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Tax Cuts and Balanced Budgets: Lessons from the States by Stephen Moore and Dean Stansel

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Introduction

The advisability of Bob Dole's 15 percent across-the-board federal income tax cut has been challenged in two ways. First, the White House and other skeptics have argued that the tax cut will preclude balancing the budget, and will even make the budget deficit worse. Second, many Washington economists question whether tax cuts will stimulate the economy or produce higher incomes, as supply-side advocates predict.

The states, in their roles as laboratories of democracy, may shed some light on the controversy. During the recession of 1990-91, more than half of the states raised taxes. But in the last two years, 26 states have enacted substantial tax cuts. In fact, the 1995-96 biennium has been the largest tax-cutting period for states since the early 1980s. The state tax reduction experience is of special relevance to the current debate in Washington, because many states have reduced income tax rates across the board--as Bob Dole's plan proposes. The top 10 tax-cutting states reduced state taxes as a share of total tax collections by about 6 to 7 percent. Michigan cut tax revenues by more than 10 percent. The Dole plan would reduce total federal revenues by 5.2 percent on a static basis and by 4.1 percent on a dynamic basis (i.e., adjusting for higher economic growth from the tax cut).

Tax-raising States vs. Tax-cutting States

In this study we contrast the economic and fiscal performance of the top 10 tax-raising states in the 1990s with that of the top 10 tax-cutting states. (We exclude Alaska from the study because of peculiarities in its revenue sources.) Major findings, as summarized in Table 1, include the following:

- Budget Reserves: The budget reserves of the tax-cutting states (7.1 percent of state expenditures) were much higher than of the states that had raised taxes (1.7 percent) (see Figure 1). That is, tax-cutting states are in better fiscal health this year than tax-increasing states.
- Bond Ratings: If tax cuts contribute to fiscal deterioration, then the bond ratings of the 10 states that cut taxes the most in the 1990s should be worse than those of the 10 states that raised taxes. Just the opposite is true. In the tax-cutting states, the average Moody's bond rating in 1995 was between Aaa and Aa. In the tax-raising states, the average Moody's bond rating was between Aa and A1.

- Population Growth: Americans voted with their feet in favor of tax-cutting states. Figure 2 shows that population gains were 4.2 percent in the tax-raising states but 7.4 percent in tax-cutting states. The tax-cutting states gained 500,000 more people than the tax increasers.
- Employment Growth: Businesses and jobs migrated to low-tax states in the 1990s. From 1990 to 1995 the United States gained 7 million net new jobs. But in the 10 states that raised taxes, total employment did not rise at all--and in fact, it fell slightly. The biggest job losses were in the tax-raising states of Rhode Island, Connecticut, California, and Massachusetts. Figure 3 shows that job growth averaged 0.0 percent in the tax-increasing states and 10.8 percent in the tax-cutting states. None of the tax-cutting states lost jobs.
- Unemployment Rate: The superior job creation performance of the tax-cutting states is also revealed in the unemployment data. Figure 4 shows that the unemployment rate at the end of 1995 was 4.7 percent on average in the 10 tax-cutting states and 6.0 percent in the 10 tax-raising states. The unemployment rate fell in the 1990s by 0.5 percentage points in the tax-cutting states but by only 0.2 percentage points in the tax-raising states.
- Incomes: Total state income grew by 32.6 percent in the tax-cutting states and by 27.0 percent in the tax-raising states (see Figure 5). Per capita income grew 21.8 percent in the tax-raising states, slightly below the 23.4 percent average in the tax-cutting states. That translated into a $400 greater increase in per capita income in the tax-cutting than in the tax- raising states.

Critics of state tax cuts contend that lower state taxes mean higher local tax burdens, thus leaving taxpayers no better off. That claim is most prominently made about the tax cuts enacted by Gov. Christine Todd Whitman in New Jersey. A recent study by the Manhattan Institute concluded that local property tax increases replaced less than one-third of the income tax cuts signed into law by Governor Whitman. Also, many states, including Arizona and Michigan, have coupled state tax cuts with restrictions on the ability of local governments to raise taxes in response.

State Economic Performance before and after Tax Cuts

We also examined the recent experience of 10 states that we think are illustrative of the impact of tax cuts on state economic development. They are states that had raised taxes in the late 1980s or early 1990s, then cut them in more recent years. We therefore examine those states' economic performance before and after the tax cuts. The 10 states analyzed are Arizona, California, Connecticut, Georgia, Massachusetts, Michigan, New Jersey, New York, North Carolina, and Pennsylvania. In 8 of the 10 states, job growth had been negative or zero in the years before the tax cuts. Economic growth has been positive in the years after the tax cuts, as shown in Table 2. Here are the summaries of the fiscal and economic circumstances in each of those states:

Arizona: Under Gov. Fife Symington, taxes have been cut by $1.5 billion since 1992. The top income tax rate has fallen from 8.7 to 5.6 percent, and the corporate income tax has been cut as well. Over that time period job creation, population, and new business creation have grown at three times the national average. Employment had actually fallen in Arizona in the two years before Symington's tax cutting.

California: No state has turned around its fortunes as dramatically as California in recent years. In 1990 the legislature and Gov. Pete Wilson enacted a $7 billion tax increase, the largest in the history of the 50 states. The income tax hikes were noteworthy in that they failed to raise any new revenue while sinking the state deeper into recession as upper income families and entrepreneurs moved out. The already ailing economy continued to decline. From 1990 to 1993 the state lost 350,000 jobs. In 1995 the tax hikes were repealed. Since then California has gained 150,000 jobs and the unemployment rate has fallen sharply.

Connecticut: In 1991 Connecticut became the 41st state to adopt a personal income tax. That was also the largest tax increase in Connecticut history. It has caused an exodus from the state. Connecticut is one of only two states to lose population in the 1990s. In 1995 Gov. John Rowland enacted a $200 million income tax cut, paid for by a zero growth budget after inflation. He has cut the general assistance welfare budget, public housing aid, and transportation funds and imposed a hiring freeze. The tax cuts have helped pull the Connecticut economy out of the depths of the early 1990s recession that devastated the state's insurance, defense, and banking industries--a recession exacerbated by Gov. Lowell Weicker's tax grab. From 1990 to 1995, 125,000 jobs were lost. Since July 1995, one-third of those lost jobs have been replaced.

Georgia: In recent years, Georgia, under Gov. Zell Miller has enacted a series of tax cuts. In 1996 Miller signed a $500 million tax cut, exempting food from the sales tax. In 1994 Miller approved a $100 million tax cut for families with children by raising the dependent exemption from $1,500 to $2,500 and an income tax cut for senior citizens with retirement income. This tax-cutting state is booming economically. In the 1990s Georgia has by many measures enjoyed the fastest growth rate of any state east of the Mississippi. Employment has grown more than twice the regional average since 1990.

Massachusetts: Gov. Michael Dukakis's last budget contained a series of tax increases designed to close a $1-billion-plus budget deficit. The budget deficit was closed in William Weld's first two years as governor through tight spending restraint, privatization of state services, and a reduction in the public payroll. In 1991 Weld enacted an income tax rollback--the first of eight tax cuts he pushed through in his first term. He also canceled several Dukakis tax hikes. Since then, the state has regained all of the 150,000 jobs lost during the 1990-91 recession--and the budget is running a surplus now.

Michigan: Gov. John Engler inherited a $1.5 billion deficit in 1991 and quickly closed the gap through an impressive budget-cutting agenda. He ended a general assistance program for 75,000 employable adults, slashed 6,000 workers from state payrolls, ended low-priority programs such as funding for the arts, and privatized homeless services and other state activities. In 1991 Engler enacted the first of 15 tax cuts. The largest and most controversial was a school financing/tax restructuring program under which local property taxes were sharply reduced and the state sales tax was raised by 2 percentage points. The plan provided a net tax cut of more than $500 million a year. The economy is now surging in Michigan, and the unemployment rate is lower than at any time since the mid-1960s and well below the national average at 4.5 percent. In the two years before Engler's tax cutting, the state had no net new jobs. Since then, Michigan businesses have created 450,000 net new jobs.

New Jersey: Last year Gov. Christine Todd Whitman made good on the final portion of the 30 percent income tax cut she promised in the campaign of 1993. The top income tax rate in New Jersey has now been chopped from 7 to 6.37 percent--a $1.2 billion tax cut. The typical middle-income family will now pay about $300 less per year in state income tax. Whitman's tax cuts were a reversal of the soak-the-rich tax hikes enacted by her predecessor Jim Florio. As of July 1996, 80 percent of the jobs lost during the Florio years had been recovered under Whitman. Personal income in the state grew by nearly 4 percent last year after virtually no growth in the Florio years.

New York: In 1994 George Pataki narrowly defeated the nation's most articulate champion of big-government liberalism, Mario Cuomo, by running on a platform of Whitman-style income tax cuts. Last year, the 20 percent income tax cut under Pataki was as large ($2.5 billion) as those enacted by all of the rest of the states combined. Pataki also overhauled the state's antiquated workmen's compensation system, which now costs New York businesses 30 percent more than the national average. After losing one-half million jobs because of the tax from 1990 to 1995, New York actually enjoyed an increase of 90,000 jobs over the past 12 months.

North Carolina: In the early 1990s North Carolina went on a state spending binge. In 1992 total state expenditures exploded from $16.9 billion to $19.0 billion--an enormous 12.5 percent increase. Gov. Jim Hunt pushed for more funding for schools, day care, apprenticeship programs, and health insurance coverage. Activist government was the guiding principle of the day in Raleigh. And the economy grew slowly. Since 1995 the spending spree has ended and the budget has grown only slightly faster than inflation. In 1995

Hunt, a Democrat, pushed through a $400 million tax cut that included an income tax cut and elimination of the state intangibles tax. Job growth has more than doubled since the tax cuts, and the state economy is flourishing.

Pennsylvania: Gov. Robert Casey enacted a $2 billion major income tax increase--raising the rate from 2.1 to 2.8 percent--during the 1990-91 recession. From 1990 to 1995 there was virtually no net job creation in Pennsylvania. In his first year in office, 1995, Gov. Tom Ridge pushed through a $200 million business income tax cut and a workmen's compensation reform measure that is expected to reduce premiums by as much as 10 percent. In 1996 he endorsed a reduction in the franchise tax and a $1,000 tax credit for new hires. He has also been tight-fisted on spending. His 1996 budget allowed spending to grow by just 0.6 percent. In 1997, for the first time in a quarter century, the general fund budget spends less than the year before. That combination of tax cuts and budget restraints has helped lead to a net gain of 100,000 jobs so far in 1996.

Lessons for Washington

These results--suggesting that tax cuts and spending restraint contribute to state economic competitiveness--are consistent with those of earlier studies. For example, in 1993 the Joint Economic Committee compared the job creation performance and per capita growth of incomes in the states that raised taxes over the period 1990-93 with those of the states that cut taxes or avoided raising taxes. The JEC found that tax-avoiding states created 653,000 new jobs over the period versus just 3,000 in the tax-increasing states. Yet the tax-increasing states have much larger populations.

The experience of the states in recent years supports the theory that when a state raises its taxes, that raises the cost to businesses of producing goods and services within the state relative to the tax climate in other states. Similarly, higher taxes may reduce the take-home pay of workers or raise the cost of living in the state--both of those effects give workers an incentive to migrate to other states where taxes are less burdensome.

The state experience should be seen as evidence of the potential impact of an across-the-board federal income tax cut. There is little question that states that have cut taxes in the 1990s have improved their economic competitiveness--particularly compared to tax-increasing neighbors. The evidence is most persuasive in the northeastern states of Connecticut, Massachusetts, New Hampshire, New Jersey, New York, and Pennsylvania, where pro-growth governors have helped turn around their states' dismal performance in the early 1990s through income tax reductions and expenditure control.

Table 1

Taxes and State Economic Performance in the 1990s

Total FY90-96 Rev. Increases as % of 1990 Pers. Inc.	1990-95 Growth in: Population	Employment	Unemployment Rate (% pts.)	1995 Unemployment Rate

							Per Capita Personal Income	To St Inc
1.	Rhode Island	2.401%	-1.5%	-6.7%	0.2	7.0%	22.5%	
2.	West Virginia	2.340%	2.0%	4.5%	-0.5	7.9%	28.3%	30.
3.	Connecticut	2.043%	-0.4%	-7.1%	0.3	5.5%	19.2%	18.
4.	Vermont	1.720%	3.5%	5.8%	-0.8	4.2%	20.0%	24.

5.	Maine	1.688%	0.8%	0.6%	0.5	5.7%	20.5%	21.
6.	Montana	1.517%	8.8%	8.7%	-0.1	5.9%	25.4%	36.
7.	California	1.425%	5.6%	-0.8%	2.0	7.8%	14.7%	21.
8.	Kentucky	1.214%	4.5%	5.9%	-0.5	5.4%	26.2%	31.
9.	Massachusetts	1.165%	0.9%	-1.2%	-0.6	5.4%	21.3%	22.
10.	Arkansas	1.095%	5.5%	11.0%	-2.1	4.9%	26.4%	33.
	Tax Hikers Avg.	**1.661%**	**4.2%**	**0.0%**	**-0.2**	**6.0%**	**21.8%**	**27.**

Top 10 Tax-Cutting States, FY90-96

		Total FY90-96 Rev. Increases as % of 1990 Pers. Inc.	1990-95 Growth in Population	Employment	Unemployment Rate (% pts.)	1995 Unemployment Rate	Per Capita Personal Income	To St Inc
1.	Hawaii	-0.845%	6.6%	2.3%	3.0	5.9%	18.3%	26.
2.	Michigan	-0.760%	2.6%	5.8%	-2.3	5.3%	29.1%	32.
3.	Oregon	-0.690%	9.9%	11.6%	-0.8	4.8%	26.4%	38.
4.	Utah	-0.418%	12.8%	19.9%	-0.7	3.6%	29.6%	37.
5.	Idaho	-0.137%	14.9%	22.0%	-0.5	5.4%	25.9%	44.
6.	Wisconsin	-0.105%	4.5%	11.1%	-0.7	3.7%	25.5%	31.
7.	Arizona	0.000%	14.7%	18.3%	-0.4	5.1%	25.6%	43.
8.	Virginia	0.001%	6.5%	7.7%	0.2	4.5%	20.8%	28.
9.	New Hampshire	0.122%	3.2%	2.6%	-1.7	4.0%	24.3%	28.
10.	Colorado	0.124%	13.4%	19.5%	-0.8	4.2%	24.6%	35.
	Tax Cutters Avg.	**-0.271%**	**7.4%**	**10.8%**	**-0.5**	**4.7%**	**23.4%**	**32.**
	U.S. Average	0.641%	5.4%	5.9%	0.1	5.6%	22.1%	28.

Note: Alaska was excluded from the tax-increasing group because of peculiarities in its tax code that make interstate comparisons problematic.
Source: Cato Institute calculations, based on National Association of State Budget Officers, Fiscal Survey of the States, various editions, and data from U.S. Bureau of the Census and U.S. Bureau of Labor Statistics.

Table 2

Number of Residents Employed, by State, 1990-July 1996

State	1990	1991	1992	1993	1994	1995	Jul-95

California	14,319,192	14,004,151	13,973,904	13,918,275	14,132,936	14,205,866	14,201,400	
Connecticut	1,738,695	1,716,245	1,680,758	1,672,617	1,639,260	1,614,931	1,611,900	
New York	8,375,118	8,095,673	7,911,253	7,973,256	7,980,520	7,955,265	7,946,000	
North Carolina	3,323,957	3,307,735	3,334,507	3,380,985	3,432,810	3,478,588	3,477,900	
Pennsylvania	5,475,923	5,418,971	5,439,531	5,470,346	5,465,286	5,495,124	5,497,900	
U.S. Total	117,914,000	116,877,000	117,598,000	119,306,000	123,060,000	124,900,000	124,832,500	1
State	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**Jul-95**	
New Jersey	3,860,673	3,770,249	3,690,214	3,690,762	3,739,434	3,803,126	3,805,700	

U.S. Total	117,914,000	116,877,000	117,598,000	119,306,000	123,060,000	124,900,000	124,832,500	1

State	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**Jul-95**	
Arizona	1,701,079	1,668,823	1,673,329	1,715,112	1,857,454	2,012,498	2,025,800	
Massachusetts	3,032,863	2,875,527	2,875,809	2,945,402	2,976,710	2,997,569	2,997,400	
Michigan	4,246,205	4,151,912	4,245,010	4,373,777	4,480,353	4,490,922	4,474,000	
U.S. Total	117,914,000	116,877,000	117,598,000	119,306,000	123,060,000	124,900,000	124,832,500	1

Source: Cato Institute calculations, based on data from the U.S.
Bureau of Labor Statistics.