revenue sources. This enables a relatively parsimonious model to be used in a transparent and conservative way to convert its findings to the growth, revenue and other economic impacts associated with the proposed tax rate change.

It is noteworthy, also, to observe that at no time does the Arduin, Laffer and Moore Econometrics assume or find that lowering the marginal income tax rate will pay for itself in higher personal income tax revenues, as many simple-minded criticisms of supply-side economics take as the central conclusion of the Laffer Curve notion. The relationship between tax rates and revenues has always been an empirical question to Laffer and adherents to that theoretical notion.

Why the Progressives' Critique should be Ignored

The Oklahoma study by Arduin, Laffer and Moore Econometrics has been subject to criticism by the Institute on Taxation and Economic Policy (ITEP) and joined by several Oklahoma-based economists.[40] The timing and formatting of the various critiques give the appearance of a coordinated effort to attack Arduin, Laffer and Moore Econometrics and ALEC studies.[41]

Arduin, Laffer and Moore Econometrics' regression analysis used the combined federal and state top marginal tax rates. ITEP and Willner argue that federal tax rates should not have been included. Ironically, ITEP appears to disagree with itself on this issue. In its own 2011 guide to state and local taxes, ITEP states:[42]

> *When we evaluate the fairness of a tax system, we should also consider overlapping tax systems that affect the same taxpayers. It is important, in particular, to consider state and local tax policy in the context of federal tax policy.*

In fact, basic economics and common sense alone make it obvious that a taxpayer's response to a state tax rate will be very different if that taxpayer is also subject to a 15 percent or a 35 percent federal tax rate. The combined levels of taxation will influence marginal economic and tax avoidance behavior. Moreover, it is a long-accepted notion in tax theory and practice that tax bases are the common property of different levels of government. In other words, competition for a common tax base among the wide range of governments is a key feature of tax policy.

ITEP and Willner complain that the statistical model does not include certain other variables that may affect economic growth, ranging from sunshine to oil production. ITEP cites one study as evidence that "more than 130" variables explain state economic growth.[43] Willner attacks Arduin, Laffer and Moore Econometrics for leaving out important variables. Willner provides a laundry list of general types of variables (human capital, infrastructure) that should have been included. Neither ITEP nor Willner provide specific variables that they believe to be crucial or how those variables should be measured.

In fact, the types of econometric models performed by Arduin, Laffer and Moore Econometrics use very short-term rates of change (e.g. year-over-year) and not levels of the variables of interest in the study. Many fixed or slow-moving cross-state non-fiscal factors fall away arithmetically in a rate-of-change. For example, the share of the population with at least a bachelor's degree does not change much from year to year.

While economists tend to prefer more data to less, at the same time the most potent econometric techniques are very consumptive of data, which is why one must be cautious to include large numbers of factors in the analysis. Adding more variables is not a good substitute for well thought out, *a priori* theoretical case for each variable. Indeed, an agnostic focus on the key variables is a less biased research posture than a selective inclusion of many factors in a limited-data setting.

Rogers also criticizes the use of percent changes in personal income as the dependent variable in the Arduin,

Laffer and Moore Econometrics study. Rogers fails to provide an alternative measure that she believes to be superior. Ironically, Rogers employs percentage changes in examining the employment impacts of tax changes in a paper she co-authored in 2004.[44]

As the only study cited in ITEP's critique, ITEP places a great deal of weight on Alm and Rogers' article. Alm and Rogers paper is so muddled, however, that a recent working paper reviewing the literature in this area had to exclude the Alm and Rogers paper from the review.[45] Indeed, it thus comes as no surprise that the authors themselves find their results statistically "fragile."[46]

In fact, of the more than 130 variables examined by Alm and Rogers, the study does not include statutory tax rates. This is despite Rogers' earlier advice that research should include such data. While Alm and Rogers' analysis includes many variables from sunshine to oil production, the paper provides no indication of the significance or size of these variables. The exclusion of statutory rates from the paper suggests that many of the variables used by Alm and Rogers are irrelevant. Olson attempts to provide a highly technical criticism of the statistical model used by Arduin, Laffer and Moore Econometrics. However, Olson's memorandum fundamentally mischaracterizes the independent variables used by Arduin, Laffer and Moore Econometrics, thus rendering nearly all of Olson's analysis meaningless.

Rogers argues that the link between tax rates and economic growth has not been established. In contrast, in 2010—two years before Rogers' memorandum—one of the top journals in economics published a widely circulated article making such a link.[47] The results were discussed in the pages of *The New York Times* and *The Wall Street Journal*. Indeed, the economics profession has hundreds of articles, working papers and other research testing the existence and size of the relationship between tax rates and economic growth. An EconLit search of the term "tax rates" with the term "economic growth" provided more than 400 articles—and that just since 1960. Indeed, Rogers' own work—which she cites in her memorandum—advises the use of tax rates to evaluate tax effects.[48]

Willner makes the bold and unsupported statement that "economists use real, inflation-adjusted data almost exclusively." He argues that the data must be "inflation-adjusted." Willner does not explain what he means by "inflation-adjusted," but it seems that he is confusing consumer inflation with a GDP deflator. Nevertheless, there are important reasons why researchers would avoid using any form of inflation-adjusted data for a state-level-analysis. The key reason is that much of the data that is inflation adjusted by the data provider tends to apply a national inflation rate to the state-level data. This then raises the question whether the results are from actual state-by-state changes or from use of an inappropriate inflation adjustment.

Willner complains that Arduin, Laffer and Moore Econometrics' use of state and local expenditures as a share of personal income is problematic. However, he provides no alternative that he believes to be superior.

Tennessee Death Taxation: Elimination Would Stimulate Economy[49]

In work done for the Beacon Center of Tennessee, Laffer and Wayne Winegarden examine the economic impact of Tennessee's gift and estate tax policy. Gift and estate taxation is a carryover from the early days of taxation in the United States when it was difficult to measure and impose taxes on income or sales or to assess and collect ad valorem property taxes. In contrast, the resolution and distribution of an estate is a centuries-old practice, and levying taxes on this activity can be administratively convenient.

In the modern setting, the gift and estate tax fails standard criteria for efficient and equitable tax instruments. Its collection is unrelated to any burden placed on society by the taxpayer and can have terribly inequitable effects on the well-being of the deceased's survivors. Finally, for many, it is a tax on what is mostly the accumulations of labor income that has already been taxed at the time of receipt. Some progressive proponents of the tax see it as a means of keeping family dynasties from accumulating wealth over time. Others see the bequest motive as a natural aspect of the human family relationship.

Laffer and Winegarden find that if Tennessee had eliminated its death tax in 2000, by 2010, the state would have seen the following positive impacts:

- Economic output would have been 14 percent larger in 2010.
- As many as 220,000 more people would be working in the state.
- State and local tax collections would have been as much as $7.3 billion higher.

Data and Methodology used by Laffer and Winegarden

The statutory complexity of gift and estate taxation rates, the uncertainty of the timing and incidences of the burden of the tax and other factors make it a difficult tax to model statistically. Hence, it should come as no surprise that Laffer and Winegarden extract the economic implications primarily by comparisons of performance of states without such taxes. Comparisons of various states over time and differences between states with and without gift and estate taxation are used instead of formal statistical models.

The Progressives' Flawed Critique

Laffer and Winegarden's Tennessee has been subject to criticism by ITEP.[50] First, ITEP questions Laffer and Winegarden's characterization that Tennessee's policies are "first-rate" because Tennessee embraces so many of the 15 factors that Laffer has identified in ALEC's annual *Rich States, Poor States* report as crucial to a state's competitiveness. ITEP's critique does not refute that the *Rich States, Poor States* factors are important, but that additional factors should be considered, such as the size of the mining sector, educational attainment, infrastructure and "even climate" (much like ITEP's earlier critique that an analysis should include everything from sunshine to oil production).

As the analysis summarized in Figure 15 indicates, the factors in the *Rich States, Poor States* competitiveness index are strongly associated with higher long-term GSP per capita, personal income per capita, lower unemployment, unfunded pension liabilities, welfare costs and other key performance indicators. In contrast, it is difficult to find statistical associations between public spending measures and economic outcomes.

ITEP also questions the relevance of state versus state comparisons made by Laffer and Winegarden in their effort to isolate the incremental effect of the gift and estate tax levies. Ironically, while criticizing that such comparisons cannot control for unmentioned variations between the states, ITEP attempts to use an analogous technique to make their own counterclaims. Indeed, they admit that the average estate size in Florida (with no estate tax) is much larger than that in Tennessee. To explain this longstanding difference, they invoke the (one-time) death of Sam Walton's wife to assert that the level of "noise" created by such events makes it "simply impossible to use it to show that state estate tax laws are driving changes in average estate size."

ITEP states that in 2009 "Florida had almost twice as many federal estates filed per 100,000 residents than Tennessee." ITEP also incorrectly asserts that the increase began before the phase out of the Florida tax in 2002. In fact, the spikes in relative estate filings in Florida occurred well after the phase out began.

ITEP incorrectly asserts that "few economists" believe the effects of gift and estate taxes to be of any significance. On the contrary, as the National Bureau of Economic Research's Wojciech Kopczuk has pointed out, such taxes have long been controversial and the economic effects are expected to be large. Kopczuk's 2006 analysis leads him to conclude, "that it is both inherently unfair to levy a tax at death and that it is particularly costly to do so, highlighting its adverse effect on wealth accumulation, discrimination against savers, negative consequences for the survival of small businesses and a multitude of avoidance opportunities."[51] In contrast to ITEP's unsupported assertions, Kopczuk's numerous academic articles at Columbia University on the death tax leads him to conclude the following:

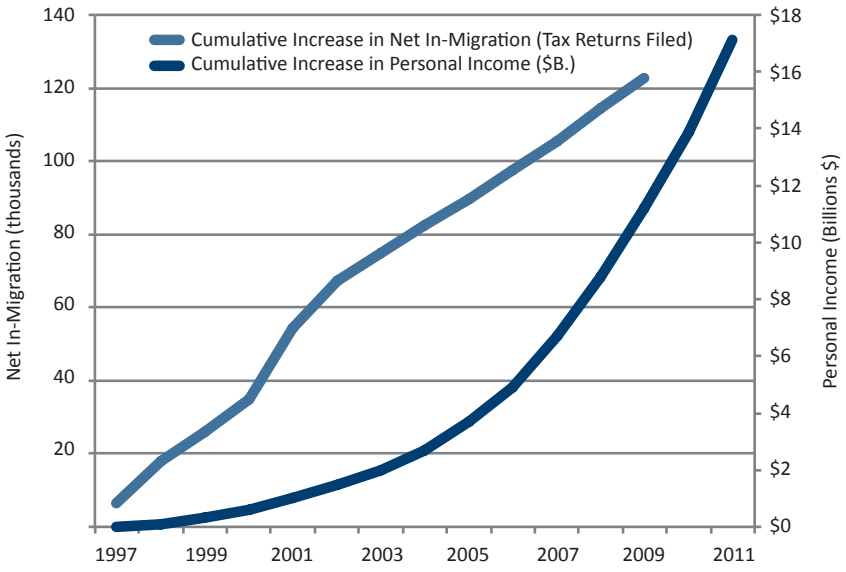
> "[T]he estate tax does, in fact, reduce reported estates, either because it curtails wealth accumulation or induces tax avoidance or both."[52]

Additional evidence of significant economic effects comes from Fruits and Pozdena. They have used large, historical state panel datasets to measure the scale of the impact of estate taxation on net in-migration and personal income growth using econometric models. We find that Tennessee has historically had fairly large gross in-and out-migration of approximately 125,000 tax filers per year in each direction. However, net in-migration has been extraordinarily low—on the order of 500 to 700 tax filers per year—or only about one-hundredth of a percent of the ambient population of tax filers.

Applying the respective econometric models to the Tennessee case with the existing gift and estate tax removed yields numbers that are not inconsistent with Laffer and Winegarden's findings (see Figure 16). Specifically, cumulative increases in personal income of $17.1 billion, and cumulative net in-migration of tax return filings of 122,000 to 140,000 is not inconsistent with Laffer and Winegarden's estimate of 200,000 to 220,000 new jobs over the same time period.

For example, $17.1 billion in personal income implies a personal income per job of approximately $85,000. Similarly, depending upon the number of jobs associated with each tax filing, higher net in-migration alone could yield a change in employment similar to Laffer and Winegarden's estimates. Although this represents a large change in absolute net in-migration, annual in-migration (relative to the existing number of filers) would still be only one-quarter or so of that of a state like Oregon The fact that independently developed models of the Tennessee gift and estate tax policy yield impacts of approximately the same order of magnitude illustrates the hazard of relying on the non-scientific rebuttal strategies of employed by ITEP.

Figure 16: Estimated Impacts of Elimination of Tennessee's Gift and Estate Tax, 1997-2011



Dubious and Failed Policies

The contrast between free-market and typical progressive policy approaches is highlighted well in the Progressive States Network's 2012 *Blueprint for Economic Security*. Even as Europe rushes to repair the damage of such policies, the blueprint calls for more aggressive taxation, particularly of the wealthy, and dramatic enlargements of the spending responsibility of the state. Specifically, the 2012 policy statement recommends (among other things)[53]:

- Creation of jobs through development of "green" infrastructure.
- Creation of jobs through work sharing.
- Solving state revenue crises through progressive taxation and business tax increases.

- Securing health and retirement security for all.
- Expansion of the minimum wage.

Written against the backdrop of the demonstrated failure of identical social democratic policies in Europe, one wonders what is the empirical basis for these policies.[54] Our review of recent critiques of market-oriented tax reforms confirms that progressive advocacy organizations, in fact, tend not to perform their own research and are unaware of the professional literature on tax policy (or they choose to ignore it). The critiques tend to rely on simplistic comparisons and ridicule of other researchers by innuendo, name-calling and scare tactics.

There is little demonstration of the virtues of progressive policies in the work of the primary critics examined here, such as ITEP and its sister organization CTJ. They function as pundits of policy innovation without offering any case of their own, beyond strident calls for the preservation of the status quo or further progressivity in taxation and redistribution of wealth. The same is generally true of the organizations that have promulgated critiques of the tax reform proposals of Laffer et al.

Because ITEP figures prominently in the critiques of the tax reform proposals, it is worth noting that ITEP itself operates a 1996 vintage tax model that it describes as a tax policy microsimulation model.[55]

From its description of the model, it is clear that the model has limited, if any, dynamic scoring capability—i.e., the ability to model behavioral responses of households and businesses to changes in tax parameters.[56] This is important because the reaction of economic agents to tax (and other) policy parameters is central to understanding the economic growth and other impacts of policy.

There is no evidence that ITEP implemented its tax model in formulating its comments on the Laffer tax reform proposals discussed herein. The nature of the weaknesses of their tax model, however, reveals a fundamental inconsistency between their tax simulation models and the tax issues of our day—i.e., the potential for using tax policy to re-grow a damaged economy.

Absent the efforts of ALEC, Laffer, and others, there would be little, if any, consideration of this important linkage in the policy debate. To be fair, the Office of Management and Budget (OMB) and Joint Economic Committee (JEC) models have embraced some features of "dynamic scoring" (such as shifting of the timing of tax payments). However, policymakers tend to rely primarily on "static" models that suppress the impact of behavioral responses or limit their inclusion in tax policy simulation. That seemingly simple, technical act may underestimate the effects of responses by labor alone by three to six times, according to Harvard's Greg Mankiew.[57,58]

Conclusion

The policies of the progressive movement in the United States spring from a philosophy that has neither theoretical nor empirical foundation. It has its foundation in a mistaken belief that personal effort, entrepreneurship and risk-taking are unrelated to the economic health of the nation and that the benefits of that initiative can be redistributed without adverse consequence.

In contrast, as this paper has demonstrated, it is clear that free markets, low marginal tax rates, fiscal restraint and small government constitute the real foundation for economic growth. The divisive progressive agenda of policies that punish success and reward failure should be shunned and Americans should return to the principles of unfettered markets and equal opportunity.

Implementation of the progressive agenda undoubtedly will succeed in reducing the wealth of a minority of Americans but will impair the prospects and economic well-being of the least fortunate even more dramatically. Free-market policy and the growth it engenders is the most effective means of improving the lives of all Americans.

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Endnotes

1 Romer and Bernstein (2008).

2 The alternative view, expressed in the 1930s by Hayek, F.A., an Austrian economist, was that economic downturns are caused by excessive credit extension in the previous boom (not unlike the housing bubble). This causes wasteful "malinvestment" that turns the boom to bust as projects' infeasibility is revealed. Taking money from the private sector to maintain boom-level spending was counterproductive. Rather, one must go through a short period of pain to restore saving to support real, new investment and growth.

3 Feldstein, M., "The Tax Rebate Was a Flop. Obama's Stimulus Plan Won't Work Either," The Wall Street Journal, Opinion section, August 6, 2008.

4 http://blogs.edmunds.com.

5 Excerpted from http://truth-out.org/index.php?option=com_k2&view=item&id=6656:policy-follies-in-the-housing-market-the-firsttime-homebuyers-tax-credit

6 This form of time-dependent effect demonstrates what is called "Granger" causality.

7 See, for example, Krugman, P., "The Laffer Test (Somewhat Wonkish)." The New York Times, August 10, 2010.

8 Martin Feldstein, George F. Baker Professor of Economics, Harvard University, former chairman, Council of Economic Advisors. Feldstegin and de Long are quoted in Dylan Matthews, "Where Does the Laffer Curve Bend?" Washington Post, August 9, 2010.

9 Brad deLong in his blog article, "Where is the Peak of the Laffer Curve?" deLong (2010).

10 Approximated here by the cubic equation: Revenue per capita = 121508*(tax rate^2) -121508*(tax rate^3).

11 The observation of the stability of this ratio was first made by economist William Hauser in 1993 and has come to be known as "Hauser's Law". See Hauser, W. Kurt., "The Tax and Revenue Equation." The Wall Street Journal, March 25, 1993.

12 The Laffer Curve is a theoretical construct, whereas Hauser's Law is an empirical observation in search of theoretical elucidation. Both should make policymakers cautious about the policy of adopting tax increases to enlarge government's role in the economy.

13 State and local governments depend on a variety of tax sources. Nevertheless, the long-term trend marginal tax rate on income may still be a useful indicator of overall state-level trends in tax rates.

14 See ALEC's *State Budget Reform Toolkit*.

15 See, for example, studies by Alesina and Ardagna (1998), Ardagna Silvia (2004), Blanchard, Olivier (1990), Broadbent, Ben and Daly, Kevin (2010), Cournede, B. and Gonand, F. (2006), Giavazzi F. and Pagano M. (1990), Guihard, S., Kennedy, M., Wurzel, E., and Andre, C. (2007), Giavazzi, F. and Pagano, M. (1996), McDermott, J. and Wescott, R. (1996), Lambertini, L. and Tavares, J. (2005), Tavares, J. (2004), von Hagen, J. and Strauch, R. (2001).

16 Regression analysis on personal income tax rate increases (percent change) and Gross State Product (GSP) growth rates, in fact, is slightly negative over the 2006 to 2011 period.

17 Ohio, Indiana, North Dakota, Missouri, Alabama, West Virginia, Louisiana and Michigan. From Gordon (2012).

18 Gordon (2012).

19 Of course, states can do certain things that make this constraint less burdensome in the short-run, such as under-maintaining public infrastructure, promising spending in the future (via public pension plans, for example) in return for current public wage growth constraints or (more rarely) establishing "rainy-day" funds in prosperous years to maintain spending levels in years of revenue decline.

20 Computations cited are from Garrett (2010).

21 The data for the chart is from Garrett (2010).

22 Orszag and Stiglitz (2001).

23 Laffer, A. B., Moore, S., and Williams, J. (2012). *Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index.* American Legislative Exchange Council, Washington, D.C.

24 The factors include (1) the Top Marginal Personal Income Tax Rate, (2) the Top Marginal Corporate Income Tax Rate, (3) a measure of Personal Income Tax Progressivity, (4) the Property Tax burden as a share of state person al income, (4) the Sales Tax burden as a share of personal income, (5) whether or not an Estate or Inheritance tax is levied in the state, (6) the size and direction of recent legislated personal income tax burdens, (7), state debt service as a share of state tax revenue, (8) the number of public employee FTE as a share of total population, (9) (change in tax liability per $1,000 of income), (10) a measure of state judicial system function and impartiality, (11), the level of the state minimum wage, (12) workers compensation costs as a share of payroll, (13) whether the state is a "right-to-work" state or not, (14) an index the number of Tax Expenditure Limits imposed by voters,property tax burden and (15) the burden of other taxes not directly mentioned.

25 Citizens for Tax Justice (2012). Arthur Laffer's *Rich States, Poor States* Is More Wish List Than Analysis. April 13.

26 This exercise used the Spearman Rank Correlation statistic to measure the extent to which the ranking of states in terms of median household income was associated with the Competitiveness Index rank.

27 These tests were performed using Ordered Logic and Ordered Profit regressions of state per capita GDP against the index and various measures of the shares of public spending relative to state GDP.

28 See, for example, the Laffer, Small and Winegarden, "Economics 101." OCPA, February 2012.

29 Peter Fisher, "The Doctor is Out to Lunch: ALEC's Recommendations Wrong Prescription for State Prosperity Iowa Policy Project," July 24, 2012. http://www.iowapolicyproject.org/2012Research/120724-rsps.html

30 To quote Fisher, "The share of state GDP accounted for by each [selected industry] sector in 2007 should help explain how that state fared over the next five years. These shares were entered as variables in a multiple regression equation, along with two variables deemed important by Laffer and company: total state and local tax revenue as a percent of state personal income over the period 2007-2009, and 'right-to-work' status." He concludes, "Neither variable—total taxes or 'right-to-work'—had a statistically significant effect."

31 "...the ALEC ranking had no effect."

32 It is a long-established convention in economics to use statutory tax rates rather than revenues, for example, because the latter confuse the reaction of the economy to changes in rates with the rates themselves. The use of "tax wedges" is another accepted means.

33 The accepted means of controlling for background factors is to employ a panel dataset methodology and solve for so-called state fixed effects. This method, in effect, allows each state to have idiosyncratic differences that affect its performance.

34 Specifically, the Federal Reserve Bank of Philadelphia produces a monthly index for each of the 50 states. The indexes combine four state-level indicators to summarize current economic conditions in a single statistic. The four state-level variables in each index are nonfarm payroll employment, average hours worked in manufacturing, the unemployment rate, and real wage and salary disbursements (inflation-adjusted). Nonfarm payroll employment, the unemployment rate, average hours worked in manufacturing and the consumer price index are obtained from the Bureau of Labor Statistics. Wages and salary disbursements (a component of personal income) and gross domestic product by state can be obtained from the Bureau of Economic Analysis. The methodology employed by the Philadelphia Fed ensures consistent measurement across the 50 states, so the state indexes are comparable to one another.

35 See Crone et al. (2005).

36 Data on state indices retrieved September 2012 from: http://www.philadelphiafed.org/research-and-data/regional-economy/indexes/coincident/coincident-historical.xls. The data used are the monthly June indices for all states, to permit analysis for the years 2008 through 2012, and are ranked by the authors.

37 Given the simplicity of the ALEC-Laffer state ranks (as an unweighted average of its component rankings), this is an impressive correlation.

38 Arduin, Laffer and Moore Econometrics, "Eliminating the State Income Tax in Oklahoma: An Economic Assessment." OCPA, November 2011.

39 Although not included in the budgetary analysis, it is argued that greater economic growth would reduce the demand for certain safety-net expenditures.

40 Institute on Taxation and Economic Policy (2012). Arthur Laffer regression analysis is fundamentally flawed, offers no support for economic growth claims; Olson, K. (2012). The voodoo economics of phasing out Oklahoma's personal income tax. http://dl.dropbox.com/u/19732897, OLSON_VOODOO_PHASING_OUT_INC_TAX.pdf. Retrieved June 13, 2012. Rogers, C. (2012). The flawed case for eliminating personal income taxation in Oklahoma. http://dl.dropbox.com/u/19732897/rogers_on_ocpa_report_final_2_13_12-1.pdf. Retrieved June 13, 2012. Willner, J. (2012). Putting real economics into an economic assessment of the Oklahoma income tax. http://dl.dropbox.com/u/19732897/Willner-PuttingRealEconomics_into_an_Economic_Assessment_of_the_OklahomaIncomeTax.pdf. Retrieved June 13, 2012.

41 ITEP identifies itself as a "non-profit, non-partisan research organization" in its IRS filings. Even so, approximately half of ITEP's board members appear to have ties to organized labor organizations such as AFSCME, AFL-CIO, SEIU. In addition, two board members co-founded the American Prospect, a publication with a stated mission, "to counteract the growing influence of conservative media." ITEP's self-described "sister" organization is called Citizens for Tax Justice (CTJ), and appears to serve as a government, public relations, and press relations organization for ITEP, especially at the state level. CTJ pens op-eds and other syntheses of ITEP research, customized to state and local tax initiatives and other policy issues.

42 Institute on Taxation and Economic Policy (2011). The ITEP guide to fair state and local taxes.

43 Alm, J. and Rogers, J. (2011). "Do state fiscal policies affect state economic growth? Public Finance Review," 39(4):483–526.

44 Reed, W. R. and Rogers, C. L. (2004). "Tax cuts and employment in New Jersey: Lessons from a regional analysis. Public Finance Review", 32(3):269–291.

45 Kneller, R. and Misch, F. (2011). "What does ex-post evidence tell us about the output effects of future tax reforms?" Discussion Paper No. 11-029, Center for European Economic Research.

46 It is also interesting that the authors include federal spending at the state level in their analysis, contrary to ITEP's admonition of Laffer et al. that blending state and federal fiscal policy variables is inappropriate in a state study.

47 Romer, C. D. and Romer, D. H. (2010). "The macroeconomic effects of tax changes: Estimates based on a new measure of fiscal shocks. American Economic Review," 100(3): 763–801.

48 Reed, W. R. and Rogers, C. L. (2006). "Tax burden and the mismeasurement of state tax policy. Public Finance Review," 34(4): 404–426. "Statutory tax parameters (e.g., property and sales tax rates, including information on the tax base; income tax rate parameters, including bracket and tax credit data) are obvious candidates for instruments." [Emphasis added]

49 Laffer, A. B. and Winegarden, W. H. (2012). "The economic consequences of Tennessee's gift and estate tax." The Laffer Center for Supply-Side Economics and Beacon Center of Tennessee.

50 The ITEP critique is presented in "Repealing Estate Tax Will Not Create An Economic Boom: Laffer/Winegarden Report Utterly Fails to Support Claim That Tennessee's Estate Tax Cost State 220,000 Jobs." ITEP April 2012.

51 Kopczuk, W. "Estate Taxation," NBER Reporter: Research Summary Spring 2006.

1. W. Kopczuk, "Bequest and Tax Planning: Evidence from Estate Tax Returns," NBER Working Paper, forthcoming.

2. W. Kopczuk and J. Slemrod, "The Impact of the Estate Tax on Wealth Accumulation and Avoidance Behavior of Donors," NBER Working Paper No.7960, October 2000 and Rethinking Estate and Gift Taxation, W. G. Gale, J. R. Hines Jr., and J. B. Slemrod, eds, Washington, D.C.: Brookings Institution Press (2001), pp. 299-343.

3. W. Kopczuk, "Tax Bases, Tax Rates, and the Elasticity of Taxable Income," NBER Working Paper No. 10044, October 2003, and Journal of Public Economics, 89(2005), pp. 2093-119; J. Slemrod and W. Kopczuk, "The Optimal Elasticity of Taxable Income," NBER Working Paper 7922, September 2000, and Journal of Public Economics, 84(2002), pp. 91-112.

52 Kopczuk, W. (2006).Estate taxation. NBER Reporter: Research Summary, National Bureau of Economic Research. See also Kopczuk, W. and Slemrod, J. (2003). Dying to save taxes: Evidence from estate-tax returns on the death elasticity. Review of Economics and Statistics, 85(2):256–265.

53 See www.progressivestates.org/blueprint - Accessed March 2012.

54 All of these policies have proved counterproductive where applied:

1. Green policies have proved a costly fraud in Europe, eliminating many more conventional jobs than they create, with negative effects on the economy. Alvarez (2010), Frondel, et al. (2009).

2. There is a persistent 30 percent wage gap between Europeans and Americans which "can be almost entirely explained by Europeans working less than Americans." Boeri, Burda and Kramarz (2008).

3. The United States does not need more progressive taxation. It already has the most progressive household tax system in the OECD industrialized countries. OECD (2012), and the highest rate of corporate income taxation in the world.

4. Broadening the health safety net is, in fact, an unsustainable policy and, according to the Social Security Advisory Board, "...the most significant threat to the long-term economic security of workers and retirees." SSAB (2009).

55 http://www.itepnet.org/about/ITEP_tax_model_simple.php - Accessed May 2012.

56 "The ITEP model is a tool for calculating revenue yield and incidence, by income group, of federal, state and local taxes. It calculates revenue yield for current tax law and proposed amendments to current law. Separate incidence analyses can be done for categories of taxpayers specified by marital status, the existence of children in the family and age. To forecast future revenue and incidence the model relies on government or other widely respected economic projections."

57 Mankiew observes that CBO estimates that the change in tax revenues from the shift in labor supply would offset roughly 4 percent of the static revenue loss. This implies that they use e an earnings- weighted compensated labor supply elasticity is 0.14. Mankiew, G and Weinzierl , M. (2006) estimate a number closer to 0.5, whereas Kimball and Shapiro (2003) estimate it to be closer to 1.0. With such a small elasticity, their model naturally yields small behavioral responses to changes in tax rates.

58 The ITEP model's use of an input-output (I/0) representation of the business side of the economy means that the many adjustments that businesses make in real life are held constant. In real life, firms react to changes in prices, taxes and technologies to find substitute methods of doing their job. Input-output models (by design) assume that these ubiquitous substitution behaviors do not occur. It has no capability of being used to measure economic growth effects when the economy is changing dynamically.

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