Center on Budget and Policy Priorities

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

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TAX CUTS AND CONSEQUENCES: The States That Cut Taxes the Most During the 1990s Have Suffered Lately

By Robert Zahradnik

Summary

Between the mid-1990s and 2001, states enacted a wave of tax cuts. Some 44 states enacted tax cuts that ultimately reduced state revenue by an average of 7.6 percent. Sixteen states reduced revenue by more than seven percent, and six states reduced revenue by more than 10 percent.

Those big tax cuts do *not* seem to have contributed to state fiscal and economic health. In fact, when the economy began to weaken in 2001 and states fell into a fiscal crisis, those big tax-cutting states generally faced larger fiscal problems, and had worse economic performance, than other states that had been more cautious about tax cuts.

Specifically, the states that cut taxes most during the 1990s:

- **Had larger budget shortfalls.** In the 16 states that cut taxes by at least seven percent during the economic expansion, fiscal year 2004 budget deficits averaged 14.9 percent of spending. This compares to budget deficits of "only" 8.9 percent of spending for the other 34 states.

- **Cut spending more deeply.** Spending reductions made to balance budgets were deeper in the tax cutting states than in the other states. The top 16 tax-cutting states cut real per capita spending by 2.5 percent between 2002 and 2004, compared to a 1.1 percent reduction for the other states.

- **Raised taxes more sharply.** The top 16 tax-cutting states raised taxes in 2002 and 2003 by 3.4 percent of revenue, compared to tax increases of 2.7 percent of revenue for the other 34 states.

- **Were more likely to have their credit rating downgraded.** The 16 top tax-cutting states received more than half of the 15 general obligation bond downgrades from the three major rating agencies in 2001, 2002 and 2003.

The tax cuts apparently did not help states' economic performance during the downturn, either. The states that cut taxes most during the 1990s:

- **Lost more jobs.** The 16 states that cut taxes the most between 1994 and 2001 had larger declines in total payroll employment from 2001 to 2003 than states with smaller or no tax cuts. On average, the states with large tax cuts lost 1.5 percent of their jobs, compared with job loss of 0.5 percent in states with smaller or no tax cuts.

  Only two of the 16 states that cut taxes at least seven percent during the economic expansion created jobs between 2001 and 2003. By contrast, of the other 34 states with smaller or no tax cuts ten created jobs during that period.

- **Had slower income growth.** The 16 states that enacted the deepest tax cuts also experienced less personal income growth (4.4 percent versus 5.8 percent) and a larger increase in unemployment (1.4 percentage points versus 1.0 percentage points) between 2001 and 2003 compared to the other 34 states.

The disparity in economic performance between the big tax-cutting states and other states is even more striking in the six states that cut taxes by more than 10 percent during the economic expansion. The top six tax-cutting states experienced payroll job losses of 2.3 percent, compared to job losses of 0.6 percent in the other 44 states. And total personal income in five of those six states has declined after adjustment for inflation, even as it has risen in most other states.

State policymakers propounded two major reasons for cutting taxes. First, they said the tax cuts were affordable. Second, they said the tax cuts would improve the economic performance of the state — despite a body of literature showing that taxes have modest impacts, if any, on business activity and economic growth (see the box on page 3). The findings of this report suggest that both justifications were questionable at best.

The tax cuts of the 1990s had seemed affordable, it is now clear, because of the unusual, overheated economy. Capital gains income, stock options and other forms of executive compensation grew to inflated — and unsustainable — levels. Consumption peaked because paper stock market gains led people to feel wealthy and because consumer debt soared. Most states based tax cuts on the assumption that the revenue from the bloated income and consumption levels would continue into the future. It did not; the level of revenues experienced in the late 1990s was a "bubble." When the stock market declined and the economy went into recession, state revenue also declined sharply. The states that cut taxes deeply found they had overshot the mark of affordability by a significant margin.

On the issue of tax cuts and economic growth, it is impossible to know what the economic performance of tax-cutting and non-tax-cutting states would have been had policy-makers made different decisions. However, comparing the economic and fiscal performances of those two groups of states during the economic slowdown suggests that proponents of tax cuts did not get the desired results, certainly not in a sustained way.

Substantial Body of Academic Literature Questions Role of State Taxes in Economic Development

A large body of academic literature has found that state and local taxes have, at best, a modest impact on economic development. In a recent study, economist Robert G. Lynch analyzes the existing research on the impact of state and local taxes on economic development.[a] Lynch's study confirms that the costs of taxes are much less important to businesses than other location specific costs such as qualified workers, proximity to customers and quality public services. Some other key findings of the study include:

- There is little evidence that state and local tax cuts — when paid for by reducing public services — stimulate economic activity or create jobs. There is evidence, however, that increases in taxes, when used to expand the quantity and quality of public services, can promote economic development and employment growth.

- A review of the hundreds of survey, econometric, and representative firm studies that have evaluated the effects of state and local tax cuts and incentives makes clear that these strategies are unlikely to stimulate economic activity and create jobs in a *cost-effective* manner

- Even with optimistic assumptions, for each private-sector job created by state and local tax cuts, governments may lose between $39,000 and $78,000 or more in tax revenue annually. This substantial revenue loss can force governments to lay off public employees in numbers that probably exceed the number of jobs created in the private sector.

[a] Robert Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development*, Economic Policy Institute, 2002.

Moreover, to the extent that the tax-cutting states might have experienced a small economic boost in good times, the deeper economic distress in terms of lower employment and income growth during the downturn is likely to have wiped out those gains. For example, Massachusetts cut taxes by over 10 percent of revenue between 1996 and 1998. At the end of the 1990s the economy of Massachusetts, similar to the rest of the nation, performed well. In fact, Massachusetts saw job growth of about 145,000 jobs between 1998 and 2000. However, between 2001 and 2003 Massachusetts lost 143,000 jobs, virtually wiping out the job gains of the late 1990s.

Unlike the federal government, which can run large operating deficits when necessary, states have few palatable options for adapting when their fiscal and economic circumstances turn down. These results suggest a need for more prudent state fiscal policies. When contemplating tax reductions, states should consider carefully multi-year revenue projections and potential down-side risks of revenue shortfalls. In addition, states should assure that their rainy day funds are adequate before embarking on programs of significant tax cuts.

The Tax Cuts of 1994-2001

As the economy emerged from the recession of the early 1990s and entered the remarkable boom period of the middle and late 1990s, many states enacted quite dramatic tax cuts. Beginning in 1994 and continuing all the way into 2001, states in aggregate enacted net tax cuts that by the end of the period were costing them roughly $33 billion, or about 7.6 percent of their revenue. Although some 44 states enacted tax cuts, the bulk of the tax cuts occurred in 16 states in which tax cuts exceeded 7 percent of tax revenue. The deepest tax cuts occurred in the six states — Colorado, Connecticut, Delaware, Massachusetts, New Jersey, and New York — that reduced state taxes by more than 10 percent of revenue. These tax cuts are described in more detail in other Center on Budget and Policy Priorities papers.[1]

The tax cuts were premised on the unusual level of revenues states were collecting in the boom years of the economy, and on the assumption that those revenue levels would continue into the future. For example, nationally capital gains realizations rose from $180 billion in 1995 to $644 billion in 2000, plunging to $256 billion in 2002. Realizations remain at about half their peak level.[2] This decline, coupled with rising joblessness, declining wage and salary income, and flagging consumption growth combined to cause state deficits. State revenues declined for eight consecutive quarters, adjusting for inflation and legislated tax increases.[3]

Tax-cutting States In the Fiscal Crisis

This report considers of all of the tax cuts enacted between 1994 and 2001. It finds that the states that enacted the biggest tax cuts in the 1990s suffered *worse* economic and fiscal outcomes during the 2001-2003 economic recession and fiscal crisis period than states with more modest tax cuts or none at all.[4]

Economic Performance

Table 1 compares the economic performance of the 16 states that cut taxes substantially between 1994 and 2001 — those that cut taxes by 7 percent of revenue or more — to the 34 states that enacted smaller tax cuts or none at all. It also compares the economic performance of the six states that cut taxes by 10 percent of revenue or more between 1994 and 2001 to the 44 states that enacted smaller tax cuts or none at all. The 16 tax cutting states represent about 85

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[1] See, for instance, *The State Tax Cuts of the 1990s, the Current Revenue Crisis and Implications for State Services*, November 2002, at http://www.cbpp.org/11-14-02sfp.htm.

[2] Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2005 to 2014, January 2004.

[3] Nicholas W. Jenny, "State Tax Revenue Grows Slightly," *State Revenue Report No. 54*, The Nelson A. Rockefeller Institute of Government, December 2003.

[4] Some argue that the tax increases that were enacted during the fiscal crisis exacerbated job losses. The timing of the tax increases relative to the job losses, however, suggests this cannot be true. The job losses that occurred at the beginning of the economic downturn were not influenced by the tax increases that have resulted from the downturn, because the job losses mostly predated the tax increases. Nationally, from the start of the recession in March 2001 until the job losses bottomed out in August 2003 the nation lost 2.7 million jobs. Two-thirds of the job loss, 1.8 million jobs, occurred between March 2001 and December 2001. Only Alabama and North Carolina enacted significant tax increases during 2001. The vast majority of job losses occurred before most states started raising taxes.

TABLE 1

Indicator	Sixteen States with Tax Cuts Greater than 7% of Revenue in the 1990s	Other 34 states
Jobs lost: Percent change in average annual payroll employment, 2001 to 2003.	-1.5%	-0.5%
Unemployment: Change in annual unemployment rate, 2001 to 2003.	1.4	1.0
Personal Income: Change in total state personal income, 2001 to 2003.	4.4%	5.8%
	Six States with Tax Cuts Greater Than 10% of Revenue in the 1990s	**Other 44 states**
Jobs lost: Percent change in average annual payroll employment, 2001 to 2003.	-2.3%	-0.6%
Unemployment: Change in annual unemployment rate, 2001 to 2003.	1.8	1.0
Personal Income: Change in total state personal income, 2001 to 2003.	2.8%	5.7%
Sources: Center on Budget and Policy Priorities calculations of data from Bureau of Labor Statistics and Bureau of Economic Analysis.		

percent of the net tax cuts for the 1994 to 2001 period; the top six tax cutting states represent almost half of the net tax cuts. (For detailed data on the 16 states, see Appendix Tables A & B).

- The 16 states with the largest tax cuts in the 1990s saw payroll employment decline by 1.5 percent between 2001 and 2003, compared to a 0.5 percent decline for the other 34 states.

- Only two of the 16 tax-cutting states of the 1990s created jobs between 2001 and 2003. By contrast, 10 of the other 34 states with smaller or no tax cuts created jobs.

- The 16 tax-cutting states have also had a larger increase in unemployment (1.4 percentage points versus 1.0 percentage points) and less personal income growth (4.4 percent versus 5.8 percent) compared to the other 34 states.

Focusing on the six states with the very largest tax cuts in the 1990s, with tax cuts exceeding 10 percent of annual revenue, the disparities are even greater.

- The top six tax-cutting states experienced payroll job losses of 2.3 percent, compared to 0.6 percent job losses for the other 44 states.

- The unemployment rate among the top six tax-cutting states has grown by 1.8 percentage points between 2001 and 2003, compared to 1.0 percentage points for the other 44 states.

- In five of the six largest tax-cutting states, personal income has grown slower than the rate of inflation between 2001 and 2003.

Fiscal Performance

By cutting taxes in the 1990s, the large tax-cutting states reduced the ability of their revenue system to generate sufficient revenue during the economic downturn. In some cases, they also were unable to save as much as they needed in reserve funds. As a result, states that cut taxes the most during the 1990s had lower reserve levels at the start of the fiscal crisis, faced larger deficits during the fiscal crisis and had to raise taxes and cut spending more to close deficits. Table 2 compares the fiscal performance of the 16 states that enacted tax cuts in the 1990s exceeding seven percent of annual state tax revenue to the 34 states that enacted smaller tax cuts or none at all. It also compares the fiscal performance of the six states that enacted tax cuts exceeding 10 percent of revenue to the other 44 states. The data show that:

- Budget deficits in the top 16 tax-cutting states in fiscal year 2004 averaged 14.9 percent of spending, compared to "only" 8.9 percent of spending for the other 34 states.

  California is one of the top 16 tax-cutting states and its deficit was dramatically larger than any other state at 36.7 percent of spending. However, even when California is removed from the analysis, the remaining 15 large tax-cutting states had average deficits of 13.4 percent compared to 8.9 percent for the other 34 states. Four out of the six largest tax-cutting states had larger deficits than the national average state deficit.

- The top 16 tax-cutting states had reserve levels of 9.5 percent of expenditures at the start of the fiscal crisis, compared to balances of 11.5 percent of expenditures for the other 34 states.

- Because the states that cut taxes had smaller reserves and larger deficits, they were forced to cut spending and raise taxes more than the states that cut taxes less. The top 16 tax-cutting states cut real per capita spending by 2.5 percent between 2002 and 2004, compared to a 1.1 percent reduction for the other states. The top 16 tax-cutting states raised taxes in 2002 and 2003 by 3.4 percent of revenue compared to 2.7 percent for the other 34 states.

- The bond rating agencies have recognized the fiscal risks of large tax cuts. The 16 top tax-cutting states received more than half of the 15 general obligation bond downgrades from the three major rating agencies in 2001, 2002 and 2003.

TABLE 2

Indicator	Sixteen States with Tax Cuts Greater than 7% of Revenue in the 1990s	Other 34 states
Budget Deficits: Highest projected FY 2004 budget deficit as a percent of spending.	14.9%	8.9%
Reserves: Total ending balance as a percent of expenditures, FY 2001.	9.5%	11.5%
Spending Cuts: Average annual real per capita change in state spending 2002 to 2004.	-2.5%	-1.1%
Tax Changes: Net tax changes as a percent of collections, 2001 to 2003.	3.4%	2.7%
Bond Downgrade: Downgraded by at least one rating agency in 2001, 2002 or 2003	8 Downgrades	7 Downgrades
	Six States with Tax Cuts Greater Than 10% of Revenue in the 1990s	**Other 44 states**
Budget Deficits: Highest projected FY 2004 budget deficit as a percent of spending.	14.3%	10.5%
Reserves: Total ending balance as a percent of expenditures, FY 2001.	9.3%	11.1%
Spending Cuts: Average annual real per capita change in state spending 2002 to 2004.	-1.8%	-1.5%
Tax Changes: Net tax changes as a percent of collections, 2001 to 2003.	6.3%	2.4%
Bond Downgrade: Downgraded by at least one rating agency in 2001, 2002 or 2003	4 Downgrades	11 Downgrades

Sources: Center on Budget and Policy Priorities calculations of data from National Conference of State Legislatures, National Association of State Budget Officers, Moody's, Fitch, Standard and Poor's.

The results for the six states with the very largest tax cuts in the 1990s, exceeding 10 percent of annual revenue, tell a similar story. The top six tax-cutting states had larger deficits, smaller reserves at the start of the crisis and larger tax increases and spending cuts than the other 44 states. Four of the six top tax-cutting states (67 percent of the states in the category) received bond downgrades, compared to 11 bond downgrades among the other 44 states (25 percent of states). Each of large tax-cutting states has experienced varying degrees of fiscal and economic hardship over the last few years.

- **Colorado** made large personal income tax cuts during the 1990s, and also cut the state sales tax rate and provided substantial tax rebates. During the fiscal crisis, Colorado cut spending by more than three times the national average and saw its bond rating downgraded in 2002. Although Colorado's economy did well in the 1990s, between 2001 and 2003 Colorado saw the largest unemployment rate increase in the nation.

- **Connecticut** cut personal and corporate income taxes during the 1990s. Between 2001 and 2003 Connecticut's growth in unemployment was second only to Colorado's. Connecticut faced a budget deficit in excess of 15 percent of its budget in 2004 and received a bond downgrade in 2003.

- **Delaware** also cut its personal income tax significantly during the 1990s, a time in which the state's economy performed slightly better than average. During the economic downturn, Delaware's job losses exceeded the U.S. average.

- **Massachusetts**, which cut its personal income tax rate during 1990s, had a budget deficit equal to 13 percent of spending during the fiscal crisis; it enacted spending cuts and tax increases that were more than double the US average. Massachusetts lost over 140,000 jobs between 2001 and 2003, a 4.3 percent decline — the largest proportional decline in the nation. Between state fiscal year 2001 and 2003, personal income in Massachusetts grew at a rate that was less than one-third the rate of growth of inflation.

- **New Jersey** cut personal income tax rates and other taxes during the 1990s. New Jersey's budget situation during the fiscal crisis was one of the worst in the nation, with a 2004 deficit equal to nearly 20 percent of the budget. In 2002, New Jersey's bond rating was downgraded. Between 2001 and 2003, New Jersey experienced above average growth in unemployment and below average growth in personal income.

- **New York** was the largest tax-cutting state in the 1990s, with tax cuts exceeding 20 percent of revenues. New York faced deficits in excess of 20 percent of the budget during the fiscal crisis, had above average spending cuts and tax increases, and received a bond rating downgrade. New York's personal income growth from 2001 to 2003 was less than one-third of the national average.

Conclusion

This analysis serves as a caution to state policymakers who may be tempted to begin another round of tax cuts as state revenue performance improves over the next few years. States would do well to assess carefully their long-term revenue projections and the assumptions behind those projections. Claims that tax cuts might boost jobs and wages in a state should be scrutinized with a great deal of skepticism. In addition, states should strongly consider filling their depleted rainy day funds before embarking on new rounds of tax cuts.

Appendix: Table A
Economic Performance of Large Tax-Cutting States During the State Fiscal Crisis

State	Jobs Lost	Unemployment	Personal Income
States with Tax Cuts of 10% to 25% of Revenue, 1994 to 2001			
Colorado	-3.4%	2.3	2.8%
Connecticut	-2.3%	2.2	2.0%
Delaware	-1.4%	1.0	6.6%
Massachusetts	-4.3%	2.1	1.2%
New Jersey	-0.4%	1.7	3.0%
New York	-2.2%	1.4	1.5%
States with Tax Cuts of 7% to 10% of Revenue, 1994 to 2001			
Arizona	1.1%	0.9	7.5%
California	-1.3%	1.3	2.7%
Georgia	-2.1%	0.7	5.4%
Iowa	-1.7%	1.2	4.3%
Maine	-0.3%	1.2	7.7%
Maryland	0.6%	0.5	7.5%
Michigan	-3.2%	2.0	4.1%
Minnesota	-1.1%	1.3	4.7%
Pennsylvania	-1.4%	0.9	3.9%
Washington	-1.4%	1.1	4.8%
Top 16 Tax Cutters	-1.5%	1.4	4.4%
Other 34 States	-0.5%	1.0	5.8%
Top 6 Tax Cutters	-2.3%	1.8	2.8%
Other 44 States	-0.6%	1.0	5.7%
US Total\Average	-0.8%	1.1	5.3%
Rate of Inflation (2001 to 2003)			3.9%

Tax Cuts: Net tax change as a percent of previous year's revenue, 1994-2001
Jobs Lost: Percent change in average annual payroll employment, 2001 to 2003.
Unemployment: Change in annual unemployment rate, 2001 to 2003.
Personal Income: Change in total state personal income, 2001 to 2003.

Note: US averages are unweighted averages because each state is considered an equal unit of analysis. Using a weighted average would bias the analysis in favor of large states.

Sources: Center on Budget and Policy Priorities calculations of data from National Conference of State Legislatures, National Association of State Budget Officers, Moody's, Fitch, Standard and Poor's.

Appendix: Table B
Fiscal Performance of Large Tax-Cutting States During the State Fiscal Crisis

	Fiscal Indicators				
State	Budget Deficits	Reserves	Spending Cuts	Tax Increases	Bond Downgrades
States with Tax Cuts of 10% to 25% of Revenue, 1994 to 2001					
Colorado	7.1%	7.0%	-4.7%	0.0%	Downgrade
Connecticut	15.6%	5.2%	0.6%	9.3%	Downgrade
Delaware	8.0%	21.0%	-0.7%	6.6%	
Massachusetts	13.1%	13.6%	-3.2%	8.5%	
New Jersey	19.2%	6.2%	0.5%	7.5%	Downgrade
New York	22.8%	2.8%	-3.1%	5.8%	Downgrade
States with Tax Cuts of 7% to 10% of Revenue, 1994 to 2001					
Arizona	23.6%	6.1%	-4.8%	1.8%	
California	36.7%	3.9%	-6.9%	1.8%	Downgrade
Georgia	4.5%	16.9%	-0.3%	0.8%	
Iowa	9.2%	8.3%	-2.5%	-0.1%	
Maine	19.0%	6.9%	-2.9%	0.8%	
Maryland	8.3%	13.9%	-5.0%	1.3%	
Michigan	14.1%	10.5%	-6.2%	0.1%	Downgrade
Minnesota	17.0%	12.4%	1.9%	0.0%	Downgrade
Pennsylvania	11.4%	6.9%	-0.9%	7.9%	
Washington	8.4%	9.8%	-2.4%	1.8%	Downgrade
Top 16 Tax Cutters	14.9%	9.5%	-2.5%	3.4%	8 Downgrades
Other 34 States	8.9%	11.5%	-1.1%	2.7%	7 Downgrades
Top 6 Tax Cutters	14.3%	9.3%	-1.8%	6.3%	4 Downgrades
Other 44 States	10.5%	11.1%	-1.5%	2.4%	11 Downgrades
US Total\Average*	10.9%	10.9%	-1.5%	2.9%	15 Total

Tax Cuts: Net tax change as a percent of previous year's revenue, 1994-2001
Budget Deficits: Highest projected FY 2004 budget deficit as a percent of spending.
Spending Cuts: Average annual real per capita change 02-04.
Tax Changes: Net tax changes as a percent of collections, 2002 to 2003.
Bond Downgrade: Downgraded by at least one rating agency in 2001, 2002 or 2003
Reserves: Total ending balance as a percent of expenditures, FY 2001.

*US average budget deficit is the average deficit among the 47 states that reported deficits, all but Alabama, Nevada and Tennessee.

Note: US averages are unweighted averages because each state is considered an equal unit of analysis. Using a weighted average would bias the analysis in favor of large states.

Sources: Center on Budget and Policy Priorities calculations of data from National Conference of State Legislatures, National Association of State Budget Officers, Moody's, Fitch, Standard and Poor's.