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THE STATE FISCAL CRISIS WAS NOT CAUSED BY OVERSPENDING

By Liz McNichol

A report released in February by the Cato Institute, *States Face Fiscal Crunch after 1990s Spending Splurge,* asserts that the current state fiscal crisis is the result of overspending by the states. This report concludes that overspending is the source of the state fiscal crisis; that federal assistance to the states would be counterproductive because it would encourage states to continue overspending; and that states could prevent future budget crises by imposing tax and spending limits that restrict future growth in state spending.

Cato's report bases these conclusions on a selective and flawed analysis of data on state spending and revenues. The sections below address some of the key findings of this report and demonstrate the flaws in Cato's analysis and conclusions.

Have States Overspent?

Cato report: "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 to fuel an unsustainable expansion in spending. … If states had limited spending growth to that benchmark [inflation plus population], budgets would have been $93 billion smaller by FY01."

Facts: The state fiscal crisis is not the result of irresponsible spending decisions by the states during the 1990s. In fact, the response of the states to the economic growth of the 1990s was balanced. During the economic boom years of the 1990s, states built their reserves and cut taxes. State spending did increase but the increases were modest.

- State spending grew faster than population and inflation because of disproportionate growth in specific populations such as school age children that need to be educated and senior citizens who have costly health needs, and because the public demanded increased investment in areas such as education, health care and law enforcement.

- After factoring out inflation, nine out of ten dollars of new state spending in the 1990s went to schools, health care and public safety.

Despite the booming economic growth of the period, the pace of state spending growth during the 1990s was low by historical standards.

Colorado is Not a Model of Fiscal Health

Cato's report recommends that states adopt a strict "tax and expenditure limit" as a way to restrain spending and avoid future fiscal crises. The specific model that Cato recommends is Colorado's "TABOR" amendment, a package of constitutional provisions that severely limits the state's ability to raise and spend revenue. Cato is correct that TABOR is perhaps the nation's most restrictive tax and expenditure limit. Colorado's limit, however, has most certainly not made the state a model of fiscal health. In the 1990s, the Colorado limit forced the state to enact large and (as it turned out) unaffordable tax cuts. As a result, TABOR has worsened the state's fiscal crisis, contributed to damaging spending cuts, forced the state to borrow against its own fiscal future, and lowered the state's bond ratings.

- Colorado's fiscal situation is worse than those of many other states. For 2003, the state is struggling to close a $1 billion deficit, equal to about 20 percent of total spending — among the largest deficits in the nation. The outlook for 2004 is no better.

- The state's fiscal plight has led bond rating agencies to downgrade the state's bond rating and credit outlook in recent months; analysts specifically blamed TABOR for making the fiscal crisis worse. The bond-rating agencies are not the first outside observers to recognize the havoc TABOR is playing with Colorado's finances. In a pair of studies in 1999 and 2001, *Governing* magazine ranked Colorado's finances as among the worst-managed in the country, again due to TABOR.

- Real per capita state spending grew an average of 2.0 percent per year in the 1990s, which is well below the average annual growth of 2.9 percent over the last five decades.

- State general fund spending is a lower percentage of total personal income than it was a decade ago and state government employment has declined as a share of total employment.

If state budgets were slashed by $93 billion, $1 out of every $5 of state spending would have to be cut. That could not be accomplished in most states without raising class sizes; reducing coverage for low-income families the elderly and disabled under state health plans; or significantly reducing the number of people who are incarcerated.

Moreover, limiting spending changes to the growth in inflation plus population is no guarantee of fiscal health.

- According to the Cato study, Arizona's real per capita spending growth was low compared to other states — Arizona ranked 41st of the 50 states — yet Arizona faces as large a budget gap for fiscal year 2004 as other states.

- Cato's analysis shows a decline in real per capita spending between 1990 and 2001 for New York, yet New York faces one of the nation's largest deficits both in dollar terms and as a percent of budget.

Is the Fiscal Crisis Real?

Cato report: "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."

Facts: Statements such as the above from Cato — that states are merely reducing the rate of growth of spending not actually cutting spending — have been interpreted by some observers as meaning that states do not face a real crisis. Data from the National Association of State Budget Officers, however, show that state spending is indeed being cut.

- From fiscal year 2001 to fiscal year 2002 spending declined 1.0 percent after adjusting for population and inflation and is projected to decline 2.3 percent in FY03.

- Some three out of four states cut spending, adjusted for population and inflation, between FY01 and FY03.

Moreover, the projected cut for fiscal year 2003 reported by NASBO is based on state budgets enacted last spring. Large additional budget gaps have opened up since then, and governors have begun making mid-year cuts that will reduce spending below the appropriated levels. Thus it is likely that the decline in real general fund spending will be greater when the books are closed on 2003, and greater still in fiscal year 2004. These cuts come even as states face rising costs due to homeland security, increasing health care costs and recession-driven needs.

The claim that states are *not* cutting spending is based on the fact that the total funds appropriated by all states unadjusted for inflation and population growth continue to rise from year to year.

- Comparing nominal spending totals does not accurately measure states' ability to continue providing their current level of services. That ability is steadily eroded both by inflation (which increases the number of dollars needed to provide a given service to a given individual) and by population growth. Population growth — especially growth in specific expensive-to-serve populations such as school-age children and the elderly — increases the number of individuals who must be served.

- In addition, many state programs are designed to be counter-cyclical: their costs rise during economic downturns as they assist families that have lost jobs or income.

- States also may be required to take on new costs as the result of federal policies and mandates, which further increases the cost of maintaining current services.

So the appropriate test is not whether states are increasing nominal spending but rather whether they are maintaining or cutting existing programs and services. Cutting is what is now happening across states. Moreover, in a number of individual states — most notably California — the budget gap is so large that the state is cutting spending in nominal terms as well as real terms.

Will Raising Taxes Hurt the Economy?

Cato report: "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."

Facts: The effect of taxes on economic growth is an area where misperceptions and misinformation abound. It is important to remember that taxes exist to fund government services such as education, transportation, and law enforcement, and these services have a large impact on economic performance. Economic research into the long-term tradeoff between taxes and public expenditures suggests that public expenditures can contribute as much, if not more, to economic growth as low taxes.

The Cato report purports to demonstrate the impact of taxes on economic performance by comparing the growth in personal income in states with higher average state and local taxes as a percent of personal income to states in which that measure is lower. The results of analyses of this type are highly dependent on the measures and years chosen and cannot control for other features of these states that affect economic growth, such as the availability of a well-educated workforce and proximity to markets.

There is a large body of literature that has carefully studied the impact of taxes on economic growth using a variety of measures with controls for characteristics of states other than tax levels.

- These well-designed studies of the effect of taxes on economic growth find that the impact of taxes on economic growth is very small and exists only if you hold everything else — including the level of government services — equal.

- In addition, business executives, in hundreds of surveys, have placed taxes lower on the list of important location factors than such factors as labor availability, costs and training; access to markets; access to raw materials; transportation costs; public services; and quality of life.

Careful studies of the relationships between taxes, spending, and job growth show that undermining a state's educational system, its infrastructure, or other services vital to businesses and workers over the long run can do more damage than maintaining or increasing taxes.[1]

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[1] See for example, Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review*, March-April 1997, reprinted in *State Tax Notes,* June 23, 1997, pp. 1883-95; Robert G. Lynch, *Do State and Local Tax Incentives Work?*, Economic Policy Institute, Washington, D.C.,

In addition, the Cato study ignores the short-term impact that state budget-cutting could have on the economy's ability to recover from the current downturn. In order to balance their budgets in the current fiscal crisis, with most of their reserves depleted, states face a choice: They can cut services or they can protect public services by raising taxes. The choices states make could have significant implications for whether the nation's economy emerges from the recent recession or whether the recession is extended. Although the economic perils of tax increases are often touted by their opponents, spending cuts could actually be more damaging to the nation's economy than tax increases.

As Nobel Prize-winning economist Joseph Stiglitz and Peter Orszag of the Brookings Institution have pointed out, a $1 reduction in state public-sector spending typically results in a $1 reduction in a state's economic activity. A $1 increase in taxes, by contrast, is likely to result in a smaller reduction in a state's economic activity, because to some extent the tax increase would be financed out of reduced savings, or from reduced out-of-state consumption. This is particularly true of tax increases on higher-income individuals, because such individuals are most likely to have access to savings.

> *Stiglitz and Orszag conclude:* If anything, tax increases on higher-income families are the *least* damaging mechanism for closing state fiscal deficits in the short run. Reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, are likely to be more damaging to the economy in the short run than tax increases focused on higher-income families. In any case, in terms of how counter-productive they are, there is no automatic preference for spending reductions rather than tax increases.

1996; Timothy Bartik, *Who Benefits From State and Local Economic Development Policies?*, W.E. Upjohn Institute for Employment Research, Kalamazoo, Michigan, 1991.