



## THROUGH THE LAFFER LENS: STATE COMPETITIVENESS AND FED POWERS

By Arthur B. Laffer, Kenneth B. Petersen and Mark A. Wise

### Summary

- State economic policies affect the decisions of where to locate a firm, as the Fortune 500 rankings recently reaffirmed. Pay attention to the state competitive environment when making investment decisions.
- While the Treasury blueprint to modernize the regulatory structure of the U.S. financial markets does make some good recommendations, allowing the Fed to set the strategy of financial institutions is beyond what is reasonable.

### • **As State Economic Policies Go, So Go Fortune 500 Companies**

As we have demonstrated in several recent papers, large global firms look to find the best operating environment for their operations. Companies move operations and open new factories in countries in which the cost of doing business is lowest. It really is a simple story: If you raise tax rates and regulations in country A and lower them in country B, expect labor, production and prosperity to move from country A to country B.

And that's exactly what we see happening. Just in the last several years, huge multi-national firms like Hewlett-Packard, Hitachi, Honeywell, Sony and Ford have opened new plants in Eastern Europe, often after shutting plants in relatively high-tax Western Europe. The same story played out in the early part of this decade when firms like Intel and Microsoft developed operations in Ireland following huge cuts in their corporate tax rate. Expect this trend to only accelerate as the countries of Eastern Europe continue moving toward lower, flatter tax rates on both personal and corporate income. With increased employment and output in these low-tax countries, their economies will really take off. As we have seen repeatedly, stronger economies will translate into big gains in asset valuations.<sup>1</sup>

A logical extension of firms setting up operations in economically-friendly countries is that companies based in the United States also place their operations in states within the U.S. that offer the best business environment. *Fortune* recently published the 2008 edition of the Fortune 500, their ranking of the country's top 500 companies based on gross revenue.<sup>2</sup> While there were no big surprises in terms of winners and losers or entries and exits, we did notice an interesting change in the geographical distribution of this year's Fortune 500. Texas posted 58 companies on the Fortune 500, up from 56 last year, overtaking New York, which dropped from 57 to 55, as the state home to the most Fortune 500 headquarters. This shift in corporate headquarters is merely the latest example of the pivotal role that fiscal policy, especially tax rates, plays in the economic competitiveness and attractiveness of a state.

When you consider the economic rationale, it comes as no surprise to us that companies are moving to low-tax, right-to-work states like Texas at the expense of high-tax, high-regulation states like New York. Not only does New York state have a corporate income tax of 7.1%, but for companies in the metropolitan region there is an additional mass transit surcharge of 17%, which brings the overall rate to 8.3%. And if that's not enough, New York City imposes its own non-deductible corporate tax rate that brings the all-in-rate up to an astounding 17.23%!<sup>3</sup> Now it's one thing for people to "vote with their feet" in response to high personal marginal tax rates, but when a Fortune 500 company decides to relocate its headquarters, it takes with it a multitude of resources, hundreds if not thousands of jobs, and millions in tax revenue.

The Laffer State Competitive Environment provides a supply-side ranking of the states based on a blend of economic factors that quantify key aspects of the state's economic environment. Over the years, the model has repeatedly demonstrated its ability to forecast changes in state competitiveness and thereby economic health and asset values. Just look at the difference in economic performance between our 10 highest ranked states and our 10 lowest ranked states over the last five years (see table on following page). Our newest rankings will come out later this summer, incorporating all of the changes enacted this past fiscal year. Keep these rankings in mind throughout the investment process—whether evaluating a company, a bond issue, hard assets, or a pool of mortgages.

<sup>1</sup> For proof, just look at Arthur B. Laffer, "Global Investing—Let Tax Rates be Your Guide," Laffer Associates, March 26, 2008.

<sup>2</sup> <http://money.cnn.com/magazines/fortune/fortune500/2008/index.html>

<sup>3</sup> <http://www.nysun.com/news/fortune-500-postscript>

**How the Laffer State Rankings Have Fared:  
Historical Ranking vs. Five-Year Performance in Selected Economic Variables**  
(performance between 2002 and 2007 unless otherwise noted)

	<u>Rank*</u>	<u>Gross State Product Growth**</u>	<u>Personal Income Growth</u>	<u>Population Growth</u>	<u>Net Domestic In-Migration as a % of Population</u>	<u>Non-Farm Payroll Employment Growth</u>	<u>Unemployment Rate, 2007</u>
Tennessee	1	31.8%	28.7%	6.1%	3.1%	5.0%	4.7%
Indiana	2	27.5%	23.7%	3.2%	0.0%	3.0%	4.5%
Colorado	3	29.4%	30.4%	7.8%	1.3%	6.7%	3.8%
Georgia	4	26.8%	30.4%	11.1%	3.9%	7.2%	4.4%
North Carolina	5	31.1%	33.3%	8.9%	4.3%	8.1%	4.7%
Utah	6	39.4%	41.8%	13.2%	1.6%	16.6%	2.7%
South Dakota	7	35.2%	31.1%	4.5%	0.8%	7.7%	3.0%
Florida	8	43.4%	41.6%	9.5%	5.0%	12.2%	4.0%
Missouri	9	23.9%	25.5%	3.6%	0.6%	3.6%	5.0%
Oklahoma	10	42.7%	37.0%	3.8%	0.6%	6.3%	4.3%
<b>10 Highest Ranked States***</b>		<b>33.1%</b>	<b>32.3%</b>	<b>7.2%</b>	<b>2.1%</b>	<b>7.6%</b>	<b>4.1%</b>
<b>10 Lowest Ranked States***</b>		<b>28.4%</b>	<b>28.4%</b>	<b>1.8%</b>	<b>-1.9%</b>	<b>3.7%</b>	<b>4.5%</b>
West Virginia	41	28.3%	23.6%	0.7%	0.8%	3.3%	4.6%
Connecticut	42	23.7%	28.9%	1.5%	-1.9%	2.0%	4.6%
Illinois	43	23.7%	25.3%	2.2%	-3.0%	1.6%	5.0%
California	44	32.8%	32.4%	4.5%	-2.9%	4.9%	5.4%
New Jersey	45	24.8%	26.8%	1.5%	-3.5%	2.2%	4.2%
Maine	46	26.5%	23.4%	1.8%	1.1%	1.8%	4.7%
Hawaii	47	39.4%	38.5%	4.4%	-0.7%	12.0%	2.6%
Vermont	48	28.6%	26.2%	1.0%	-0.5%	2.8%	3.9%
Rhode Island	49	29.9%	24.1%	-0.8%	-3.4%	2.8%	5.0%
<b>New York</b>	<b>50</b>	<b>26.4%</b>	<b>35.0%</b>	<b>0.9%</b>	<b>-5.5%</b>	<b>3.3%</b>	<b>4.5%</b>
<u>The others</u>							
Michigan	11	13.9%	16.4%	0.3%	-2.9%	-5.0%	7.2%
Iowa	12	34.9%	27.0%	1.9%	-0.7%	4.8%	3.8%
Virginia	13	33.4%	32.6%	5.9%	1.3%	7.6%	3.0%
New Hampshire	14	27.1%	25.9%	3.4%	1.0%	4.9%	3.6%
Wisconsin	15	24.9%	23.6%	2.9%	-0.2%	3.6%	4.9%
Arizona	16	40.6%	45.2%	16.4%	8.1%	17.7%	3.8%
<b>Texas</b>	<b>17</b>	<b>39.8%</b>	<b>41.9%</b>	<b>10.0%</b>	<b>2.0%</b>	<b>10.0%</b>	<b>4.3%</b>
South Carolina	18	27.2%	31.4%	7.4%	4.3%	8.1%	5.9%
Idaho	19	40.1%	38.2%	11.7%	5.6%	15.3%	2.7%
North Dakota	20	42.4%	33.1%	0.9%	-1.1%	8.4%	3.2%
Oregon	21	36.4%	27.9%	6.4%	2.6%	9.3%	5.2%
Kentucky	22	26.8%	27.0%	3.7%	1.4%	4.5%	5.5%
Minnesota	23	28.6%	27.7%	3.5%	-0.8%	4.0%	4.6%
Alabama	24	35.3%	31.7%	3.5%	1.7%	-3.0%	3.5%
Delaware	25	36.5%	32.4%	7.4%	3.6%	5.4%	3.4%
Maryland	26	33.8%	30.0%	3.4%	-1.4%	5.2%	3.6%
Nevada	27	53.2%	55.9%	18.3%	10.1%	22.8%	4.8%
Alaska	28	54.5%	33.1%	6.3%	-0.4%	7.5%	6.2%
Massachusetts	29	20.3%	26.7%	0.3%	-3.9%	0.6%	4.5%
Kansas	30	29.2%	29.8%	2.3%	-1.5%	3.2%	4.1%
Wyoming	31	56.1%	46.2%	5.2%	2.1%	16.2%	3.0%
Arkansas	32	33.2%	34.8%	4.9%	2.2%	5.0%	5.4%
New Mexico	33	47.8%	37.8%	6.4%	1.7%	10.1%	3.5%
Mississippi	34	27.7%	31.6%	2.1%	-0.5%	2.5%	6.3%
Washington	35	30.0%	32.4%	6.7%	1.9%	10.4%	4.5%
Nebraska	36	31.8%	28.4%	2.8%	-1.2%	5.6%	3.0%
Louisiana	37	44.5%	32.3%	-3.9%	-6.4%	1.3%	3.8%
Pennsylvania	38	25.5%	26.2%	1.0%	-0.1%	2.8%	4.4%
Montana	39	43.8%	36.2%	5.2%	3.0%	12.3%	3.1%
Ohio	40	23.1%	20.0%	0.5%	-1.9%	-0.4%	5.6%

*New York (50th):  
Sub-Par  
Performance in  
Almost Every  
Category*

*Texas (17th):  
Terrific  
Performance  
Across-the-  
Board*

\*Average rank in the Laffer State Competitive Environment model in 2005, 2006 and 2007 (period in which current methodology was used).

\*\*Data are available only through 2006. \*\*\*Equal-weighted averages.

**• More powers to the Fed?**

Hedge funds, investment banks, and other financial institutions that, up until now, have lived quiet lives far away from the reach of the Federal Reserve may soon have to deal with the Fed up close and personal. The U.S. Treasury, in its recent report<sup>4</sup> on how to modernize the regulatory structure of the U.S. financial markets, recommends that the Fed influence investment strategies of financial institutions if those strategies pose a risk to the overall economy. In particular, if approved by Congress, the Fed will be allowed to force financial institutions to change their investment strategy.

The Fed will become market stability regulator extraordinaire, and will be granted access to a very broad pool of financial market data from a wide range of financial institutions. This data combined with the Fed's proposed new powers should help prevent future asset price bubbles from developing and minimize the risk of financial instability, according to the U.S. Treasury.

This is a powerful but also very dangerous form of regulation. Unless adopted on a global scale, one can already see the hedge funds and investments banks heading for the exit. What we need is sensible regulation, not the KGB. Stable and well functioning financial markets are critical to the vigor of the economy, and financial regulation is absolutely needed to ensure that financial markets stay healthy. Yet, too much regulation will make things worse and could end up killing the patient instead of healing it.

The toolbox of monetary policy and the regulatory framework associated with financial institutions are in need of a tune-up. The Fed has already begun this process by implementing the term auction facility (TAF) and the term securities lending facility (TSLF) to deal with liquidity management. The very fact that primary dealers can tap liquidity at the Fed suggests that these institutions to some extent must report to and be regulated by the Fed. But allowing the Fed to annul strategies of financial institutions is a giant leap in the wrong direction and is reminiscent of the dreadful days of communism in the Soviet Union.

So what should be done? Requiring financial institutions that have access to liquidity at the Fed to report back to the Fed about the health of their books and business in general is reasonable. The same goes for the TAF and the TSLF, which should be made permanent and expanded, as these are clever policy tools that directly address the issue of liquidity while eliminating the stigma associated with borrowing from the discount window.

What we are still missing is a general implementation of the Basel II accord to all financial institutions requesting liquidity from the Fed.<sup>5</sup> By requiring that such financial institutions implement rigorous risk and capital management to ensure that their capital reserves stay healthy and in accord with the level of perceived credit, market, and operational risks, we may just be able to avoid any new failures à la Bear Stearns and prevent fundamentally unsound financial institutions from operating.

Allowing the Fed to set the strategy of financial institutions is beyond what is reasonable, but demanding that all financial institutions that want liquidity from the Fed report and maintain capital reserves in line with the risks they face will make for a more stable financial system in the future.

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<sup>4</sup> "Blueprint for a Modernized Financial Regulatory Structure," U.S. Treasury, March 31, 2008 .

<sup>5</sup> The Basel II accord specifies how much capital, banks (depository institutions) must put aside to guard against the types of financial and operation risks they face.