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Why Are There Rich States and Poor States?

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The following is an adaptation of a lecture delivered at Northwood University's 35th Annual Freedom Seminar on April 12, 2013.

Tax policy can get extremely nauseating. There is a reason people hate the word tax. As Justice John Marshall famously said, "the power to tax involves the power to destroy." The most fascinating part of economics is applying the theory in the real world of tax and fiscal policy and participating in policy debates, both nationally and across the 50 states capitals. There is a significant distinction in public policy making between the federal level and the state and local levels of government. In our book, *Rich States, Poor States*, my colleagues, and I have investigated why freedom is working across the 50 states, not just in an idealistic way, but also in an empirical way. To quote legendary Northwood Professor, Dale Haywood, "That is one of the ultimate measures of economic freedom; you make a dollar, you keep a dollar."

In the states, there are no such things as printing presses; and that is a major difference. In Washington DC, when there is a shortage of funds, they print money; or just add to the "quantitative easing" (QE) taking place. One of the other major differences is that nearly every state must have a balanced budget. While some states like California routinely use gimmicks to avoid the substance of the requirement, the states are still far ahead of a federal government that is roughly $17 trillion in the red. Also, policy making at the state level has generally been seen as less partisan than at the federal level. Rather than ridged battles between the parties, you have more compromise and more give and take when problems need to be solved and budgets need to be balanced.

On the tax side of the ledger, there are major differences as well. While some states like Texas and Florida avoid an income tax altogether, the federal government is very dependent on the personal income tax. The federal income tax has a long and controversial history. For the majority of America's first century as a nation, there was no federal income tax – because it was ruled unconstitutional by the Supreme Court. The income tax was introduced during the Civil War to pay for the extremely costly conflict, but was once again ruled unconstitutional after the war ended. Then in the early 20th century, the "progressive" movement, under President Woodrow Wilson, enacted a federal income tax under the 16th Amendment to our Constitution.

The income tax at the federal level has grown into a behemoth. It is unbelievable how complicated it is; from both a business and individual standpoint. Rates have increased, and over time, the government has grown more and more dependent on the revenue. When the income tax was introduced it had a low rate and only affected a fraction of the population. However, under President Franklin Roosevelt, the top marginal rate swelled to more than 90 percent until the Kennedy and Reagan tax cuts reduced the top rate to 70 percent, and finally 28 percent. Today we have increased the rate back to roughly 40 percent.

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FIVE PRINCIPLES OF SOUND TAX POLICY

When we talk about tax policies, I like to outline five guiding principles of an economically sound tax system. It is important to remember that all taxes adversely affect economic growth when they extract wealth from the private sector and redistribute it through the political system. However, not all forms of taxes were created equally. Taxes on capital for instance are far more damaging to economic growth and opportunity than taxes on consumption. That is a relationship demonstrated by decades of academic research, as well as practical experience. The following are the five guiding principles of sound tax policy:

SIMPLICITY

In 2014, it is estimated that Americans will spend more than $450 billion in tax compliance costs, due to our incredibly complicated federal income tax code alone. That huge cost to the United States economy hurts all of us, and when totaled, equals more than 20 percent of all federal income tax receipts collected. This is a dead weight loss to the economy when Americans are using their time and resources for non-productive purposes, such as filling out tax forms and looking up rules and regulations.

Unfortunately, our tax code is creating a nation of tax crooks because it is next to impossible for Americans to know exactly what they owe. For many years *Money Magazine* compiled an annual study; they give the same tax return to different professional tax preparers, then they ask the professionals for their expert opinions. The last year they conducted the survey, they give the same tax return to 46 different tax professionals and come back with 46 different results as to what was actually owed. If the professionals can't even get the income tax right, how can we expect the American people to get it right?

TRANSPARENCY

The key here is that taxpayers ought to know who has the ability to tax them. This is where it comes into the state and local level a little bit more, because with the federal government you know you are going to have to deal with the IRS. However, at the state and local level, sometimes it isn't nearly as clear which jurisdictions have authority over you—both regulatory authority and tax authority. When you look across the country, there is a large degree of deviation. There are some states that allow library boards to levy their own taxes, including property taxes or sales taxes; as well as water boards in some places that have the taxing authority over businesses and individuals. In some states there are even mosquito abatement districts that have taxing authority. Transparency is letting taxpayers know who has the ability to tax them and that is a key principle at all levels of government.

NEUTRALITY

This is the principle of treating everyone equally in terms of taxes, and not allowing the government to pick winners and losers through tax policy. I think this is one of the largest threats to taxpayers out there from the 50 states and Washington D.C., because when the government gets in the business of becoming kingmaker, and picking winners through special deductions, regulations, and carve-outs for particular businesses and industries, you see this nexus arises between big business and big government. Some have called this "crony capitalism;" that is a dangerous precedent when people make decisions based on special rules and tax provisions, instead of economic reasons. The lack of tax neutrality is a large problem that creates distortions in the marketplace.

PREDICTABILITY

This is something that businesses like tremendously; there is nothing that freezes capital as much as unpredictability. At the federal level, the government is a prime example of what not to do, because we govern our tax system based on many short-term provisions. Some people do very well at this method; they make a great living trying to renew their tax provisions every year. There are many important sections in the tax system that are one year provisions, so every year they are altered at the last minute. It brings a lot of unpredictability to the marketplace. Now, California passed a tax by taking it to the vote of the people last year. It passed, and they have the highest state income tax, at 13.3 percent. This new tax is a personal income tax, just for the privilege of living or working in California. They retroactively passed the increase; so while it passed on the ballot in November 2012, it was able to tax incomes from the beginning of 2012. All of a sudden, taxpayers were shocked to discover they owed another 10 months of taxes at the higher rate. This is exactly the type of tax policy that governments should avoid making.

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COMPETITIVENESS

The first four principles are necessary guiding principles; however, they are not sufficient in themselves. The final principle is the key because it is the competitiveness principle, or the pro-growth principle. This is pretty basic, economics 101. The idea is: when you tax something, you get less of it; when you tax something less, you get more of it. Taxes are a cost of doing business. They are an entry cost for a business, whether we are talking about a national, state, or local tax. Therefore, you have to

remain competitive with your neighbors, as well as competitors across the world, considering capital is more mobile than ever. Companies can go and invest anywhere, and they are! Some companies are even bypassing the United States now because the United States has the highest business taxes in the world. There have been some questions in what matters for growth. In my book *Rich States, Poor States*, we focus on labor policy factors, regulatory policy, and tax policy across the 50 states in a cross-sectional way to see what works and what doesn't. Why, for example, is California lagging behind Texas and Florida? Rich States, Poor States reviews that in a case study method.

Table 5 | **9 No Income Tax States vs. 9 Highest Income Tax States**
Growth Rates, 2001-2011

States	Population	Gross State Product	Nonfarm Payroll Employment	State & Local Tax Revenue†
9 States with No Income Tax*	15.00%	63.50%	12.70%	76.30%
U.S. Average**	9.50%	51.40%	7.60%	49.80%
9 States with Highest Personal Income Tax Rates*	6.00%	45.20%	4.90%	47.90%

Source: Bureau of Economic Analysis, U.S. Census Bureau, Bureau of Labor Statistics, Laffer Associates
*Equal-weighted average
**Equal-weighted average, does not include Washington, D.C.
†2000–2010 (2011 data not yet available)

Of particular interest, the nine states without personal income taxes are significantly outperforming the states with the highest marginal tax rates, as shown in the table above. The results are truly shocking. The no-income-tax states outperform their high-tax counterparts across the board in gross state product growth, population growth, job growth, and, perhaps astonishingly, even tax receipt growth.

Let us not forget that many small businesses pay these personal income taxes as subchapter S Corporations (S Corps), Limited Liability Partnerships (LLPs), and other "pass-through" entities. These small businesses make up more than 90 percent of all businesses, employ more than 50 percent of American workers, and pay more than 40 percent of all business taxes.

The more mobile something is, the more sensitive it is to tax rates. When you look at something like the capital gains tax, investors are hyper sensitive to taxes that affect their rates of return. People only pay the capital gains tax when they realize the gain. Business profits are also volatile.

Using the same methods as before, but focusing on the corporate income tax, there are similar outcomes. High taxes, whether corporate or personal, drive people and capital towards states with lower taxes. Of course, it is always important to remember the axiom that businesses don't pay taxes, people do. Governments that attempt to soak businesses to pay higher taxes are actually affecting individuals in one form or another, as businesses pass along the tax costs to consumers, workers and investors.

CONCLUSION

Though there are many conclusions to draw from *Rich States, Poor States*, we believe there is one that stands out among the rest. In general, states that spend less, especially on transfer programs, and states that tax less, particularly productive activities such as working or investing, experience higher growth rates than states that tax and spend more. Through statistical and anecdotal evidence, *Rich States, Poor States* makes a compelling case that pro-growth fiscal policy is what really makes the difference for economic vitality in the states. No state has ever taxed, or spent, its way into prosperity.

The beauty of the American experiment is that it allows states to choose which path they will follow. As the great Ronald Reagan would say, the choice is not about Republican versus Democrat; the choice is between up or down for the future of our states. *Rich States, Poor States* provides 50 unique snapshots from our "laboratories of democracy" for you to evaluate. ■

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