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The Doctor is Out to Lunch

ALEC's Recommendations Wrong Prescription for State Prosperity

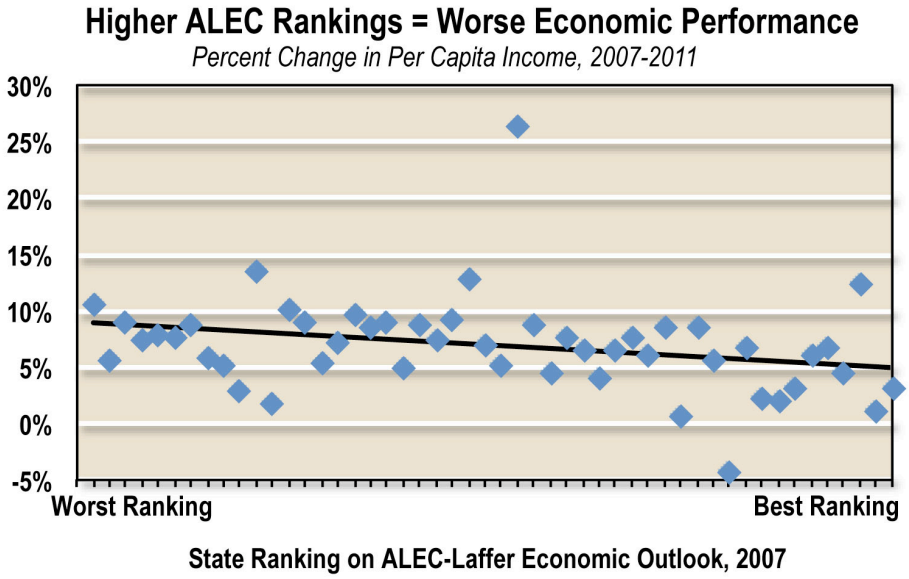
By Peter S. Fisher

This year marks the fifth anniversary *of Rich States, Poor States: The ALEC-Laffer State Economic Competitiveness Index*. First published in 2007, this report written by Dr. Arthur Laffer and others and published by the American Legislative Exchange Council (ALEC) purports to be a guide to state policies that promote economic growth. It seems an opportune time to assess how well their measure of a state's Economic Outlook in 2007 actually performed: Did it accurately predict the economic performance of states over the next several years?

The policy prescriptions laid out in the ALEC report embody the right-wing agenda of ALEC: reduction or abolition of progressive taxes, fewer government services, weaker or non-existent unions. To attain the highest ranking would require a state to have no individual or corporate income tax, no estate or inheritance tax, no state minimum wage, severe tax and expenditure limits and very limited public services. It also would have to be a so-called "right-to-work state" — that is, it would provide no right for employees to negotiate a union contract that requires all employees who benefit from the contract to pay a share of the costs of negotiating it. Laffer and company have been arguing for five years that adoption of such policies is the sure-fire prescription for state growth and prosperity. The better a state ranks on their index of 15 such policies, the better its economic outlook, they say.

So how should we assess the economic performance of states and the validity of the ALEC Economic Outlook Ranking? A good place to start is with the set of performance measures that the ALEC report itself relies on: growth in state GDP (Gross Domestic Product), growth in nonfarm employment, growth in per capita income, and growth in population. ALEC would be disappointed.

Simply put, the ALEC Outlook Ranking fails to predict economic performance. There is virtually no relation between the ranking in 2007 and a state's five-year rate of growth in GDP; the correlation is 0.02, almost zero. On another measure, the correlation is only slightly stronger, but in the opposite direction (-0.06): The lower a state was ranked on the A-L Index the better it did in terms of job growth. Other trends were stronger but again in the opposite direction: the



less "competitive" a state according to ALEC the *more* per capita income grew (see chart above).

It makes sense as well to judge the ALEC rankings by two other measures of the standard of living of the state's population: median family income and the poverty rate. The ALEC report, after all, attempts to predict which states will be richer, which ones poorer.

The ALEC Outlook Ranking fails to predict economic performance. In fact, the less a state followed ALEC's prescriptions, the better it did in terms of job growth, and the better it did on change in poverty rate and median income.

If the states following the prescriptions of Laffer and company succeeded in generating more income for their residents than the states who failed to subscribe to their policies, they should have higher incomes and lower poverty rates. The opposite is the case. The more a state's policies mirrored the ALEC low-tax, regressive taxation, limited government agenda, the lower the state's per capita income and median family income throughout the period 2007-2010, and the higher the poverty rate. Not only that, but the better a state did on the ALEC Outlook Ranking, the worse it did in terms of the change in the poverty rate and the change in median family income from 2007 to 2010 — that is, poverty increased and family income decreased in the best ranking states.

What about population growth? This turns out to be the only measure on which the ALEC Outlook Ranking performs as advertised: States ranked higher in 2007 experienced greater population growth from 2007 to 2011. But population growth is not a measure of economic performance. Population change, as demographers are well aware, is driven by a wide range of factors. It may be driven in part by economic performance, in that people should be drawn to states with more job growth, and better job opportunities as reflected in higher incomes. But this is obviously not what is happening here. Clearly Laffer and company cannot draw the line of causation that they would like to: from their right-wing policies to stronger economic growth and more prosperity, which in turn cause more people to migrate to those states and/or fewer to leave.

What about the particular components of the competitiveness index? In the 2011 edition, Laffer and company focus particular attention on six that they say "have consistently stood out as the most important in predicting where jobs will be created and incomes will rise:" personal income taxes, corporate income taxes, the sales tax, estate and inheritance taxes, total taxes, and right-to-work laws. While Laffer and company rely almost exclusively on simple correlations, it is not difficult to control for other factors explaining growth through a more sophisticated statistical analysis.

State economies are largely at the mercy of national and international economic trends, particularly in the short run, for example the five-year period 2007-2011. One would expect that the state economies that did the best over that period were the ones with economies that were best positioned to take advantage of growth in national and worldwide markets, or whose economies were most insulated from declines in particular sectors.

The industries that experienced the most growth in recent years and where there was substantial variation among states in terms of dependence on those industries were mining; nondurable goods manufacturing; durable goods manufacturing; finance and insurance; trade, transportation and warehousing; education and health services; and professional and scientific. The share of state GDP accounted for by each sector in 2007 should help explain how that state fared over the next five years.

These shares were entered as variables in a multiple regression equation, along with two variables deemed important by Laffer and company: total state and local tax revenue as a percent of state personal income over the period 2007-2009, and "right-to-work" status. This allows us to answer the question: Did these latter policy variables influence the rate at which states grew, holding constant the composition of the state economy?

The short answer is: "No, they did not." Neither variable — total taxes or "right-to-work" — had a statistically significant effect on growth in state GDP, growth in non-farm employment, or growth in per capita income. The composition of the state economy, on the other hand, had a great deal to do with how fast a state grew, particularly in explaining growth in employment and per capita income. The share of the economy consisting of extractive industries (mining, oil) was a very significant determinant in all equations.

There are three tax components that Laffer insists are crucial determinants of how well a state economy performs: the top individual income tax rate, the top corporate income tax rate, and the existence of an inheritance or estate tax. When these components are substituted for the overall tax level, none turn out to be part of the explanation for why some states grew faster in terms of state GDP, non-farm employment, or per capita income from 2007 to 2011. Neither did "right-to-work" status have any effect in any of the three models. Once again, the composition of the state economy was the major statistically significant factor.

Similar results follow when the state's Economic Outlook Ranking in 2007 is substituted for the tax variables and "right-to-work" status. This ranking, after all, purports to be a summary of all the policy variables contributing to growth. Once again, the composition of the state economy determined growth; the ALEC ranking had no effect.

The moral of the story is quite simple: The policy prescriptions in *Rich States, Poor States* do not help at all to explain why some states created more jobs than others, or why some states experienced more growth in income per person than others, over the past five years. In other words, the policies that make up the Economic Outlook Ranking are not a recipe for growth and prosperity. If anything, they are quite the opposite: They are a recipe for economic inequality, low wages, and stagnant incomes that at the same time deprive state and local governments of the revenue needed to maintain the public infrastructure and education systems that are the underpinnings of long term economic growth.

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