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States Face Fiscal Crunch after 1990s Spending Surge

by Chris Edwards, Stephen Moore, and Phil Kerpen

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Across the nation, large budget gaps are forcing state governments to make tough policy choices. While some states are trying to control spending, others are turning to tax increases to balance their budgets. Some state officials are trying to pass the buck for their poor fiscal management by pleading for a bailout from Washington. But a bailout would encourage states to continue overspending, which is the source of the current fiscal mess.

The states' mistake was to allow rapid tax revenue growth during the 1990s to fuel an unsustainable expansion in spending. Between fiscal years 1990 and 2001, state tax revenue grew 86 percent—more than the 55 percent of inflation plus population growth. If states had limited spending growth to that benchmark, budgets would have been $93 billion smaller by FY01—representing savings roughly twice the size of today's state budget gaps. If revenue growth higher than the benchmark had been given back to taxpayers in permanent tax cuts and annual rebates, rebates could have been temporarily suspended during FY02 and FY03 to provide a cushion with which to balance state budgets.

Current budget gaps provide policymakers an opportunity to weed out the budget excesses built up during the past decade. Yet overall state spending continues to grow. After soaring 8.0 percent in FY01, state general fund spending has not been cut in FY02 or FY03 even as large budget gaps have appeared.

States should impose tax and spending growth caps to prevent budgets from growing too quickly during the next boom. Revenue growth above a benchmark would be given back in tax cuts and tax rebates. That would prevent spending from increasing too quickly and provide the option of suspending rebates during slowdowns to close budget gaps without the damage caused by tax rate increases.

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State general fund spending grew 7.0 percent in FY99, 6.6 percent in FY2000, and 8.0 percent in FY01.

Introduction

State policymakers are looking for ways to close large budget gaps during their 2003 legislative sessions. Budget gap estimates are changing all the time but have recently ranged from about $17 billion to $50 billion for the 50 states as a whole.[1] Unlike the federal government, states have legal requirements to balance their budgets. Thus, legislators face tough fiscal tradeoffs.

Some state lawmakers are pushing for further tax increases on the heels of an aggregate state tax increase of more than $8 billion in fiscal year 2002 (effective for FY03), which was the largest net increase in a decade.[2] But tax hikes will not solve the overspending problem that prevailed in the states during the past decade. Groups such as the National Governors Association and the National Conference of State Legislatures have misdiagnosed the cause of the states' current troubles and pointed fingers everywhere but at state lawmakers themselves. Those groups say that the tidal wave of red ink is caused by external factors, such as federal mandates and supposed "structural problems." NGA executive director Raymond Scheppach argues that "structural problems states have in their tax base will continue to undermine a recovery in state revenues."[3]

Some pundits are blaming the tax cuts of the 1990s for current state budget troubles.[4] Data from the National Association of State Budget Officers show that net state tax cuts in the late 1990s (FY95 to FY01) totaled $33 billion.[5] But those cuts were not enough to return to taxpayers the $36 billion in net state tax increases that occurred during the early 1990s (FY90 to FY94). With 2002's $8 billion in state tax increases, and increases in FY03, taxpayers will be even further in the hole.

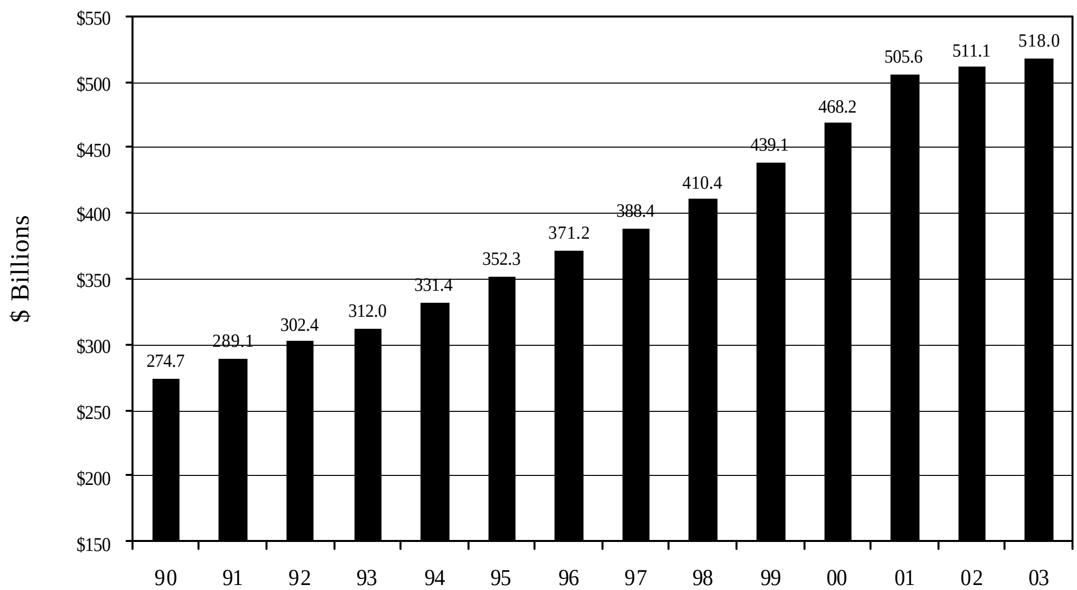
State officials are blaming the federal government for their budget woes and calling for greater federal aid to the states.[6] The nation's Democratic governors are asking for a $50 billion federal bailout.[7] The Bush administration has offered the states $3.6 billion.[8] But the federal government has its own $200 billion or more deficit problem, and, of course, the taxpayers who pay the federal bills are the same ones who live in the 50 states and pay state taxes.

Nonetheless, there is a drumbeat for a federal taxpayer bailout. Bob Herbert of the *New York Times* has called for a revenue-sharing plan between the federal government and the states, which would mean that citizens of fiscally responsible states would have to support the mismanaged budgets of states such as California.[9] The *Washington Post*'s David Broder has also called for increased federal aid to states, claiming that "the problem is not that states are profligate spenders."[10]

In fact, rapid state spending growth is exactly the problem, as shown in Figure 1. While inflation averaged just 2.8 percent annually from FY90 to FY01, state general fund spending grew at an average rate of 5.7 percent, according to NASBO. Total state general fund spending grew particularly rapidly at the end of the 1990s, with growth of 7.0 percent in FY99, 6.6 percent in FY2000, and 8.0 percent in FY01.[11] Even as economic growth slowed and budget gaps appeared, state spending still increased 1.1 percent in FY02, and it is expected to increase further in FY03.[12] Despite the word "crisis" being thrown around by state officials, Figure 1 does not suggest a crisis in state spending at all; it simply suggests a slowdown from prior rapid growth rates.

This paper reviews state budget growth during the 1990s, provides a state-by-state calculation of excess budget growth, and examines the inverse relationship between taxes and economic growth. The authors conclude that states should turn current budget problems into opportunities to weed out the excessive spending that was added during the boom years of the 1990s. Spending cuts would allow states to avoid tax increases that would delay economic recovery. In the longer term, states should enact caps on budget growth to avoid repeating the excesses of the 1990s during the next economic growth cycle.

Figure 1
General Fund Spending in the 50 States, FY90–03



Source: NASBO, "Fiscal Survey of the States," November 2002 and prior issues. FY02 and FY03 are preliminary.

Revenue "Shortfalls" or Spending Excesses?

Few governors or state legislators seem to have learned the lessons from the economic recession a decade ago. In the boom of the 1980s, the states added many costly new programs, and when the economy went into recession in the early 1990s states found themselves in financial trouble.[13] Then-governor Mario Cuomo of New York declared, "We're broke to the marrow of the bone."[14] Today, governors are using similar hyperbole as state revenues stagnate and political demands to meet new spending commitments rise.

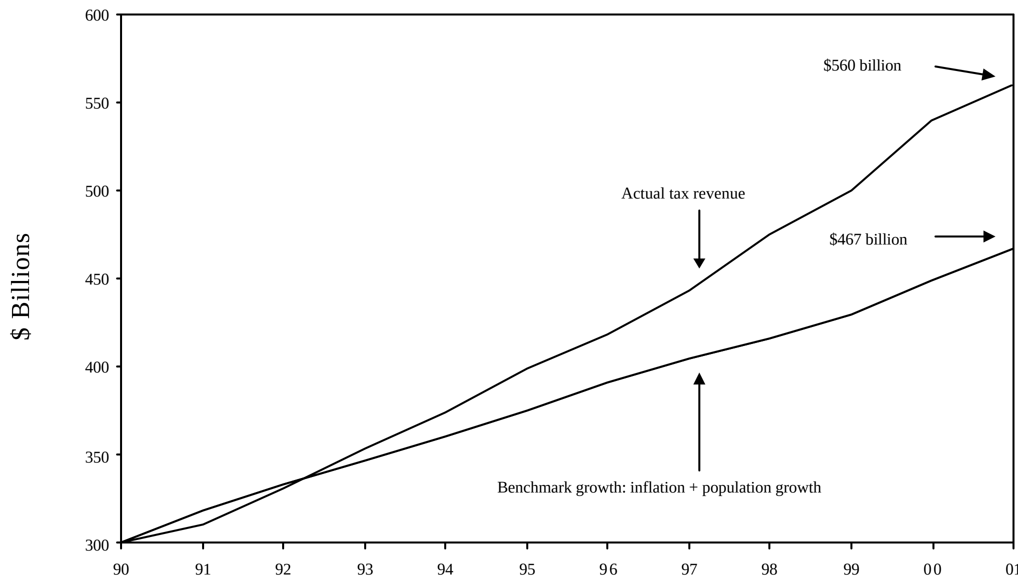
State government officials proclaim themselves innocent victims of revenue "shortfalls." But are states suffering from revenue shortfalls or spending excesses? Consider that the budget gaps being reported are partly fictions created by prior budget forecasts that were far too optimistic—sort of like sales growth forecasts for telecom companies in the 1990s. Suppose that a fictitious Governor Spendthrift had planned for a 6 percent rise in her state budget, but Governor Frugal planned for an increase of 3 percent. Then suppose that actual revenue growth in both states turned out to be 3 percent. That would be no problem for Frugal. But Spendthrift would describe her situation as a 3 percent "shortfall." Yet Spendthrift's actual problem is a "spending excess" caused by an overly optimistic budget plan.

Are states suffering from revenue shortfalls or spending excesses?

Another variation on the shortfall theme is the supposed identification of "structural shortfalls." Several states have used this bogeyman as an excuse to push for broad-based tax increases. It is said, for example, that Internet sales are eating away at state sales tax bases. Yet U.S. Department of Commerce data show that Internet sales are still only about 1 percent of all U.S. retail sales, thus hardly posing a current threat.[15]

Supposed structural shortfalls are

Figure 2
$93 Billion Tax Revenue Windfall by 2001



Source: Authors' calculations based on U.S. Bureau of the Census data.

State and local spending rose 4.8 percent in the first three quarters of 2002.

nowhere to be seen in state tax revenue data. U.S. Bureau of the Census data show that total state tax collections grew 7.1 percent in FY98, 5.2 percent in FY99, 8.0 percent in FY2000, and 3.7 percent in FY01.[16] On a calendar year basis, total state and local revenues rose 3.9 percent in 2001, and they will rise about 3.4 percent in 2002 based on three quarters of data.[17] (State and local spending rose 4.8 percent in the first three quarters of 2002, compared to the same period in 2001.)[18] Excluding fast-growing federal aid to states, revenues still inched 1.8 percent higher in 2001 and at least 1.0 percent higher in 2002. While state and local income tax collections fell substantially in 2002, sales tax revenue rose. Once the economy returns to a strong growth path, revenues can be expected to grow at the previous robust rate.

During the 1990s, large tax revenue increases occurred despite substantial state tax cuts. Indeed, total state tax revenues grew $186 billion between 1994 and 2001 ($374 billion to $560 billion), even though states enacted net tax cuts of $33 billion. During economic expansions, income tax revenues tend to grow faster than incomes because taxpayers pay higher average rates as their earnings rise. Also, most states do not index tax brackets for inflation as the federal government does, thus subjecting state taxpayers to bracket creep.[19]

Figure 2 shows that during the 1990s the growth of state tax revenues substantially exceeded the benchmark of inflation plus population growth. Revenue growth at the benchmark rate would have kept the real per capita burden on taxpayers unchanged. The top line in Figure 2 shows actual total state tax revenue. The bottom line shows what revenue would have been if growth since FY90 had been limited to the benchmark—and excess revenues returned to taxpayers. If budgets had grown at that more reasonable rate, state tax revenue after rebates would have been $467 billion in FY01, $93 billion less than actual revenue. Instead, that excess revenue was being spent in FY01—extra spending that the states and taxpayers could not afford when the economic slowdown came in FY02. (Note that Figure 2 shows that state revenue grew by less than the benchmark in FY91 because of the recession, but that shortfall was quickly recouped in 1992. We could have started Figure 2 in a year other than 1990 to illustrate how excess revenue growth accumulates over time. The illustration simply shows that, regardless of when budget growth controls are enacted and tax cuts are implemented, taxpayer savings will accumulate over time.)

State coffers become flush with revenues during economic booms, prompting politicians to expand eligibility for programs and to launch expensive multiyear projects, which nearly always end up far over budget. Consider the boom year of FY01 when aggregate state spending grew by 8 percent. Did citizens' needs for government services suddenly increase by 8 percent that year? Instead, it is more likely that the easy money simply encouraged legislators to avoid responsible tradeoffs and to spend with much less restraint than usual.

An alternative budget approach could have been taken by the states during the 1990s. Suppose half of the revenue windfall above the benchmark of population growth plus inflation had been given back to taxpayers in permanent tax cuts and the other half given back in annual tax rebates. Annual rebates would act as a fiscal buffer when economic downturns occur. As tax revenues stagnated in 2002 and 2003, states could have temporarily suspended rebates and cut spending until revenues recovered, without resorting to economically damaging tax rate increases.

The "structural" problem that faces state budgets is that revenues rise too quickly during economic booms and cause politicians to overspend. The solution is a combination of permanent tax cuts and annual tax rebates to give back excess revenue above a benchmark growth rate. We propose a benchmark of inflation plus population growth, but other benchmarks are possible. The important thing is that spending growth be limited during the booms by rebating excess revenues to taxpayers.

In addition to implementing budget growth controls, state policymakers should always look for unneeded programs to terminate, as well as programs to privatize when businesses are better able to provide services. One approach to eliminating unnecessary state spending is the enactment of "sunset" laws.[20] Texas has perhaps the most successful sunset law of the 16 or so states that use such budget procedures. Sunsetting is a process of automatically terminating government agencies and programs after a period of time—perhaps five years—unless they are specifically reauthorized. State sunset commissions review programs on a rotating basis and recommend major overhauls, privatization, or elimination. Widespread sunsetting would help states avoid overspending by reforming state governments on an ongoing basis.

Excess Spending by State

Figure 2 shows that if state governments, in aggregate, had limited annual spending growth to a benchmark of inflation plus population growth beginning in FY90, they would have generated savings of $93 billion by FY01. That excess amounts to $878 per household, on average, across the 50 states. However, fiscal trends have varied considerably among the states, as shown in Table 1. The table shows each state's actual FY90 and FY01 tax revenue, based on U.S. Bureau of the Census data.[21] The percentage increase in tax revenue is compared to growth in the benchmark of inflation plus state population growth. The right-hand columns in the table show the tax windfall, or excess, that states received above the benchmark growth amount.

The table ranks states by the size of the per household tax windfall state governments enjoyed at the expense of taxpayers. The five states with the largest per household windfalls were Connecticut ($2,408), Vermont ($2,350), California ($1,899), New Hampshire ($1,779), and Minnesota ($1,584). This is the amount of money taxpayers would have saved per year by 2001 if budgets had been limited to benchmark growth rates during the decade. In only three states, South Carolina, Arizona, and Alaska, did tax revenues grow more slowly than the benchmark.

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Table 1
State Tax Revenue Windfall, FY90–01

	Actual Tax Revenue			Benchmark Growth in Population plus Inflation	Per Year Tax Windfall by 2001: Revenue in Excess of Benchmark		
	1990 ($ millions)	2001 ($ millions)	Increase		$ millions	Per Household	Rank
U.S. Total	$300,490	$559,765	86%	55%	$93,319	$878	
Connecticut	$5,268	$10,590	101%	41%	$3,152	$2,408	1
Vermont	$666	$1,553	133%	48%	$570	$2,350	2
California	$43,419	$90,454	108%	57%	$22,248	$1,899	3
New Hampshire	$595	$1,776	198%	54%	$861	$1,779	4
Minnesota	$6,819	$13,535	98%	54%	$3,034	$1,584	5
Massachusetts	$9,369	$17,225	84%	44%	$3,764	$1,533	6
Michigan	$11,343	$22,264	96%	46%	$5,743	$1,509	7
Arkansas	$2,261	$4,911	117%	55%	$1,403	$1,336	8
Utah	$1,768	$4,065	130%	79%	$909	$1,276	9
North Dakota	$677	$1,231	82%	34%	$321	$1,264	10
New Jersey	$10,434	$19,253	85%	49%	$3,736	$1,209	11
Nebraska	$1,513	$3,028	100%	47%	$803	$1,204	12
Colorado	$3,069	$7,567	147%	82%	$1,989	$1,168	13
Rhode Island	$1,233	$2,243	82%	43%	$479	$1,163	14
Wyoming	$612	$1,124	84%	47%	$222	$1,144	15
Delaware	$1,130	$2,174	92%	62%	$344	$1,134	16
Idaho	$1,139	$2,558	125%	78%	$533	$1,112	17
Mississippi	$2,396	$4,749	98%	51%	$1,143	$1,088	18
New Mexico	$2,014	$4,002	99%	64%	$708	$1,038	19
Kansas	$2,669	$4,994	87%	47%	$1,060	$1,019	20
Virginia	$6,600	$13,085	98%	57%	$2,695	$984	21
Oregon	$2,786	$5,893	112%	66%	$1,280	$945	22
Wisconsin	$6,558	$11,768	79%	50%	$1,956	$931	23
Kentucky	$4,261	$7,851	84%	50%	$1,480	$925	24
Illinois	$12,891	$23,150	80%	48%	$4,077	$883	25
Maine	$1,561	$2,669	71%	42%	$452	$865	26
Oklahoma	$3,477	$6,342	82%	49%	$1,160	$862	27
Pennsylvania	$13,220	$22,562	71%	40%	$4,038	$845	28
South Dakota	$500	$977	95%	47%	$241	$827	29
Louisiana	$4,087	$7,194	76%	43%	$1,335	$807	30
North Carolina	$7,865	$15,625	99%	67%	$2,465	$774	31
Ohio	$11,436	$19,618	72%	42%	$3,369	$756	32
Missouri	$4,939	$8,837	79%	49%	$1,474	$667	33
Georgia	$7,078	$14,369	103%	75%	$1,956	$635	34
Texas	$14,717	$29,423	100%	70%	$4,389	$580	35
New York	$28,615	$44,856	57%	43%	$3,881	$549	36
West Virginia	$2,230	$3,423	53%	36%	$386	$526	37
Montana	$858	$1,496	74%	53%	$180	$501	38
Maryland	$6,450	$10,786	67%	52%	$960	$478	39
Tennessee	$4,245	$7,822	84%	59%	$1,052	$467	40
Indiana	$6,102	$10,204	67%	49%	$1,084	$462	41
Iowa	$3,313	$5,159	56%	43%	$434	$378	42
Alabama	$3,820	$6,368	67%	50%	$650	$373	43
Florida	$13,289	$24,939	88%	72%	$2,118	$326	44
Washington	$7,423	$12,679	71%	67%	$304	$132	45
Nevada	$1,583	$3,832	142%	137%	$74	$94	46
Hawaii	$2,335	$3,508	50%	50%	$13	$31	47
South Carolina	$3,934	$6,148	56%	58%	-$64	-$41	48
Arizona	$4,377	$8,457	93%	96%	-$131	-$67	49
Alaska	$1,546	$1,429	-8%	56%	-$990	-$4,403	50

Source: Authors' calculations based on U.S. Bureau of the Census data, www.census.gov/govs/www/statetax.

Table 2
Change in Real per Capita General Fund Spending, FY90–01

State	1990–2001	Rank	State	1990–2001	Rank	State	1990–2001	Rank
Montana	95.0%	1	Texas	24.9%	18	Arkansas	15.9%	34
Ohio	58.1%	2	Mississippi	24.6%	19	Maine	15.9%	35
Illinois	49.4%	3	Virginia	23.4%	20	North Dakota	15.5%	36
Oregon	44.9%	4	Minnesota	23.3%	21	New Hampshire	13.9%	37
Nebraska	41.1%	5	South Dakota	20.6%	22	Indiana	12.9%	38
Kentucky	33.3%	6	Iowa	20.0%	23	Maryland	11.2%	39
Connecticut	32.9%	7	Pennsylvania	19.9%	24	Alabama	8.1%	40
Massachusetts	31.8%	8	Oklahoma	19.4%	25	Arizona	6.0%	41
Wyoming	31.8%	9	Georgia	19.2%	26	Washington	5.8%	42
New Mexico	31.5%	10	New Jersey	18.5%	27	South Carolina	2.6%	43
Utah	30.0%	11	50-state average	18.1%	n/a	Nevada	1.4%	44
Delaware	28.2%	12	Tennessee	17.6%	28	Vermont	1.3%	45
Wisconsin	27.2%	13	Florida	17.4%	29	Louisiana	0.9%	46
Colorado	26.9%	14	Rhode Island	16.6%	30	New York	-5.1%	47
Missouri	26.4%	15	Idaho	16.4%	31	Michigan	-13.8%	48
California	25.9%	16	West Virginia	16.1%	32	Hawaii	-14.4%	49
Kansas	25.2%	17	North Carolina	16.1%	33	Alaska	-41.1%	50

Source: Authors' calculations based on NASBO, "Fiscal Survey of States," various issues.
Note: Data for Colorado and Virginia are adjusted to exclude tax cut amounts that are included in NASBO spending totals. Also note that Montana changed its school funding structure in the mid-1990s causing its general funding spending to jump higher (and other state spending to fall). Thus Montana's ranking overstates its overall spending increase.

Looking at the spending side of state budgets offers another perspective on excess budget growth during the 1990s. NASBO data on general fund spending provide a measure of budget growth for functions that are under the most direct discretionary control of state policymakers. (By contrast, the Census Bureau tax revenue data in Table 1 provide a broader measure of state budget growth, since taxes fund both general fund and non-general-fund portions of state budgets.) The NASBO data show that budgets in nearly all states grew substantially faster than inflation plus population growth during the past decade. (Table 2). Real per capita general fund spending in the 50 states increased 18.1 percent, on average, between FY90 and FY01.

State Case Studies

California

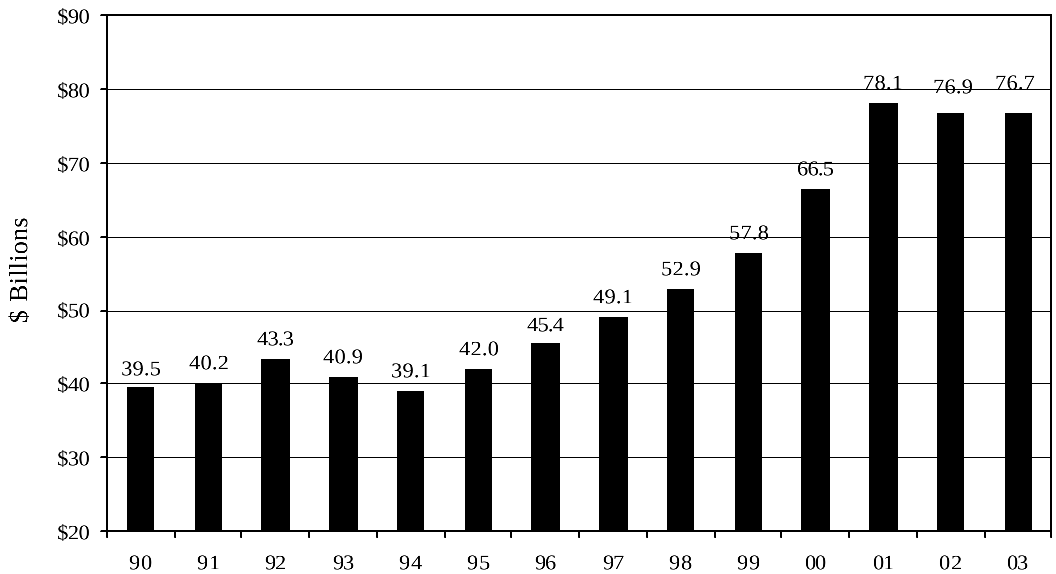
California is probably in the poorest fiscal shape of any state. The budget gap for FY03 and FY04 combined is estimated to be $35 billion.[22] The budget gap was caused by a remarkable run-up in state spending in the late 1990s under Gov. Gray Davis, as shown in Figure 3. Spending doubled between FY94 and FY01 from $39 billion to $78 billion.

California's general fund expenditures jumped 15 percent in FY2000 and then another 17 percent in FY01.[23] Thus, in just two years spending increased by one-third. State government employment has expanded rapidly under Governor Davis as well. Employment, measured in full-time equivalents, jumped from 296,000 in FY2000, to 311,000 in FY01 and to 326,000 in FY02, even as a large budget gap was opening.[24]

Despite a dreadful fiscal record, Davis managed to get reelected in November. He has proposed spending cuts to close the budget gap, but he has also hinted that tax increases may be on the way for California.[25] Democrats in the legislature are proposing tax hikes, but Republicans have so far opposed that shortsighted policy option.

NASBO data show that budgets in nearly all states grew substantially faster than inflation plus population growth during the past decade.

Figure 3
California General Fund Spending, FY90–03



Source: NASBO, "Fiscal Survey of the States," November 2002 and prior issues. FY02 and FY03 are preliminary.

The boom-bust budget cycle in California can be tamed by moving away from volatile income and capital gains tax revenues.

Figure 3 makes clear that the major spending cuts that are required in the state budget have not yet occurred. Although general fund spending jumped almost $12 billion in FY01, FY02 spending was reduced only by just over $1 billion. As in other states, newspaper headlines in California make fiscal restraint sound draconian. A recent *Los Angeles Times* story declared "Wrenching Changes Likely with Budget Cuts,"[26] but the "wrenching" changes listed included such items as the first university fee increase since 1994, small increases in admission charges for state parks, deferral of some transportation projects, and a modest tightening in eligibility for the state's low-income health program. Those are hardly wrenching changes in a sprawling state government.

More aggressive spending cuts are needed to put the state on the road to fiscal recovery. In the longer term, the boom-bust budget cycle in California can be tamed by moving away from volatile income and capital gains tax revenues, which fueled much of the excess spending in the late 1990s. In FY03 tax revenue from capital gains and stock options dropped to $5 billion after a high of $17 billion in FY2000.[27] Such taxes on capital not only are bad for high-tech economic growth in the state; they leave the state government more vulnerable in downturns.

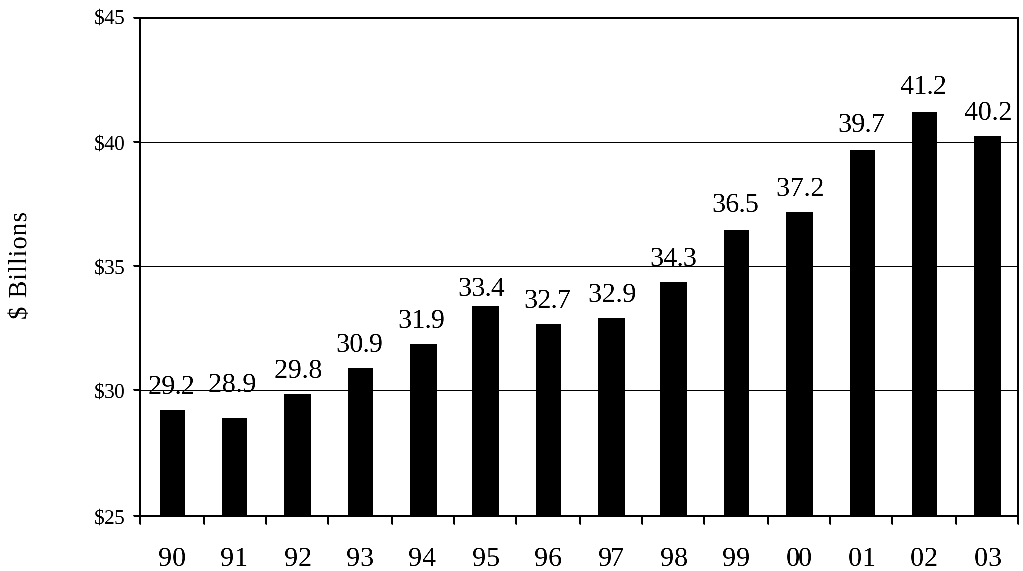
New York

New York faces a $2.5 billion budget gap in FY03.[28] As it was in many other states, rapid tax revenue growth during the late 1990s was used to expand state government, instead of being rebated to citizens. Figure 4 shows that New York's general fund spending soared from $32.9 billion in FY97 to a peak of $41.2 billion in FY02. Although spending is projected to dip in 2003, it will still be above the FY01 level.

The rapid rise in spending erased the progress Gov. George Pataki made in restraining spending in his first few years in office in the mid-1990s. At the time, Pataki pushed through a reduction in state income tax rates that helped revive New York's economy. Pataki also cut the workers' compensation tax, the capital gains tax, and inheritance taxes.

More recently, however, Pataki has been

Figure 4
New York General Fund Spending, FY90-03



Source: NASBO, "Fiscal Survey of the States," November 2002 and prior issues. FY02 and FY03 are preliminary.

more of a friend to big government than to the taxpayer. In addition to large spending increases, he has supported two tax hikes on cigarette consumers that have increased taxes from 56 cents to $1.50 per pack. His approval was also necessary for New York City's recent massive tax hike on cigarette consumers from 8 cents to $1.50 per pack. Those hikes will almost certainly expand the state's large cigarette black markets and strengthen organized crime.[29] Pataki needs to rediscover his fiscal conservative roots and cut state spending to balance the budget. He has wisely not proposed broad-based tax increases to close the current gap, but he has not ruled anything out.[30]

Meanwhile, New York City's new mayor, Michael Bloomberg, seems intent on driving economic activity out of the city with the enactment of a 25 percent increase in property taxes. Like the state, the city is facing a large budget deficit caused by overspending. New York City spending rose from $34.0 billion to $40.5 billion between FY97 and FY01, an increase of 19 percent in four years.[31] Tax increases will push more businesses and individuals out of the city and reduce the tax base, thus placing city finances on an even more unstable footing. To better match the solution to the problem, New York should focus on spending reduction—a policy that is strongly supported by New Yorkers. A recent poll by Maurice Carroll of Quinnipiac Univeristy found that New York City voters prefer service cuts to tax increases to close the budget gap by a two-to-one margin.[32]

Virginia

Virginia faces a budget gap in FY03 of about $1 billion, the largest in its history.[33] To address the shortfall, the state has frozen the scheduled phaseout of the car tax cut and enacted modest reductions in the budget. Virginia, like other states, could have avoided the budget crisis by controlling spending in the go-go years of the 1990s. Like California legislators, Virginia legislators acted as if the state's high-tech boom—and the resulting windfalls of income and capital gains taxes—would continue indefinitely.

Figure 5 shows that Virginia general fund spending soared from $7.6 billion in FY96 to $11.6 billion in FY01, a 53 percent increase in just five years. In the late 1990s Gov. Jim

New York City's new mayor, Michael Bloomberg, seems intent on driving economic activity out of the city.

Virginia policymakers should heed the message of the resounding "no" vote on the sales tax increase referenda in November 2002.

Gilmore did provide Virginians a phased-in cut in property taxes on automobiles, but he pushed state spending up to full throttle. (Figure 5 excludes the effect of the partial car tax repeal, which is counted as spending in the state budget.)

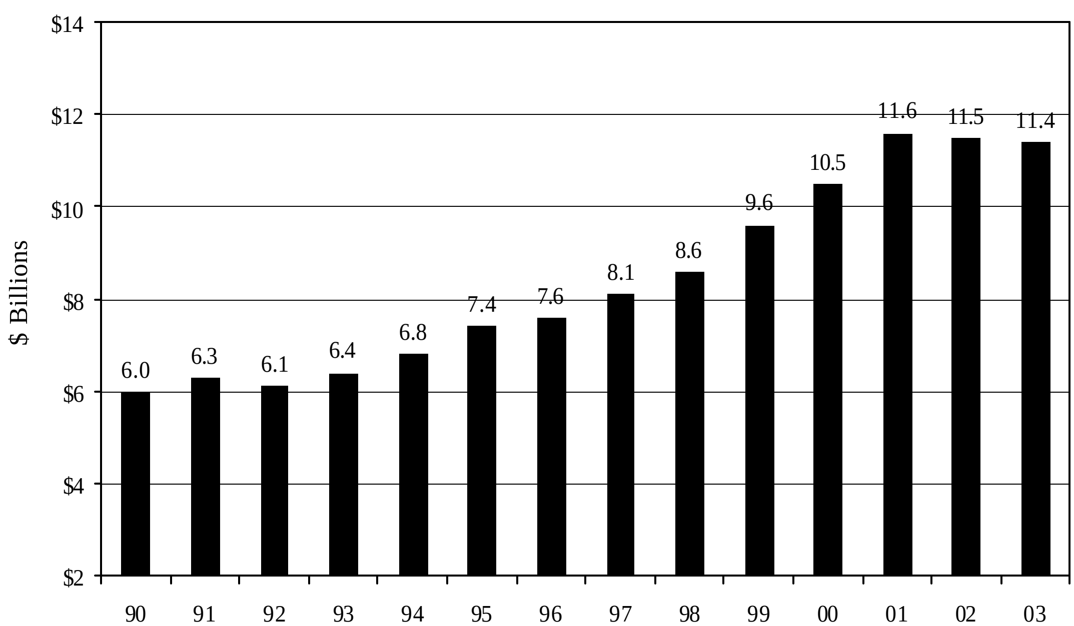
The current governor, Mark Warner, has so far resisted broad-based tax increases. However, some policymakers in the state are pushing for a tax increase on tobacco consumers. State policymakers should heed the message of the resounding "no" vote on the sales tax increase referenda in November 2002.[34] Voters in Northern Virginia and the Hampton Roads area soundly rejected higher taxes to pay for transportation spending, signaling that they believe that taxes in the state are already high enough.

Although Governor Warner did back tax increases in the referenda, he has recently proposed restraining state spending and cutting bureaucratic waste in agencies such as the Department of Motor Vehicles. He is right that "to fully regain the trust of our people . . . we must give the taxpayers of Virginia the full confidence that we are good stewards of their tax dollar."[35] He can begin by reversing some of the large budget increases of the late 1990s. Figure 5 indicates that even with restraint in FY02 and FY03, spending is up substantially from FY2000.

Maryland

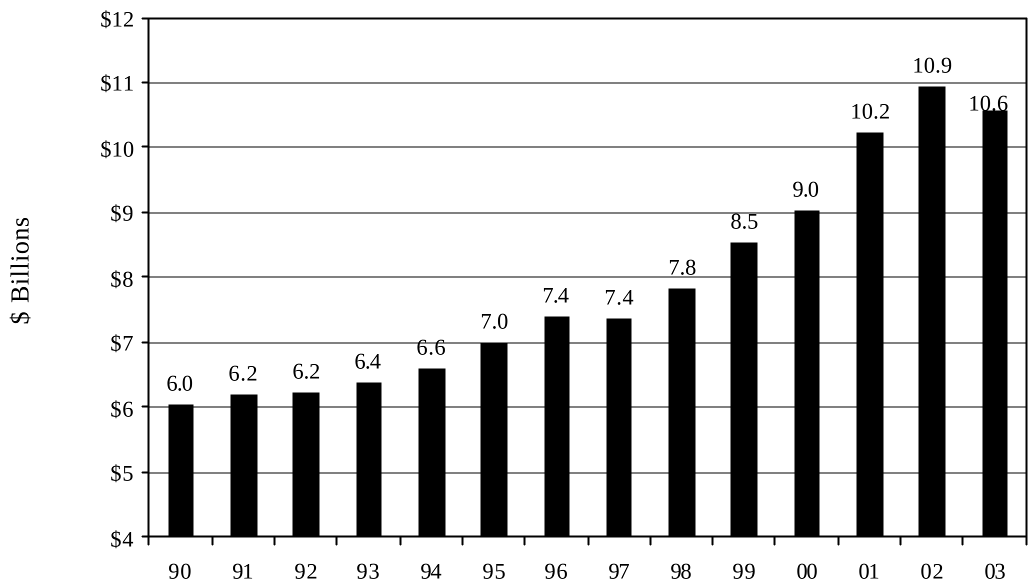
In November Maryland elected its first Republican governor in 36 years. Robert Ehrlich will be responsible for cleaning up the fiscal mess left by his predecessor Parris Glendening, who left office with a $1.2 billion budget gap and a record of high spending. (Glendening had also left his prior job as a county executive in Maryland in a blaze of red ink.) On his way out of the governor's office in 2002, Glendening used executive orders to spend millions of dollars that Maryland cannot afford.[36] His last-minute hikes in spending, such as giving state workers a $100 million pay hike, were "the dirtiest trick I've ever known any governor to do" noted the state's

Figure 5
Virginia General Fund Spending, FY90–03



Source: Virginia Department of Planning and Budget, www.dpb.state.va.us/budget/budget.htm. FY03 is preliminary.
Note: State spending on car tax repeal is excluded from figures.

Figure 6
Maryland General Fund Spending, FY90-03



Source: NASBO, "Fiscal Survey of the States," November 2002 and prior issues. FY02 and FY03 are preliminary.

comptroller William Donald Schaefer.[37] An editorial in the *Washington Post* called Glendening's last-minute budget gimmickry "simply deceitful."[38]

The burden of reining in Glendening's big-spending legacy will fall on Governor Ehrlich. Figure 6 shows that Maryland's general fund spending soared from $6.6 billion in 1994 to $10.9 billion by 2002, a 65 percent increase.[39] Ehrlich has promised not to raise sales or income taxes and is generally supportive of spending cuts. Given the large run-up in state spending under his predecessor, major spending cuts are the best way for Ehrlich to balance the state budget.

Avoiding the Economic Mistake of Tax Increases

The near-term question facing state governments is, Should budget gaps be closed by restraining spending or by increasing taxes? In FY02, almost half of the states raised taxes to balance their budgets with total net tax increases of $8.3 billion, which was the largest net state tax increase in a decade.[40] In addition to tax hikes, many states resorted to one-time gimmicks to close budget gaps and put off tough choices until FY03.

So far, most states have avoided large, broad-based increases in sales or income taxes; instead, they have focused on raising cigarette taxes and various fees. Cigarette taxes were raised in 20 states in 2002, often sharply, as in New York. Although they are viewed as innocuous levies that improve public health, cigarette taxes have very negative side effects, including creation of large black markets, which provide a funding source for terrorists and organized crime.[41]

In the early 1990s many states made the mistake of jacking up tax rates in an effort to close budget gaps. That strategy did not solve budget problems because it stifled economic growth and fueled higher spending.[42] Income taxes, the most economically destructive taxes, were raised substantially in many states. Govs. Pete Wilson of California, James Florio of New Jersey, Lowell Weicker of

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State tax policies have a significant impact on economic performance.

Connecticut, Bruce Sundlun of Rhode Island, Bob Casey of Pennsylvania, and George Voinovich of Ohio all enacted "soak the rich" income tax increases. Those tax-raising states lost jobs, income, and investment capital relative to other states after those tax actions.[43]

Then the trend was reversed in the mid–1990s with 28 states cutting taxes in 1995, 28 states cutting taxes in 1996, and 20 states cutting taxes in both 1997 and 1998.[44] Top tax cutters included Michigan's John Engler, New Jersey's Christine Todd Whitman, Wisconsin's Tommy Thompson, Texas's George W. Bush, and Arizona's Fife Symington. Business and individual income tax rates fell as states realized that they needed to create a competitive economic climate to attract skilled workers and businesses. By the late 1990s even liberal governors, such as Maryland's Glendening, acknowledged that high tax rates damage state economic performance. Glendening said that cutting taxes "is the single most important step we can take to make Maryland more competitive and create more jobs."[45] Glendening signed into law a phased-in income tax rate cut, though that cut has now been suspended.

Glendening stated what numerous economic studies have concluded: State tax policies have a significant impact on economic performance. States with high tax burdens are more likely to suffer economic decline, while those with low tax burdens are more likely to enjoy robust growth.[46] Capital, labor, and consumers searching for the best economic cli-

Table 3
State and Local Taxes vs. Income Growth, FY80–2000

States and D.C.	Taxes as a Percentage of Income, Average 1980–2000	Change in Personal Income, Real Increase 1980–2000
Highest-tax jurisdictions		
Alaska	19.3%	49.7%
D.C.	13.6%	34.5%
New York	13.5%	63.2%
Wyoming	11.7%	17.8%
Hawaii	11.5%	47.4%
Maine	11.5%	65.6%
Wisconsin	11.3%	52.9%
Minnesota	11.3%	80.3%
New Mexico	11.2%	73.0%
Montana	10.9%	37.2%
Average - Highest 10	12.6%	52.2%
Lowest-tax jurisdictions		
Arkansas	9.1%	63.2%
Nevada	9.0%	200.6%
Virginia	9.0%	94.9%
Indiana	9.0%	52.9%
Texas	8.8%	96.8%
Missouri	8.7%	59.3%
Alabama	8.5%	64.5%
Florida	8.5%	119.8%
Tennessee	8.1%	88.0%
New Hampshire	7.8%	117.4%
Average - Lowest 10	8.7%	95.7%

Source: Authors' calculations based on U.S. Bureau of the Census data, www.census.gov/govs/www/estimate.html.

mate are increasingly mobile across state and international borders. As a result, governments must maximize their efficiency and not let tax rates get out of line with those of neighboring jurisdictions.[47] Tax increases will result in fewer businesses, slower economic growth, and a smaller tax base.

We have performed an analysis comparing economic growth with state and local tax levels in the 50 states and the District of Columbia. The tax measure used in the analysis is average 1980–2000 state and local tax revenues as a percentage of personal income.[48] Economic growth is measured as the increase in real, or inflation-adjusted, state personal income during the 20-year period. Table 3 presents the results for the 10 highest- and 10 lowest-tax states. Real income increased an average 96 percent during the 20-year period in the 10 lowest-tax states but increased just 52 percent in the 9 highest-tax states and D.C.

Other studies have found a similar relationship between taxes and economic growth. A 1995 study by the Joint Economic Committee of Congress looked at state taxes and personal income growth between 1960 and 1993. The study concluded that "higher state and local taxes had a distinct and significant negative effect on personal income growth . . . when state and local taxes were raised, personal income growth slowed markedly. By the same token, states with lower taxes enjoyed substantially higher personal income growth."[49] A 1996 study by the Federal Reserve Bank of Atlanta looked at state and local taxes compared to state income growth from 1960 to 1992. The study found that incomes in the poorer states tended to slowly catch up to incomes in the wealthier states over time. When the study controlled for that factor, it found that high taxes were negatively related to economic growth, whether marginal tax rates or overall tax levels were considered.[50]

At the international level, a 2001 survey of academic studies on investment by James Hines of the University of Michigan Business School concluded that taxes substantially influence the location of foreign direct investment, research and development, and other activities that promote economic growth.[51] A study by economists Eric Engen and Jonathan Skinner looked at growth rates of 107 countries from 1970 to 1985 and found "strong and negative effects of both government spending and taxation on output growth."[52] International investment flows into the United States are also affected by state-level taxes. For example, a study by Deborah Swenson of the University of California–Davis found that U.S. states that have higher taxes attract fewer new investments and plant expansions from foreign companies than do lower-tax states.[53]

Limiting Budget Growth to Avoid Budget Gaps

To avoid budget gaps during economic slowdowns, states should limit spending growth during economic booms. States can do that with a mandatory budget cap that provides automatic taxpayer refunds when tax revenues grow faster than a benchmark rate, such as inflation plus population growth. Budget growth caps can prevent governments from starting too many new spending programs in good times, thus making it easier to balance budgets during downturns.

Currently, 26 state governments operate under some form of tax or expenditure limitation (TEL).[54] TELs are statutory or constitutional restrictions on the growth rate of government revenues or spending, or both. The effectiveness of TELs varies widely, with Colorado's Taxpayer Bill of Rights, which took effect in 1994, probably the most effective. It limits the growth in state tax revenues to inflation plus population growth. Revenue increases above the limit are refunded to taxpayers. Colorado rebated more than $2.3 billion to taxpayers between FY98 and FY01.[55] Colorado's legislature can allow revenues and spending to increase faster than the limit, but it must first get the approval of voters in a referendum. Six such referenda

Real income increased an average 96 percent in the 10 lowest-tax states but just 52 percent in the 9 highest-tax states and D.C.

States should adopt budget caps that prevent excessive growth in revenues and spending during economic booms.

have been held in Colorado since TABOR was adopted, and the public has rejected five of them.

If tight tax and budget growth caps were widely implemented, states could avoid large budget gaps in the future. Excess revenues would be given back to taxpayers in both permanent tax cuts and annual tax rebates during economic booms. Then, if revenue stagnated during future downturns, annual tax rebates could be temporarily suspended. That action, along with use of rainy day funds and spending cuts, should be sufficient to balance state budgets without resorting to economically damaging tax rate increases. As states pull out of their current budget morass, they should seek new approaches such as TELs to avoid being confronted with another budget crunch.

Conclusion

Current state budget woes are the result not of revenue shortfalls but of spending excesses built up during the 1990s. The recent stagnation of state tax revenues comes after a decade of soaring budget growth fueled by the economic boom. Even with the recent large budget gaps, state spending still crept higher in FY02 and FY03.

In an effort to avoid needed spending cuts, many states are asking for a bailout from Washington. But it makes no sense for the federal government to collect more taxes from citizens in the 50 states, only to turn around and send the money back to state governments. That simply adds to federal bureaucracy and doesn't solve the underlying overspending problem.

Many governors and state legislators are proposing further tax hikes. But tax hikes will simply delay the return to strong economic growth and shrink tax bases as businesses and individuals move to lower-tax states, such as Florida, Nevada, and Texas. Tax increases would also invite another stampede of excess spending in the future.

Instead, states should turn current budget problems into opportunities to weed out excessive and wasteful spending added during the boom years. For example, states should explore opportunities to save money by privatizing state services. To avoid running into serious budget crunches in the future, states should adopt budget caps that prevent excessive growth in revenues and spending during economic booms.

Notes

1. National Conference of State Legislatures (NCSL), "State Budget Update," November 2002, www.ncsl.org. This survey found a FY03 budget gap of $17.5 billion. NCSL had previously reported that the FY02 budget gap was $37 billion, and the initial estimate for the FY03 budget gap was $49 billion. See NCSL, "State Budget & Tax Actions 2002," October 11, 2002. Budget gap figures should be treated with caution because they are based on constantly changing projections rather than actual revenues and spending.

2. National Association of State Budget Officers (NASBO), "Fiscal Survey of the States," November 2002, www.nasbo.org. All budget figures are for state fiscal years.

3. National Governors Association, "State Fiscal Woes Continue," Press release, May 16, 2002, www.nga.org/nga/newsRoom.

4. See, for example, Nicholas Johnson, "The State Tax Cuts of the 1990s, the Current Revenue Crisis, and Implications for State Revenues," Center on Budget and Policy Priorities, November 18, 2002.

5. NASBO, "Fiscal Survey of the States," November 2002.

6. Jonathan Weisman, "Governors Cite U.S. in Fiscal Crises," *Washington Post,* December 6, 2002, p. A1.

7. Jonathan Weisman, "Democratic Governors Seek $50 Billion in Aid," *Washington Post,* January 20, 2003, p. A6.

8. Bob Davis and Greg Ip, "Bush Stimulus Package Needs Many Assumptions to Pan Out," *Wall Street Journal,* January 8, 2003, p. A1.

9. Bob Herbert, "For Struggling States, All Solutions Point to Washington," *New York Times,* December 2, 2002, p. A21.

10. David Broder, "States in Fiscal Crisis," *Washington Post,* May 22, 2002, p. A37.

11. NASBO, "Fiscal Survey of the States," November 2002 and prior issues. These figures are based on the change in actual final spending amounts for each year, not the Table 2 figures in the Fiscal Survey report that show the percentage change based on preliminary spending figures.

12. NASBO, "Fiscal Survey of the States," November 2002.

13. Stephen Moore, "State Spending Splurge: The Real Story behind the Fiscal Crisis in State Government," Cato Institute Policy Analysis no. 152, May 23, 1991.

14. Quoted in "Fiscal Shock, Cuomo-Style," *Newsday*, February 9, 1991, p. 44.

15. U.S. Department of Commerce, "Retail E-Commerce Sales in Third Quarter 2002 Were $11.1 Billion," Press release, November 22, 2002, www.census.gov/mrts/www/current.html.

16. U.S. Bureau of the Census, "State Government Tax Collections," www.census.gov/govs/www/statetax. Data for 2002 are available from the U.S. Bureau of Economic Analysis.

17. U.S. Bureau of Economic Analysis, *Survey of Current Business*, December 2002, p. D-9. See also electronic data at www.bea.gov/bea/dn/nipaweb/index.asp.

18. Ibid.

19. Tax Foundation, "State Individual Income Tax Rates," www.taxfoundation.org/individualincome taxrates.html.

20. For further information, see Chris Edwards, "Sunsetting to Reform and Abolish Federal Agencies," Cato Institute Tax & Budget Bulletin no. 6, May 2002.

21. U.S. Bureau of the Census, "State Government Tax Collections." The number of households for 2001 was estimated by adjusting Census Bureau households in 2000 for population growth between 2000 and 2001.

22. Gregg Jones, "Davis Hints at Tax Hikes to Close Shortfall," *Los Angeles Times*, December 19, 2002, p. 1. This story reported a new gap estimate by Governor Davis, but estimates of gaps in this and other states are constantly changing. California had reported a budget gap of $21 billion just four weeks earlier. See also NCSL, "State Budget Update," November 2002, p. 2.

23. NASBO, "Fiscal Survey of the States," November 2002. See also California Department of Finance, "Governor's Budget, Background Information," www.dof.ca.gov/HTML/BUD_DOCS/backinfo.htm.

24. NASBO, "Fiscal Survey of the States," November 2002, p. 36.

25. Jones, p. 1.

26. "Wrenching Changes Likely with Budget Cute," *Los Angeles Times*, December 15, 2002, p. 1.

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35. Quoted in R. H. Melton, "Warner Proposes Agency Overhaul," *Washington Post*, December 4, 2002, p. A1.

36. Lori Montgomery, "As Glendening Spends, Ehrlich Camp Steams," *Washington Post*, December 17, 2002, p. B1.

37. Quoted in ibid.

38. "Governor Glendening's Budget Fix," Editorial, *Washington Post*, November 22, 2002, p. A40.

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40. NASBO, "Fiscal Survey of the States," November 2002.

41. Fleenor.

42. Stephen Moore, "Taxing Lessons from the States: Why Much of America Is Still in a Recession," U.S. Congress, Joint Economic Committee, October 1993.

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46. For background, see Richard Vedder, "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," U.S. Congress, Joint Economic Committee, December 1995. See also Stephen Moore and Dean Stansel, "Tax Cuts and Balanced Budgets: Lessons from the States," Cato Institute Fact Sheet, September 17, 1996.

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48. For tax levels, we calculated the average of state and local taxes as a percentage of income in 1980, 1990, and 2000. All tax data were from the U.S. Bureau of the Census, www.census.gov/govs/www/index.html.

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51. James Hines, *Introduction to International Taxation and Multinational Activity*, ed. James Hines (Chicago: University of Chicago Press, 2001), p. 1.

52. Eric Engen and Jonathan Skinner, "Fiscal Policy and Economic Growth," Working Paper 4223, National Bureau of Economic Research, December 1992, p. 32.

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