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National Center for Policy Analysis

POLICY BACKGROUNDER No. 106
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For Immediate Release
October 9, 1990

STATE GOVERNMENTS TURN TO NEW TAXES

"During 1990, 25 states have already approved $10 billion in new taxes."

Background. This year 25 states — led by California, Massachusetts, New Jersey and New York — have approved roughly $10 billion in new taxes, making 1990 the second-largest state tax increase year on record.[1] No state cut taxes significantly.

The fiscal forecast for the early 1990s, in state capitals from Boston to Sacramento, is for more of the same: higher taxes to stave off burgeoning red ink. Even with the just-enacted 1990 tax hikes, the National Conference of State Legislatures warns of a "continued deterioration in state finances in the years ahead."[2] The evidence confirms this bleak assessment:[3]

- Aggregate state budget reserves plummeted by 50 percent between 1989 and 1990.
- Two-thirds of the states spent more than they collected in taxes this year, and many will try to erase these operating deficits with new taxes next year.

"This is the second-largest state tax increase year on record."

Yet, even as these events unfold, a taxpayer revolt similar to that of the early 1980s is underway.

The Case for Higher State Taxes. State lawmakers contend that higher state taxes are necessary to combat budget shortfalls for several reasons: 1) regional economic downturns combined with declining federal aid have reduced revenue growth in many states; 2) without increased taxes, states might be forced to sharply cut back vital and neglected public services; and

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3) spending requirements mandated by Washington and the courts — have forced expenditures and tax increases.

The Case Against Higher State Taxes. Opponents of new state taxes contend: 1) state revenues have grown rapidly over the past decade with the overall state tax burden already at record levels; 2) the budget crisis in the states — particularly the New England states — is the result of unprecedented spending during the 1983-89 economic expansion; 3) new state taxes would fuel even higher state spending; and 4) state tax hikes impede economic growth.

"Two-thirds of the states spent more than they collected in taxes in 1990."

NEW STATE TAXES

A 1990 *New York Times* report notes that "more than half of the states are battling serious budget problems and about eight eastern states are striving to avoid deficits that could disrupt state-wide services."[4] According to Ray Scheppach, executive director of the National Governors' Association, the states' fiscal condition is "the worst since 1983."[5]

To avoid falling into debt, a growing number of states — led by powerful governors such as Mario Cuomo of New York, James Florio of New Jersey, George Deukmejian of California and Jim Thompson of Illinois — have turned to taxes in 1990. A total of 25 states have enacted a combined $10 billion in new taxes over the year, with a handful of states accounting for more than half of this increase:[6]

"New Jersey enacted the largest one-year state tax increase in U.S. history."

- New Jersey enacted $2.8 billion in new taxes — *the largest one-year state tax increase in U.S. history.* (Higher sales taxes will raise $1.5 billion annually, and a hike in the income tax to finance education reform accounts for the rest.)

- Massachusetts approved $1.2 billion in new income, sales and motor fuel taxes.

- New York raised $938 million in miscellaneous fees and excise taxes to erase a $1 billion projected deficit.

- California voters approved Proposition 111 to double the state gasoline tax from 9 cents to 18 cents per gallon to pay for new roads — raising a projected $18.5 billion over ten years.

"As many as 30 states are preparing to raise taxes next year."

Next year could see a continuation of these fiscal trends. An estimated 20 to 30 states are preparing major tax hikes for the 1992 fiscal year.[7] The budget crisis that began in New England has begun to shift toward the Southeast. For example, the fiscal conditions of Florida, Georgia, North Carolina and Virginia continue to deteriorate, and each is contemplating tax increases next year. The most likely to be raised are sales taxes, income taxes, excise taxes and taxes on professional services.

ARE STATE TAXPAYERS UNDERTAXED?

State officials claim the national economic slowdown is causing a decline in state revenues. Yet, aggregate state taxes have reached record highs:[8]

"State taxes per person have doubled since 1980."

- Per capita state tax receipts have doubled since 1980 and quadrupled since 1970. [See chart]

- State revenues now consume 8.4 percent of gross national product — the highest level in 30 years and up from just 5.0 percent in 1960. [See chart]

The effect of the tax revolt of the late 1970s and early 1980s has disappeared. The Tax Foundation reports that more than 34 cents of every dollar earned by American families in 1990 will be absorbed by the government at the local, state or federal level. "Americans are no better off than they were in 1981 despite economic growth, cuts in income tax rates and repeated claims that government has been cut," concludes the Foundation.[9]

IS SPENDING UNDER CONTROL IN THE STATES?

The fiscal crisis that is spreading from northeastern to southeastern and some western states has little to do with slow revenue growth and much to do with burgeoning expenditures. The evidence shows:

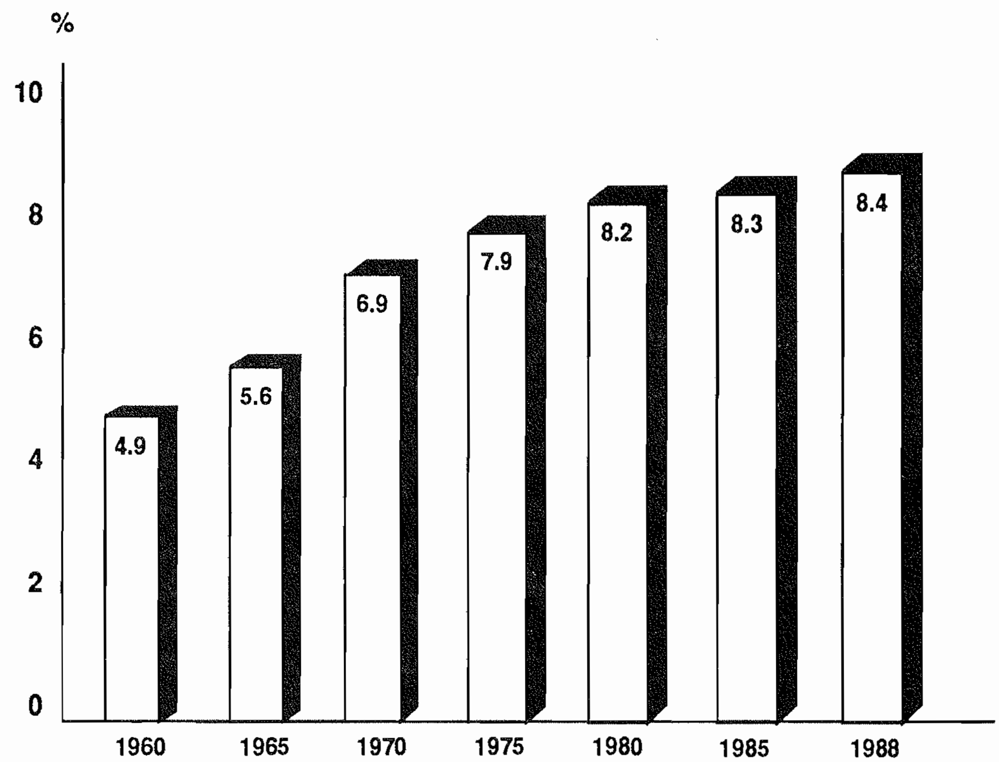
"State spending has been growing at almost double the rate of inflation."

- Aggregate state spending grew by 8.4 percent per year from 1984 through 1990 — almost double the 4.8 percent inflation rate for the period.[10]

- This year 15 states raised spending for elementary-secondary education by at least 10 percent; 29 states expanded spending for corrections by at least 10 percent;

"State revenues as a percent of GNP are at an all-time high."

STATE REVENUES AS PERCENT OF GNP



Source: Advisory Commission on Intergovernmental Relations

28 states appropriated at least 10 percent increases for Medicaid; and 13 states increased AFDC outlays by at least 10 percent.[11]

Runaway spending is clearly at the root of current budgetary problems in the Northeast. The fiscal tale of the 1980s for Massachusetts, New Jersey, New York and other states in this region can be summarized concisely: economic growth created unprecedented revenue riches which generated an even greater surge in state spending, which now appears unaffordable as the regional economy stagnates.

"Runaway spending is the root of the problem."

- Between 1981 and 1988, outlays escalated by 101 percent in Connecticut, 92 percent in Massachusetts, 84 percent in New Jersey and 81 percent in New York.[12] For the Northeast as a whole, expenditures outpaced the rest of the states by 35 percent over this eight-year period.[13]

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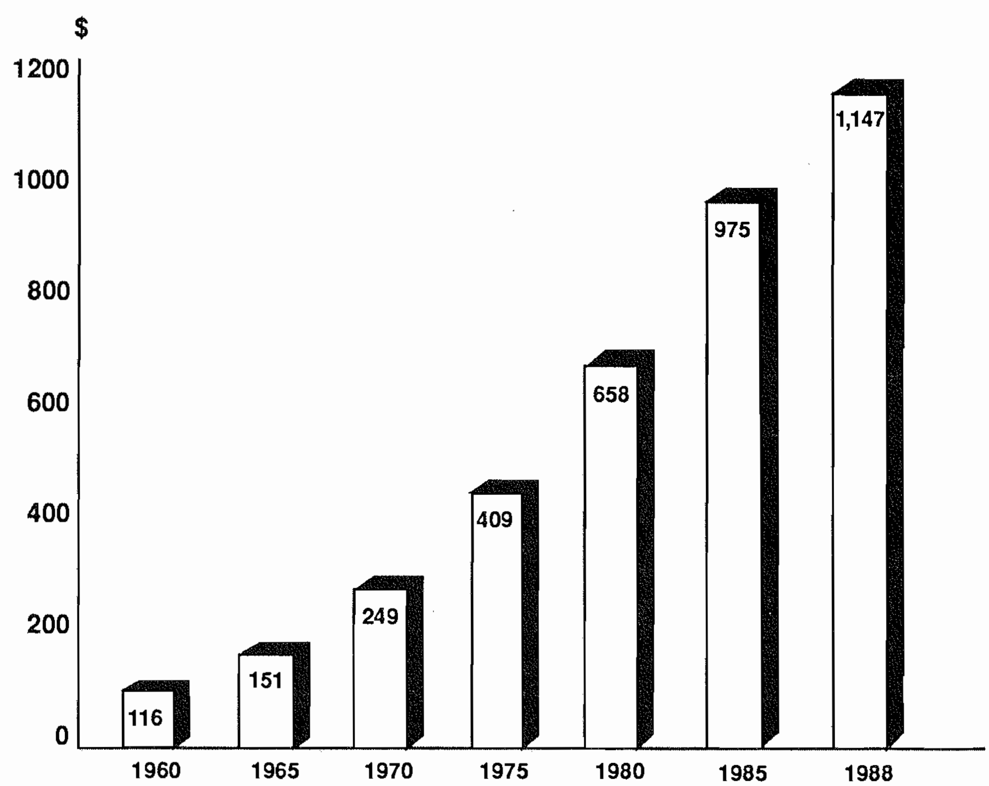
- In its 1989 investigative report of the New England states' fiscal problems, the *Washington Post* pinpointed the source of the breakdown: "The main reason for budget shortfalls from Concord to Trenton has been ... mushrooming spending programs that doubled and tripled many outlays in these prosperous states."[14]

IS THE FEDERAL GOVERNMENT FORCING STATES TO RAISE TAXES?

State officials blame Washington for their fiscal woes. They insist that the states are increasingly burdened by congressionally mandated spending for Medicaid, environmental cleanup and other programs. There is truth to this claim. Federal mandates are a financial burden which Congress increasingly has shifted to the states as a back door form of federal spending.[15]

"Aggregate state taxes have reached a record high."

PER CAPITA STATE TAX RECEIPTS



Source: U.S. Department of Commerce, Bureau of the Census, "Government Finances, 1987-88," and earlier volumes.

"Under federal mandates, Congress provides the benefits, and the states pay for them."

- This year, new Medicaid mandates alone carry a $2.4 billion price tag to be paid by the states.
- New federal mandates in 1990 have added $1 billion in new costs for state legislatures.
- Louisiana budget officials estimate that after meeting federal mandates, state lawmakers have discretion over only 35 percent of the state's revenues.

But it is a myth that declining federal aid has forced the states to raise taxes:[16]

- Although federal aid to states fell in the mid-1980s as part of Reagan's New Federalism, it rose in constant 1982 dollars from $91 billion per year in fiscal 1987 to a projected $101 billion this year.
- Federal grant payments to the states rose by 7.2 percent this year.

"Federal aid to the states has been rising, not falling."

Hence declines in federal aid cannot account for *current* state budget shortfalls. In addition, studies show that federal aid actually encourages states to raise taxes by requiring them to provide matching funds. Between 1954 and 1983, the correlation between per capita own-source state revenue collection and per capita federal aid to the states was 0.98.[17]

WILL HIGHER TAXES RESTORE BALANCED BUDGETS IN THE STATES?

On the federal level there is convincing historical evidence that higher taxes invite higher spending rather than lower budget deficits.[18] There is some evidence of a similar pattern at the state level. For example, two former U.S. Department of the Treasury economists examining the relationship between taxes and subsequent spending levels in the 50 states between 1952 and 1982 discovered that state tax hikes were associated with commensurate increases in spending three to five years later."[19]

The fiscal performance of the states during the 1980s provides further evidence that higher state revenues do not necessarily improve long-term fiscal health.

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"In the Northeast, state revenues grew 21 percent faster than in other states while their reserves dropped to zero."

The Northeast. If increased revenues were a recipe for long-term fiscal balance, the northeastern states should now be rich. Between 1987 and 1990, these states' revenues climbed 21 percent faster than revenues in all other states. But their reserves dropped to zero, while the rest of the states accumulated higher reserves despite less robust revenue growth.[20]

New York. Between 1981 and 1988, New York State enjoyed 80 percent revenue growth — 20 percent more than the rest of the states. Nonetheless, it now must raise $1 billion in new taxes to balance the budget. The reason: New York ranks third among government workers as a percent of population, third in per-case welfare costs, first in per capita Medicaid costs and second in per-pupil education expenditures — despite state officials' insistence that the budget has been cut to the bone.[21]

"Adjusted for population, New York ranks first in Medicaid spending, second in education spending, third in welfare spending and third in the number of state employees — now it needs another $1 billion."

California. Although revenues have grown by a healthy 8 percent per year in California, expenditures have climbed by 11 percent. The bipartisan tax hike was narrowly approved by voters on the basis of arguments that the state's 1978 expenditure limitation had starved the public sector. Since 1983 the state budget has expanded by 50 percent to $54 billion, and spending as a percent of income has risen from 7.5 to 8.5 percent of state income. The state offers the most generous welfare system in the nation and has seen per-pupil education expenditures (adjusted for inflation) rise by one-third in 15 years.[22]

WILL THE STATES HARM THEIR ECONOMIES BY RAISING TAXES?

Many states have won approval for tax increases with virtually no discussion of the consequences. Proponents of tax increases have even argued that increased spending on education or roads or the newest fad, economic development, will enhance their state's relative economic performance.

Yet an overwhelming body of research shows that a state's tax burden relative to that of its neighbors has a significant negative impact on its economic health. Growth in income, jobs and new business activity all respond negatively to higher state taxes. Progressive income taxes, according to these studies, have the largest negative effect.[23]

"Studies show that state taxes hurt economic growth, and slow the rise in personal income."

- A study by the Harris Bank in Chicago covering the period 1963 to 1980 found that *increases* in relative state tax burdens slow down the growth in personal income.[24]

- A 1988 study by Laffer Associates found that during the 1980-86 period taxes accounted for as much as one-third of the variation in interstate economic growth — with higher taxes causing lower growth.[25]

- A 1985 *National Tax Journal* study found that between 1973 and 1980 the ratio of state taxes to personal income had a "negative and statistically significant effect on overall employment growth and specifically employment growth in manufacturing, retail trade and services."[26]

- A Heartland Institute study shows that each 1.0 percent increase in "tax effort" (relative to other states) reduces the growth of personal income (relative to other states) by 0.6 percent.[27]

THE NEW TAXPAYER REVOLT[28]

Neighboring New Hampshire and Vermont are very similar — geographically and economically. Yet New Hampshire has the lowest taxes in the nation (12.3 percent of personal income), while taxes in Vermont are nearly 40 percent higher. Why the difference?

"New Hampshire and Vermont have similar state services — but very different tax burdens."

- The difference in tax burden is not explained by either the quantity or quality of public services — if anything, public services are better in New Hampshire.

- The difference is not explained by federal aid — Vermont receives more federal aid per capita.

Instead, the difference appears to stem from the states' tax structures.

- Vermont obtains substantial tax revenue from a general sales tax and a personal income tax.

- New Hampshire has no general sales tax and no income tax on wages and salaries, and it relies primarily on local property taxes.

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"New Hampshire is the lowest-taxing state, while Vermont is one of the highest."

In New Hampshire, taxes collected locally tend to stay local. In Vermont, taxes collected by state government tend to stay at the state level.

- In Vermont, state government spends about 60 percent of state and local expenditures.
- In New Hampshire, the share of total spending by state government is only 47 percent.

Vermont is also fond of hiring people. State and local employees number 439 per 10,000 population in Vermont, compared with only 392 in New Hampshire.

"In high-tax states, signs of a tax revolt are unmistakable."

THE TAX REVOLT OF THE 1990s

The last time state and local taxes reached the level they have today, citizens launched a historic nationwide campaign, starting with Proposition 13 in California in 1978, to roll back taxes and clean up government. In high-tax states throughout the nation, unmistakable signs of another taxpayer revolt are emerging. Lew Euler, President of the National Tax Limitation Committee, calls this movement the "Tax Revolt of the 1990s."

"The tax revolt of the 1990s is similar to the tax revolt a decade ago."

- In Arizona, Illinois, Massachusetts and New Jersey, citizens have launched popular initiatives to repeal recent state tax hikes pushed through by the governors.
- Oklahomans will vote in November on a referendum to repeal a recently enacted $200 million education tax hike.
- Coloradans will soon vote on a referendum to limit state and local tax and spending increases to the level of inflation and population growth.
- A Nebraska grass roots group has launched the "Two Percent Solution," which would limit state and local budgets to last year's level plus 2 percent and would take a vote of four-fifths of the state legislature to exceed.
- Congressional term limitation initiatives have been enacted in Oklahoma and will soon be voted on in California and Colorado.

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- Colorado, Michigan, Oregon and a handful of other states now have movements to push through local property tax reduction measures.

CONCLUSION

"New taxes would only exacerbate state budget crises."

The widespread *myth* is that states are raising taxes because of slow revenue growth due to the sputtering national economy and lost federal aid. The *fact* is that, with few exceptions, the states are raising taxes to finance a decade of extravagance.

The worst policy prescription for these fiscally-troubled states would appear to be new taxes. Such taxes would only fuel further spending and slow economic growth, exacerbating the budget crisis in these regions for years to come.

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NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

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Footnotes

[1]As measured in constant dollars. Fiscal Year 1983 was the largest tax increase year in history.

[2]National Conference of State Legislatures, "State Fiscal Pressure Worsening, New NCSL Study Finds," News Release, August 6, 1990.

[3]"Grandeur of Governorships," *City and State*, May 7, 1990.

[4]"Half of States Strive to Avert Perilous Deficits," *New York Times*, March 4, 1990.

[5]National Conference of State Legislatures, 1990.

[6]National Conference of State Legislatures, "State Budget and Tax Actions, 1990," Legislative Finance Paper #74, August 1990.

[7]National Association of State Budget Officers, "Fiscal Survey of the States," September 1990.

[8]U.S. Department of Commerce, Bureau of the Census, "Government Finances in 1987-88," 1989; and Tax Foundation Inc., "Facts and Figures on Government Finance," 1988-89 Ed.

[9]Ibid.

[10]National Association of State Budget Officers, "Fiscal Survey of the States," March 1990, p. 1.

[11]National Conference of State Legislatures, "State Budgets and Tax Actions," 1990.

[12]Author's calculation, based on: "U.S. Bureau of the Census, "Government Finances in 1980-81," GF #5, 1982; and "Government Finances in 1987-88," in GF #88-5, 1989.

[13]Ibid.

[14]"Northeast Scrambling to Pay the Bills," *Washington Post*, April 16, 1989, p. A-30.

[15]"After a Bad 1990, States Brace for '91," *City and State*, August 13, 1990.

[16]Office of Management and Budget, "Historical Tables of the U.S. Budget," February 1990, p. A-321.

[17]Stephen Moore, "States and Cities Pay a High Price for their Federal Aid," Heritage Foundation *Backgrounder*, 1986.

[18]See Stephen Moore, "Do We Need New Taxes?", NCPA Policy Backgrounder No. 105, National Center for Policy Analysis, August 1990.

[19]Michael L. Marlow and Neela Manage, "Expenditures and Receipts: Testing for Causality in State and Local Government Finances," *Public Choice*, 1987, pp. 243-55.

[20]Stephen Moore, "Taxes, Economic Growth, and Budget Deficits: What Washington Can Learn from the States," Heritage Foundation Backgrounder, 1989.

[21]"Why It Costs So Much to Run New York State," *New York Times*, August 14, 1990.

[22]See Tim Ferguson, "California Seen Wasting Away and Needing a Tax Gulp," *Wall Street Journal*, May 29, 1990, p. 15.

[23] A summary of these studies may be found in Joseph Bast and Diane Bast, *Coming Out of the Ice* (Chicago: Heartland Institute, 1989).

[24]Robert J. Genetski, "The Impact of State and Local Taxes on Economic Growth, 1963-1980," Harris Bank, Chicago, IL, 1982.

[25]Victor A. Canto, "The State Competitive Environment: 1987-88 Update," A.B. Laffer Associates, 1988.

[26]Michael Wasylenko and Therese McGuire, "Jobs and Taxes: The Effect of Business Climate on States' Employment Growth Rates," *National Tax Journal*, Vol. 38, 1985, pp. 497-511.

[27]Bast and Bast, *Coming Out of the Ice*. "Tax effort" is the amount collected in taxes relative to a state's capacity to collect taxes and is calculated based on 26 different sources of revenue.

[28]This section is based on Colin Campbell and Rosemary Campbell, *The Fiscal Systems of New Hampshire and Vermont, An Update, 1975-1987*, (Hampton, NH: The Henley League Ltd., 1989).

THE NATIONAL CENTER FOR POLICY ANALYSIS

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute, funded exclusively by private contributions. The NCPA originated the concept of the Medical IRA (which has bipartisan support in Congress) and merit pay for school districts (adopted in South Carolina and Texas). Many credit NCPA studies of the Medicare surtax as the main factor leading to the the 1989 repeal of the Medicare Catastrophic Coverage Act.

NCPA forecasts show that repeal of the Social Security earnings test would cause no loss of federal revenue, that a capital gains tax cut would increase federal revenue and that the federal government gets virtually all the money back from the current child care tax credit. These forecasts are an alternative to the forecasts of the Congressional Budget Office and the Joint Committee on Taxation and are frequently used by Republicans and Democrats in Congress. The NCPA also has produced a first-of-its-kind, pro-free-enterprise health care task force report, representing the views of 40 representatives of think tanks and research institutes.

The NCPA is the source of numerous discoveries that have been reported in the national news. According to NCPA reports:

- Blacks and other minorities are severely disadvantaged under Social Security, Medicare and other age-based entitlement programs;
- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and
- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in our environment.

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