ALEC Tax and Budget Proposals Would Slash Public Services and Jeopardize Economic Growth

By Erica Williams and Nicholas Johnson

Governors and legislatures in numerous states are considering, or have recently enacted, sweeping tax and budget proposals that follow recommendations of the American Legislative Exchange Council (ALEC), with potentially adverse consequences for middle- and lower-income families, individuals, and communities across the country.

These policies would cut taxes deeply for wealthy individuals, investors, and corporations; shift tax burdens substantially from well-to-do to middle- and low-income households; and impose strict constitutional or legal limits on revenues or spending that would severely limit states’ ability to provide adequate funds for education, health care, and other priorities, and impair state economic growth.

The specific policies include deep cuts in income taxes, particularly for affluent households and corporations; a repeal of state income and estate taxes; a shift in state revenues from graduated-rate income taxes to sales taxes that are much higher than most states have today; the end of various state-based tax credits for low-income working families; a Taxpayer Bill of Rights (TABOR) that would impose rigid constitutional limits on state revenues and spending; requirements that state legislatures garner two-thirds or other “super-majority” votes to raise any taxes or fees; and other mechanisms that would reduce the funds available to finance key public services. (For more on this, see “ALEC Proposals and Their Potential Impacts,” p. 2.)

Of particular concern is that these proposals rest on a weak foundation of questionable economic and fiscal assumptions and faulty analysis promoted by ALEC and its allies and spokespersons, most prominent of whom are Arthur Laffer, who is best known for popularizing the “Laffer Curve” — the dubious Reagan-era notion that cutting income tax rates would produce more government revenues due to the economic activity that it would generate — and Stephen Moore, a Wall Street Journal editorial board member and former president of the anti-tax Club for Growth. (An overview of ALEC publications on fiscal policy is found in the Appendix.)

ALEC’s studies and reports claim that its agenda would boost economic growth and create jobs, but they are disconnected from a wide body of peer-reviewed academic research on public finance. The “ALEC-Laffer Economic Outlook Index,” for instance, is heavily biased toward states with low taxes and limited government, and the index has failed to predict how well state economies actually perform. In addition, the preponderance of mainstream research refutes core elements of ALEC’s
argument, showing that state tax cuts or lower state taxes generally do not boost the economy, state tax cuts do not pay for themselves in the form of higher economic growth that generates more revenues, progressive taxes and corporate taxes do not inherently damage the economy, and taxes generally do not cause people to flee a state.

In their analyses, ALEC and Laffer make many exaggerated claims, present misleading data, commit basic statistical errors, and do not control for other factors known to affect economic growth. They use techniques that manipulate data in ways that violate accepted standards of research. ALEC-related writings that experts have strongly criticized include a report by Laffer and his consulting firm for the Florida legislature on property taxes; a study by Laffer’s firm on the state income tax in Oklahoma; a study by Laffer and a colleague on the estate tax in Tennessee; and an op-ed by Laffer for the Wall Street Journal on states with income taxes, among others. (For more on this, see “Reliance on Faulty Analysis,” p. 8.)

To be sure, state tax and budget systems need improvement, both to help states meet their balanced budget requirements and to help them create the conditions for economic growth and a higher quality of life. Rather than enact ALEC’s radical tax and budget agenda, however, states would benefit far more by adopting a commonsense approach through which they would collect adequate revenue in an equitable manner, invest in key priorities such as education that are important for long-term economic growth, and reform state budget processes so that they can better plan for an uncertain future. (For more on this, see “A Better Way Forward,” p. 16.)

ALEC Proposals and Their Potential Impacts

ALEC operates under the banner “Limited Government — Free Markets — Federalism.” Through its publications, the public appearances of its high-profile spokespeople, the model legislation that it drafts, its work with other like-minded national organizations, and the reach of its closely affiliated network of free-market state-level organizations, ALEC promotes a set of policies that would have dramatic effects on state budgets, state economies, and families and individuals.

Based on an extensive review of ALEC’s publications, the public statements of its allies and spokespeople, and ALEC-backed legislative proposals, we find that ALEC’s fiscal policies would cut taxes deeply especially for corporations, investors, and wealthy Americans; shift tax burdens from corporations and the wealthy to other state residents; and impose rigid limits on state revenues and spending through changes in both state laws and constitutions. All told, its fiscal agenda would shrink state tax revenues, make it much harder for states to invest in education, infrastructure, and other priorities important for economic growth, and likely reduce growth over time. The remainder of this section describes ALEC’s proposals and their likely consequences.

Prescription #1:
Very Deep Tax Cuts, Especially for Corporations, Investors, and the Wealthy

ALEC recommends that states:

• Deeply cut income tax rates, particularly for affluent households and corporations.
  While few states have income tax codes as progressive as the federal code, most have at least some degree of progressivity (as distinguished from state sales and other taxes, which tend to be quite regressive).
ALEC instead favors flat, single-rate income taxes, and its proposed income-tax cuts are designed mainly to reduce the rates that higher-income taxpayers pay. For instance, at the urging of its ALEC-affiliated state policy center, Maine enacted laws in 2011 and 2012 that phase in a set of income tax rate cuts that will transform the current progressive rate structure (with the highest-income households paying a top marginal rate of 8.5 percent) to a flat tax of 4 percent — cutting taxes for high-income residents, raising them on the middle class, and substantially reducing state revenue.¹

- **Repeal state income taxes.** Beyond cutting rates, ALEC proposes that states repeal state personal and corporate income taxes, which provide one-third to one-half of a typical state’s funding for schools, health care, and other key services. No state other than oil-rich Alaska, which derives much of its revenue from taxes on oil production, has ever repealed its state income tax, but in 2012 there were major efforts in Oklahoma, Kansas, and Missouri to do so, and so far in 2013 governors and/or leading legislators in four additional states — Louisiana, Nebraska, North Carolina and South Carolina — have proposed or have voiced plans to propose full repeal of personal or corporate income taxes or both.

- **Prevent new state income taxes.** ALEC and its allies are working to ensure that states that now lack income taxes can never enact them. New Hampshire voters defeated an ALEC-supported constitutional amendment on the 2012 ballot that would have banned the state from ever putting an income tax in place. Tennessee is expected to place a similar measure on its ballot in 2014. The nine states that do not have broad-based personal income taxes rely on other sources of revenue — including levies on oil and gas production, tourism revenue, and property and consumption taxes — that are often inadequate, volatile, regressive, or harmful to the economy in other ways. Keeping open the option of an income tax is a potentially important policy tool for policymakers to fund services in these states in the future.

- **Repeal state estate taxes.** There is little or no credible evidence that estate taxes, which affect an extremely small share of the population, hurt economic growth.² But *Rich States, Poor States* argues for repealing these taxes as “confiscatory taxes on the geese that lay the golden eggs.”³ Laffer pushed for an end to Tennessee’s estate tax in a report that he co-authored with colleague Wayne Winegarden and the Beacon Center of Tennessee (which belongs to the State Policy Network with which ALEC is affiliated).⁴ As described below, the analysis was deeply flawed, but the effort succeeded: Tennessee enacted legislation to eliminate the state’s estate tax by 2016.

**Prescription #2:**

**Shift Taxes from Wealthy Households and Corporations to Other State Residents**

ALEC’s proposals to cut income and estate taxes not only pose a threat to adequate funding of services, but they also raise a very significant likelihood that middle- and lower-income households would pay higher taxes. Typically, state and local taxes represent a larger share of the income of

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lower- and middle-income households than of higher-income households. That’s because sales, excise, and property taxes are not progressive (i.e., based on one’s ability to pay, with those with more income paying a larger share of their income in those taxes). Instead, they are generally regressive (i.e., the lower one’s income, the greater the percentage of it one pays in these taxes). To some extent, a graduated income tax helps to mitigate these regressive state and local taxes. Typically, states without income taxes have higher sales and property taxes than other states. (States without an income tax have property taxes that are 8 percent to 12 percent above the national average and sales taxes 18 percent to 21 percent above the national average.\textsuperscript{5}) So, by eliminating graduated income taxes in favor of these other taxes, ALEC proposals generally would be expected to lead to higher taxes on lower- and middle-income families.

ALEC also embraces specific methods for shifting taxes onto low- and middle-income families to pay for high-income tax cuts, such as eliminating credits like state Earned Income Tax Credits (EITC) for low- and moderate-income working families and switching state revenue bases from income taxes to sales taxes with substantially higher sales tax rates.

ALEC would raise taxes on working families by:

- **Taxing wages more heavily than investment income.** ALEC advocates special treatment for investment income. For example, it has promoted model legislation under which states would entirely exempt the income from capital gains (the gains from sales of stocks, bonds, and other assets) from taxation.\textsuperscript{6}

More recently, ALEC and its allies have begun promoting legislation that exempts “pass-through income” — business profits that are taxed as the owners’ personal income rather than as corporate income — from taxation. Though ALEC advances the idea as a way to help small businesses create jobs, this tax exemption mostly would benefit large, profitable companies organized as Subchapter S-corporations and limited liability corporations, as well as investment funds and private consultancies that do not create many jobs.\textsuperscript{7}

A growing number of states are adopting this ALEC-backed idea. In 2011, when an ALEC-awarded “Legislator of the Year” became North Carolina’s Speaker of the House, the state enacted the nation’s first-ever exemption of pass-through income up to $50,000 per taxpayer. A year later, Kansas enacted a Laffer-designed tax plan that eliminated such taxes entirely, at an estimated cost to the state treasury of at least $245 million per year when fully phased in. South Carolina enacted a rate cut specifically for pass-through income in 2012.

\textsuperscript{5} Nicholas Johnson and Erica Williams, “Without A State Income Tax, Other Taxes Are Higher,” March 2012.

\textsuperscript{6} It is worth noting that in some publications, ALEC says it supports “a sensible, broad tax base” — a principle espoused by many economists across the spectrum. It defends the repeal of low-income tax credits (i.e., raising taxes on the working poor) partly on the grounds of tax-base broadening. But when it comes to businesses and investors, ALEC supports tax breaks that substantially narrow the tax base.

ALEC Fiscal Policies Move Forward in Kansas

Kansas has done more than any state in recent years to implement ALEC’s fiscal agenda. In 2012, Governor Sam Brownback hired ALEC’s Arthur Laffer to design and help sell a tax plan for Kansas. A version of Brownback and Laffer’s proposal became law.

Official state estimates say that the legislation will cost the state $700 million in the first year alone, or more than 11 percent of state general revenues, which otherwise could have helped fund schools, health care, and other services. (Kansas had already made some of the nation’s deepest K-12 spending cuts.) The law slashed state income tax rates, primarily for better-off Kansans, and eliminated income taxes for nearly 200,000 profitable businesses. To help fund the tax cuts, the package raised taxes on less well-off families by eliminating a food sales tax rebate for low-income Kansans and a property tax credit for renters. The governor promoted the tax package as a “shot of adrenaline” to the state’s economy.8

The Brownback proposal was met with skepticism from former and current legislators, business leaders, economists, and others. Retired Wichita State University economist William T. Terrell wrote, following a January 2012 Laffer presentation in Kansas:

“It’s amazing that economist Arthur Laffer is having a great impact on attempts to alter Kansas individual income taxes, and that neither Gov. Sam Brownback nor Revenue Secretary Nick Jordan has arranged for a critical review of Laffer’s empirical work. ... The Laffer claim [that repealing the income tax will help the state economy] is empty.”b

To date, the promised “adrenaline shot” has not occurred — the state essentially created zero net new jobs in the second half of 2012 — so the state faces a large budget shortfall. The governor has proposed closing it by continuing to underfund K-12 education and an extension of a higher sales tax rate.

As Kansas University tax law professor Martin B. Dickinson wrote after Kansas adopted such a policy:

“Low- and moderate-income workers will remain on the tax rolls. Meanwhile, wealthy Kansans will readily escape the tax, and many prosperous (but not wealthy) Kansans will be able to evade the tax as well. Beginning in 2013, the Kansas [income] tax system will be among the most regressive in the nation.”8

• **Shifting from income taxes to unusually high sales taxes.** ALEC’s support for low taxes tends not to extend to consumption taxes such as state sales taxes. For instance, ALEC supported a high-profile Missouri proposal to replace the income tax on individuals and corporations with a combined state sales tax rate of **up to 11 percent** (plus local sales taxes) that

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would cover far more purchases than the state’s current sales tax does.9 It has pushed similar proposals in other states but has made the most headway in Missouri, where the Show-Me Institute (a member of the ALEC-affiliated State Policy Network) and Laffer have pushed the idea for several years.10 This year, Laffer has teamed with North Carolina’s Civitas Institute to propose the idea there, and Louisiana’s Governor Bobby Jindal has expressed interest in a similar proposal.11

- **Eliminating tax-based supports for working-poor households.** In 2012, Laffer-devised plans to phase out income taxes in Kansas and Oklahoma called for repealing those states’ Earned Income Tax Credits (EITCs) and other credits for low-income families. Similarly, current proposals in Nebraska and North Carolina to eliminate the income tax would end those states’ tax credits for low-income working families.

These states are among the 24 with state EITCs, which help low-income working families with children meet basic needs. EITCs and other low-income credits and rebates help to offset the substantial state and local taxes — including regressive sales, property, and excise taxes — that low-wage families pay. Repealing those tax credits would constitute a tax increase on low-wage earners in order to finance tax cuts for the wealthy and profitable corporations.

**Prescription #3:**

**Impose Rigid Limits on State Revenue and Spending, Permanently Shrinking Education, Health Care, and Other Public Services**

While pushing policies that would weaken or dismantle state revenue systems that finance key public investments, ALEC promotes state constitutional amendments that would alter the budget process or tax rules to severely limit the funding available to pay for services. These mechanisms often seem innocuous on their face but, when enacted, they debilitate state funding for schools, health care, and other services. Their insertion into a state’s constitution makes them essentially permanent.

ALEC promotes the following state policies:

- **TABORs.** The Taxpayer Bill of Rights, or TABOR, is a state constitutional amendment that limits the annual growth of a state’s revenues or spending to the percentage growth in the state’s population plus inflation. “[S]uch a limit,” ALEC’s State Budget Reform Toolkit argues, “would impose much needed discipline on profligate spending patterns.”12 But, in Colorado — the only state to adopt TABOR — the reality was very different. TABOR caused a severe

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12 Leonard Gilroy and Jonathan Williams, 2011, “State Budget Reform Toolkit,” p. 11. Note that contrary to Gilroy and Williams, state spending patterns are not profligate; state own-source spending as a share of the economy has been basically flat since the early 1970s.
deterioration in the availability and quality of nearly all of the state’s major public services.\textsuperscript{13} For example, under TABOR, Colorado declined from 35th to 49th in the nation in K-12 spending and from 24th to 50th in the nation in the share of children receiving their full vaccinations. The cuts to services were so drastic that in 2005, a broad coalition of Coloradans — business leaders, higher education officials, and legislators of both parties, among others — worked together to promote a statewide measure to suspend the TABOR formula. TABOR causes such problems because its formula does not allow for maintaining current levels of even the most basic services in a state.\textsuperscript{14} TABOR also strips state lawmakers of the power to determine, on behalf of voters, the size and scope of their government.

At the urging of ALEC and allied organizations, nearly 30 state legislatures have considered TABOR proposals since 2004, and TABORs have appeared six times on state ballots for voter approval (in Florida, Oregon, Washington, Nebraska, and twice in Maine). Each time, state legislatures and/or voters have rejected them.

- **Supermajority requirements to raise taxes.** The ALEC State Economic Competitiveness Index ranks a state higher if it has a legal limit on spending or revenues, such as requirements that supermajorities in state legislatures or the state’s voters must approve any tax increases. ALEC offers states model legislation for a constitutional provision to require that state legislatures approve all new taxes and fees or any increases in existing taxes and fees by two-thirds votes.

Proponents argue that supermajority requirements are designed to control spending but, in reality, they allow a small minority of legislators to hold the budget process hostage to narrow concerns and make it difficult for lawmakers to pass reasonable tax increases that have public support.\textsuperscript{15} A supermajority requirement can produce extended legislative gridlock (which has occurred repeatedly in California due to its supermajority requirement), make it difficult for states to protect priority investments during recessions, and reduce a state’s ability to repeal costly and wasteful tax loopholes (because the loophole-closing would constitute a form of revenue-raising). The requirement also can prompt a lower state bond rating, which drives up a state’s borrowing costs, since bond rating agencies disapprove of constitutional limits on a state’s ability to raise adequate revenue to pay debt. Proponents have pushed supermajority legislation in a number of states in recent years, including Arizona, Hawaii, Idaho, Maine,

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  \item TABOR uses a formula for capping state resources that makes it impossible for a state to maintain at current levels even the most basic services, like schools and roads. The formula is based on overall population growth and inflation, as measured by the consumer price index (CPI). The problem with this formula is that the segments of the population requiring the most state services, such as senior citizens and children, often expand more rapidly than the population as a whole. Likewise, the CPI measures changes in the cost of goods people buy, like housing and food, not what governments pay for, such as health care. The TABOR formula is inadequate for keeping up with the normal growth in the cost of maintaining today’s level of services in future years, let alone new investments or improvements, and TABOR causes particularly severe problems during and after economic downturns.
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Michigan, Minnesota, New Hampshire, and Texas. In 2011, Wisconsin adopted a supermajority statute.\textsuperscript{16}

- **Other mechanisms that would reduce funds for services.** Another mechanism for starving states of the funds needed for adequate services is automatic tax-cut triggers. ALEC has promulgated model legislation for such triggers. Proposals in Kansas and Oklahoma to eliminate state income taxes would have required automatic income tax rate cuts when state revenue growth surpassed a certain level, denying policymakers in those states the ability to make decisions about how best to use those revenues in light of state needs. Likewise, a recent proposal in Montana would have implemented automatic tax cuts for profitable corporations and wealthy individuals any time that the state had a budget surplus, rather than allowing policymakers to decide whether to use some or all of those dollars to improve services or to save in a reserve fund for future economic downturns.

**Reliance on Faulty Analysis**

ALEC largely frames its proposed policies as reasonable solutions to what it sees as the problem at hand: government per se. ALEC's narrative implies that “out-of-control” state government spending — not the recent financial crisis or the ensuing Great Recession that caused state revenues to suffer their largest decline on record — is the source of current state budget woes and, hence, is an impediment to economic growth. Neither ALEC nor its advocates acknowledge that various public services such as education or infrastructure are essential to a state’s long-term prosperity. For example, the fifth edition of *Rich States, Poor States* — a publication that is intended to highlight “the policies that contribute to economic well-being in the 50 states” — contains not a single reference to K-12 education, public universities, or the importance of an educated workforce; it doesn’t mention infrastructure, either. Nor do they acknowledge that state residents value many public services and do not want to see them cut sharply.

Along with the anti-government foundation on which it’s built, ALEC’s work is often rich in deceptive statistics and just as often thin on policy detail. ALEC and its allies often use deeply flawed research to argue that states can slash revenues and impose constitutional restrictions without eliminating services and investments that people value and that underpin economic growth.

ALEC and its spokespeople buttress their tax and budget proposals with studies and reports that claim the proposals will strengthen the economy and create jobs, and they promote these findings assiduously. But, these studies are disconnected from a wide body of peer-reviewed academic research about public finance.

Starting in 2007 in its publication *Rich States, Poor States*, ALEC and Arthur Laffer have published the “ALEC-Laffer Economic Outlook Index” to predict future state economic growth based on which states are following the ALEC-Laffer agenda. The index consists of 15 indicators that ALEC and Laffer promote as critical to economic growth, and it rewards states with low taxes and limited government (see the table, below).

\textsuperscript{16} Requiring voter approval for tax increases also impedes the legislature’s ability to function effectively and can have consequences similar to a supermajority requirement.
In the last five years, the index has failed badly to predict how well state economies will perform. According to the University of Iowa’s Peter Fisher, the more closely a state followed the ALEC-Laffer recipe, the more poorly its economy has performed. In a recent study, Fisher shows that a

<table>
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<th>The ALEC-Laffer Indicators</th>
<th>What Economists and Business Leaders Say Matters</th>
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<td><strong>The ALEC-Laffer Economic Outlook Ranking vs What Really Matters</strong></td>
<td>As numerous studies cited in this report document, mainstream economists have identified a much broader array of factors than those in the ALEC-Laffer index as <strong>foundational</strong> to economic growth, and business leaders agree such factors are critical to their location decisions. They include:</td>
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<td><strong>Low or no income taxes, particularly for high-income households and profitable corporations</strong></td>
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<td>- Either low income taxes rates on wealthy households or no income tax</td>
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<td>- Either income tax rates that are no higher for the wealthy than for everyone else or no income tax</td>
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<td>- No taxes on inherited wealth</td>
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<td><strong>Low property, sales, excise taxes and fees</strong></td>
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<td>- Low property taxes for individuals and corporations</td>
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<td>- Low sales taxes</td>
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<td>- Low fees and excise taxes (e.g. taxes on alcohol or tobacco)</td>
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<td><strong>Not raised revenue, regardless of whether needs have increased and irrespective of needs for long-term infrastructure investments</strong></td>
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<td>- No recent tax increases</td>
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<td>- Low debt</td>
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<td><strong>Limited public sector</strong></td>
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<td>- Small public workforce</td>
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<td>- Limits on workers’ right to organize</td>
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<td>- Strict limits on raising revenues to fund public services</td>
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<td><strong>Limited corporate responsibility</strong></td>
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<td>- Low corporate liability for wrongdoing</td>
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<td>- Low employer financial responsibility for addressing workplace injuries</td>
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<td>- Low or no state minimum wage for workers other than the federal minimum wage</td>
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Because states must balance their budgets, tax cuts often come at the expense of education, infrastructure, and other services and thus can end up doing more harm than good. Likewise, starving the public sector of revenues, staffing and other resources needed to meet demand for important services can weaken the ability of a state’s economy to thrive.
higher ranking on the index is correlated with lower employment, lower per capita income, and less revenue. In fact, the highest-ranking states saw per capita income grow about one-third less between 2007 and 2011 than the lowest ranking states, on average. States that most closely followed the ALEC prescription experienced slower growth in median family income and larger increases in poverty than other states. People in states that pursued the ALEC-Laffer agenda, compared with those in other states, have become poorer on average, not richer. By itself, this correlation doesn’t prove that the ALEC-Laffer agenda hurts states, but it certainly casts doubt on the idea that it helps much.

In key ways, mainstream research decisively refutes central elements of the ALEC argument. For instance:

• State tax cuts (or lower state taxes) generally do not boost the economy. Contrary to what ALEC and Laffer claim, mainstream economic research indicates that in general, having low taxes or cutting income taxes, business taxes, and other state taxes is unlikely to improve economic growth much, if at all. That is true for several reasons. One reason is that other factors play more prominently in business location and investment decisions than overall tax levels, such as the quality and cost of labor, the quality of public services, and access to markets and supplies. For businesses, state taxes are relatively low, on average representing about 2 percent of their operating expenses. State and local taxes and incentives are not effective for stimulating economic activity or creating jobs in a cost-effective manner. Many other studies that considered the effects of taxes on business location, small business formation, and entrepreneurship rates have come to similar conclusions.

17 Peter S. Fisher, Greg LeRoy, and Philip Mattera, 2012, “Selling Snake Oil to the States: The American Legislative Exchange Council’s Flawed Prescriptions for Prosperity,” The Iowa Policy Project and Good Jobs First. An earlier version of the Fisher, LeRoy and Mattera findings, published in an article by Fisher, has been challenged in a new ALEC report by Eric Fruits and Randall Pozdena entitled Tax Myths Debunked (February 2013). Fruits and Pozdena assert, for instance, that Fisher’s findings are flawed because Fisher compared a ranking (ALEC’s index) to a measures of values (percentage changes in per capita income, median family income, poverty, among others) when he should have compared two sets of rankings, and because he should have used a statistical technique specifically designed for rankings. Fisher has recomputed his correlations using Fruits and Pozdena’s preferred techniques, and reports the same findings as his original: better state ALEC rankings have tended to be followed by worse state economic-performance rankings. Fruits and Pozdena also assert that one should really judge ALEC’s index — not by the standard measures of prosperity that Fisher used — but rather by a little-used index of economic performance generated by the Federal Reserve Bank of Philadelphia. In fact, as Fisher explains in a more detailed forthcoming response, the Philadelphia Fed index as deployed by Fruits and Pozdena is unsuitable for this purpose. The Fed index measures states against a benchmark year (1992), rather than against the current economic health of other states. That means that states rank high or low depending on how their economy fares relative to 1992, not a very useful way to measure the impact of policies that were in effect in 2007. And when the Fed index is adapted to focus on changes since 2007, the correlation with the ALEC index is near zero. For these and other reasons (some of which are described briefly in footnotes later in this report), ALEC’s new attack on its critics is as flawed methodologically as earlier ALEC publications.

18 For example, in Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development, Economic Policy Institute, 2004, p 19, economist Robert Lynch concludes from his review of decades of economic research: “There is little evidence that the level of state and local taxation figures prominently in business location decisions... and that state and local taxes and incentives are not the only, or the primary, influence on business investment decisions.” Economists Stephen T. Mark, Therese J. McGuire, and Leslie E. Papke reviewed the literature on business location and expansion decisions and found that “The studies do make clear that a policy of cutting taxes to induce economic growth is not likely to be efficient or cost-effective in the general case.” See “What Do We Know About the Effect of Taxes on Economic Development? Lessons from the Literature for the District of Columbia,” State Tax Notes, August 25, 1997, pp. 508-509. A study by the Illinois Commission on Government Forecasting and Accountability reviewed all state rankings by business tax climate made by various organizations and reviewed the literature on the subject. It concluded: “State and local tax cuts and incentives are not effective for stimulating economic activity or creating jobs in a cost-effective manner.” Illinois Tax Incentives, July 2009. Many other studies that considered the effect of taxes on business location, small business formation, and entrepreneurship rates have come to similar conclusions.

19 See the reviews of research on why public services matter in Peter Fisher, “Corporate Taxes and State Economic Growth,” Iowa Fiscal Partnership, revised February 2012; Jeff Thompson, "Prioritizing Approaches to Economic
percent of corporate expenses. In addition, if given a tax cut, some corporations would allocate their savings from it to out-of-state shareholders in the form of higher dividends, which is good for the shareholders but of relatively little value to the state that cut the taxes.

Another major reason is that because states must balance their budgets each year and because they allocate most of their revenue in the form of salaries, contracts, and purchases, business and individual tax cuts mean cuts to public services, which can cause a ripple effect of lower economic activity that reaches the private sector. In the short run, the economy loses at least as much from reduced spending as it may receive through tax cuts. In the long run, as an extensive body of economic research indicates, underfunded physical and human capital investments can hinder economic growth. One oft-cited review of the economic evidence found that tax-funded public services like education, health, transportation, and public safety are important ingredients for growth and jobs. Any positive effects of tax cuts typically are too small to outweigh the negative effects of cuts on areas like these.

Additionally, tax cuts for wealthy individuals and corporations are an ineffective tool for generating the new economic activity needed to promote a stronger recovery from the Great Recession. High-income households are likely to save a substantial portion of any tax cut they receive rather than increase their current level of spending. Business tax cuts are unlikely to stimulate new investment or hiring by businesses whose major problem is weak sales not a lack of cash flow to finance new investments. Moreover, a policy of shifting the tax burden onto lower-income households and cutting government services that are more effective at generating economic activity than high-income and business tax cuts would exert a drag on economic activity and job creation.

- **State tax cuts do not pay for themselves.** The most extreme version of ALEC and Laffer’s pro-tax cut argument is the notion — reflected in the Laffer Curve, a graphical depiction of which appears twice in *Rich States, Poor States* — that income tax rate cuts can pay for themselves. *Rich States, Poor States* claims: “[W]hile less tax revenue may be collected per unit of tax base, the tax base itself increases. This expansion of the tax base will, therefore, offset some (and in some cases, all) of the loss in revenues because of the now lower rates.” (emphasis added).

Serious economists across the political spectrum consider the notion that income tax cuts will pay for themselves fanciful. In a well-known economics textbook, N. Gregory Mankiw, former chairman of President George W. Bush’s Council of Economic Advisers, calls an economist...
who claims that tax cuts pay for themselves a “snake oil salesman trying to sell a miracle cure.”

Likewise, in a recent study on personal income tax rates, economists Peter Diamond (a Nobel laureate) and Emmanuel Saez estimate that top marginal rates in the personal income tax (federal or combined federal and state) could rise significantly above current levels before high-income people would change their behavior in ways that would offset the revenue gains from higher tax rates.

As Dr. Mickey Hepner, Dean of the University of Central Oklahoma’s College of Business, wrote of Laffer’s Oklahoma proposal:

Perhaps one of the most disingenuous arguments being made in support of reducing and/or eliminating the state’s personal income tax is that somehow reducing the state income tax will pay for itself. The evidence, and common sense, tell us otherwise.

Mainstream economists generally say the same about corporate income tax cuts. As Upjohn Institute economist Timothy Bartik notes, the economic literature finds that the economic benefits of corporate tax cuts “… are not large enough to produce a Laffer Curve, in which cuts in tax rates would raise the tax base enough to increase revenue. … The higher business tax base would offset only about a quarter of … [the initial] revenue loss.”

**Progressive taxes (taxes with higher rates on higher incomes) and corporate taxes do not inherently damage the economy.**  As noted above, ALEC’s agenda prioritizes tax cuts for high-income households — such as to top marginal income tax rates that make state tax systems more progressive — and profitable corporations. In *Rich States, Poor States*, Laffer, Moore, and Williams write: “Progressive corporate and personal income taxes do far more damage to the economy than do other taxes such as sales taxes, property taxes, and severance taxes…” Similarly, the ALEC-Laffer State Economic Outlook Index highly favors states with a flat or less graduated income tax rate structure, and the authors argue that a graduated rate structure is an obstacle to economic growth.

That conclusion contradicts mainstream economic research. One recent study, for example, finds that progressive income taxes do not reduce per capita personal income growth; if anything, they may increase growth. Another finds that tax cuts for high-income taxpayers may benefit the individual taxpayer but there is no evidence that they help the state’s economy overall. Moreover, a significant body of research suggests that income inequality and lack of

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economic mobility can harm an economy. A graduated income tax that’s based on one’s ability to pay can help reduce economic inequality and, by reducing taxes at the low end, enhance economic mobility, with positive effects both for affected families and possibly for the economy as a whole.

- **Taxes don’t cause people to flee a state.** One of ALEC and Laffer’s main arguments against taxes — especially on high-income households — is that they influence where people choose to live. Laffer frequently asserts that people who move from one state to another are “voting with their feet” against higher taxes. Evidence says otherwise; it shows that taxes have a negligible impact on interstate migration. The large majority of people live their entire lives in the state where they were born and, among those who move, the main reasons are not taxes but job prospects, housing costs, family considerations, and climate. A growing body of research by economists and demographers that considers the wide range of factors shows consistently that taxes have little impact on migration.

Perhaps the most carefully designed study to date concerned the impact of New Jersey’s 2004 tax increase, which ALEC, Laffer, and others claim has caused massive migration from the state. Researchers from Princeton and Stanford Universities looked carefully at the data and found that migration from New Jersey that might be attributable to the tax increase reduced the estimated revenue gain from the tax increase by a negligible 0.4 percent. (In other words, there was still a very substantial net revenue gain.) A similar study in California found that millionaires were no more likely to move to another state after a tax rate increase. These studies, like other credible analyses, essentially found that ALEC and Laffer’s claim that taxes drive large-scale migration is incorrect.

Despite the mainstream economic evidence to the contrary (as outlined above), ALEC and Laffer produce findings that their policies would promote economic growth because they make exaggerated claims, present misleading data, commit basic statistical errors, and fail to control for other factors known to affect growth. In fact, ALEC and Laffer use techniques that manipulate data in ways that violate accepted standards of research. For example:

- A report that Laffer and his consulting group (Arduin, Laffer and Moore Econometrics) prepared for the Florida legislature to promote property tax cuts contained a fundamental statistical error that biased the findings: they set up their key equation to guarantee a negative relationship between taxes and income, predetermining the study’s results. An analysis by the

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Center on Budget and Policy Priorities’ Iris J. Lav and the Urban Institute’s Kim Rueben showed that once one corrected for this basic error, personal income growth was associated with higher rather than lower taxes — the opposite of what the Laffer team concluded. “We find,” Lav and Rueben wrote, “that the authors used a flawed equation in arriving at their results.... Arduin, Laffer, and Moore have committed basic errors in examining this issue, invalidating their conclusions.”34 (Although Lav and Rueben found that personal income growth was associated with higher taxes, that does not mean that high taxes caused economic growth.)

• In a 2010 Wall Street Journal op-ed, Laffer asserted that the 11 states that enacted income taxes over the past 50 years have suffered economic harm as a result. For evidence, he stated that those states’ shares of total U.S. economic output are smaller today than when they enacted their taxes. But he omitted a fundamentally important piece of context: most of those states are located in the already populous Northeast and Midwest, and their populations and GDPs were already growing more slowly than the rest of the economy before they enacted their income taxes. In fact, data show that the trend actually eased after the states enacted their income taxes.

Moreover, under the best measure of economic prosperity — per-capita income — those 11 states on average have out-performed the nation since enacting income taxes. Specifically, seven of them have experienced growth in per capita personal income equal to or better than the nation as a whole since instituting their tax.35 University of Pennsylvania tax law professor David Shakow thoroughly refuted Laffer’s claim about the negative economic impact of enacting a state income tax, writing: “There are many problems with the proof Laffer offers in his article.... The suggestion that states such as Indiana, Illinois, and Michigan would have thrived if they had not introduced an income tax is, well, laughable.”36

• An Oklahoma analysis by Arduin, Laffer & Moore Econometrics and a local conservative think tank claimed that eliminating the state’s income tax would create 300,000 jobs. This analysis, too, contained an egregious mistake: it used a variable that measured state and federal tax rates combined, producing meaningless results.

As the Institute for Taxation and Economic Policy (ITEP) pointed out:

“The Laffer regression finds a ‘negative and highly significant’ relationship between the combined federal/state tax rate in a given state and economic growth over the 2001-2008 period — but that relationship actually becomes positive and insignificant when the model is corrected to include only variation in state tax rates. Put another way, when the noise created by changes in federal tax rates is removed, it becomes obvious that differences in state tax rates are not driving the economic predictions made by Laffer.”37


35 CBPP analysis of data from the U.S. Bureau of Economic Analysis.


37 “Arthur Laffer Regression Analysis Is Fundamentally Flawed, Offers No Support for Economic Growth Claims,” February 2012. In the Tax Myths Debunked publication cited above in footnote 18, ALEC defends itself against ITEP’s critique by asserting that it is legitimate to include federal tax rates in an analysis of state tax policy. That is true in some cases, but not in this case, because including the federal rates obscures state-to-state differentials that after all are the
Jonathan Willner, Professor and Chair of the Oklahoma City University Department of Economics and Finance, noted:

“Between data inconsistencies, omitting things that matter, and not asking about relevant impacts, the Arduin, Laffer and Moore assessment of the impact of eliminating the Oklahoma Income Tax does not constitute economic analysis in any real sense.”\footnote{Jonathan Willner, “Putting Real Economics into an Economic Assessment of the Oklahoma Income Tax,” \url{http://dl.dropbox.com/u/19732897/Willner-PuttingRealEconomics_into_an_Economic_Assessment_of_the_OklahomaIncomeTax.pdf}.}

Finally, Oklahoma State University economist Kent Olsen added:

“The claims of the report are based on an economic analysis that fails to meet generally accepted standards of economic inquiry. … [T]he study provides no valid evidence that a reduction in taxes and expenditures will generate any growth — large or small — in income, output, employment and revenue.”\footnote{Kent Olson, “The Voodoo Economics of Phasing Out Oklahoma’s Personal Income Tax,” March 14, 2012, \url{http://dl.dropbox.com/u/19732897/OLSON_VOODOO_PHASING_OUT_INC_TAX.pdf}.}

Laffer and his colleague Wayne Winegarden produced a study finding that the estate tax was the sole reason that Tennessee’s economy had not grown as fast as those of other states without an income tax, and that repealing the estate tax would prove an economic boon for the state and created 220,000 more jobs, a surprising finding given that the tax only affects a few hundred Tennessee estates per year.

ITEP deconstructed Laffer and Winegarden’s analysis:

“[Laffer and Winegarden] assert that if Tennessee’s estate tax had been repealed 10 years ago, the state’s economy would have been unleashed, and would have grown at a rate exactly equal to the average among states not levying an income tax. And from there, the math is simple: applying the higher economic and employment growth rates mentioned above leaves Tennessee with an economy that is 14 percent larger and a workforce with 220,000 additional members.”\footnote{Institute on Taxation and Economic Policy, April 2012, “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.” In its report \textit{Tax Myths Debunked}, ALEC defends Laffer and Winegarden’s report on theoretical grounds but provides no empirical evidence to dispute ITEP’s core contention that factors other than the estate tax — such as the fact that many of the comparison states had significant extractive-industry sectors in a decade when those sectors boomed — could explain much or all of the growth differential in the 2000s. \textit{Tax Myths}’ authors also provide results of their own modeling of estate tax repeal in Tennessee that they claim confirms Laffer’s results, but they provide no clues as to their methodology, and in any case the results are quite a bit different from Laffer’s, although similarly hard to believe.}

In other words, Laffer and Winegarden first assumed what their study purported to prove: that repealing the estate tax would cause faster growth. They then calculated what would happen if focus. The ALEC publication does not dispute ITEP’s central finding that, had Laffer focused solely on state tax rates, the results would have been opposite from those on which he relies so heavily in drawing his conclusions.
the assumption were true, and they then trumpeted the results as proof that their assumption was indeed true.

Despite repeated published findings that his work violates basic standards of economic research, Laffer continues to produce analysis rife with flaws that serves the ALEC agenda.

A Better Way Forward

To be sure, state tax and budget systems need improvement, both to help states meet their balanced budget requirements and to create the conditions for economic growth and a higher quality of life. But, by pushing to cut taxes deeply for corporations and well-to-do Americans, shift tax burdens from the wealthy to middle- and lower-income Americans, and impose rigid limits on taxes and spending, ALEC’s agenda would take states in the wrong direction. States would benefit, instead, from a commonsense approach through which they would ensure adequate revenues to invest in key priorities that would boost economic growth and reform state budget processes so that they can better plan for an uncertain future, including adequately funding their reserves or “rainy day” funds.

Specifically, states would adopt the following approach:

• **Modernize tax codes to match today’s economy.** Most states enacted their existing tax codes in the middle of the last century and have not updated them enough to reflect the realities of a 21st Century economy.

To move down that path, they should broaden their sales tax bases so they apply to more services as well as to goods, tighten corporate tax codes to reduce the ability of multi-state corporations to engage in bookkeeping transactions that shift profits to tax-haven states, pare back excessive tax breaks on the retirement income of affluent senior citizens, and curtail tax provisions that treat sales which are made over the Internet more favorably than sales made in bricks-and-mortar stores.

Some ALEC-backed proposals contain some of these worthy provisions. But the central focus of ALEC’s tax agenda on providing enormous tax breaks for high-income households and large corporations undermines the ability of state policymakers to move forward with these more mainstream reforms.

• **Maintain education, health care, and other public services at adequate levels and finance key new investments.** State tax revenues remain well below pre-recession levels, and the tax cuts, tax shifts, and budgetary restrictions that form the core of ALEC’s agenda would push them still lower, starving states of needed resources to invest in key priorities.

Instead, states should ensure that they have adequate funds and should use them to invest in education, infrastructure, health care, public safety and human services. Careful research studies confirm that investment in those areas can provide important payoffs for families, communities, and state economies. In some areas, such as early childhood education, the evidence is very strong that the long-term economic benefits to a state of new tax-funded investment would significantly exceed their costs.
• **Reform state budget processes.** States do not do enough long-term fiscal planning or preparing for possible recessions, and they do not produce enough information that would allow residents to understand fully the implications of state budget choices.

For example, states should produce multi-year projections that realistically predict the future consequences of today’s budget commitments on both spending and revenue. They should fully document and account for “tax expenditures” — the tax credits, deductions, and other preferences that are akin to spending through the tax code but that are often invisible in the budget process. They also should structure rainy day funds and other reserve funds in ways that make them more adequate when the economy turns down.

Finally, policymakers should take care to ensure that changes to their tax and budget systems are grounded in solid research and clear evidence.

**Conclusion**

The ALEC agenda is grounded in deeply flawed research and often based on faulty, predetermined assumptions not grounded in evidence. The prescriptions that ALEC recommends would substantially weaken or dismantle key components of state revenue systems, shift the cost of services from high-income households and corporations to other state residents, and lock in mechanisms to shrink the resources available to fund investments and services important for state residents and the economy, such as education, transportation, and health care. The agenda would primarily benefit those at the top of the economic ladder at the expense of the broad public.
Our analysis of ALEC’s proposals is based on a review of the organization’s own publications; the writings of its advisers and of colleagues at related organizations; and the speeches and media appearances of its spokespersons.

Four out of five members of ALEC’s Board of Scholars have written extensively on fiscal issues. They include Arthur Laffer, Stephen Moore, Bob Williams, a former Washington State legislator and founder of a free-market state think tank, and Ohio University economist Richard Vedder.

Laffer is perhaps ALEC’s most prolific and visible spokesperson on fiscal issues. At the national level, he popularized what became known as the “Laffer Curve” — which received much attention during the Reagan era and which implied that cutting income tax rates would generate higher government revenues. Serious researchers from across the political spectrum have largely discredited the notion. Stephen Moore, a former president of the Club for Growth and now a *Wall Street Journal* editorial board member, is also a prominent adviser.41 The *Journal’s* editorial page frequently echoes ALEC’s perspective and relies on its research.

ALEC’s focus on state fiscal issues is shared by Grover Norquist’s Americans for Tax Reform, the Charles and David Koch’s Americans for Prosperity, and the state-level policy institutes of the State Policy Network, such as the Texas Public Policy Foundation, the Maine Heritage Center, the Goldwater Institute in Arizona, and Michigan’s Mackinac Center for Public Policy. These organizations are linked formally and informally with ALEC. Americans for Tax Reform, Americans for Prosperity, the State Policy Network (SPN), and some individual SPN members that have championed anti-tax efforts in individual states are ALEC members and, specifically, members of ALEC’s tax and fiscal policy task force. In turn, ALEC is an associate member of the State Policy Network.

ALEC’s key in-house publications with major fiscal proposals include:

- *Rich States, Poor States:* This annual ALEC publication, which Laffer and Moore co-wrote in 2012 with ALEC Fiscal Policy Director Jonathan Williams, seeks to show that states with lower taxes and less government have better-performing economies.

- *State Budget Reform Toolkit:* This ALEC publication gives state legislators the narrative, policy recommendations, and model legislation to reduce the size and role of government. It recommends constitutional limits on revenues and spending, supermajority requirements for raising taxes, and other such policies. (It also includes some useful recommendations for government transparency and accountability, a goal widely shared across the political spectrum.) The Toolkit’s recommendations largely are based on ALEC’s premise that government is inherently fraught with wasteful spending and abuse.

- *State-specific papers and consulting:* ALEC proposals can also be found in various publications by Laffer and his consulting firm as well as by ALEC staffers. Laffer also consults directly with lawmakers and state-level organizations. (For instance, he was a paid consultant to Kansas Governor Sam Brownback and worked with a conservative think tank in Oklahoma, both times as the primary architect of plans to eliminate the state income tax.)

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41 Moore also previously worked at the Heritage Foundation and the Cato Institute.