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AMERICAN LEGISLATIVE EXCHANGE COUNCIL

The State Factor

Jeffersonian Principles in Action!

States Can't Tax Their Way Back To Prosperity: Lessons Learned from the 1990-91 Recession

By Steve Moore

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Introduction

Following eight years of robust state budget surpluses, the economic recession in 2001 caused a dramatic fiscal turnaround in state capitals across the nation. From Boston to Sacramento, the state financial condition is worse than it's been in a decade. Lawmakers in nearly half of the states have responded by raising taxes. The most commonly used revenue vehicles are tobacco taxes and a host of fees and user charges. With the notable exceptions of Kansas, Nebraska and Tennessee, most states avoided raising their sales, income or property taxes, undoubtedly due to reluctance to raise broad-based taxes during an election year.

Few states bit the bullet and cut bloated state budgets—which nearly doubled in size during the prosperous 1990s. Many states simply pushed their fiscal problems into 2003 by drawing down rainy day reserve funds, tobacco settlement funds, or using gimmicky accounting tricks. In fact, many of the accountants at Enron or Worldcom would feel right at home in some state capitals.

If the national economy and the stock market do not dramatically improve, many states are on a collision course with record budget deficits in 2003. Four of the nation's largest states —California, Florida, Illinois and Michigan— could face severe fiscal distress in 2003. California is facing a 2003 budget deficit of $10 billion and a two-year deficit projection of nearly $34 billion—the largest deficit in the history of state government. Consequently, due to the short-term fixes employed by many states, and the slow economic recovery, fiscal year 2003 is expected to see major initiatives to raise tax rates.in many states.

This study examines what happened during the last recession when states faced similar fiscal outlooks. The 1990s are an ideal experiment in how different fiscal strategies impact subsequent economic performance and budget health in the states. In the early 1990s, roughly a dozen governors signed major income tax hikes into law in an attempt to close budget gaps. This study reveals that these tax-raising states had among the worst subsequent rates of economic and income growth. Furthermore, states that raised taxes in the early 1990s recovered more slowly from the recession, and their budget problems persisted longer than states that did not raise taxes.

Starting in 1993 with the election of Christine Todd Whitman in New Jersey, and then carrying over into 1994 when more than a dozen additional tax-cutting governors were elected to office, many states reversed fiscal strategy and cut tax rates. This study presents several case studies in how governors and state legislators were successful in generating strong income growth, new business investment, and faster job growth by adopting incentive-based income tax rate reductions.

In sum, the fiscal lessons of the 1990s confirm nearly two decades of academic research: State tax policies can have a profound impact on the relative economic performance of the states. States with low and falling tax burdens—especially falling income tax burdens—outperform states with high and rising tax burdens. Most importantly, however,

1129 20th Street, NW, Suite 500 • Washington, DC 20036 • phone: 20: