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An INQUIRY *into* THE NATURE AND CAUSES *of the* WEALTH OF STATES

HOW TAXES, ENERGY, AND WORKER FREEDOM CHANGE EVERYTHING

WILEY

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Cover image: Flag © iStockphoto.com/nico_blue
Cover design: Wiley

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

ISBN 978-1-118-92122-7 (cloth)
ISBN 978-1-118-92124-1 (ebk)
ISBN 978-1-118-92123-4 (ebk)

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

We dedicate this book to Professor Colin Campbell of Dartmouth University and his late wife Rosemary Campbell, for their enormous contribution to our understanding of the political economics of states. We especially wish to single out their paper, A Comparative Study of the Fiscal Systems of New Hampshire and Vermont, 1940–1974, *published by the Wheelabrator Foundation in 1976.*

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Prologue

[S]cience needs much more in the way of prior hypothesis and theory than most [researchers are] willing to admit; there is no way to boil down a mass of raw data into a theory unless we are prepared to take a leap of faith by suggesting (and then testing) some generative mechanism for it.

—Philip Ball, *Curiosity*

Prior to diving into the substance of this book, we wish to recognize the enormous contribution to state economics by Dartmouth Professor Colin Campbell. Professor Campbell, now in his 90s, pioneered the analysis of the consequences of different state economic policies and the resulting differences in actual performance metrics. His paper "A Comparative Study of the Fiscal Systems of New Hampshire and Vermont, 1940–1974,"[1] coauthored with his wife Rosemary Campbell, went from policy choices all the way to the provision of public services. For many, many years, both the content of his work and its conclusions were seemingly lost to state policy makers. We intend to rectify this serious oversight.

We also wish to point out our frequent borrowing of context and quotes from the wonderful book, *Curiosity,* by Philip Ball.[2] Nearly every quote at the beginning of each chapter in this book has been drawn from *Curiosity*. If we fail to cite Ball at every instance where appropriate, we beg him please to forgive us. His work is incredible. And, last, we discovered an absolutely superb analysis by Dr. Thomas R. Dye[3] of the nine states that introduced the state income tax, starting with Michigan and

Nebraska in 1967, after having already written our Chapter 1. We started our analysis with West Virginia (1961) followed by Indiana (1963), which were not included by Dye. Dye's conclusions and ours were, as you would suspect, essentially the same.

When it comes to cross-border movements, the study of international economics usually takes as a given that both labor and capital are relatively immobile. By the very definition, international cross-border movements of land don't happen. But, as we all know from reading European and world history, even land changes hands from time to time. There's always the story of the man whose farm was part of a land repatriation from Russia to Poland, reversing the Russian annexation that had occurred after World War II. The farmer was quoted as saying, "Thank God, we won't have to suffer those long Russian winters anymore!"

Within the confines of the specific assumptions, international economics develops and expands the role that incentives have on trade, growth, production, and consumption in both static and dynamic terms, as well as how government policies and natural endowments affect the various economies of the world. International economics has been an anchor tenant for government policies from time immemorial. Trade in goods and services appears to have been an enormously powerful force for the evolution of modern economies from the very first time modern humans appeared on planet Earth. And trade still is an enormously powerful force that attracts a disproportionate amount of attention from governments large and small, near and far.

The United States was built on a clear understanding of the benefits of the free flow of goods, services, and people among the states, of Ricardo's "gains from trade" and Adam Smith's notion of specialization that leads to "comparative advantage." The ideal of total and complete free trade was written into our very foundation papers. The Commerce Clause of the U.S. Constitution has been interpreted to prohibit excessive impediments to the free trade in goods, services, and even labor among the states of the United States.

And under the Privileges and Immunities Clause, people are entitled to migrate and resettle into any state without limitation; they need only abide by the laws and regulations of their new home, just as longtime residents do.[4]

But total uninhibited free trade in goods, services, and labor, as exists among the 50 states of the United States, brings us to an extreme variant of international economics—a corner solution, so to speak. Now the only truly immobile factor of production is land itself. Some forms of fixed capital too may be immobile for the period of their useful lives, but, in due course, even buildings can in a sense slip across state borders, as is witnessed by the decline and fall of Detroit, Michigan, and the expansion and rise of Dallas, Texas. It may take time, but it does happen. Recently we concluded a study on the impact that California's aggressive tax and regulatory policies have had on the extensive infrastructure that Chevron has invested and operates in California.[5] The bottom line of that study was that once the capital is in place and impossible to disassemble and move, the capital itself is helpless to oppose complete expropriation by state government, whether implemented explicitly or implicitly through taxation and regulation.

The economics of the various states of the United States are unique. And the measures of their relative successes and failures are equally unique. In international economics, where populations and labor are essentially immobile, arbitrage across national boundaries occurs through trade in goods and services and through changes in the terms of trade (inflation-adjusted exchange rates). In the case of international economics where populations are immobile, measures of success or failure include income per capita, unemployment, and other measures of the standard of living. When labor is freely and, relatively speaking, costlessly mobile across state boundaries, however, as is the case in the United States, measures such as income per capita or unemployment rates no longer pertain. Any measure of prosperity where the number of people is in the denominator, such as income per capita or the unemployment rate, makes little or no sense when people can move to where income or jobs are located, or the jobs and income can move to where the people are located.

In the case of the 50 U.S. states, increases in income per capita, for example, can occur when a state attracts income over its borders faster than it attracts people or when a state repels people faster than it repels income. While income per capita may increase in both cases, the welfare implications are diametrically opposed. Measures of movement of the factors of production, income, goods, and people are the appropriate metrics for measuring welfare when it comes to each of the 50 states of the United States, not income per capita or unemployment rates.[6] We revisit this principle at several points in the book simply because the point is essential to understanding state economics. Do not use measures standardized by population to evaluate the efficacy of state and local economic policies.

State and local governments have almost unlimited powers to tax, spend, regulate, and oversee as long as their voters choose to permit them to do so and as long as the Commerce Clause of the Constitution and the Privileges and Immunities Clause of the Constitution are not violated. And, with the powerful presence of those clauses, people, goods, and services also have their constitutionally given rights to locate when and where they wish.

Given the trivial differences in language as spoken in the various states, the existence of a common currency, and the fairly similar social customs of the various state populations, as well as the contiguous nature of all save two of our states, in-migration and out-migration are as painless and costless as possible. The economic integration of the 50 states truly is as close to a perfect economic union as can be conceived. As such, the central theme of this book is simply to answer the following and related questions: Do state and local government economic policies redistribute income, or do they redistribute people?

One of the most immoral acts any government can perpetrate on its citizenry is to enact policies that have the effect of destroying the production base from whence all benefits flow.

The chapters of this book are all intended to provide different perspectives on the role played by state and local governments in creating and preserving state prosperity and well-being. Like different vantage points when viewing a sculpture, no one perspective contains the whole truth, but when taken all together, these chapters will comprise a complete rendition of how economic policies impact a state's economy. The mark of genuine science is that its explanations remove the mysteries of policies. Clarity and common sense, supported by direct evidence, are allies of a democratic electorate. Arcane descriptions and excessive complications only dress things up to misdirect the electorate into transferring control to an unworthy elite.

If you look carefully at the differences among the states with respect to taxes, school choice, right-to-work laws, minimum wage, and cultural factors as well, not only does it appear that the blue states are getting bluer, but also that the red states are getting redder. As interesting as the increasing polarization of the states is the drift in the overall spectrum toward red states.

Who could ever have imagined a day when Michigan, the home of the United Auto Workers union and the Teamsters, would become a right-to-work state? And while Wisconsin may not be the headquarters of the auto industry and its unions, it has long been regarded as the political epicenter of the progressive labor movement. With legislation passed under Governor Scott Walker and then unsuccessfully contested by his union-backed naysayers, Wisconsin may not be a right-to-work state in name, but it is a right-to-work state for all practical purposes.

And then, long ago, who could have ever imagined the bankruptcy of Detroit, which in 1950 had a population of 1.8 million mostly prosperous people? Now Detroit has only 680,000 mostly poor people and is the city with the highest violent crime rate in the nation. Politics have consequences, and the two sides of partisan politics, with their wildly different economic visions of what works, have never been as far apart as they are today. To overuse a cliché, America is at a crossroads, and it's not just at the federal level. The battleground is raging in almost every state capital in this nation. Politics, it would seem, bubbles up from the states to the federal level; it doesn't flow down to the states from Washington, D.C.

Chapter 1 is the story of the 11 states that adopted the income tax post-1960. The condition of each state for the five years prior to its adoption of the income tax is contrasted with that state's condition today. Sometimes truth really is stranger than fiction, because each of these 11 states, when compared to the other 39 states, with no exception, declined as a share of population and output. And as shocking as it may seem when compared to the other 39 states, not even one of the 11 states actually increased its share of state and local tax revenues following the adoption of the state income tax.

And, as if 100 percent failure weren't enough, some of the declines were shockingly large, as was the case for Ohio, Michigan, Pennsylvania, and Illinois. Even the poorest of the poor, West Virginia, was made poorer by adopting the insidious income tax. Because some of the states lost people faster than income, however, some of the 11 states reported relative increases in income per capita and tax revenues per capita.

In spite of the fact that a number of the 11 states did have an increase in income and/or tax revenues per capita, the provision of public services in these 11 states generally declined relative to the nation as a whole, putting lie to the claim that tax increases were needed to fund public services.

Chapter 2 takes a rather mundane if not boring topic—the description of much of the data used in this book—and provides those data in an accessible format for the inquisitive reader to peruse. In fact, we succumbed to the temptation ourselves on a number of occasions to point out patterns we observed. We couldn't help but illustrate the performance differences among all states, highlighting the highest and lowest tax rate and tax burden states as well as those infamous 11 states that sought solace in adopting an income tax over the past 50-plus years. You don't have to be a Harvard grad to figure out the result. It may be, as Irving Kristol was fond of saying, that it takes a PhD in economics not to understand the obvious.

Taking oil out of gross state product growth and severance taxes out of tax revenues yields an amazing correlation between individual state growth rates and reductions in tax burdens: The more a state reduces taxes, the faster it grows. The ALEC-Laffer metrics are also clearly related to state performance, but this is laid out in detail in Chapter 8, in a section lifted word for word from an ALEC study entitled "Tax Myths Debunked," by Eric Fruits, PhD, and Randall Pozdena, PhD.[7] Last, we produce in an easily usable tabular form the state migration of adjusted gross income (AGI) data from the Internal Revenue Service. But we refrain from comments here because of the thorough discussion and analysis of these data in Chapter 5. *Bon appétit!*

In Chapter 3, we compare and contrast the performances of select groups of states with respect to a number of policy variables. We are well aware that nature begins with cause and ends with experience, so in our quest to uncover state and local policy prescriptions to make for a better world, we analyze a wide set of key policy variables in their natural extremes. Such sets of extreme policy behavior should, if there are consequences, reveal those consequences in the economic metrics of the state groupings.

For example, taking population growth, net in-migration, employment growth, growth in a state's gross state product, tax revenue growth, and so on, we compare the nine states with no earned income tax to the nine states with the highest earned income tax rates. While we generally stick with percentage changes over the past decade, we make an exception in this chapter and compare the zero earned income tax states to an equal number of the highest earned income tax rate states over the past half century.

We also make these same comparisons with and without oil, as if oil were exclusively a deus ex machina beyond the purview of state lawmakers. State policy, however, does directly impact oil production. By way of example, both Texas and California are endowed with massive reserves of subterranean deposits of oil and gas, and yet California's government has instituted policies that have led to reduced oil production while Texas's government has encouraged increased production. Sticking generally with our groupings, we also compare and contrast corporate taxes (here we used the top and bottom 11 states because of ties) and tax burdens.

In Chapter 4, closely related to Chapter 3, we continue comparisons of state and local policy variables with economic performance metrics. For example, we look at state sales taxes, ALEC-Laffer state outlook rankings, tax progressivity, whether a state has a right-to-work law, state estate taxes, minimum wage differences, and percentages of the labor force unionized.

We believe that it is exceptional cases that best reveal underlying relationships. Or, in the words of William Eamon as quoted in the aforementioned book, *Curiosity*, "all the bizarre objects and rarities become urgently relevant to scientific enterprise. They became the vital clues to the underlying mechanisms." And in these two chapters, much is revealed.

The differences in performance between the pro-growth and anti-growth groupings are enormous. The nine zero earned income tax rate states absolutely demolish the highest income tax rate states over the past 10 years and over each and every year of the past 50 years. Better ALEC-Laffer test scores, lower overall tax burdens, more oil, right-to-work legislation, and fewer unions all are strongly associated with more growth in population and greater prosperity. As Larry Wayne Gatlin says, "It ain't rocket surgery."

Chapter 5 mines the recent data releases by the Internal Revenue Service on state-to-state migration of federal tax returns from tax year 1992, which is filing year 1993, to the present. This chapter also drills down on the unique role New Hampshire, with zero income tax and zero sales tax, plays among the old-world statist policies of the other states in New England. This discussion of New Hampshire adds to and updates the wonderful work by Professor Colin Campbell referred to earlier. New Hampshire, in short, is the only ray of hope in an otherwise dismal agglomeration of underperforming states.

The adjusted gross income (AGI) migration data only confirm the overwhelming importance of state economic policies on people's choice of where to live and work. The five worst states (i.e., those with largest net out-migration of tax returns) are New Jersey, New York, Illinois, Ohio, and Michigan; the five states Connecticut, Wisconsin, Maine, Rhode Island, and Minnesota round out the bottom 10. Is anyone surprised? We aren't.

Zero income tax states far outperform the highest income tax states, as do the lowest tax burden states. It's pretty straightforward. And then there are the right-to-work states versus the forced-union states. It is amazing how much better the right-to-work states are at attracting adjusted gross income and taxpayers. And to cap the analysis off, those 11 states that introduced the income tax over the past 50-plus years are all in the bottom half of net tax returns.

These data are the very data most appropriate for state governments, and their finances and the results couldn't be more definitive.

As part of a comprehensive picture of the effects of state and local taxes, regulations, and spending, Chapter 6 provides a precise statistical analysis of all 50 states over the past 10 years. Using a cross-section time-series least-squares regression analysis, tax rates, tax burdens, oil, and right-to-work legislation are found to be the key independent variables related to population growth and gross state product growth. Surprised? Of course not.

The comprehensive statistical techniques used in this chapter help to corroborate the findings in each of the other chapters. While powerful in and of themselves, the statistical results do nothing save add a whole other layer of confirmation on an already overwhelmingly demonstrated relationship between state and local economic policies and their predicted consequences. Higher tax burdens, higher income tax rates, and higher corporate tax rates all have devastating effects on population and output growth. Right-to-work legislation and oil production, however, have as large positive contributions to individual states' economic well-being as higher tax rates have negative contributions. The picture is clear—crystal clear.

In the realm of the political economy, no battleground could be more grandiose than the clash of ideologies between California and Texas. Two three-term governors are duking it out on the world stage. What could possibly have a greater impact on global opinion?

Here we have the educated, sophisticated, intellectual state of California, where all decisions are either made by government or overseen by government to assure that everything done is for the good of all. And in the other corner we have the wild, unfettered cowboy capitalism of Texas, where government involvement is eschewed and Adam Smith's invisible hand is worshipped.

In Chapter 7, the tax and regulatory differences between Texas and California are enumerated. The tax revenue differences are recorded, government spending is delineated, and, finally, the actual provision of public services, the metrics of economic growth, and the alleviation of want, deprivation, and hardship are exposed for one and all to see. We can think of no other straight-up comparison where the differences are starker or the answers clearer.

California has tax rates that are roughly 65 percent higher than are Texas's tax rates. California has tax revenues that are about 25 percent higher than are Texas's tax revenues. The two states are pretty close to even when it comes to government spending, and by the time they get to the provision of public services, Texas has it all over California.

Texas grows faster, employs more people, and attracts more residents. Texas also has better roads, police protection, fire protection, schools, and prison facilities, as well as less poverty and less need for welfare workers. *C'est ça!*

In our quest to improve public finances in individual states, our purpose is not just to cut taxes and spending, but also to make taxes and spending more efficacious. When it comes to a state's fiscal decisions, or any other government entity's for that matter, there are three considerations. The first consideration is the total size of state and local taxes and spending. Taxes and spending, as a whole, matter—and matter a lot.

Second, it also matters how a state collects the taxes it collects. Generically, the ideal would be to collect taxes in the least damaging fashion in order to garner the requisite revenues to run government at all levels.

And third, how governments in a state spend what they spend also matters enormously. On a conceptual level, the place a government hopes to find itself would be where each dollar spent is on the most beneficial projects. What people don't want is a scenario where only people who do work are taxed and only people who don't work are subsidized. The results won't be attractive.

The ideal spending and tax code for a state would be one where the damage done by the last dollar of tax collected is just a smidgeon less than the benefit provided by the last dollar spent. Then the government should stop spending and taxing dead in its tracks and let the markets solve the rest of the wants and needs of its citizenry.

The final chapter of this book—Chapter 8—is a point-by-point rebuttal of the counterarguments made by our critics. At the outset, to explain migration patterns for people and income among the 50 states, we highlight the role played by self-interest, and we also note that our own self-interest and the self-interest of our critics helps to explain some of our and their comments. And, true to form, no matter how overwhelming our logic and evidence may be, we hold out little hope that the beneficiaries of government largesse who work in tax-exempt organizations would be able to overcome their own perceived self-interest and join with us to design a better future for one and all. It's really true that to someone whose only tool is a hammer the whole world does look like a nail. Many of our critics rebut arguments they know to be true in order to curry favor with their political benefactors.

The purpose to which we intend our research to be put is as a practical guide to state and local officials to better govern and to provide prosperity and quality of life to those governed. In the words of Robert Boyle, as quoted in *Curiosity*:

> I shall not dare to think my self a true naturalist till my skill can make my garden yield better herbs and flowers, or my orchard better fruit, or my field better corn, or my dairy better cheese, than theirs that are strangers to physiology.

To us, a small truth is preferable to a great falsehood, and yet others would seem to prefer complex error to simple truth. State economics isn't all that profound. Just follow the money. To understand the practical workings of a state, you need not be a learned professor. Nor do you need to become mired in the rhetorical swamps of classical disputation. Your experience and common sense should serve you well even in the face of scholarly disapproval. We wrote this book, in part, to set you free to see for yourself just how the world does work.

The truth really should be what we harvest from the bountiful provisions of data afforded us by 50 states over as many years. Knowledge is power.

CHAPTER 1

The Fall from Grace

The Story of States 11 and the Income Tax Adopted

The mark of genuine science is that its explanations take the mystery out of things. Imposture dresses things up to seem more wonderful than they would be without the dress.

—Philip Ball, *Curiosity*

Foremost among the economic policies available to state and sometimes even local governments is the income tax. Today, 41 out of 50 states collect income taxes on so-called earned income. Of the nine states that have chosen not to tax earned income, two tax what is called unearned income. Thus, there are really only seven states where income of any sort is not taxed at either the state or local level. But this wasn't always the case.

The Implementation of an Income Tax—A Terrible Mistake

Immediately prior to 1960, there were 19 states where earned income was not taxed and 31 states where it was. Between 1960 and the present, 11 of those 19 states adopted an income tax, and one lone state—Alaska—got rid of its income tax.

The story of the 11 states that adopted an income tax summarizes the object lesson of this book. Here's their unabridged story:

The 11 states that adopted a state income tax in the past half century encompass a wide cross section of American life, but do not include any states from the South or Far West. As it so happens, there are only three states in the South without an earned income tax—Tennessee, Florida, and Texas—and there are four states in the Far West without income taxes—Nevada, Wyoming, Washington, and Alaska. The other two states without earned income taxes are South Dakota and New Hampshire.

The 11 states that deserted the no-income-tax team are Maine, Rhode Island, Connecticut, New Jersey, Pennsylvania, West Virginia, Ohio, Indiana, Illinois, Michigan, and Nebraska. At the time the income tax was adopted, each of these states believed the economic damage done by the income tax would be minimal and that the increase in public services would be considerable. They were dead wrong!

Table 1.1 shows exactly what happened to the primary economic metrics of the 11 states once they adopted an earned income tax. Because these states adopted income taxes in different years, we use the four years preceding the actual implementation of the income tax and the year of implementation itself as their pre–income tax era. We then compare their pre–income tax era to the most recent year's performance.

Comparing the 11 states to all 50 states introduces a measurement bias, in that the 11 states are double counted; that is, they would be part of the 11 as well as the 50. A preferable measure, and the one we've chosen to use in this chapter for evaluation purposes, is to compare the 11 states that adopted the income tax to the 39 remaining states. While comparing the 11 states to all 50 states creates a bias in the magnitudes, the conclusions would be minimally affected because the directions of change all remain the same. Qualitatively, whether comparing the 11 states to all 50 states or only to the 39 remaining states, the results are basically the same. Quantitatively, they are significantly different.

TABLE 1.1

Metrics of the 11 States That Adopted an Income Tax Post-1960 versus the Percentage of 39 Remaining States*

States	First Year of Tax	Maximum Tax Rate*		Shares of 39 Remaining States: Population			GSP			Total State and Local Tax Revenue		
		Initial	Current	5 Years Before	2012	% Change	5 Years Before	2012	% Change	5 Years Before	2011	% Change
Connecticut	1991	1.50%	6.70%	1.81%	1.49%	(18)	2.39%	1.92%	(20)	2.35%	2.25%	(4)
New Jersey	1976	2.50	8.97	4.94	3.68	(26)	5.38	4.25	(21)	5.40	5.25	(3)
Ohio	1972	3.50	5.93	7.59	4.79	(37)	8.03	4.27	(47)	6.07	4.46	(27)
Rhode Island	1971	5.25	5.99	0.68	0.44	(36)	0.64	0.43	(33)	0.65	0.50	(22)
Pennsylvania	1971	2.30	3.07	8.51	5.29	(38)	8.49	5.03	(41)	7.66	5.51	(28)
Maine	1969	6.00	7.95	0.74	0.55	(25)	0.58	0.45	(23)	0.60	0.60	(0.2)
Illinois	1969	2.50	5.00	8.08	5.34	(34)	9.82	5.82	(41)	7.77	5.89	(24)
Nebraska	1968	2.60	6.84	1.10	0.77	(30)	1.03	0.83	(19)	0.93	0.77	(17)
Michigan	1967	2.00	4.25	6.33	4.10	(35)	7.86	3.35	(57)	6.62	3.57	(46)
Indiana†	1963	2.00	3.40	3.80	2.71	(29)	3.81	2.36	(38)	3.37	2.29	(32)
West Virginia†	1961	5.40‡	6.50	1.54	0.77	(50)	1.19	0.63	(47)	1.09	0.69	(37)

*State tax rate only (i.e., does not include any additional local taxes).
†Due to data limitations, shares of personal income have been substituted for Indiana and West Virginia's shares of GSP.
‡Statutory rate was 6.0% of U.S. tax liability applied to a top U.S. rate of 91%.

Source: U.S. Census Bureau, Bureau of Economic Analysis, Laffer Associates.

That Giant Sucking Sound Is People, Output, and Tax Revenue Fleeing Income Taxes

In Table 1.1, we list each of the 11 states that has adopted an income tax over the past 50-plus years and, for each state, the year in which the income tax was adopted, the highest income tax rate when the tax was adopted, the current highest income tax rate, the percentage of each state's population to the total population of the 39 states in the five years prior to and including the year of adopting the income tax, the percentage of each state's population to the total of the 39 states in 2012, the percentage of the total of the 39-state gross domestic product (or gross state product [GSP]) for each of the 11 states in the five years preceding and including the adoption year of the income tax, the percentage of total 39-state GSP in 2012 for each of the 11 states, total state and local tax revenues as a share of the total of the 39 states' state and local taxes in the five years prior to adopting an income tax, and, finally, each state's share of total 39-state state and local taxes in 2011.[1] Pay close attention. The results are dramatic.

Economic Malaise

In terms of population, every single one of the 11 states that introduced the income tax over the past 50-plus years declined in relation to the total of the 39 remaining states. West Virginia, the first state in the modern era to adopt the income tax, reduced its share of the population of the 39 remaining states by a full 50 percent. West Virginia went from a population of 1.83 million in 1961 to 1.86 million in 2012. While no other of the 11 states was able to match West Virginia's precipitous decline in relative population, each and every one of the 11 states reduced its percentage of the remaining 39 states. Especially hard-hit were the industrial giants Pennsylvania, Ohio, Michigan, and Illinois.

Compared to the 39 remaining states since the inception of the income tax, Pennsylvania's population has fallen by 38 percent, Ohio's