OPINION

Soak the Rich, Lose the Rich

Americans know how to use the moving van to escape high taxes.

By ARTHUR LAFFER and STEPHEN MOORE

Updated May 18, 2009 12:01 a.m. ET

With states facing nearly $100 billion in combined budget deficits this year, we're seeing more governors than ever proposing the Barack Obama solution to balancing the budget: Soak the rich. Lawmakers in California, Connecticut, Delaware, Illinois, Minnesota, New Jersey, New York and Oregon want to raise income tax rates on the top 1% or 2% or 5% of their citizens. New Illinois Gov. Patrick Quinn wants a 50% increase in the income tax rate on the wealthy because this is the "fair" way to close his state's gaping deficit.

Chad Crowe

Mr. Quinn and other tax-raising governors have been emboldened by recent studies by left-wing groups like the Center for Budget and Policy Priorities that suggest that "tax increases, particularly tax increases on higher-income families, may be the best available option." A recent letter to New York Gov. David Paterson signed by 100 economists advises the Empire State to "raise tax rates for high income families right away."

Here's the problem for states that want to pry more money out of the wallets of rich people. It never works because people, investment capital and businesses are mobile: They can leave tax-unfriendly states and move to tax-friendly states.

And the evidence that we discovered in our new study for the American Legislative Exchange Council, "Rich States, Poor States," published in March, shows that Americans are more sensitive to high taxes than ever before. The tax differential between low-tax and high-tax states is widening, meaning that a relocation from high-tax California or Ohio, to no-income tax Texas or Tennessee, is all the more financially profitable both in terms of lower tax bills and more job opportunities.

Updating some research from Richard Vedder of Ohio University, we found that from 1998 to 2007, more than 1,100 people every day including Sundays and holidays moved from the nine highest income-tax states such as California, New Jersey, New York and Ohio and relocated mostly to the nine tax-haven states with no income tax, including Florida, Nevada, New Hampshire and Texas. We also found that over these same years the no-income tax states created 89% more jobs and had

32% faster personal income growth than their high-tax counterparts.

Did the greater prosperity in low-tax states happen by chance? Is it coincidence that the two highest tax-rate states in the nation, California and New York, have the biggest fiscal holes to repair? No. Dozens of academic studies -- old and new -- have found clear and irrefutable statistical evidence that high state and local taxes repel jobs and businesses.

Martin Feldstein, Harvard economist and former president of the National Bureau of Economic Research, co-authored a famous study in 1998 called "Can State Taxes Redistribute Income?" This should be required reading for today's state legislators. It concludes: "Since individuals can avoid unfavorable taxes by migrating to jurisdictions that offer more favorable tax conditions, a relatively unfavorable tax will cause gross wages to adjust. . . . A more progressive tax thus induces firms to hire fewer high skilled employees and to hire more low skilled employees."

More recently, Barry W. Poulson of the University of Colorado last year examined many factors that explain why some states grew richer than others from 1964 to 2004 and found "a significant negative impact of higher marginal tax rates on state economic growth." In other words, soaking the rich doesn't work. To the contrary, middle-class workers end up taking the hit.

Finally, there is the issue of whether high-income people move away from states that have high income-tax rates. Examining IRS tax return data by state, E.J. McMahon, a fiscal expert at the Manhattan Institute, measured the impact of large income-tax rate increases on the rich ($200,000 income or more) in Connecticut, which raised its tax rate in 2003 to 5% from 4.5%; in New Jersey, which raised its rate in 2004 to 8.97% from 6.35%; and in New York, which raised its tax rate in 2003 to 7.7% from 6.85%. Over the period 2002-2005, in each of these states the "soak the rich" tax hike was followed by a significant reduction in the number of rich people paying taxes in these states relative to the national average. Amazingly, these three states ranked 46th, 49th and 50th among all states in the percentage increase in wealthy tax filers in the years after they tried to soak the rich.

This result was all the more remarkable given that these were years when the stock market boomed and Wall Street gains were in the trillions of dollars. Examining data from a 2008 Princeton study on the New Jersey tax hike on the wealthy, we found that there were 4,000 missing half-millionaires in New Jersey after that tax took effect. New Jersey now has one of the largest budget deficits in the nation.

We believe there are three unintended consequences from states raising tax rates on the rich. First, some rich residents sell their homes and leave the state; second, those who stay in the state report less taxable income on their tax returns; and third, some rich people choose not to locate in a high-tax state. Since many rich people also tend to be successful business owners, jobs leave with them or they never arrive in the first place. This is why high income-tax states have such a tough time creating net new jobs for low-income residents and college graduates.

Those who disapprove of tax competition complain that lower state taxes only create a zero-sum competition where states "race to the bottom" and cut services to the poor as taxes fall to zero. They say that tax cutting inevitably means lower quality schools and police protection as lower tax rates mean starvation of public services.

They're wrong, and New Hampshire is our favorite illustration. The Live Free or Die State has no income or sales tax, yet it has high-quality schools and excellent public services. Students in New Hampshire public schools achieve the fourth-highest test scores in the nation -- even though the state spends about $1,000 a year less per resident on state and local government than the average state and, incredibly, $5,000 less per person than New York. And on the other side of the ledger, California in 2007 had the highest-paid classroom teachers in the nation, and yet the Golden State had the second-lowest test scores.

Or consider the fiasco of New Jersey. In the early 1960s, the state had no state income tax and no state sales tax. It was a rapidly growing state attracting people from everywhere and running budget surpluses. Today its income and sales taxes are among the highest in the nation yet it suffers from perpetual deficits and its schools rank among the worst in the nation -- much worse than those in New Hampshire. Most of the massive infusion of tax dollars over the past 40 years has simply enriched the public-employee unions in the Garden State. People are fleeing the state in droves.

One last point: States aren't simply competing with each other. As Texas Gov. Rick Perry recently told us, "Our state is competing with Germany, France, Japan and China for business. We'd better have a pro-growth tax system or those American jobs will be out-sourced." Gov. Perry and Texas have the jobs and prosperity model exactly right. Texas created more new jobs in 2008 than all other 49 states combined. And Texas is the only state other than Georgia and North Dakota that is cutting taxes this year.

The Texas economic model makes a whole lot more sense than the New Jersey model, and we hope the politicians in California, Delaware, Illinois, Minnesota and New York realize this before it's too late.

Mr. Laffer is president of Laffer Associates. Mr. Moore is senior economics writer for the Wall Street Journal. They are co-authors of "Rich States, Poor States" (American Legislative Exchange Council, 2009).

Please add your comments to the Opinion Journal forum.