



States with “High Rate” Income Taxes are Still Outperforming No-Tax States

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About ITEP

Founded in 1980, the Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy. ITEP’s mission is to inform policymakers and the public of the effects of current and proposed tax policies on tax fairness, government budgets, and sound economic policy. Among its many publications on state and local tax policy are *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* and *The ITEP Guide to Fair State and Local Taxes*. ITEP’s full body of research is available at www.itep.org.

Executive Summary

- Lawmakers seeking to cut or repeal state personal income taxes often claim that states without such taxes are outperforming the rest of the country, and that their economic growth can be easily replicated in any state that abandons its personal income tax. The governors of Indiana, Oklahoma, and South Carolina, as well as high-ranking officials pushing for income tax repeal in Louisiana and North Carolina, are some of the more influential lawmakers that have used this talking point. But this claim is based on an analysis by supply-side economist Arthur Laffer that is extremely flawed.
- In reality, states that levy personal income taxes, including the states with the highest top rates, have seen more economic growth per capita and less decline in their median income level over the last ten years than the nine states that do not tax income. Unemployment rates have been nearly identical across states with and without income taxes.
- Laffer's claims to the contrary rely on cherry-picking a number of blunt, aggregate measures of economic growth that are closely related to population trends, and incorrectly asserting that tax policy is a leading force behind the migration trends that fuel this growth. Laffer omits measures like median income growth and state unemployment rates in his comparisons of states with and without income taxes, yet selectively cites these measures in other studies when the story they tell fits his preferred narrative.
- More fundamentally, Laffer's simplistic analysis fails to account for the fact that states without income taxes often choose not to levy such a tax precisely because they possess unusual economic advantages that allow them to raise revenue (and grow their economies) in ways that other states cannot. In-state analysts and Laffer himself have correctly observed that factors like natural resources, federal military spending, and even favorable climate contribute to state economic growth. Many of these factors are of great significance in states without income taxes, but while Laffer mentions them in the text of his reports, he makes no effort to control for them in his quantitative analyses.
- More careful academic literature that controls for non-tax factors has often found state income taxes to have little, if any, impact on state economic growth.
- The underlying theory that Laffer uses to argue for cutting state income tax rates downplays or even ignores the importance of public investments like education and infrastructure to the success of state economies. It also assumes there is no economic cost in shifting more of the responsibility for paying taxes onto middle and low-income families—the consumers whose purchasing power is central to the success of any economy.

Introduction

Lawmakers in about a dozen states are giving serious consideration to either cutting or eliminating their state personal income taxes. In each case, these proposals are being touted as a way to boost economic growth.

One claim often made during these debates is that the nine states without personal income taxes are outperforming the rest of the country, and that their growth can be easily replicated in any state that dares to abandon its income tax. Some have also claimed that the nine states with the highest top income tax rates are experiencing below-average growth. The governors of Indiana, Oklahoma, and

South Carolina, as well as high-ranking officials pushing for income tax repeal in Louisiana and North Carolina, are just some of the more influential lawmakers that have attempted to frame the debate in this way.¹

But these talking points, which have been widely disseminated by the American Legislative Exchange Council (ALEC), Americans for Prosperity, and The Wall Street Journal's editorial board, are based on an analysis by supply-side economist Arthur Laffer that is extremely flawed.² That analysis was first debunked by ITEP in early 2012.³ In its rebuttal, ITEP explained why Laffer's simplistic state-by-state comparisons cannot reliably tease out the impact of tax policy on state economies. But ITEP also showed that even if one were to accept Laffer's methodology as somehow valid, his core finding is simply not true. In reality, the residents of the states that levy income taxes—including residents of those states with the highest top tax rates—are experiencing economic conditions at least as good, if not better, than those living in states lacking a personal income tax. Only by focusing on blunt aggregate measures of economic growth was Laffer able to purport to show the opposite.

This report updates ITEP's 2012 findings in light of new available data and explains in more detail the problems with Laffer's analysis.

Economic Performance Among the States

Using the most recent 10 year period and the same group of eighteen no-tax and "high rate" states chosen by Laffer, Figure 1 shows that the nine states with "high rate" income taxes have on average seen considerably more **economic growth per capita** over the last decade than the nine states that fail to levy a broad-based personal income tax.⁴ Figure 1 on the following page also shows that by this measure, the broader group of all 41 states that levy an income tax also experienced faster growth than the states without such a tax. Moreover, while the **median family's income**, adjusted for inflation, has declined in most states over the last decade, those declines have been somewhat smaller in states with income taxes, including in the nine states with the highest top income tax rates. Finally, the **average unemployment rate** between 2002 and 2011 has been nearly identical across all three groups of states.

The appendix to this report includes state-specific findings for each of these three measures showing, among other things, that:

- Four of the nine states without income taxes are actually doing worse than the average state in regards to economic growth per capita: Texas, Tennessee, Florida, and Nevada.

¹Pence still pushing Indiana state income tax cut." WTHR-TV. February 7, 2013. Available at: <http://www.today.com/id/50726306/#URrAUfL58ro>. Oklahoma Governor Mary Fallin. "State of the State 2012." Available at: <http://s3.amazonaws.com/content.newsok.com/documents/sots2012b.pdf>. Drury, Shawn. "Nikki Haley Pushes Regulatory and Tax Reform in Cabinet Session." St. Andrews Patch. February 12, 2013. Available at: <http://standrews.patch.com/articles/nikki-haley-pushes-regulatory-reform-in-cabinet-session>. Louisiana Department of Revenue. "Know the Facts: Personal Income Tax and the Economic Growth of States." Tax Topics weblog. Available at: <http://taxtopics.revenue.louisiana.gov/2013/01/30/know-the-facts-personal-income-tax-and-the-economic-growth-of-states/>. Berger, Phil. "End North Carolina's income tax for growth." Fayetteville Observer. Available at: <http://fayobserver.com/articles/2013/02/05/1234465?sac=fo.opinion>.

²Laffer, Arthur et al. "Rich States, Poor States, 5th Edition." American Legislative Exchange Council. April 2012. Available at: <http://www.alec.org/publications/rich-states-poor-states/>. Kerpen, Phil and Stuart Jolly. "Oklahoma Leads on Income-Tax Repeal." National Review. January 30, 2012. Available at: <http://www.nationalreview.com/articles/289588/oklahoma-leads-income-tax-repeal-phil-kerpen>. "The Heartland Tax Rebellion." Wall Street Journal. February 8, 2012. Available at: <http://online.wsj.com/article/SB10001424052970203889904577200872159113492.html>.

³Institute on Taxation and Economic Policy. "High Rate' Income Tax States Are Outperforming No-Tax States." February 2012. Available at: <http://www.itep.org/pdf/junkeconomics.pdf>.

⁴"High rate" states include California, Hawaii, Maine, Maryland, New Jersey, New York, Ohio, Oregon, and Vermont. States without a broad-based personal income tax include Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. See Laffer, Arthur et al. "Rich States, Poor States, 5th Edition." American Legislative Exchange Council. April 2012. pp. 23. Available at: <http://www.alec.org/publications/rich-states-poor-states/>.

- Five of the nine states without income taxes are doing worse than average in terms of median income growth: New Hampshire, Florida, Tennessee, Alaska, and Nevada.
- Six of the nine states without income taxes had higher than average annual unemployment rates over the last decade: Texas, Florida, Tennessee, Washington, Alaska, and Nevada.

Figure 1: Economic Performance Among the States, 2002-2011



Source: ITEP calculations based on 2002-2011 data from the BEA (per capita real GDP by state in chained 2011 dollars), Census Bureau (median household income by state), and BLS (local area unemployment statistics, annual averages).

Cherry-Picked Economic Measures

How was Laffer able to reach such dramatically different conclusions? In short, his argument relies on cherry-picking a number of measures of economic growth that are closely related to population trends (total income, total economic output, and total jobs) and simply asserting that tax policy is a leading force behind the migration trends that fuel this growth.

Since a larger population brings with it more demand, it's natural that states experiencing the fastest population growth also experience more growth in the total number of jobs and total amount of economic output.⁵ But simply counting the number of people, or the total amount of income, inside of a state's borders reveals very little about how typical families are faring in that state's economy. The economist Peter Fisher has observed that population growth "is not an end in itself." And the aggregate economic growth associated with changes in population is hardly a surefire sign of a strong economy: "growth in the economy, as measured by rising Gross State Product (GSP), is a crude measure of prosperity because GSP growth does not guarantee that the incomes of the average family will rise."⁶

⁵Nobel Prize-winning economist Paul Krugman explained this phenomenon in the context of Texas, the largest of the nine states without a personal income tax: Krugman, Paul. "The Texas Unmiracle." *The New York Times*. August 14, 2011. Available at: <http://www.nytimes.com/2011/08/15/opinion/the-texas-unmiracle.html>.

⁶Fisher, Peter et al. "Selling Snake Oil to the States." *Good Jobs First and the Iowa Policy Project*. November 2012. pp. 9. Available at: <http://www.goodjobsfirst.org/sites/default/files/docs/pdf/snakeoiltothestates.pdf>.

Controlling for population growth—as Laffer himself has done in previous studies that examined state per-capita income growth, median income growth, and unemployment rates—makes it possible to look past the overwhelming influence that population trends have on aggregate economic variables.⁷ This is valuable because differences in population trends are decidedly not determined by differences in tax policy between states.⁸

Eighteen of the top twenty states in terms of population growth over the last ten years are located in the south or west, where housing prices tend to be significantly lower than in the rest of the country.⁹ In fact, the median home price in states without income taxes is almost \$80,000 cheaper than in the nine states with the highest top income tax rates.¹⁰

Seven of these top twenty states in terms of population growth are also part of the so-called Sunbelt, known for having warm weather that Laffer himself admits “clearly... make these states desirable locations.”¹¹

This ongoing south and westward migration has disproportionately favored states without personal income taxes, since six of those nine states happen to be located in the south or west. But states with above-average top income tax rates like Idaho and North Carolina have benefited from this trend in very much the same manner as no-tax states like Florida and Wyoming.

Moreover, some of the population growth advantage enjoyed by states without income taxes can be attributed to a simple difference in birth rates—not the conscious decision of adults to live in one place or another. The nine states without income taxes have an average birth rate that is 10 percent higher than in the states with the highest top income tax rates.¹² And the largest of the no-tax states, Texas, has a birth rate 27 percent higher than in the average “high rate” state—on top of the immigration-fueled advantage in population growth that Texas sees as a result of its proximity to Mexico.¹³

Simplistic and Faulty Methodology

Even more fundamental than the problems with Laffer’s choice of economic measures is that his simplistic methodology includes no attempt to control for a huge range of important economic determinants, including a number of variables that Laffer has admitted can affect growth. In previous studies, Laffer (and his co-author, Stephen Moore of *The Wall Street Journal*) have pointed to the availability

⁷Arthur Laffer’s *Rich States, Poor States* report makes per capita personal income growth a centerpiece of its analysis. It also compares unemployment rates in Kentucky vs. Tennessee and California vs. Texas in attempting to measure state economic performance. Furthermore, a report Laffer wrote for the Civitas Institute called *More Jobs, Bigger Paychecks* points to North Carolina’s slow median income growth, among other measures, as evidence that the state should repeal its income tax. See Laffer, Arthur et al. “*Rich States, Poor States*, 5th Edition.” American Legislative Exchange Council. April 2012. Available at: <http://www.alec.org/publications/rich-states-poor-states/>. ALME and the Civitas Institute. “*More Jobs, Bigger Paychecks*.” December 2012. Available at: <http://www.nccivitas.org/2012/more-jobs-bigger-paychecks/>.

⁸Tannenwald, Robert et al. “*Tax Flight Is a Myth: Higher State Taxes Bring More Revenue, Not More Migration*.” August 4, 2011. Available at: <http://www.cbpp.org/cms/?fa=view&id=3556>.

⁹Population figures based on ITEP analysis of U.S. Census data for the ten years of growth spanning 2002 to 2012. The other two states among the top twenty are Alaska and Hawaii, both in the “Pacific” region according to the U.S. Census.

¹⁰ITEP analysis of median home price data from the Federal Housing Finance Agency (FHFA) for the second quarter of 2010, the most recent period for which data are available.

¹¹Laffer, Arthur and Stephen Moore. “*Taxes Really Do Matter: Look at the States*.” The Laffer Center for Supply-Side Economics. September 2012. pp. 6. Available at: <http://www.laffercenter.com/wp-content/uploads/2012/09/2012-09-TaxesDoMatterLookAtStates-LafferCenter-Laffer-Moore.pdf>.

¹²In 2010, the most recent year for which final data are available, no-tax states saw 13.3 births per woman age 15 to 44, while “high rate” states saw just 12.1, according to an ITEP analysis of: Martin, Joyce et al. “*Births: Final Data for 2010*.” National Vital Statistics Reports, Volume 61, Number 1. August 28, 2012. pp. 42. Available at: http://www.cdc.gov/nchs/data/nvsr/nvsr61/nvsr61_01.pdf.

¹³McNichol, Elizabeth and Nicholas Johnson. “*The Texas Economic Model: Hard for Other States to Follow and Not All It Seems*.” Center on Budget and Policy Priorities. April 3, 2012. Available at: <http://www.cbpp.org/cms/index.cfm?fa=view&id=3739>.

of energy resources, military spending by the federal government, weather, and even the presence of beaches as factors that impact state economic growth.¹⁴

These omissions from Laffer's quantitative analysis are particularly troublesome given that a number of states have chosen not to levy income taxes precisely because they possess one or more unusual economic (and revenue-generating) advantages of this type. Most obviously, four of the top ten states with the largest mining sectors, relative to their economies, also lack an income tax (Wyoming, Alaska, Texas, and Nevada). Alaska, in fact, is the only state to ever repeal its personal income tax, and it did so only after the discovery of millions of barrels of oil in the Prudhoe Bay Oil Field. Due in part to the high demand for energy and the recent run-up in energy prices, all four of these mining-dependent states are also among the top performers in terms of Laffer's preferred measures of economic success. By contrast, none of the nine states with the highest top tax rates rank among even the top twenty states in terms of the importance of mining to their economies.¹⁵

For a clear-eyed assessment of the impact of natural resources on state economic growth, one need look no further these states' own economic experts. The Wyoming Economic Analysis Division, for example, recently described the condition of their state's economy as such:

*After a short, but severe recession, Wyoming's economy turned around in the beginning of 2010, thanks to the robust rebound of the energy industry. The state's employment growth was generally faster than the U.S. average since the recovery began.*¹⁶

And the most recent Alaska Economic Performance report explains that:

*Alaska's economy fared extremely well during 2009 compared to other states. While most of the U.S. was significantly impacted by the collapse of the real estate market and job losses in the financial sector, Alaska's economy remained strong. Alaska is one of only four states in which gross state product increased during 2009. . . . Solid oil prices continued providing funds to the state's treasury while seafood, minerals, tourism, and timber continue to provide economic opportunity statewide.*¹⁷

But natural resources are hardly the only important factor that Laffer overlooks in his attempt to explain state economic growth. Federal military spending, which Laffer has conceded can boost a state's economy, also happens to be stacked in favor of states without income taxes. Seven of the nine states without broad-based personal income taxes have seen federal military spending within their borders grow at a rate faster than the national average over the last decade.¹⁸

To take just one more example, tourism provides certain states with an unusual knack for drawing in outside dollars and growing their economies, as the above quote from Alaska indicates. Tourism also affords many of those same states the luxury of generating substantial consumption tax revenues from non-residents, as opposed to through the income tax. Four states without income taxes—Alaska, Florida, Nevada, and Wyoming—are ranked among the top states in the country in terms of reliance on tourism-related jobs.¹⁹

¹⁴Laffer, Arthur and Stephen Moore. "Taxes Really Do Matter: Look at the States." The Laffer Center for Supply-Side Economics. September 2012. Available at: <http://www.laffercenter.com/wp-content/uploads/2012/09/2012-09-TaxesDoMatterLookAtStates-LafferCenter-Laffer-Moore.pdf>.

¹⁵ITEP analysis of data from the Bureau of Economic Analysis (BEA).

¹⁶Wyoming Economic Analysis Division. "Economic Summary: 3Q2012." December 2012. pp. 1. Available at: http://eadiv.state.wy.us/wef/Economic_Summary3Q12.pdf.

¹⁷Department of Commerce, Community, and Economic Development, et al., "2009 Alaska Economic Performance Report." February 2011. pp. 1. Available at: http://www.commerce.state.ak.us/pub/2009_Performance_Report_web.pdf.

¹⁸ITEP analysis of data spanning 2001 to 2010 (the most recent 10 year period for which data are available) from the Bureau of Economic Analysis (BEA).

¹⁹These states made up four out of the top five states in terms of "travel and tourism employment as a percent of total non-farm employment" in "The Impact of Travel on State Economies," U.S. Travel Association, June 2009. Available at: <http://commerce.idahogov/assets/content/docs/Research/Impact%20of%20Travel%20on%20State%20Economies%2009.pdf>.

In the text of his reports, Laffer often admits that “the drivers of economic growth are many faceted.”²⁰ And yet when he constructs analyses that attempt to show the harm of state income taxes, somehow every non-tax “facet” happens to get left out.

At Odds with the Academic Literature

Peer-reviewed academic papers that attempt to control for non-tax factors have often reached a very different conclusion than the simplistic comparisons constructed by Arthur Laffer: namely, that personal income taxes have little if any effect on state economic growth.

Alm and Rogers (2011), for example, tested the impact of more than 130 explanatory variables in attempting to explain state economic growth, including not just tax and spending factors, but many geographic and demographic variables as well. They found that neither corporate nor personal income taxes reduced state economic growth, and that in some cases higher taxes are actually associated with stronger growth.²¹

Reed and Rogers (2004) studied a personal income tax cut enacted in New Jersey in the mid-1990's. Using a difference-in-difference approach to compare growth rates in New Jersey counties with those in nearby counties, the authors concluded that “this study's analysis does not support the hypothesis that tax cuts stimulated employment growth in New Jersey.”²²

Using state data spanning nearly two decades, Chernick (2010) found that “income tax burdens do not have a [statistically] significant effect on growth,” and that “the progressivity of a state's tax structure does not have a statistically significant effect on the rate of growth of personal income.”²³

Tomljanovich (2004) examined developments in the states from 1972 to 1998. While the study found some evidence that state tax cuts can be stimulative for the economy in the short-run, it also found that “long-run growth is unaffected by changes in state tax rates, even after adjusting for the effects of initial per capita output levels, state expenditures, and aid from the federal government.”²⁴

Deeply Flawed Theory

Putting aside the methodological problems and oversights in Laffer's analyses, the deeper problem lies in the theory he uses to explain why tax cuts should cause state economies to thrive. In its most basic form, this theory says that:

*Surely if location A lowers its tax rates and location B raises its tax rates, other things being equal, businesses, capital and people will migrate from B to A, i.e. to where tax rates have fallen and from places where tax rates have risen.*²⁵

²⁰ ALME and the Civitas Institute. “More Jobs, Bigger Paychecks Revisited: A Response to Critics.” February 2013. pp. 1. Available at: <http://noincometaxnc.org/files/mjbp-response.pdf>.

²¹ Alm, James and Janet Rogers. “Do State Fiscal Policies Affect State Economic Growth?” Public Finance Review. July 2011.

²² Reed, W. Robert and Cynthia Rogers. “Tax Cuts and Employment Growth in New Jersey: Lessons from a Regional Analysis.” Public Finance Review. May 2004.

²³ Chernick, Howard. “Redistribution at the State and Local Level: Consequences for Economic Growth.” Public Finance Review. July 2010.

²⁴ Tomljanovich, Marc. “The Role of State Fiscal Policy in State Economic Growth.” Contemporary Economic Policy. July 2004.

²⁵ The Laffer Center and the Civitas Institute. “Taxes Really Do Matter: Look at the States.” October 2012. pp. 4. Available at: <http://www.nccivitas.org/2012/taxes-really-do-matter-look-at-the-states/>.

But in the real world, states never hold “other things equal” when their tax codes are revised. Why would anybody living in “location B” ever vote to raise taxes if the extra revenues were not put to use in some way?

Holding all else equal in Laffer’s hypothetical universe would require that location A provide the same public services as always with less money, and that location B simply burn its additional tax revenue on the trash heap, rather than using it to hire teachers or fix potholes or cut down on wait times at the courthouse and DMV.

Cutting taxes requires difficult tradeoffs regarding which state services should no longer exist, or which other taxes should be raised to make up the difference. But as Laffer has explained in previous reports:

*Of course, Americans want to live in states with good schools, clean parks, safe neighborhoods, good roads, prisons that keep the criminals off the streets and all the vital services that state and local governments provide.*²⁶

Indeed, the factors listed above are not just things that Americans “want”—they are actually central to the economic success of any state. Eric Spiegel, President and CEO of Siemens Corp., recently explained his company’s decision to open a large plant in Charlotte, North Carolina by pointing out that:

*The reasons you bring a plant like this to the United States are higher-skilled labor, access to the world’s best research and development, and good, sound infrastructure. ... If you read all the studies about what it’s going to take for the U.S. to grow, it’s really about two things. Modernizing the infrastructure and retooling the education system. Those are the two big keys to creating more-productive, higher-paying jobs.*²⁷

Businesses in Oklahoma, after learning about plans to repeal their state’s income tax, made clear that they have a very similar view of the public services they need to continue operating efficiently:²⁸

If our ability to educate and train employees for a 21st century economy is damaged through lack of funding, if we can’t maintain our roads and bridges, strong health care system, robust research and technology infrastructure, safe streets, etc., then the benefits of a reduction in the income tax rates may be limited.

— Chris Bengel, Tulsa Metro Chamber of Commerce Senior Vice President for Government Affairs

I can’t sit here and say having no income tax, having low property tax, whatever, is going to make a big difference. We have to have a state that’s known for excellence.

— Wes Stucky, Ardmore Chamber of Commerce President

Progressive income taxes have long played a central role in allowing state governments to provide the services that individuals and businesses alike need to prosper. Abandoning these sustainable and fair sources of revenue would come at great economic cost, both in

²⁶ Ibid. pp. 17.

²⁷ Montgomery, Lori. “Siemens plant in Charlotte offers lessons as Obama, Romney talk job creation.” The Washington Post. September 4, 2012. Available at: http://articles.washingtonpost.com/2012-09-04/business/35494989_1_siemens-plant-job-creation-charlotte.

²⁸ Krehbiel, Randy. “Chambers of commerce officials decry elimination of state income tax.” Tulsa World. October 21, 2011. Available at: http://www.tulsa-world.com/news/article.aspx?subjectid=11&articleid=20111021_16_A10_BIXBYE382272.

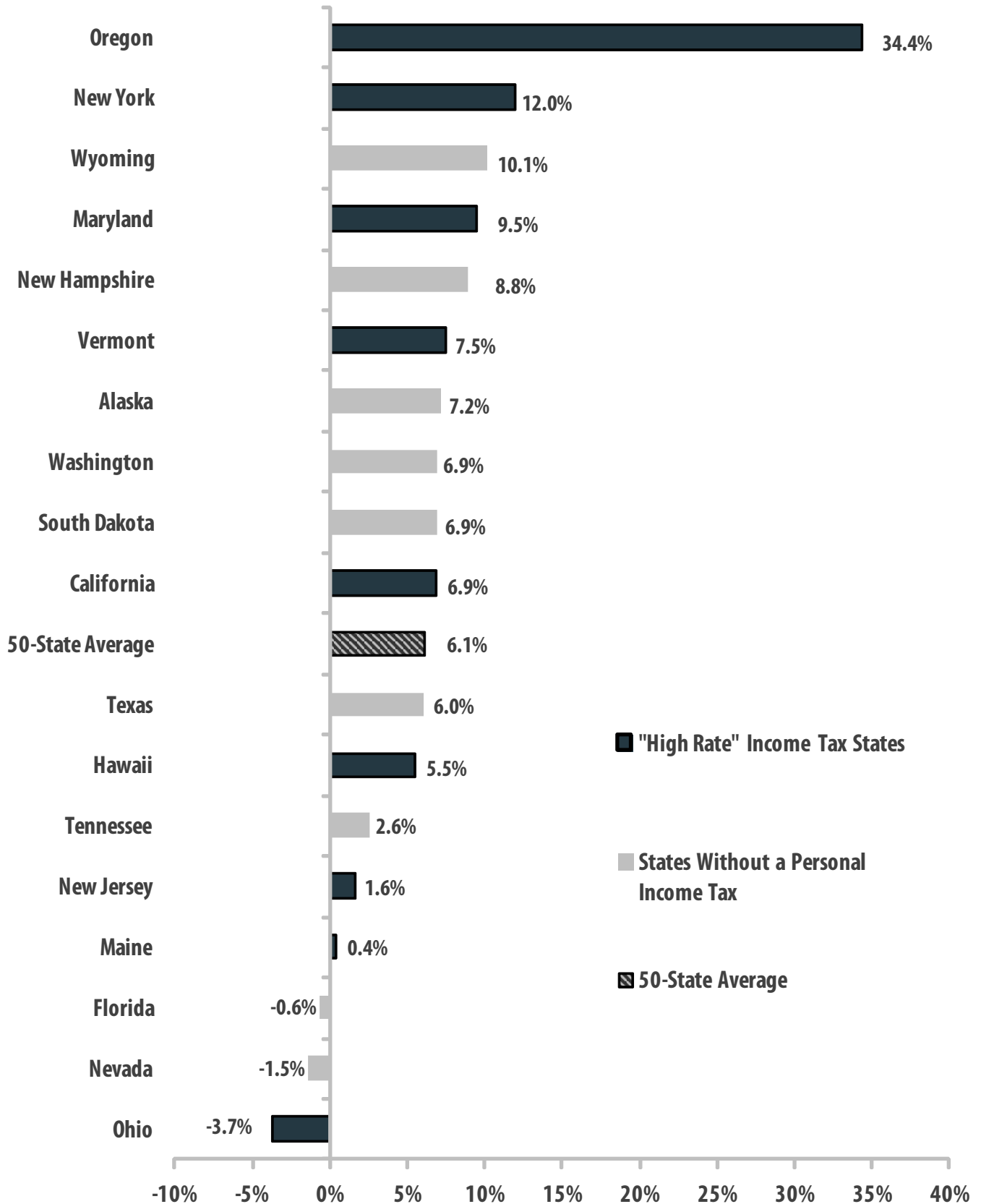
the form of reduced public services, and potentially through shifting the responsibility for paying taxes more heavily onto middle and low-income families—the consumers whose purchasing power is central to the success of any economy.

Conclusion

Residents of the states that levy income taxes—including residents of those states with the highest top tax rates—are experiencing economic conditions at least as good, if not better, than those living in states lacking a personal income tax. Arthur Laffer's claims to the contrary rely on cherry-picking a number of blunt, aggregate measures of economic growth that are closely related to population trends, and incorrectly asserting that tax policy is a leading force behind the migration trends that fuel this growth. More fundamentally, Laffer's simplistic analyses fail to account for the fact that states without income taxes often choose not to levy such a tax precisely because they possess unusual economic advantages that allow them to raise revenue (and grow their economies) in ways that other states cannot. Finally, the theory Laffer uses to argue in favor of cutting state income tax rates downplays or even ignores the importance of public investments like education and infrastructure to the success of state economies. 📌

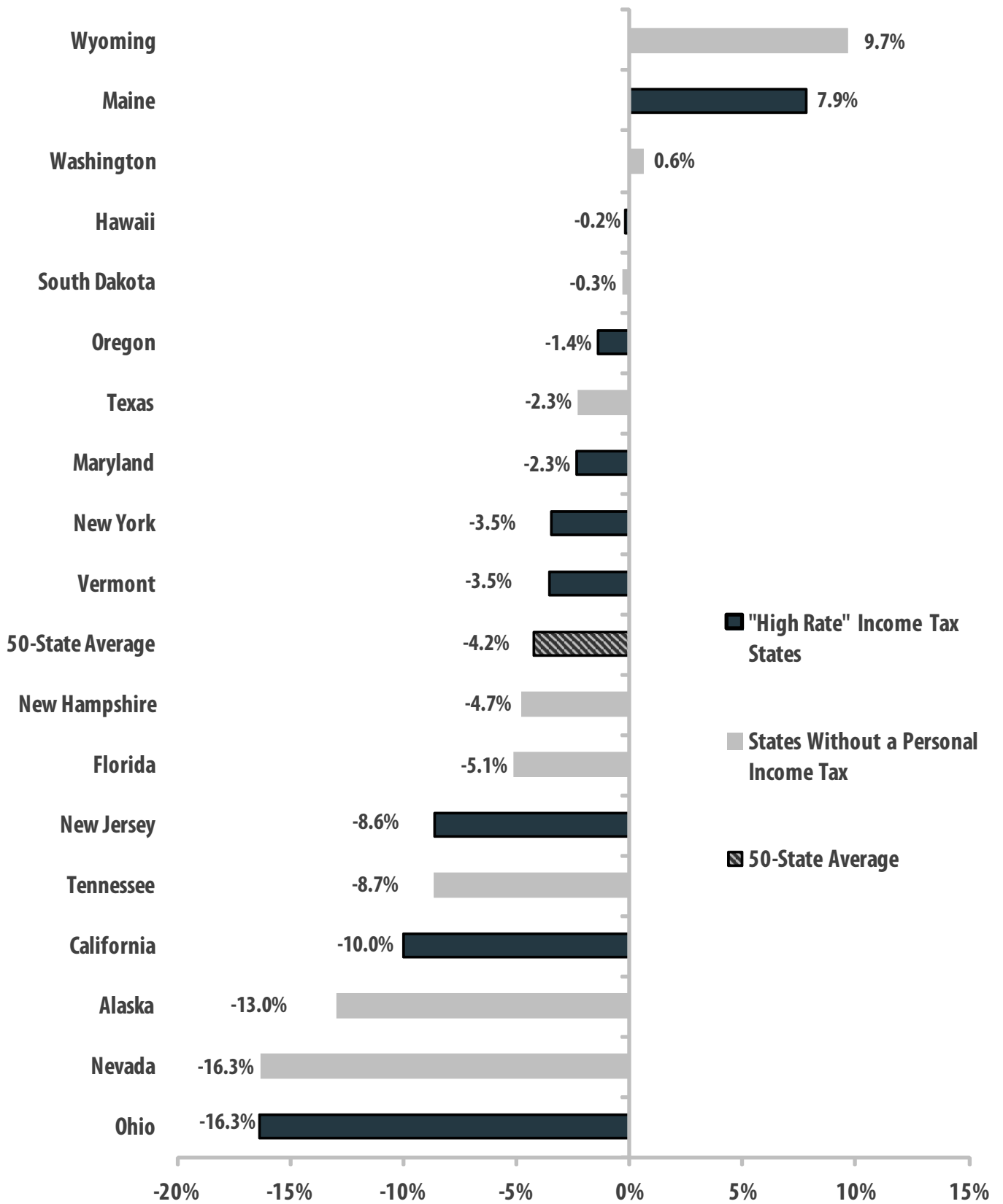
Appendix: Nine Non-Income Tax vs. Nine "High Rate" States

Figure 2: Growth in Per Capita Real GDP, 2002-2011



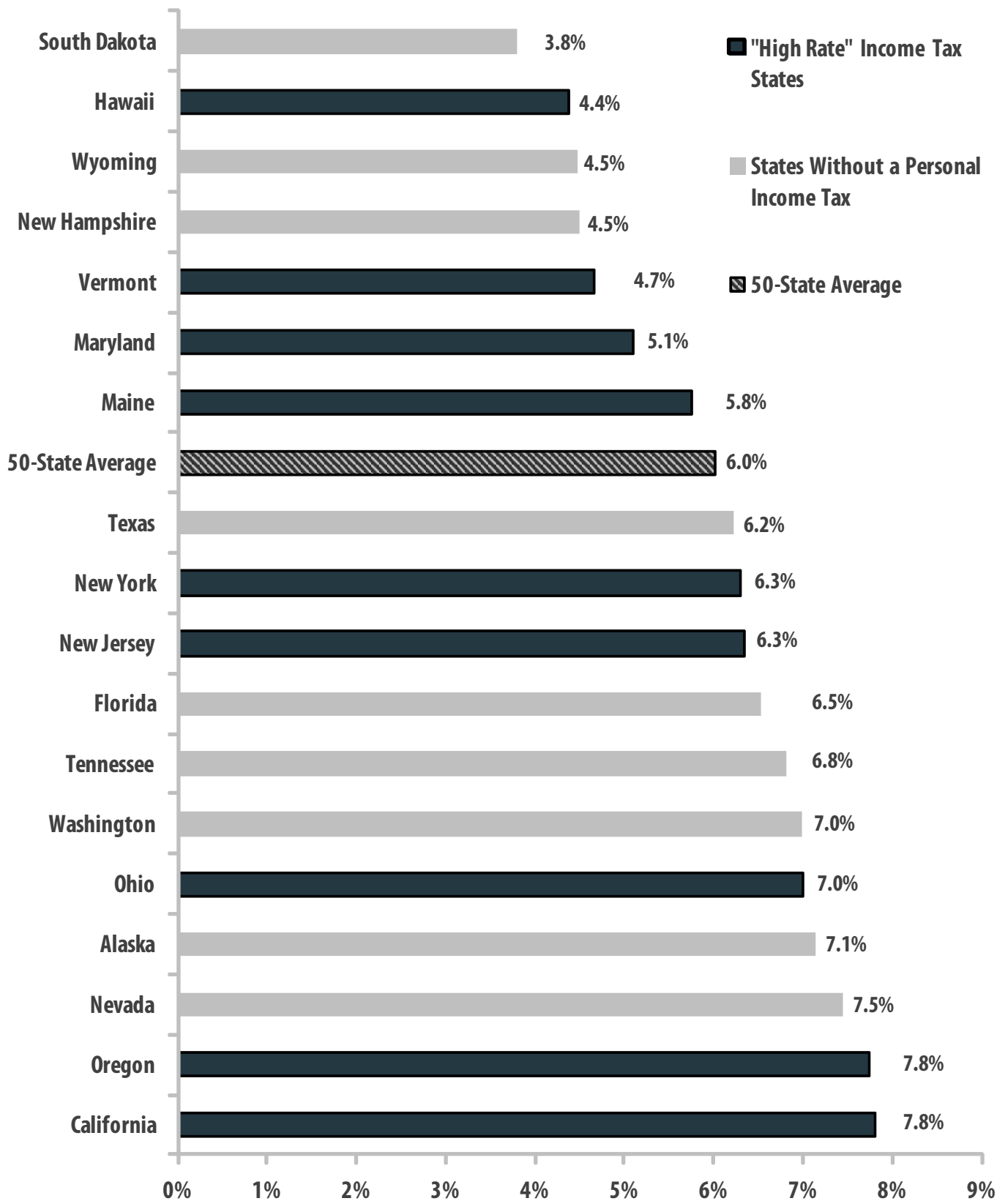
Source: Analysis of BEA data by the Institute on Taxation and Economic Policy (ITEP)

Figure 3: Change in Real Median Household Income, 2002-2011



Source: Analysis of Census data by the Institute on Taxation and Economic Policy (ITEP)

Figure 4: Average Annual Unemployment Rate, 2002-2011



Source: Analysis of BLS data by the Institute on Taxation and Economic Policy (ITEP)