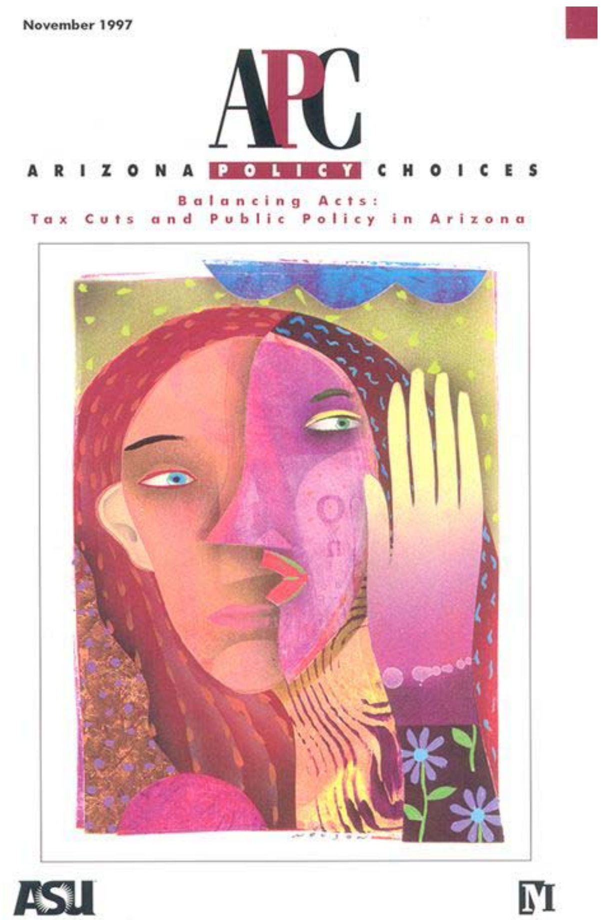
Balancing Acts:
Tax Cuts and Public Policy in Arizona
November 1997



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ARIZONA POLICY CHOICES

Balancing Acts: Tax Cuts and Public Policy in Arizona

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TABLE OF CONTENTS

Policy Choice: Consider the Consequences

For Further Reading

About *Arizona Policy Choices*

This volume is the first publication in the *Arizona Policy Choices* series. The purpose of the series is to provide objective, nonpartisan information and analyses on a public policy issue that is especially critical in Arizona at the time of publication. True to its name, *Arizona Policy Choices* will provide the readers with facts and perspectives on the choices which Arizona policy makers can make on an issue. And, perhaps most importantly, the series and the outreach events that will be coordinated with the release of each volume will present the potential consequences—both good and bad—of each choice.

Public policy-making has become a very complicated process. Politicians and other public officials have no shortage of inputs and scrutiny of the choices they make on behalf of their constituents. Nevertheless, some policy choices are based on relatively little information or on information that is not widely available. By producing a comprehensive document on a timely public policy issue—one that contains the views of scholars, journalists, and public policy practitioners—Arizona's leaders will have a vital resource for their decision making.

Morrison Institute for Public Policy, as the publisher of *Arizona Policy Choices,* plays the role of "convener" among the authors of articles contained in each volume of the series. We appreciate our authors' work on this initial publication. Each one has made an important contribution to this critical public issue. In addition, we wish to thank the members of the Institute's Board of Advisors for their assistance with the development of *Arizona Policy Choices.*

It is our hope that this work—and the thought, discussion, and understanding it stimulates—makes a significant contribution to public policy-making in Arizona.

Rob Melnick, Ph.D.
Director, Morrison Institute for Public Policy
School of Public Affairs, Arizona State University, November 1997

Why Study Tax Cuts in Arizona Now?

Rob Melnick, Director
Morrison Institute for Public Policy

This edition of *Arizona Policy Choices* is devoted to tax policy. More specifically, it focuses on the issue of tax cuts in Arizona. Government revenue, particularly in the form of taxes, enables public officials to provide government programs and services. Thus, the effect that taxes—sustained or cut—have on other policy issues is profound. And clearly, taxes (or the relative lack thereof) are at the very core of important philosophical debates over the role that government should play in people's lives. Thus, this topic seemed most fitting as the point of departure for *Arizona Policy Choices.*

Even so, some readers may still wonder why this topic was chosen for study at this time. They may point to the fact that recent elections around the country (on "first Tuesday" 1997) made clear the electorate's desire to lower or eliminate state and local taxes, and to favor candidates who promised to do so. Indeed, the best time to consider all aspects of an issue is when it is currently in vogue. Unfortunately, it is all too easy for politicians and other policy leaders to "go with the flow" by making *popular* decisions rather than *informed* decisions.

The role of a public policy research institute should be, among other things, that of "contrarian." It should always challenge conventional wisdom, bypass partisanship, and present a balanced view of the options available to policymakers. Thus, this volume on state tax cuts in Arizona is **a comprehensive look at tax policy and tax cuts in Arizona.** It provides both quantitative and qualitative analyses, offers time-honored philosophies, and presents passionate cases for the various choices inherent in making state fiscal policy. In this way, it emphasizes the notion of policy guiding politics, not the other way around.

Balancing Act: Tax Cuts and Public Policy in Arizona is a compendium. It includes original articles by Arizona policy practitioners and observers, reprints of pertinent articles by experts beyond Arizona, and a list for further reading. Articles of varying lengths and complexities are purposefully included so as to offer something to readers with different levels of interest in and knowledge of the subject matter.

As with all volumes in the *Arizona Policy Choices* series, readers are presented with both fact and opinion. The articles on state tax cuts in Arizona in this particular volume are grouped according to four major policy choices, including:

- developing a state tax policy that considers business cycles in addition to other factors to determine if tax cuts are warranted
- continuing Arizona's trend of making tax cuts with the intent of stimulating the economy and reducing the tax burden on residents
- using a dependable stream of tax revenue to invest in and improve Arizona, instead of cutting taxes
- evaluating proposed tax cuts according to their budgetary consequences

Arizona Policy Choices provides data and analyses of this wide range of policy options with the hope that they will enable our policy leaders to make decisions that will truly improve Arizona in the future.

The Cuts in Context

John Stuart Hall, Professor
School of Public Affairs, Arizona State University

Taxes are usually a serious topic of conversation, but not always. Mo Udall, who could find the humorous side of any subject, recalled Adlai Stevenson's comment on taxes: "There was a time when a fool and his money were soon parted; now it happens to everyone."[1]

More to the point of this volume the consequences of tax cuts in Arizona is an episode of the 1970s television show "Green Acres." In it, Oliver Wendell Douglas led a successful revolt against a tax levied on Hooterville farmers. No one seemed to know how each farmer's tax liability was calculated and it appeared that the area had not even been represented in the state government when the tax measure was passed. Because of Douglas' revolt, the state refunded all of the taxes paid by the farmers since the adoption of this particular levy, making him a local hero. His popularity quickly vanished, however, when the state government sent bills to his neighbors for all of the state-financed improvements, including schools and roads, put in place in the years since the farm tax had been enacted.[2]

There are multiple morals to this little story that are developed more fully in the articles contained in this volume, such as: taxes are seldom popular, tax reductions often are, and both taxes and tax cuts are likely to have multiple intended and unintended consequences. In addition, any change in taxes or tax policy affects people and their interests differently. One of the principal reasons that the U.S. Tax Code is several hundred pages of complex, impenetrable prose is that it has been built by the political system over time as an enduring but unpleasant compromise. Taxing decisions in a democracy are always debatable. Much of the debate stems from conflicting heartfelt beliefs about the impacts of taxes and suggested reforms. Yet it is possible to find examples of agreement among those who dispute the consequences of taxes. This may be proof of the proposition attributed by another Arizona icon, Carolyn Warner, to a former Speaker of the House of the Florida Legislature who said in effect, "Facts are negotiable, but perceptions are rock solid!"

Tax Cut Facts Lead to New Questions

The decision to examine tax cut policy in Arizona was prompted by two basic questions. First, when it comes to Arizona tax cuts, just exactly WHAT are we talking about? What are the dimensions of Arizona's tax cut activity, how long has it been going on, how much has been cut, what types of taxes are involved, and what laws have changed.

Articles in this volume provide factual answers to these "what" questions, but raise parallel questions about impact, consequence, cause and effect. It is no surprise that when it comes to taxes, any agreement about facts is quickly followed by debate about policy ramifications as the following examples show:

FACT: During the 1990s Arizona embarked upon a conscious tax reduction policy that is projected to total more than $2.5 billion in tax cuts by the end of the decade.
Arizona's sustained tax cut policy, that began with modest tax reductions from 1991 through 1993, has mushroomed to the point that the state is considered one of the national leaders in the tax-reduction movement. By 1995, Arizona was one of only seven states to offer tax cuts in excess of three percent of tax revenue (the others were New Jersey, North Carolina, Oregon, South Carolina, South Dakota and Utah.)[3]

QUESTIONS: What accounts for this sustained policy? What have been the net impacts of these cuts? What are the downstream consequences of the cumulative reduction in state revenues?

FACT: Arizona's 1990s tax cut policy resulted in permanent reductions to all major state taxes, although the most significant cuts, by far, were made to individual income taxes (see summary tables of 1990s tax reductions in the articles by Tom Rex and Frank Sackton). Arizona income taxes traditionally have ranked below average when compared to other states and are relied on for a lower percentage of state spending than most other states. Conversely, Arizona's sales tax as a percentage of state revenue is consistently higher than the average state.
QUESTIONS: Are tax cuts and changes properly, efficiently focused? What are the consequences of this pattern for tax equity, balance, and overall tax policy?

FACT: Through most of the 1990s, Arizona has been a national leader in economic growth using many important measures such as personal income, employment rates, and job creation. This sustained economic expansion has resulted in year-end revenue receipts in excess of projections. State leaders currently are debating the disposition of approximately $500 million in surplus revenues, approximately ten percent of the state's $5.2 billion budget. Some favor using it all for tax reduction.
QUESTIONS: What part have state tax cuts played in recent economic growth? What should be done with revenue surpluses? Should they be used to reduce taxes further?

Tax Policy Choices

These and related facts and questions deserve deep and full consideration as state tax decisions for the new millennium are made. Arizona's recent tax reduction policy and some of its consequences can be attributed in part to conscious public choice and in part to good economic fortune. The exact nature of this relationship and the precise contributions of tax cuts to economic growth are debatable. Nevertheless, these issues have high policy relevance and deserve full disclosure and discussion.

This volume offers data and rich commentary to sharpen the debate. It raises a host of significant questions surrounding Arizona's tax cut policy. What are the implications of this dialog for future public-policy decisions? Given the context of tax reductions and economic growth during much of the 1990s, what are the Arizona tax policy choices that seem most pressing?

Perhaps the best way to outline the range of policy choices that is pointed to by this collection is to discuss them as options with consequences--some known, many unknown.

Make Tax Policy

Some people assert that tax cuts are made simply because they can be made and not on the basis of some thoughtful policy. In the first section of this Arizona Policy Choices volume, articles are presented that essentially make the case that a well-reasoned, holistic state tax/fiscal policy should drive tax cuts, not the other way around.

In his comprehensive explanation of Arizona's recent tax cuts, Tom Rex, research manager of ASU's Center for Business Research, spells out the full dimensions of policies that are affected by tax cuts. Rex specifies the dimensions of recent cuts against the backdrop of tax increases in the late 1980s, examines the impact of these cuts on major state spending, describes relevant changes to the tax code, and examines cause and effect relationships (or lack thereof) among economic growth, population growth, and tax policy. The data and ideas developed by Rex underscore the very complicated connections between tax cuts and other aspects of tax policy. His sections on shifting tax impacts and likely declines in federal aid suggest an urgent need to examine tax cuts closely in a longer term tax policy context.

A focus on tax cuts within the tax policy framework raises familiar concerns about the impact of income tax cuts on the sales tax. Arizona traditionally ranks among the states with the highest dependence on sales tax revenues. The state's recent tax cut policy has resulted in even greater reliance on that source thereby increasing concerns about the cyclical and lagging nature of the sales tax, the narrow base of this tax it applies only to certain goods and not to faster growing services its regressive aspects shifting more of a tax burden to poor people, local competition for pieces of the sales tax pie, and general responsiveness and balance of the tax system. The sales tax has its advantages, though, including relative simplicity of administration and application, and a pay-as-you-go approach based on what you spend. Contributor Tom McGovern who thinks highly of the sales tax, identifies other reasons for relying on it, but as the history of tax debate in Arizona shows, this is a question that will not go away.

It seems appropriate after a decade of focus on reducing the income tax and to a lesser degree, property tax reduction to make decisions about the overall tax system. The historical base and rationale for this perspective is contained in the state's "Fiscal 2000" analysis. After providing an exhaustive, objective analysis of the multiple prongs of the state tax system, that commission recommended, among other suggestions, a reexamination of the state's tax bases. This is in keeping with the advice contained in the article in this volume by the National Council of State Legislatures fiscal affairs director, Ronald Snell that "It is time to consider more fundamental questions of how well state tax systems in the 1990s reflect the American economy of the 1990s."

A reexamination of Arizona's tax system that focuses on what is reasonable to expect from that system would look at such universally agreed upon criteria as equity, simplicity, efficiency, competitiveness, bases, and productivity.

Continue the Cuts

This section contains material that supports tax cuts in and of themselves as good public policy. The articles argue that tax cuts stimulate economic growth and, thus, enhance government revenue at the same time they reduce the burden of government on individuals and businesses. Thus, this policy option is to build on and continue state tax reductions. Those who believe in and/or want to stress the direct consequences for people and the economy of tax reductions, will prefer this path. Supply-side theorists, commentators, and many taxpayers will no doubt agree with the sentiments of contributors to this volume like Senator Marc Spitzer and public issues analyst Robert Robb, that when it comes to tax cuts, "More, much more, is needed."

Contributors to this section believe that logic and evidence point to a new era, one in which a Wall Street economist said recently "We're all supply-siders now."[4] Robert Robb and the Cato Institute's Stephen Moore reflect in this section that as a general proposition, states that have cut taxes the most during the 1990s have had the strongest economic growth. In other words, they make the case that supply-side economics works for states.

By contending that the state's recent tax cut policy is not only economically sound but morally right, Robb's article provides a passionate rationale for the prevailing tax reduction policy. Senator Spitzer is similarly fervent in his claim that recent tax cuts have fostered "a positive economic climate that creates opportunities and sent the people a message that they are entitled to the fruits of their labor." Likewise, Tom McGovern in "Why Tax Income?"

evokes images of Abraham Lincoln and the crisis of secession from the Union as ammunition to build his case to end state and national income taxes by moving to full reliance on state and national sales taxes.

Clearly, in Arizona and elsewhere, tax cutting has had great and immediate political impacts during the 1990s, benefits of such significance that some commentators contend they represent a qualitative departure from old patterns of state tax increases the year after an election.[5] "We've entered an era where you're not going to see any additional tax increase."[6]

A parade of tax cut plans around the country has been led by governors and state legislative leaders. Like the California Proposition 13-spawned property tax fad of the late 1970s, these plans have a high degree of overlap. Examples of the bipartisan popularity of the politics of tax cuts include "dramatic" tax cut proposals of Governors Wilson (R) of California, Bush(R) of Texas, Glendening(D) of Maryland, and Locke (D) of Washington as well as Illinois House Minority Leader (former Speaker) Madigan (D).

One of the most well-known examples of political benefits is Governor Christine Todd Whitman's call for a 30 percent cut in New Jersey state income taxes less than 2 months before her narrow victory over incumbent Governor Jim Florio in 1993. In all cases, significant tax cuts have multiple consequences, including some costs that accompany obvious political benefits.

Is the tax cut promise so politically powerful that it marks a new era? If so, how long will that era last? Twentieth Century Fund Vice President Jon Shure believes that someday U.S. voters will reject tax cut policy and asks residents to imagine "a politician proposing a big fat tax cut and people telling him to get lost. It would be the end of Pavlovian economics; no longer could someone running for office say 'tax-cuts' and expect voters to obligingly salivate all the way to the polls."[7]

"Pavlovian economics" aside, responsible pursuit of this option demands close examination of perpetual questions how far (how deep) should cuts go? Who wins, who loses, who benefits? and of potential consequences. Beyond totaling and averaging individual taxpayer benefits, what are the direct consequences of sustaining this course for the state's fiscal system, its budget, economy, and quality of life? Answers to these questions should affect public choice concerning taxes in ways explored below.

Instead of Tax Cuts, Make Investments in Arizona

In stark contrast to the material in the previous section, the authors of these articles believe that tax cutting is bad for Arizona. Instead they suggest a proactive approach to investing a state revenue stream that should not be reduced by cuts.

In his contribution to this volume, Tucson's Mayor George Miller offers a case for a balanced approach to investment in the state's future. It is possible and desirable, according to Miller, to stimulate the economy while strengthening the state through prudent public investment in such areas as human capital, physical infrastructure, and environmental protection.

Other contributors make the case for choosing investment in the future over adding to tax cuts of recent years. Carol Kamin, executive director of Children's Action Alliance, argues that developing a secure future requires serious attention to deferred and neglected problems of human and physical infrastructure. This theme is expanded upon by Monsignor Edward Ryle and Jim Kiser, editorial page editor of The Arizona Daily Star, who contends that "Arizona's tax cut binge is irresponsible and harmful," resulting in a simple choice for the future:

Responsible, forward-looking leaders would not use our burgeoning resources for tax cuts. They would use them to make Arizona a better state by helping provide the needy the skills and opportunity to improve their lives. It's a choice every conservative understands: Spend today or invest in tomorrow.

Hal Hovey, editor of State Budget and Tax News and State Policy Reports, advises that it is impossible to separate cautious investment and spending decisions from tax reduction strategies during these "blue-chip" times. E. J. Dionne Jr. in his article written originally for The Washington Post, describes a similar balance among some states diverting portions of budget surpluses to specific education needs. Similarly, Penelope Lemov of Money magazine documents new and creative state investments in physical infrastructure.

Around the country, state elected officials have cautiously proposed a "have-your-cake-and-eat-it-too" scenario of modest investment increases with tax cuts. How can this be achieved? Pray for continued economic good news and strive for innovative ways of doing more with less seems to be the recipe. Oregon's Governor Kitzhaber (D) used 1990s political code words well when he declared: "I believe we do need to put more resources into our schools and colleges to make them better and more affordable. But that increased investment must also be accompanied by increased accountability."[8]

Is this investment approach simply a new way of describing the negative connotation "tax and spend," or will its advantages outweigh its downsides? This policy choice, like a decision to continue the cuts, needs to be considered in terms of desired effects and anticipated consequences.

Consider the Consequences

The final section of articles focuses on how tax cutting policy (or the lack thereof) can play out. It stresses the dynamics of how external economic events can affect even the "best" tax policy.

Many analysts contend that economic cycles are inevitable. They ask policymakers to look to the future and develop alternatives for the inevitable, to craft policy that heeds contributor Carol Kamin's advice: "Arizona's tax cuts won't buy us a secure future. No matter how we brag about Arizona's growth, we cannot repeal the business cycle."

In his essay for this section, Frank Sackton, ASU Professor Emeritus of Public Affairs, retired U.S. Army General, former Comptroller of the Army, and aide to Arizona Governor Jack Williams, notes the inevitability of economic cycles while discussing Arizona's tax cut policy from a budget perspective. In essence, Sackton describes the complex and incontrovertible link between budget and tax policy while explaining that recent tax cuts did not cause, but were funded by, a combination of economic growth and budget reductions.

Given the close relationship among economic cycles, need for public services based on population growth, and the state's relatively low tax burden, Sackton urges that Arizona policymakers look closely at the use of some of the state's recent good economic fortune. He suggests that it would be wise to save more for that "rainy day." The state's Budget Stabilization Fund, like the "Rainy Day Funds" of 16 other states is a step in that direction, but it is capped, represents a small proportion of the state budget and according to ASU's Tom Rex, is "...inadequate to offset the loss of revenues during an economic downturn."

In addition to savings, tax policy analysts who are particularly concerned with the consequences of business cycles might also suggest other uses of the largess of recent boom times such as tax rebates rather than tax cuts. Consideration of these measures seems particularly prudent to experts concerned with the impact of eventual economic downturns on public budget needs because of tax policies. It is always difficult to raise taxes to replace lost revenues, particularly so in Arizona, which like seven other states requires a two-thirds legislative majority (the so-called super majority) rather than a simple majority to pass tax increases.

Articles by national state finance expert Hal Hovey, Money magazine's Ann Reilly Dowd, and David Cay Johnston of the New York Times display a wide range of choices and decisions being made among states as they deal with the pleasant for a change problems of budgeting revenue surpluses. All states have different circumstances and have dealt with budgetary good fortune differently, but Hovey concludes that most states have approached the task conservatively, with attention to balance and caution by:

- building hedges against future adversity by rebuilding balances and rainy-day funds
- caution in cutting taxes
- cutting spending in some areas such as welfare and Medicaid
- cautious performance-based approaches to raising spending in other areas such as education.

Putting the Public into Public Choice

In a democratic society, the development and allocation of tax resources is roughly determined by taxpayers/voters. Voter expression takes many forms from "throwing the rascals out" (or in) to enacting public referenda to cut taxes and spending like Arizona's Proposition 106 enacted in 1980.

But as Anthony Downs warned in his seminal article on the topic, "because it is such a complex and time-consuming task to acquire adequate information, the electorate is chronically ignorant of the costs and benefits of many actual and potential government policies."[9]

There are many references in this volume to Arizona's "rank" among the states by various categories of taxes. That is the nature of discussions of state taxes, economic growth, budget allocations, and so forth. All of these state rank-order categorizations should be understood in context.

While it would be more difficult to measure, the place that Arizona might be advised to strive for would be in the top group of states developing understandable, relevant assessments of impacts of proposed new tax measures. The policy choices outlined by our authors can be used to help get to that point. Regardless of choices made and policy paths eventually pursued by state decisionmakers, how well is the state doing when it comes to explaining choices between tax reductions of one type and tax increases of another? What will be the impact of tax reduction policies on savings and investment policies? If nothing else, the wide range of views that follow demonstrate conclusively that when it comes to taxes, there is no uniformly agreed upon "best" policy choice. An unfortunate by-product of the development of this volume was the realization that facts about tax cuts are scattered and incomplete, often developed narrowly to support a particular point-of-view or policy position.

Senate Minority Leader George Cunningham, a critic of the state's decade of tax reduction policy said recently, "Basically, we need to think about what we're doing."[10] This simple, but profound, statement deserves serious consideration because ultimately the taxpaying electorate will make policy choices; and public officials as stewards of this process need to develop understandable, coherent, full information packages about the policy choices that exist, to make this process work well.

This volume and related follow up efforts to Arizona Policy Choices should help both leaders and residents to better understand the tax cut issue and thus, help them make more informed public policy decisions.

Notes

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2. David C. Nice and Patricia Fredericksen, The Politics of Intergovernmental Relations, 2nd ed. (Chicago:

Nelson-Hall, 1995), p. 49.

3. Steven D. Gold, "State Tax Cuts of 1995: Is Something New Afoot?" Public Budgeting and Finance

(Spring 1996): p. 14.

4. Gene Epstein, "Despite Supply-Side Theory, Slimmer Tax Rates Don't Necessarily Fatten Uncle Sam's

Wallet," Barron's (August 21, 1995): p. 29.

5. Frances Stokes Berry, "Read My Lips: The Sequel," State Government News (January 1995).

6. Florida Senate Budget Chairman Ken Jenne, as quoted in Berry, p. 14.

7. Jon Shure, KRF Global News (September 12, 1997).

8. Brad Knickerbocker, "Governors Vow to Put Kids at Top of Agenda and Still Cut Taxes," Christian

Science Monitor (February 17, 1997): p. 3.

9. Anthony Downs, "Why the Government Budget Is Too Small in a Democracy," World Politics 12

(1966): pp. 541–63.

10. Keven Willey, "Commentary," Arizona Republic (December 1995): p. B2.

The Facts of the Matter: Arizona's Tax Cuts

Tom Rex, Research Manager
Center for Business Research, Arizona State University

In each year since 1991, the Arizona Legislature has reduced state taxes. Some argue that these tax cuts have gone too far while others contend that the cuts have not gone far enough.

This article explores the facts of the matter, quantifying the magnitude of the cuts and identifying other factors that affect government finance. It begins by examining historical revenues and expenditures of state and local governments in Arizona, in total and by type, making comparisons to the national average. This backdrop helps in understanding the changes made to the tax code since 1980, particularly tax cuts passed since 1991. Following this review of government finance in Arizona, the discussion turns to various other factors that have an impact on government finance.

Methodology

The review of governmental revenues and expenditures focuses on combined finance data of all state and local governments in Arizona, with comparisons to the national average. The data are combined because the level of government responsible for some programs varies over time and by state.

Annual government finance data for all 50 states, including combined figures for state and local governments, are produced and published in the U.S. Bureau of the Census Government Finance series. In order to compare Arizona finance data over time and to other places, these data are adjusted for inflation and population. The latest available data are for fiscal year (FY) 1994 (July 1, 1993 through June 30, 1994).

Since most of the tax cuts of the 1990s have been made at the state government level in Arizona, finances for state government alone also are examined. The source of the state revenue data is the Joint Legislative Budget Committee (JLBC). The latest JLBC data are for FY 1997 (July 1, 1996 through June 30, 1997).

Fiscal years 1994 and 1997 bracket the peak of the current economic cycle. While the absolute peak occurred in FY 1995, economic growth in fiscal years 1994 and 1996 was nearly as strong. Gains during FY 1997 were slower but still solid. Thus, the latest Census Bureau and JLBC data are compared to FY 1985, which was the peak of the prior economic cycle.

Other factors contributed to selecting fiscal year 1985 as the comparison year. Tax cuts and tax increases of the early 1980s had been implemented by then, few changes to the tax code were made at that time, and the tax increases of the late 1980s had not yet occurred. In addition, FY 1985 preceded large increases in expenditures for AHCCCS (Arizona Health Care Cost Containment System), Arizona's equivalent of Medicaid. Expansion of AHCCCS was a significant factor in government finance, especially in the late 1980s and early 1990s.

This analysis emphasizes the tax cuts that began to be made in 1991 and have continued to date. However, to provide historical perspective, some information is provided back to 1980. In that year the first of several significant changes to government finance was passed by the Arizona Legislature. A review of historical tax-code changes shows that because of the economic cycle, tax cuts tend to be made when the economy is strong, while tax increases are most likely when the economy weakens. The countercyclicality of demands on government (for example, expenditures for unemployment insurance rise during recessions) also contributes to this pattern, which holds not only in Arizona, but in most states.

The impact on revenues resulting from changes in the Arizona tax code discussed in this paper should be interpreted as estimates. Such impacts are very difficult to measure, with the uncertainty increasing when projections of the impacts are made into the future. Estimates of the effects of the tax increases of the late 1980s and tax cuts of the 1990s come from the JLBC.

Historical Record of Revenues, Expenditures, and Tax Changes

Revenues

In FY 1994, total revenue available to state and local governments in Arizona was $14.9 billion. More than $2.8 billion came from the federal government, while state and local taxes were the source of $8.9 billion. The balance came from user fees, interest earned, and other miscellaneous sources.

Per Capita Revenues. Real (inflation adjusted in FY 1997 dollars) per capita state and local government revenue in Arizona in FY 1994 was $3,880, the highest on record, but only 1 percent more than in FY 1990. In the nine years between the comparison year of FY 1985 and FY 1994, real per capita revenues (in FY 1997 dollars) rose about $529, or 16 percent. This increase was less than the national average, however, causing Arizona's per capita revenues as a ratio to the national average to fall 7 percentage points to 86 (U.S. average = 100). In other words, government revenues in Arizona divided by the state's population were 14 percent less than the national average in FY 1994.

The magnitude of the increase in revenues between fiscal years 1985 and 1994 resulted from a variety of factors, the most important of which are changes to the tax code and variations in economic conditions. Substantial Arizona state tax increases occurred during the late 1980s, but hardly any of the 1990s tax decreases had an effect by FY 1994. During the 1985 to 1994 period, the Arizona economy slid from an economic boom in the mid-1980s to a recession in 1990-91, back to strong growth in FY 1994.

Thus, while tax increases were responsible for a good part of the increase in revenues, economic weakness held down the magnitude of the increase. Compared to the national average, revenues rose less in Arizona between FY 1985 and FY 1994, probably resulting largely from Arizona's relatively weak economy over much of this period.

About 19 percent of all Arizona state and local government revenues in FY 1994 came from the federal government. Funds from the federal government rose substantially over the nine years (see Table 1). This was due to increased funding of public welfare programs; other federal funding decreased. The overall increase in revenues from the federal government was well in excess of the national average, yet per capita federal aid to Arizona as a ratio to the national average had only risen to 83 by FY 1994.

Table 1
Arizona State and Local Government Revenues

	FY 1994		Per Capita Change: FY85-94 Inflation Adjusted		
	In Billions	Ration to U.S. Avg*	$**	Percent	Ratio to U.S. Avg
TOTAL	$14.90	**86**	$529	16%	**-7**
From federal government	2.83	**83**	306	71	**16**
Own Source	2.83	**86**	223	8	**-12**
Taxes	8.87	**90**	303	15	**-5**
Property	2.73	**87**	175	33	**2**
General Sales	3.07	**130**	53	7	**-16**
Selective Sales	0.90	**77**	2	1	**-15**
Income	1.71	**69**	75	20	**0**
Other	0.46	**62**	-2	-1	**-5**
Current Charges	1.83	**72**	86	22	**-14**
Interest Earned	0.63	**82**	-61	-27	**-30**
Other	0.75	**95**	-105	-35	**-50**

* In per capita dollars. ** Expressed in fiscal year 1997 dollars

Source: Center for Business Research, L. William Seidman Research Institute College of Business, Arizona State University, from the Government Finance series of the U.S. Bureau of the Census. Inflation adjustment by the GDP Implicit Price Deflator of the U.S. Bureau of Economic Analysis. Population estimates from the Center for Business Research and the U.S. Bureau of the Census.

Revenues raised directly by state and local governments in Arizona rose 8 percent over the nine years. This increase was considerably less than the national average, dropping per capita revenues from state and local sources as a ratio to the national average to 86.

Almost three-fourths of Arizona's directly raised revenues came from state and local taxes in FY 1994. The 15 percent inflation-adjusted increase in such taxes per person over the nine years was less than the national average, causing the ratio to the national average to fall to 90. Arizona's per person tax level has been below the national average since state taxes were reduced in 1980.

The general sales tax was the largest single source of tax revenues in FY 1994. Real per person collections from this tax were only a little higher in FY 1994 than in FY 1985, while per capita sales tax collections nationally rose considerably over these nine years. Despite a substantial drop in the ratio to the national average, Arizona's FY 1994 ratio still was far above average at 130. Arizona's tourists and seasonal residents contribute to this high level of sales tax collections. However, even after considering this nonresident spending, Arizona is overly dependent on the general sales tax relative to other states.

The property tax was the second major source of revenue among Arizona state and local governments in FY 1994. Collections from this tax rose substantially over the nine years, and slightly in excess of the national average. Yet per capita collections in FY 1994 as a ratio to the national average was only 87.

The income tax (personal and corporate combined) was the other major source of tax revenues in FY 1994. The individual income tax accounted for $1.41 billion in revenues in FY 1994, while the corporate income tax was responsible for $0.30 billion. Per capita collections from the income tax rose moderately between FY 1985 and FY 1994, at a pace equaling the national average. Both individual and corporate income taxes per capita were more than 30 percent below the national average in FY 1994.

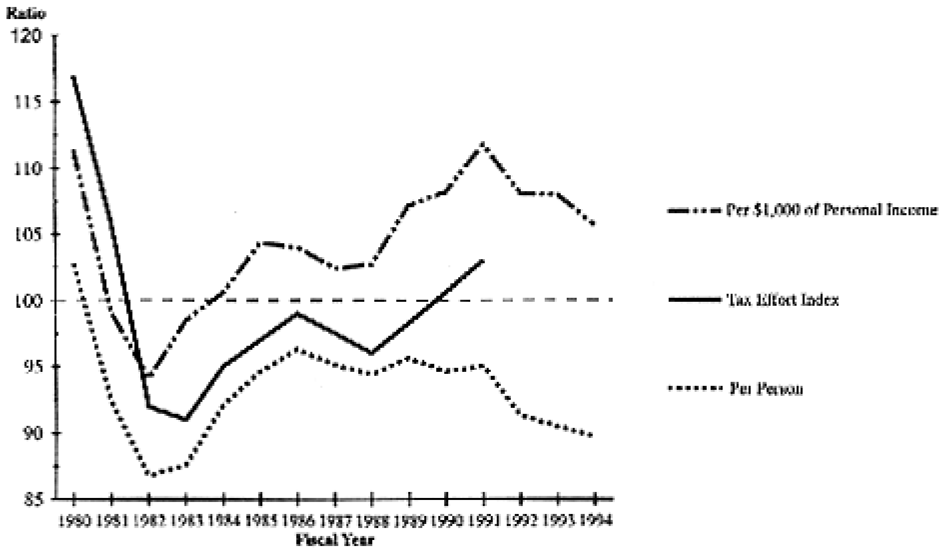
Collections per capita from selective sales taxes (such as on motor fuel) and miscellaneous other taxes (such as motor vehicle licenses) also were far less than the national average in Arizona in FY 1994. The ratios to the national average fell from the FY 1985 levels. Other than taxes, state and local governments receive revenues from current charges (user fees), interest earned, and various other sources. Over the nine years, per capita collections in Arizona from each of these sources rose less than the national average; in FY 1994, the per person level of each was below average.

Thus, of the major sources of state and local government revenues, per person collections in Arizona in FY 1994 were above the national average only for the general sales tax, and were more than 10 percent below the national average in each of the other sources. Except for property and income taxes, growth in per person collections did not keep up with the national average between FY 1985 and FY 1994.

Other Measures.

Government-finance data sometimes are adjusted for factors other than population, such as differences in income levels across states. For example, the Census Bureau presents finance data divided by $1,000 of state personal income, which is the total income from all sources received by all residents in a state. The relationship between government finance and personal income is an attempt to get at the concept of "ability to pay." Arizona state and local taxes per $1,000 of personal income were above the national average in each fiscal year from 1984 through 1994 (see Figure 1). However, tax collections as a ratio to personal income presents a misleading picture of ability to pay.

Figure 1
Arizona State and Local Government Taxes
As a Ratio to the National Average



Source: Center for Business Research, L. William Seidman Research Institute College of Business, Arizona State University, from the U.S. Bureau of the Census and the Advisory Commission on Intergovernmental Relations.

Tourists and seasonal residents are unusually numerous in Arizona compared to most states. These nonresidents pay state and local government taxes and user fees while they are here, thus their impact is captured in the revenue portion of the revenue-to-personal-income measure. The incomes of tourists and seasonal residents, however, are not included in calculations of Arizona personal income, biasing the revenue-to-personal-income measure. Thus, Arizona government revenues per $1,000 of personal income can be higher than in most states without placing an undue burden on residents.

A better measure of ability to pay is produced by the Advisory Commission on Intergovernmental Relations (ACIR).[1] However, the latest data available are for FY 1991. The ACIR created a measure of tax effort, that is the ratio of a state's actual tax collections to its "tax capacity." Tax capacity is the amount each state would raise if it applied national average tax rates to commonly used tax bases. For example, in the case of the tax on tobacco products, the tax base in Arizona is the actual volume of cigarette sales.

The tax cuts of the early 1980s lowered Arizona's tax effort from well above to well below the national average. The subsequent tax increase in 1984 pushed the tax effort measure close to, but still below, the national average. Then, the combination of a lowered tax capacity due to the weak economy in the late 1980s and early 1990s and the tax increases of the late 1980s pushed Arizona's tax effort index a little above the national average by 1991. Even without the tax cuts of the 1990s, Arizona's tax effort likely would have dropped to the national average, or below, simply from the improved economy raising the state's tax capacity.

Another way of measuring tax burden is to calculate personal taxes for a representative household or set of households in each state. The consensus of various studies conducted in the early-to-mid-1990s using this methodology is that the tax burden in Arizona was a little below average. For example, a 1995 study by

Kiplinger's Personal Finance Magazine ranked the tax burden on a retired couple in Arizona as 32nd highest among the 50 states.[2] *Money* magazine in 1995 ranked Arizona 24th on tax burden on a high-income household,[3] while a District of Columbia study in 1994 ranked Arizona 32nd on tax burden on a family of four earning $50,000.[4] Thus, even before most of the 1990s tax cuts took effect, Arizona ranked as a middle-to-low-tax state.

The most recent study (*Kiplinger's Personal Finance Magazine*, June 1997) was done by city. Among 106 cities across the country, Tucson ranked 94th, and Phoenix 96th, in tax burden among the major taxes (state and local income, property, and sales).[5]

In contrast, a 1995 State of Utah study on business taxes indicated that the business tax burden in Arizona was the highest of seven western states.[6]

State Government Only.

Since so much of the tax cutting in Arizona has occurred at the state government level, it also is useful to look at actual revenues collected just by the state government. These data, which are available on a preliminary basis through the latest complete fiscal year (FY 1997), are produced by the JLBC. Because of different accounting systems, revenues as measured by the JLBC cannot be directly compared to the figures produced by the Census Bureau.

Total state government revenues per person in FY 1997 were $1,124. On an inflation adjusted basis, this was up 3.2 percent from FY 1996 and the highest figure on record. Real per capita revenues were $147, or 15 percent, higher than in the comparison year of 1985. Tax collections accounted for 93 percent of the state's revenues in FY 1997. The real per capita figure of $1,046 was a record. It was up 1.5 percent from FY 1996 and 11 percent from FY 1985.

While real per capita taxes and total revenues rose over the last 12 years, they dropped marginally as a percentage of personal income. State taxes collected in FY 1997 were 4.97 percent of personal income, compared to a figure of 5.27 percent in FY 1985.

Sales and use taxes as a whole are the major source of tax revenues (see Table 2), accounting for 47 percent of all tax revenues in FY 1997. Real per person collections were no higher in FY 1997 than in FY 1985.

Table 2
Arizona State Government Revenues

	FY 1997		Per Capita Change, FY85-97 Inflation Adjusted	
	In Billions	**Per Capita***	**$***	**Percent**
Total	$5.05	$1,124	$147	15%
Taxes	4.70	1,046	104	11
Sales and Use	2.21	492	0	0
Individual Income	1.73	385	97	34
Corporate Income	0.60	134	40	43
Property	0.05	11	-14	-55
Other	0.11	24	-19	-45
Other	0.35	78	43	120

*Expressed in fiscal year 1997 dollars.

Source: Center for Business Research, L. William Seidman Research Institute, College of Business, Arizona State University, from the Joint Legislative Budget Committee. Inflation adjustment by the U.S. GDP Implicit Price Index of the U.S. Bureau of Economic Analysis. Population estimates from the Center for Business Research and the U.S. Bureau of the Census.

The individual income tax was the other major source of tax revenues, accounting for 37 percent of all taxes collected. Real per capita collections jumped 9 percent in FY 1997 and were 34 percent higher than in FY 1985, but they were not quite equal to the record set in FY 1991.

Corporate income tax collections surged even more in FY 1997, up 28 percent to a record level. The sharp increase in income tax collections in Arizona in FY 1997 was part of a nationwide phenomenon.

The impact of the 1996 legislative action to reduce property taxes was obvious in FY 1997, with collections down $132 million. The real per capita decline was 74 percent in FY 1997, putting the level less than one-half that of any year since 1980.

Expenditures

Arizona state and local government expenditures totaled more than $15.0 billion in FY 1994. In FY 1997 dollars, per person spending was $3,914 in FY 1994. This was 9 percent less than the peak figure of $4,299 in FY 1990. In real per capita terms, spending rose a little more than $550 between FY 1985 and FY 1994, or 16 percent. This increase, however, was considerably less than the national average, pushing Arizona per capita expenditures as a ratio to the national average down to 89 percent. This was the lowest ratio in at least 30 years.

Nearly all types of spending rose less than the national average between FY 1985 and FY 1994. The exception was public welfare (see Table 3), particularly AHCCCS.

Table 3
Arizona State and Local Government Expenditures

	FY 1994		Per Capita Change, FY85-94 Inflation Adjusted		
	In Billions	**Ratio to U.S. Avg***	**$****	**Percent**	**Ratio to U.S. Avg**
Total	$15.03	**89**	$553	16%	**-12**
Education	5.28	**95**	104	8	**-14**
K-12	3.53	**90**	120	15	**-10**
Higher	1.57	**109**	-22	-5	**-27**
Public Welfare	2.41	**85**	364	138	**24**
Vendor Payments	1.61	**89**	260	164	**10**
Other	0.80	**78**	104	98	**31**
Health and Hospitals	0.83	**52**	57	36	**0**
Transportation	1.24	**92**	-87	-21	**-40**
Highways	1.09	**96**	-71	-20	**-34**
Public Safety	1.53	**103**	53	15	**-20**
Corrections	0.52	**103**	37	37	**-25**
Environment/Housing	1.22	**89**	9	3	**-23**
Government Administration	0.97	**110**	47	23	**-8**
Interest	0.89	**102**	-7	-3	**-19**
CAPITAL OUTLAYS	2.09	**111**	-101	-16	**-49**
Education	0.75	**164**	44	29	**-22**
Highways	0.60	**95**	-91	-37	**-74**
CURRENT OPERATIONS	12.94	**86**	653	24	**-6**
Education	4.53	**88**	60	5	**-15**
Highways	0.49	**96**	20	19	**11**

* In per capita dollars. ** Expressed in fiscal year 1997 dollars.

Source: Center for Business Research, L. William Seidman Research Institute, College of Business, Arizona State University, from the *Government Finance* series of the U.S. Bureau of the Census. Inflation adjustment by the U.S. GDP Implicit Price Deflator of the U.S. Bureau of Economic Analysis. Population estimates from the Center for Business Research and the U.S. Bureau of the Census.

Two-thirds of the public-welfare spending was in the category of "vendor payments," which was more than 2.6 times higher in FY 1994 than in FY 1985 on a real per capita basis. Almost all of this category represents spending by AHCCCS. Very large spending increases also occurred nationally, so that per person expenditures on vendor payments in Arizona still were 11 percent less than the national average in FY 1994. In unadjusted total dollars, vendor payments in Arizona rose almost $1.3 billion in the nine years, including nearly $500 million in the three years (FY 1988 through FY 1990) in which taxes were raised by a like amount.

The huge increases in AHCCCS over this time period were mandated, and were a prime reason why taxes were raised in the late 1980s. The nine year real per capita spending increase of 164 percent in vendor payments compares to an increase of only 9 percent in all other types of spending. The real gain in per capita personal income over these nine years was 8 percent.

The total expenditure figures include capital outlays spending on infrastructure (such as new schools and new roads) and for equipment and land. Arizona's rapid population growth is responsible for per person capital outlays being above the national average. Capital outlays fell sharply in the early 1990s, putting the FY 1994 figure lower than that of FY 1985.

Spending on current operations compensation, supplies, materials, operating leases, contractual services was 14 percent less than the national average in FY 1994. The rapid rise in this category, largely due to AHCCCS, still was less than the national average.

Changes to Arizona Tax Code

At the beginning of the 1980s, two changes were made to Arizona state taxes: the sales tax on food to be consumed at home was eliminated and property taxes were reduced. In addition to the substantial reductions in revenues that resulted from these changes, Arizona state and local governmental revenues fell due to reductions in federal-revenue sharing and an economic slump. Even with the strong economic recovery that began in 1983, a substantial tax increase (making permanent a temporary rise in the general sales tax rate) was passed in 1984, putting the state budget back in balance. Even with this tax increase, the tax burden was less than it had been in FY 1980 (see Figure I).

From FY 1985 through FY 1987, few changes were made to the state tax code. After this, the Arizona economy weakened, reducing governmental revenues. At the same time, spending on AHCCCS was skyrocketing. The result was substantial tax increases in three consecutive years from 1988 through 1990. These increases cumulated to nearly $500 million according to estimates made at the time.

Beginning in 1991, Arizona governmental revenues were affected by two circumstances. First, the economy began to recover, boosting revenues. Second, strong philosophical preferences for tax cuts took hold in both the executive branch and the legislature.

These tax reductions began slowly, due to the still-weak economy limiting revenues while AHCCCS spending continued to rise. Very modest cuts, mostly to the individual income tax, were passed in the legislative sessions of 1991 and 1992. More numerous and larger tax cuts were passed in the legislative session of 1993, but most of these changes were phased in over several years. Thus, the net impact on the FY 1993 budget from tax cuts made from 1991 through 1993 was only $9 million, according to estimates by the JLBC.

The tax cuts passed in 1993 affected a number of taxes, most particularly the sales and use tax and the individual income tax. A wide variety of taxes also were cut during 1994, but the individual income tax was especially reduced. This was the first of three consecutive years of tax cuts of about $200 million per year, though the 1994 cuts again were phased in, with most of the impact in FY 1995 and FY 1996.

The tax cuts passed in 1995 were almost wholly to the individual income tax. However, an agreement was made to reduce property taxes in 1996. This became a reality during a special session of the legislature during the summer of 1996. Further tax cuts were passed in 1997, amounting to an initial impact of $134 million in FY

1998 and another $20 million in FY 1999. The majority of the cut was $111 million in individual income taxes.

According to the JLBC, the overall annual impact on revenues from tax code changes made between 1991 and 1997 rose from $9 million in FY 1993 to $38 million in FY 1994. After advancing to $215 million in FY 1995, the annual impact jumped to $514 million in FY 1996 and $776 million in FY 1997 (the fiscal year just ended). The projection for FY 1998 is $1,035 million, with a projection of $1,125 million for FY 1999. The impacts by major tax are shown in Table 4. More than one-half of the tax cuts have been made to the individual income tax.

Table 4
Revenue Adjustments for Recent Legislation
Annual Impact in Millions of Dollars

	Fiscal Year						
Tax	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
TOTAL	-9.1	-37.8	-215.5	-513.9	-775.8	-1034.5	-1124.7
Individual Income	-8.1	-30.0	-159.2	-382.8	-414.4	-558.2	-609.5
Corporate Income	0.0	0.0	3.1	-28.4	-41.5	-41.0	-43.0
Property	0.0	-0.2	-1.8	-7.5	-154.1	-161.5	-170.1
Sales and Use	-0.6	-7.8	-59.0	-85.7	-146.2	-249.0	-265.7
Other	-0.5	0.3	1.4	-9.5	-19.6	-24.7	-36.4

Source: Joint Legislative Budget Committee, unpublished data.

In some discussions, the impacts of tax cuts have been expressed on a cumulative basis. For example, over the five years from FY 1993 through FY 1997, the annual tax cuts noted above cumulate to nearly $1.6 billion. Legislative staff estimates that nearly two-thirds of these tax cuts have gone to individuals.

The $1.1 billion in tax cuts projected for FY 1999 probably should be weighed against the $500 million in tax increases passed in the late 1980s. Further, if this $500 million estimate is adjusted for inflation and population growth, the impact grows. The JLBC estimated that by FY 1993, the annual effect had grown to nearly $800 million. No more up-to-date estimates are available, but it seems likely that the $500 million in tax increases between 1988 and 1990 will grow to nearly $1 billion in FY 1999. From this perspective, the net effect of the tax cuts passed between 1991 and 1997 and the tax increases of the late 1980s probably is a loss of a little more than $100 million per year in state revenues. That is, in FY 1999, state government revenues will be approximately $100 million less than they would have been if no tax code changes had occurred in the late 1980s and 1990s.

The Current Situation

State government finished the 1997 fiscal year with a budget surplus of about $550 million. While large in dollar terms, the surplus was not unusual in percentage terms; substantial surpluses typically occur at the peak of economic cycles.

The FY 1997 surplus resulted primarily from unexpectedly high collections of income taxes, both individual and corporate. Strong collections occurred across the nation and seem to have resulted from large capital gains.

The JLBC projects that the surplus will be smaller at the end of FY 1998. If the unexpectedly high collections of income taxes dissipate as quickly as they accumulated, the surplus would be smaller than predicted. Recent stock market volatility makes this possibility more likely.

Eventually, slowing economic growth in combination with growing impacts of tax cuts already passed ($260 million additional impact between FY 1997 and FY 1998 alone) will shrink the surplus. The surplus will turn into a deficit whenever the next economic recession occurs.

Factors Impacting Government Finance

Population Growth

Arizona consistently is one of the fastest growing states in the nation. Percentage-population growth usually is about three times the national average, ranking second or third among all states. This rapid growth puts a considerable strain on the public sector.

This is most easily seen in the category of capital outlays. The state must spend more per person than a moderately growing state on infrastructure such as roads, schools, and sewers. However, taxes levied on newcomers are not high enough to cover the costs of infrastructure and public services required by the new residents. Thus, everything else being equal, Arizona's total public-sector spending per capita should be above the national average, as should per person taxes. This is not the case, however, as both taxes and expenditures in Arizona are below the national per capita average.

Economic Cycle

National economic-growth rates vary over the period of several years between strong gains and declines. The Arizona economic cycle corresponds closely to the national cycle in timing, but the Arizona economy is more cyclical than the national economy. Gains in Arizona are much stronger at the peak of the cycle, but the last three recessions in Arizona were as deep, or deeper, than the national average.

This extreme cyclicality creates significant variations in revenues realized by state and local governments in Arizona. For example, during periods of economic strength the state government frequently enjoys annual surpluses in excess of $200 million (in FY 1997 dollars). Within just a year or two of such a surplus, however, the state sometimes has had to resort to a mixture of spending cuts and tax increases just to balance the budget. Unlike the federal government, the state constitution prohibits the state government from running more than an insignificant deficit.

The current economic cycle began with the end of the last recession in mid 1991. Economic growth was relatively slow until mid-1993. It then accelerated to the very strong growth rates typical of the peak of the cycle in Arizona. Growth rates currently are slowing, but remain moderately strong.

The strong growth of recent years is a cyclical phenomenon, with growth rates not exceeding those of prior economic cycles. For example, annual percentage-growth rates in real personal income less transfer payments (the measure used in calculations for the budget stabilization fund discussed in the next section) in each year of the current cycle have been less than in the comparable year of each of the two prior cycles (see Table 5). Similarly, growth in this measure during the current cycle in Arizona, relative to the national average, has been less than in the two prior cycles. In contrast, numeric-employment growth has increased in each economic cycle over the prior cycle. Thus, the stronger gains in the current cycle fit the historical pattern.

Economic growth in the current cycle peaked in 1994 and 1995. Growth rates are expected to continue to slow in 1997 and 1998. However, no sign of a national recession is yet apparent. If the current cycle lasts as long as the previous cycle, the next national recession would begin at the end of 1998. The Arizona economy always slows at about the same time as the national economy. Unlike the last three recessions, the next downturn in Arizona may not be as severe as the national average. Certain industries, such as commercial real estate and commercial construction, got off to a slow start in this cycle and may moderate the next downturn.

Thus, while the next economic slump may be less severe in Arizona than any of the last three, a substantial slowdown in growth from the rates of the last four years is likely. This will have a depressing effect on governmental revenues.

Table 5
Economic Growth Rates in the Current Cycle
Compared to Two Prior Cycles

Inflation-Adjusted Personal Income Less Transfer Payments (percent change)						Nonagricultural Wage and Salary Employment (change in thousands)					
1993	4.5%	1983	5.5%	1976	6.5%	1993	69	1983	48	1976	30
1994	6.0	1984	10.1	1977	6.8	1994	106	1984	104	1977	51
1995	7.4	1985	8.1	1978	10.6	1995	104	1985	97	1978	86
1996	5.8	1986	6.9	1979	10.2	1996	100	1986	59	1979	85
1997*	4.7	1987	4.9	1980	5.1	1997*	76	1987	48	1980	34

Budget Stabilization Fund

In 1990, the Arizona Legislature created the Budget Stabilization Fund (BSF), also known as the "rainy-day fund." The BSF is designed to set aside revenue during times of strong economic growth to be spent during times of weak growth or recession. It applies only to state government. The change in the BSF during a fiscal year is determined by comparing the inflation-adjusted percent change in Arizona personal income, less transfer payments, for the latest calendar year to its average growth rate over the last seven years. The difference is multiplied by the state government general-fund revenue of the prior fiscal year. When growth is above trend, monies are transferred from the general fund into the BSF. When growth is below trend, the transfer is from the BSF to the general fund.

The first payment into the BSF was made in FY 1994. An additional payment into the BSF was made in FY 1995, resulting in a balance of about $225 million. Since the legislature in 1995 changed the maximum balance in the BSF from 15 to 5 percent of revenue, the fund was already at its maximum level. This legislative change precluded the transfer of about $223 million into the BSF during FY 1996, as called for by the formula. Another $121 million deposit for FY 1997 also was deferred. Tax cuts of similar magnitudes were passed in each year.

Growth in revenues has pushed the BSF cap to about $250 million in FY 1997. The fund continues to grow from interest earned, which pushed the balance past the cap in fiscal years 1995 and 1996, causing small revertments to the general fund to have occurred.

In 1997, the legislature again changed the maximum balance in the Budget Stabilization Fund. It will gradually rise from 5 percent in FY 1997 to 7 percent in FY 2000. The legislature also appropriated an ad hoc contribution to the BSF of $30 million in FY 1998. The JLBC projects that the FY 1998 year-end balance in the BSF will be equal to the limit of $291 million. In FY 1999, a balance of $328 million is projected.

Based on the experience of the last three economic cycles, the 7 percent cap imposed on the BSF as of FY 2000 is too low to ensure that adequate funds will be available at the bottom of an economic cycle to meet the transfer that should occur from the BSF to the general fund.

Had the BSF existed before 1990, the formula would have called for a cumulative transfer from the BSF to the general fund of more than $300 million in fiscal years 1974 and 1975. (This and subsequent dollar figures are expressed in terms of FY 1997 dollars.) However, with a 7 percent cap, the BSF would have had only a little more than $100 million. Even with a 15 percent cap, the fund would have had only about $230 million available.

Since general-fund revenues at that time were only one-third those of today in inflation- adjusted dollars, the equivalent payout today would be nearly $1 billion. General-fund revenues are higher today largely because of the state's population growth. The state's population today is twice that of the mid-1970s.

In the early 1980s recession, a cumulative transfer of nearly $220 million from the BSF to the general fund would have been called for by the formula. With a 7 percent cap, the BSF would have had only $170 million available. However, considering interest earnings, the fund would have fallen only a few million dollars short of the payout called for by the formula. Since general-fund revenues then were about one-half those of today, the equivalent transfer today would be more than $425 million.

In the prolonged economic slump of the late 1980s and early 1990s, the formula would have called for a cumulative transfer from the BSF to the general fund of about $570 million. (An equivalent payout today would be about $725 million.) With a 7 percent cap, the payout from the BSF would have been about $300 million short.

Thus, with a 7 percent cap, BSF funds in each of the last three economic slowdowns would have been exhausted short of the payout to the general fund called for by the formula. Thus, the rainy-day fund with a 7 percent cap should be viewed as inadequate to offset the loss of revenues during an economic downturn. Even if the next downturn is milder than any of the last three, the projected BSF balance of $328 million in FY 1999 is unlikely to be sufficient to meet the formula's recommended transfers.

Political

Politics influence government finance in a variety of ways. For example, general opposition to government spending and a desire for tax cuts are far stronger in the 1990s than in the 1980s. This has led to spending, at least by state government, having been restrained throughout the 1990s. Rather than by eliminating programs, spending has gradually been reduced by disallowing inflation to be considered in state agency budget requests. Salary adjustments for state government employees have barely kept pace with inflation over the last five years, following inflation-adjusted declines in wages in the late 1980s and early 1990s. Further, new or expanded spending that typically occurs during a strong economy has been less than in the past.

Another example of a political factor is the requirement passed in the early 1990s that two-thirds of each house of the legislature must approve a tax increase. This will make it more difficult for the state budget to be balanced in the next economic downturn since tax increases commonly have been used to increase revenues during times of economic difficulties. This then magnifies the consequences of the tax cuts in the 1990s and of capping the BSF at 7 percent.

Federal Funds

Funds transferred from the federal government to state and local governments represented about 19 percent of all general fund revenues in Arizona in the early 1990s (about $2.8 billion in FY 1994). Federal aid to state and local governments in Arizona increased to about $3.3 billion in FY 1996.

These intergovernmental transfers from the federal government will be reduced as Congress tries to reduce federal government spending and decentralizes programs, passing responsibility to state and local governments. According to Fiscal Planning Services, Inc. of Bethesda, Maryland, the Congressional Budget Resolution passed in June 1996[7] will result in a decline of 9 percent in cumulative-federal aid to Arizona state and local governments in the six years from FY 1997 through FY 2002. The cumulative-dollar reduction will exceed $2.2 billion. This reduction in federal aid will be phased in. By FY 2002, the annual reduction will be nearly 15 percent, or several hundred million dollars.

A decline of similar relative magnitude occurred in the early 1980s as federal revenue-sharing programs were cut soon after President Reagan took office. This drop in federal transfers to Arizona followed substantial cuts in the state's sales tax and property tax. The impact of these revenue losses was intensified by an economic recession.

Thus, the consequences of the tax cuts made in Arizona in the very early 1980s were complicated by both an economic downturn and reductions in federal spending. The same situation could occur in coming years: the full impact of the tax cuts passed during the early and mid 1990s could collide with a significant reduction in federal monies and an economic slowdown.

Shifting Tax Sources

Relative to their shares of state government revenues in the early 1990s, a disproportionately large portion of the tax cuts passed in Arizona in the 1990s have been to income taxes, upon which Arizona already had a low dependence relative to other states. A relatively small part of the tax cuts has been to sales taxes. This means that a shift is occurring with the sales tax becoming an even greater share of overall governmental revenues. Arizona governments already were overly dependent on the sales tax, relative to the national average, before the tax cuts of the 1990s occurred.

This increasing reliance on one tax is contrary to prevailing tax theory that a balance of taxes is better. Heavy reliance on the sales tax raises a number of additional issues.

First, the sales tax collected on goods, excluding food to be consumed at home, is highly variable because consumer expenditures are so cyclical. The downside of a heavy reliance on the sales tax was demonstrated in Maricopa County in the late 1980s and early 1990s. Almost immediately after the public vote in 1985 to increase the sales tax to fund highway construction, the economy slumped. Consumer spending dropped for several years, lowering revenues from the sales tax. Sales tax collections thus were far less than anticipated, a major factor in so few miles of freeway being opened to date, relative to what had been planned.

Second, collections from Arizona's sales tax, which only applies to certain goods and not to faster-growing services, has not kept pace with overall economic growth. Between 1985 and 1996, real personal income in Arizona rose 57 percent, but retail sales subject to the sales tax increased only 43 percent. Thus, an even stronger dependence on the general sales tax will result in a growing gap between governmental revenues and expenditures.

Third, sales taxes are more regressive than income or property taxes. That is, greater dependence on the sales tax shifts more of the tax burden onto the less affluent.

Economic Impacts of Tax Cuts

The link between an increase or decrease in taxes and subsequent economic performance is unclear. A review of economic research articles published in refereed journals shows no consensus. Most of these studies have focused on tax increases, rather than decreases. Some studies conclude that tax increases harm economic growth, while others reveal no impact or even a small positive effect on the economy.

While disagreements still can be found in the literature, on net the most recent and sophisticated studies suggest that state and local taxes have marginal effects on economic development and growth. Since the magnitude of the effects is small, a large differential between states would be required to influence business location decisions. State and local government taxes are just one of many factors that affect economic growth, and studies have not found them to be one of the more important factors.

A specialized aspect of the economic impact of tax cuts is supply-side effects: that a reduction in taxes will stimulate growth so much that governmental revenues will be greater than if tax rates were higher. While the bulk of the literature suggests that such an effect does not exist to any significant degree, it remains a topic of considerable debate. Whether a supply-side effect will accrue in Arizona, however, is a critical point in assessing the consequences of the state's tax cuts, as discussed in other contributions in this volume.

Summary

In the early to mid 1990s, before most of the tax cuts passed during the 1990s had taken effect, Arizona's tax burden already was a little below the national average. Similarly, governmental spending was a little below average, despite upward pressures caused by the state's rapid population growth.

When fully implemented, the tax cuts of the 1990s (through 1997) largely will only offset the tax increases of the late 1980s. Despite an impact of about $1.1 billion in FY 1999 from the tax cuts, the net tax cut probably will be about $100 million (relative to the revenue that would have been generated had the tax code of the mid 1980s not been changed).

In FY 1997, the $776 million impact from the tax cuts had not yet equaled the revenue impact from the tax increases of the late 1980s. Thus, it is not surprising that the tax cuts have not yet had a strong impact on state and local government finances. Further, the tax cuts have been made during a strong economy, with cyclical factors pushing up revenues. Spending also has been cut, contributing to budgetary surpluses.

Economic growth in the current economic cycle is similar to that of prior cycles. Growth rates already are slowing and likely will continue to slow in the next few years due to cyclical factors. This will have a downward influence on governmental revenues.

Governmental revenues in Arizona in the next few years also are likely to be affected by reductions in federal funds. Further, increased relative reliance on the sales tax will gradually cause governmental revenues to grow less rapidly than the overall economy.

When the next economic downturn occurs, the rainy-day fund of $328 million projected for FY 1999 will help to offset the decline in general fund revenues. Even in a mild downturn, however, this balance is unlikely to be adequate to meet the transfers called for in the law that set up the Budget Stabilization Fund. Coupled with the other factors that likely will reduce government revenues, the state government could be faced with a significant imbalance between revenues and expenditures.

In the past, the solution to such a situation typically has been a combination of spending reductions and tax increases. The two-thirds majority now needed in the legislature to increase taxes makes such an option questionable in the next economic slowdown. Thus, substantial spending cuts may be necessary to meet the constitutional mandate of a balanced budget.

Notes

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3. "We Rank the States by Tax Load," Money, (January 1995): p. 92

4. *Tax Rates and Tax Burden in the District of Columbia: A Nationwide Comparison*, (Washington, DC: District of Columbia Department of Revenue and Finance, 1994).

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State's Income Tax Below U.S. Average But Sales Tax Among 10 Highest

Pat Flannery, The Arizona Republic

Gov. Fife Symington and his legislative allies have forged a powerful political base by repeatedly slashing taxes and blaming bureaucratic bloat for picking Arizonans' pockets.

Now, Symington wants to cut the state income tax by $100 million and eventually make the tax go away entirely.

But the questions lingering since the first few tax-cutting forays of the '90s are these: Are we really overtaxed? And how much is too much when it comes to slashing taxes?

Studies by the state and federal governments, and private groups with agendas to press, have offered conflicting findings and proposals. Arizona's tax burden was too high, too low or just about right, depending on how they crunched the numbers from the U.S. Census Bureau.

But some clear patterns emerge in recent studies comparing tax burdens among the states:

Despite the calls for killing the income tax, Arizona's income-tax burden remains below the national average. It was well below average before Symington took office, and repeated cuts have pushed it lower. Only 13 states have a lower reliance on income taxes seven of those have no income tax at all.

Arizona's reliance on sales taxes the most regressive tax, which falls most heavily on the poor is well above average. Arizona had the eighth highest per-capita sales-tax collections in the United States in 1993, the most recent numbers available. It had the sixth highest rate when measured as a percentage of personal income.
Those who prefer a sales tax, including Symington, maintain that it is necessary to collect a fair share of taxes from the millions of tourists and part-time residents, who don't pay Arizona income tax.

On a radio talk show last week, Symington praised the sales tax as "wonderful" and added, "It's not a confiscatory tax the way the income tax is."

But figures show that only about 12 to 15 percent of the sales tax is collected from out-of-state visitors. That means Arizona's poor pay a disproportionate amount of their income to sales taxes, although food and prescription drugs are exempt from the tax.

Arizonans are getting back $1.18 in federal funds and services for every $1 in federal income taxes paid, a higher return than two thirds of the states. Many states pay more than they get back.

The state is slightly below the national average in state and local property taxes when measured on a per-person basis. But it is slightly above average when property taxes are measured as a percentage of personal income.
Property taxes on businesses in Arizona are much higher than on residential property: 25 percent to 10 percent. And business property taxes are higher than in many other states.

Arizona ranks among the lowest in combined state and local income and property taxes, according to a recent report by the penny-pincher's bible, Money magazine.
Money measured the tax load on a fictitious, two-career family of four with income of $88,764 in 1996. The study, published last month, rated Arizona 14th lowest among the 50 states and the District of Columbia. The study did not include sales taxes.

Comparing the state's tax system to that of its neighbors is risky business, because every state taxes its people differently and at varied levels of government.

Total state and local taxes raised in a state can be compared on a per-person basis or as a percentage of total personal income in the state. A state can rate much higher on one measurement than the other.

Arizona, for example, rated No. 27 in the broad middle third of U.S. states when ranked by the amount of state and local taxes paid for each man, woman and child in 1993. Yet it rated 10th highest in the amount of taxes raised in relation to personal income in 1993.

The reason: Personal income in Arizona is lower than that in many other states. So, when their tax burden is viewed as a percentage of their earnings, Arizonans end up paying comparatively more.

"The fact we rank as high as we do in personal income (tax measures) ...argues that, on balance, citizens here aren't being undertaxed," said Kevin McCarthy, president of the Arizona Tax Research Association.

But McCarthy adds that state income taxes are relatively low.

"If the Legislature is of the mind to cut taxes, they ought to cut taxes in meaningful ways," he said.

Doing so is not a simple technical or political proposition. Arizona's tax system is complicated, and for every cut in one place, it increases the burden borne somewhere else.

If business property taxes are cut, for example, then homeowners will take on a bigger load over time.

If there is one area of agreement among tax gurus, it is that Arizona's system is too complicated in both the number of taxing authorities and tax categories.

In addition to state and county taxes, there are taxes by 87 cities and towns, 226 school districts, 10 community college districts and nearly 1,400 special taxation districts.

To address some of the tax-system problems, Arizona nine years ago commissioned Fiscal 2000, a blue-ribbon tax study. It triggered an avalanche of criticism by concluding that some taxes needed to be hiked.

Since then, lawmakers and the governor have largely ignored Fiscal 2000.

The state income tax has been pared frequently since Symington took office in 1991. Arizona took among the lowest bites in the country in 1993: 36th out of the 50 states and the District of Columbia when measured either on a per-person or personal-income basis, according to the Census Bureau.

Now, Symington wants to eliminate the income tax, a move that would bring a $1.5 billion price tag.

Seven states have no income tax, though most of those tax a major economic activity heavily to replace income-tax revenues. Florida, for example, has tourism taxes. Texas and Alaska have oil income. Nevada has gambling revenues.

"We don't think there is a major problem with personal income taxes we are below average there," McCarthy said. "I don't think I would look to decrease personal income taxes."

If there is one set of taxes that businesses want reduced, it is business property taxes. Although they are much higher than residential property rates, the residential taxes provide most of the revenues.

But it is the sales tax that provokes the most controversy.

The 5 percent state tax matches the U.S. median. It is levied on various types of transactions and all goods except food and prescription drugs. Seventeen states have higher rates, 20 have lower rates.

Some experts argue that Arizona relies too much on its sales taxes, which provide most of the state's tax revenues.

The general state sales tax alone raised nearly half of all state revenues in 1995, a higher percentage than all but six other states. Arizona was among the nation's 10 highest in sales tax when measured on both a per-capita and personal-income basis.

The state's reliance on sales taxes has been a conscious choice of policymakers. It squeezes pennies out of every seasonal visitor, and is viewed by conservative policymakers as the most friendly to economic development.

In that view, the sales tax eases pressure on income and property taxes, which siphon off money that businesses and the wealthy would otherwise invest in the economy.

A study by the Goldwater Institute, a conservative think tank, gave this recipe to promote economic growth: limit state spending, rely heavily on sales taxes, and don't increase income and property taxes.

Symington chimed in last week with similar sentiments, telling a radio audience that proposals to abolish sales or property taxes are "wrong-headed."

Wiping out income taxes within five or six years, he said, would "propel our economy forward, increase the wealth base in our state."

Yet experts like McCarthy say the sales-tax reliance is dangerously high. The revenues from sales tax do not keep pace with long-term economic growth as well as income and property taxes. If a state relies too heavily on sales taxes, it could have trouble paying the costs of growth.

Advocates for the poor, meanwhile, want sales taxes reduced because of their impact on that population. The more-progressive income tax is more fair, they say.

Still, if Cliff Cowles and his neighbors are any indication, many Arizonans do not trust government to act responsibly with their money. They want whatever relief is offered, even if it's in an area where the state already is low.

Cowles, a member of the Northwest Valley Taxpayers Association, insists that "there isn't a government going that doesn't spend, and spend wildly."

He believes that regular tax trimming forces fiscal austerity.

A growing number of advocates are tiring of that view, and have begun arguing to lawmakers that equitable taxation, including increases in some areas, is a vital factor in Arizona's social and economic equation.

Timothy Hogan, of the Arizona Center for Law in the Public Interest, pointed to the flip side of Symington's tax-cutting arguments.

"There are people around here continually telling us we are high on taxes and that it supposedly impedes economic development," said Hogan, whose lawsuit triggered the push to rewrite Arizona's school-funding formulas.

"We never focus on the cost of economic development. One [cost] is manifest immediately in the school-finance situation. We're cutting our revenues while increasing the supply of kids we have to educate."

Arizonans seem willing to forgo tax cuts if their money is used to solve problems they care deeply about.

A statewide poll released recently by pollster Bruce Merrill reported that 67 percent would give up an income-tax cut if the money was used to solve the school-funding crisis.

Frank Sackton, professor of public policy at Arizona State University, says education has been a big loser in the assault on income taxes during the '90s, and he thinks the cuts were unnecessary. Arizona was below the U.S. average income-tax burden when Symington took office in 1991.

A vast majority of the state budget nearly 90 percent is spent on health and welfare programs, prisons and education. Health and welfare spending is dictated largely by federal regulations, while prison funding is a function of the number of convicted criminals.

Sackton said education spending is the only big-ticket budget item that the state can realistically lower to pay for large tax cuts.

"When you say, 'Let's cut government,' they think 'bureaucracy' and everyone is in favor of cutting 'bureaucracy," Sackton said. "But it's schools they're cutting."

Taxes: The Eternal Debate

Nancy Welch, Senior Research Analyst
Morrison Institute for Public Policy

Southwestern writer Lawrence Clark Powell once observed that "Arizona is a young state in an old land."[1] Settled for centuries and for some time part of Mexico, Arizona became a U.S. territory in 1863 and the forty-eighth state in 1912. Arizona's separate entry into the Union (one option had been joint statehood with New Mexico) was notable for its constitution in which 51 Democrats and 11 Republicans included the initiative, referendum, and recall.

In his initial address to the state legislature, George W.P. Hunt, Arizona's first governor, advocated agricultural education, old-age pensions, workers' compensation, and a merit system for state employees. Clearly, building a state would require more revenue than administering a territory. Thus in a place that valued both development and citizen participation, taxes and spending were guaranteed to be eternal topics of debate and a battleground for proponents of competing philosophies of government and special interests.

For example in 1931 a group of citizens organized in Globe because taxes were "out of proportion to the increase of population and to the actual needs of good government."[2] The sales tax of 1933 was challenged in the Arizona Supreme Court and subsequently revised. Powerful mining, agricultural, and railroad interests "weren't about to stand for somebody raising their taxes foolishly"[3] and dominated debates and the legislative-appropriation process until the state established an executive-based budgeting system in the mid-1960s.

Plus, in 1978 an initiative for an amendment to the Arizona constitution which would limit spending to seven percent of the state's personal income passed. This was just one of a number of limitation options considered over the years. After years of discussion, residents voted in 1980 to remove the four percent sales tax on food. The 1992 voter-approved Proposition 108 resulted in a mandate that all state-tax increases be approved by a two-thirds majority in the Arizona House and Senate.

Throughout the state's history, Arizonans have received a variety of state-tax rebates and refunds and the rates at which various taxes are levied have changed frequently. Indeed, the often session-to-session changes have made it difficult for residents to grasp Arizona's complicated tax system. Taxes, it seems, are always on someone's agenda.

Despite the current assumptions that Republicans and Democrats can never see eye-to-eye about tax relief or investments in the state's future, Arizona's recent history provides some examples to the contrary. In 1977, Republican Burton Barr and Democrat Alfredo Gutierrez said the state's needs should come before Democratic Governor Raul Castro's proposed $84 million tax relief package. "...[T]he legislature decided to spend more money on things like prisons, universities, and public schools. Budget makers had to scratch to come up with the $50.2 million needed for the package finally approved."[4]

Phoenix Republican Peter Kay helped to lead the fight to exempt food from sales tax, a move which benefited all Arizonans, and particularly those with low incomes, but also cost the state an estimated $100 million. Even the ever-conservative Arizona Republic supported the effort in "A Doomed Tax," a January 4, 1980 editorial. "For years sentiment has grown to repeal this tax, which undoubtedly bears most heavily on the poor.... This is one problem that has been around long enough."[5] Arizona voters approved the repeal in June 1980 as a part of a ten-proposition tax package which was described later as "a massive reform in the state's tax structure."[6]

Taxes are certainly not just a topic for the 1990s. There is every indication that the debate will continue into the 21st century with each side assuming that their way is best for Arizona.

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Our Outmoded Tax Systems

by Ronald K. Snell

Ronald K. Snell is director of NCSL's fiscal affairs program.

Now that state tax collections have improved, Medicaid cost increases are no longer burning like a prairie fire through state budgets, and sustained economic growth seems likely, can legislators put tax issues out of their minds?

If state finances are improving, why even raise the issue? "If it ain't broke, don't fix it." Why should state officials subject themselves to the stress and misery of talking about taxes, let alone the fundamental reconsideration of state tax policy?

States' tax policy may not be *broken*. But it's chugging along like a '39 Studebaker on 1990s expressway: getting somewhere, in a manner of speaking, but not efficiently, not reliably, not in a very satisfactory way.

From 1989 through 1993, budget shortfalls and tax increases dominated legislative sessions. Legislators debated countless changes designed to give larger shares of shrinking resources to corrections, education and health care while revenue stalled. Time and again, unhappy legislators voted to increase taxes to sustain state spending while constituents' incomes were stagnant or shrinking. Legislators, governors and taxpayers alike are ready to put the subject of taxes aside—except for the possibility of tax cuts, which occupied many legislatures in 1994.

But the time to stop thinking about taxes has not yet come. The issue that needs attention, however, is not revenue raising in the short term. For now, most states appear to be in solid fiscal health—with the exception of northern New England and California, places where the recession of 1990 has never ended.

It's Time to Remodel
It is time to consider more fundamental questions of how well state tax systems in the 1990s reflect the American economy of the 1990s. That is the subject of the book *Financing State Government in the 1990s,* published jointly by the National Conference of State Legislatures and the National Governors' Association. Three other formidable 50-state policy associations—the Federation of Tax Administrators, the Multistate Tax Commission and the National Association of State Budget Officers—provided much of the policy discussion in the book. The result, according to Hal Hovey of State Policy Research Inc., is "the new conventional wisdom among state officials." Conventional wisdom or not, the book asks legislators and governors to consider remodeling a structure of state taxation that has developed haphazardly for over half a century.

To see why this is necessary, consider the general nature of state tax policy—the kind of taxes state governments rely upon, what they tax and how the taxes operate. Then consider how America has changed since the foundations of current state tax policy were laid.

States Tax Alike

It's possible to talk about tax systems in terms of the 50 states, despite the great differences in individual policies, because states have tended to make their policies resemble those of their neighbors. The 50 state governments have two major sources of tax revenue—the general sales tax and the personal income tax.. The third state tax source is the corporate income tax, which in terms of revenue is far less important than either of the two mainstays. And all 50 states mandate that local governments impose property taxes, usually to finance a substantial chunk of elementary and secondary education as well as to pay for local administrative expenses.

Every state, except New Hampshire and Alaska, has either a general sales tax or a broad-based personal income tax and most have both. Only five states (Alaska, Delaware, Montana, New Hampshire and Oregon) do not impose a general sales tax. Seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming) have no personal income tax, and two more (New Hampshire and Tennessee) tax only investment income.

States rely heavily on sales and personal income taxes. In FY 1992 state governments collected $328 billion in taxes (not including any local government taxes). Of that amount, $108 billion or 33 percent came from the general sales tax and $104 billion or 32 percent from personal income taxes. The corporate income tax (collected by 45 states) produced $21.5 billion, a little under 7 percent of total state tax collections.

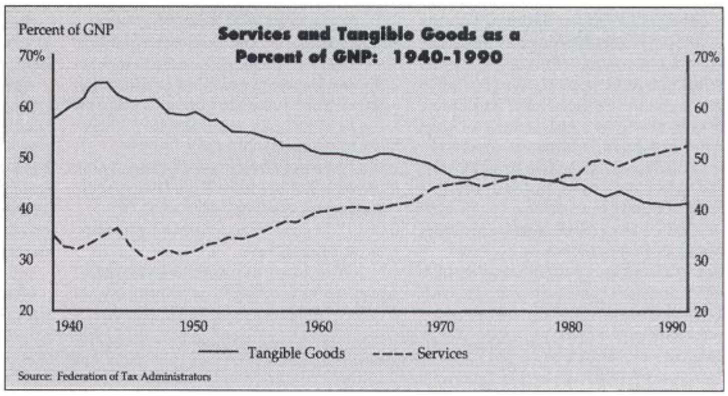
Local property taxes produce more revenue than any state tax. Figures for FY 1992 are not yet available, but in the year before local property tax collections were more than half as large as total state tax collections. For that reason, any substantial reduction in local property taxes, such as the one the Michigan Legislature approved in 1993 or the one Oregon voters approved in 1990, forces major revisions in finances if state government makes up for the revenue forgone.

This basic picture of heavy reliance upon general sales taxes and personal income taxes, supplemented by a corporate income tax at the state level and by property taxes at the local level, has characterized state government since 1971. From 1961 through 1971, income taxes were enacted in 10 states and sales taxes in 10 states (for 19 states in all—Nebraska double-dipped). Only two states have added either tax since 1971, so that the general outline of state tax systems has been stable for 20 years. But the roots of the current tax systems go back much further, to the years of the Great Depression.

Replacing State Property Taxes

The current system was invented in the 1930s to replace old state property taxes. As late as 1932, state governments collected more revenue from property taxes than from their sales, personal income and corporate income taxes combined. During the Depression, the failure of property taxes to produce revenue and their potential for destroying the assets of farmers and homeowners led 16 states to adopt individual income taxes from 1931 to 1937. Even more states—23 from 1933 to 1938—followed Mississippi's lead in trying out the newly invented general sales tax. Although the nation's economy has enjoyed a sea of change since the dismal 1930s, these taxes remain much as they were designed to be in the days of dust bowls and Hoovervilles.

The state adoption of sales and income taxes in the 1930s represented modernization. Basing state taxes on wages, salaries and consumption instead of real estate recognized that the United States had become a nation of factory and office workers instead of farmers. That was, of course, a belated discovery for state policymakers in the 1930s—in 1929, nonfarm personal income was 10 times as great as farm income in the United States. It took an economic crisis of previously unknown proportions to bring the discovery home.



System Outmoded Again

Over the past 50 years, economic changes of similar magnitude have again outmoded state tax systems. The economy of smokestack industries they were designed for no longer exists. The way Americans generate wealth and the way they spend their income has changed dramatically since the 1930s.

Manufacturing is in decline relative to other areas of the economy. In the 1930s, services accounted for about one-third of GNP; the share fell briefly because of wartime manufacturing growth, but has grown steadily since the late 1940s. The share of GNP attributable to the production of goods has declined steadily since the mid-1940s. In 1975, the production of services became a larger share of GNP than that of goods, and the services sector has continued to grow in relative as well as absolute terms.

An equally important change has occurred in how Americans spend their money. We eat at MacDonald's instead of buying groceries, and we rent videos instead of buying books. Consumers in 1990 spent smaller proportions of their money on durable and nondurable goods than in 1960, much less on groceries and about the same share on housing. But expenditures on services (which include restaurant and take-out meals and explain how Americans manage to eat) grew from 25 percent to 42 percent of consumer expenditures.

The trend toward producing and consuming more services and fewer manufactured goods is likely to continue. The services sector is the fastest-growing and healthiest part of the economy. In the 1980s, the goods-producing sector of the economy grew at a rate of 0.2 percent a year while services grew at 3.8 percent a year.

Two other kinds of changes deserve notice because they are also significant in the structure of state tax policy. Americans are growing older. In 1940, less than 7 percent of Americans were over age 65. By 1990, their share had grown to 12.5 percent. The share of the population that has reached what we consider to be retirement age will continue to grow for the next 50 years.

Finally, not only has the nature of business production changed, but so has the scope. The most dramatic signs have been the rapidity with which the latest round of the General Agreement on Tariffs and Trade (GATT) followed the North American Free Trade Agreement—international business is more and more a visible, everyday fact. Exports of goods and services grew from 5.6 percent of gross national product in 1970 to 10.5 percent in 1991; imports have grown even faster.

Within the United States, a steadily increasing share of business transactions crosses state lines. Millions of homeowners send their mortgage payments to a bank in another state. Mail-order catalog sales have grown enormously. More and more businesses operate in more than one state. The local department store may exist in name, but it is likely to belong to a national conglomerate. National franchises have replaced mom-and-pop operations.

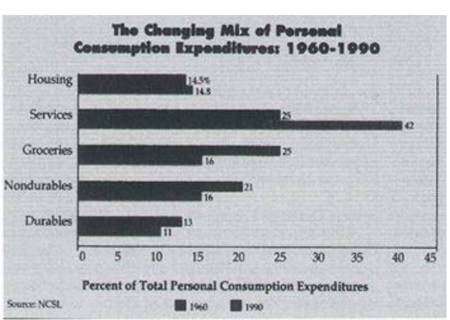
So far this is a familiar story. Its relevance for state tax policy is this: All three of the most important state taxes—the general sales tax, the personal income tax and the corporate income tax—have, to some extent, been made obsolete by economic and demographic change. States have tended to overlook the need for fundamental tax reform while the national economy has changed. States have tended to overlook the need for fundamental tax reform while the national economy has changed. State tax systems have been revised, updated and reformed to an extent that would be admirable if the American economy were still what it was in 1972. But tax policy has fallen behind the times.

What a Good System Is

It matters because the fundamental changes just described have distorted the workings of state taxes so that they no longer comport with reasonable expectations of what ought to characterize a state tax system:

- *Equity*—Taxpayers who are in similar circumstances should be treated similarly, and dissimilar treatment should be reserved for taxpayers whose situations are dissimilar.
- *Promoting economic efficiency*—As a rule, it is desirable to design taxes to have as little impact on individual and business decisions as possible. When taxes are intended to discourage or encourage specific behavior, they should be carefully targeted to their intended purpose.
- *Broad bases*—Broad bases help to distribute tax burdens, and, by contributing to low rates, minimize the effect of taxation on the private sector's economic decisions.
- *Productivity*—How much revenue a government should collect is a political issue, but whatever the decision is, a tax system should predictably produce that amount in order to prevent frequent changes to bases and rates to preserve the revenue stream.

The economic and demographic changes listed above have had specific consequences for state taxes.



State Sales Taxes
Sales taxes are a good example of how states have failed to adapt their tax systems to changes in the economy. In almost every state, sales tax bases remain, as they were in the 1930s, focused on tangible goods; in most states, they exude most services. The shift toward production and consumption of services and away from manufactured goods has prevented the sales tax base from growing in proportion to the national economy, requiring rate increases to maintain the relative productivity of the tax. Purchases of services are favored over purchases of goods, since goods are taxed and services are not. The tax is less stable and more regressive than a broader based sales tax would be.

Because more than half of the states enacted their current sales tax statutes during the 1930s, the tax base reflects the U.S. economy during the Great Depression. Most personal consumption at that time consisted of purchases of tangible property. Such services as existed (other than housing, education and utilities) were generally from manual labor. As a result, most sales tax systems became taxes on retail sales of tangible property, and they mostly excluded purchases of services.

Despite recent attempts in some states to broaden the sales tax base, service transactions still are generally untaxed. Because a growing share of consumer money is spent on services, this explains the fact that sales tax collections fail to grow in proportion to the economy. The average state sales tax rate grew from 3.54 percent in 1970 to 5.07 percent in 1992. Yet due to the narrowing of the tax base through enacted exemptions and increased service consumption, the substantial rate increase succeeded only in holding collections at a constant share of GNP. State sales tax collections were 2.7 percent of GNP in 1970, and they remained at 2.7 percent in 1990.

Excluding services from state and local sales and use tax bases raises policy issues beyond that of revenue productivity. Exclusion affects the neutrality of the tax by treating similar transactions in dissimilar fashion. A system that taxes the purchase of new items, but does not tax repairs, favors repairs over purchases. Exclusion of services also affects the stability of the tax during the economic cycle. A tax structure that includes only purchases of tangible personal property (especially one that exempts food for home consumption) is more sensitive to downturns in the economy than a more broadly based tax. Finally, the expansion of a sales tax to services can make the sales tax less regressive.

Personal Income Taxes
Changes in the U.S. economy and demographic patterns pose growing problems for the base and equity of the state personal income tax as well as its responsiveness to personal income growth. A growing proportion of personal income goes untaxed because of specific federal and state decisions to give it preference.

The same is true of American workers' pay. Untaxed fringe benefits are increasing—health insurance, pre-tax contributions to pension plans, various forms of deferred compensation for retirement savings and flexible spending accounts. Since state income tax bases generally conform to the federal tax base, this income goes largely untaxed at the state level as well.

These benefits affect the equity of the tax because two workers can receive similar total compensation, but substantially different untaxed benefits. They will be treated differently because one worker enjoys more tax-exempt income than the other. Since there is a tendency for higher paid workers to receive more fringe benefits than lower paid workers, the exclusion of fringe benefits from income taxation reduces the progressivity of the income tax.

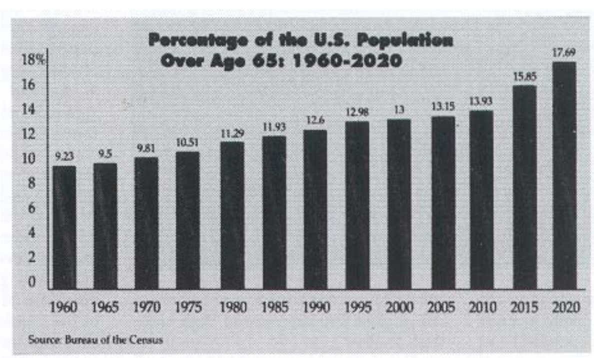
Exempting fringe benefits from income taxation while more compensation is made in the form of fringe benefits also reduces the responsiveness of income taxes to economic growth in the United States. The reason is that a greater proportion of that growth is used for nontaxable compensation.

In addition, many states provide special tax credits, deductions, exemptions and exclusions for certain kinds of income received by people over age 65, often without means testing. Such preferences pose a number of policy problems. Households headed by people over 65 are less likely than any other age group to be below the poverty line; 6.5 percent of such households were below the poverty line in 1992, as opposed to 11.5 percent of all American households.

Age-specific tax breaks, therefore, benefit a relatively prosperous group of people. They also benefit a growing number of people, as the American population ages. Such policies are not only inequitable, if equity requires similar treatment for people whose incomes are similar, but they will also be increasingly expensive as more of the population becomes able to take advantage of them.

In general, the proportion of American personal income subject to taxes is shrinking (although the *dollar* amount continues to grow). Tax-protected income such as social security, pension payments, welfare benefits and untaxed fringe benefits have grown from 14.3 percent of personal income in 1970 to 20.5 percent in 1990. Earnings and investment income have fallen as a percent of national personal income, while the kinds of income that are not so fully taxed have grown as a percentage of national income. Thus, state personal income taxes are being levied on a smaller proportion of total personal income than in the past.

Without changes in tax policy or patterns of compensating workers, the responsiveness of the personal income tax to growth in national personal income will steadily decline.



Taxes on Business

A third area in which change in the economy has outstripped state policy is the taxation of business. Current corporate income taxes were written largely with manufacturers in mind and are not as effective in reaching businesses that produce services. One reason springs from the difficulty of determining where provision of a service can be said to occur for tax purposes. Take an imaginary example: A New York advertising agency develops a TV ad campaign for a company in Chicago. The agency uses data stored in a computer in Massachusetts, and it has a design studio and some offices in Connecticut. As the campaign progresses, presentations sometimes are done by teleconference using a rented satellite uplink studio in Connecticut and sometimes in the client's Chicago office. So diffuse a set of activities was not envisioned in corporate tax law as it exists in most states.

Even for more traditional forms of production, the increase in interstate and international activity has created situations state business tax law was not designed to handle. Inconsistencies among the states allow for loopholes that interstate corporations can legitimately use to protect income from taxation. The rapid growth in interstate and international commerce confronts the states with questions about their authority to tax multi-jurisdictional transactions and businesses, the preservation of tax bases, and the distribution of the tax burden between companies that operate in only one state and those that operate across state lines.

Policies Create Problems

Finally, policies of the federal government and of state governments themselves have created problems. Federal preemption through statutes is one threat, a good example being the way that the Railroad Revitalization and Regulatory Reform Act preempted some aspects of state control of taxation and created a privileged position for railroads vis-a-vis other transportation industries. Federal courts also can limit state freedom to act, as the Supreme Court did in the *Bellas Hess* case, which limits states' authority to require out-of-state vendors to collect sales tax on items shipped into the state. The possibility exists that GATT may infringe upon state powers of taxation. State governments themselves can damage their tax systems with economic incentive packages that erode tax bases and shift tax burdens, thus raising issues of fairness.

What's To Be Done?

Given all these ways that state tax systems have failed to keep pace with economic change, what will happen? And what will legislators do?

Two things seem likely if states fail to modernize their taxes. Tax bases will become even less equitable, as the winds of change benefit some groups in the population and some kinds of business. Equity matters; taxpayers notice unfairness and have never been very patient with it.

Second, with tax bases becoming narrower, taxes will not grow in proportion to economic growth without repeated rate increases. State expenditures in recent years have tended to grow as fast as the economy or faster, driven by education and health spending. Proponents of higher education, welfare reform and more aid to local governments are likely to exert pressure for greater state spending and will push for tax increases. Proponents of smaller government could welcome taxes that produce slow revenue growth as a brake on government growth.

If state governments see these issues as problems to be solved, what can be done? Good analysis of state tax policy is the first step, since in some cases the statement of a problem suggests a solution. *Financing State Government* in the 1990s has some general recommendations:

- **Review the ways that changing economic conditions affect a state's tax structure.** The kinds of structural issues discussed in this article have received little attention in state tax reform in recent years, a point made very clear in a recent report by Steven D. Gold and Jennifer McCormick, *State Tax Reform in the Early 1990s*. Although states continue to make personal income taxes somewhat more progressive and sales tax bases a little broader, they have ignored fundamental issues.
- **Consider state tax policy systemically, not as a set of unrelated components.** State and local tax policy are intertwined; the progressivity of one tax can offset regressivity of another; scant use of one tax can require high rates from another.

- **Carefully evaluate the impact of economic development incentives upon state tax policy.** Interstate competition for economic development can force states to grant incentives or shape tax policy in ways that may not be cost effective overall.
- **Cooperate with other states.** States have preferred to go it alone, but the complexities of the modern economy, the pressures to grant economic development incentives and the dangers of federal preemption increase the value of cooperative efforts, state compacts and uniform state laws.

Specific Taxes
Recommendations with regard to specific taxes are harder to make since they have to be adjusted to individual situations in the states, but here are potential courses of action for policymakers to consider:

- **Expand sales taxes to more sales.** Expanding sales tax bases to reflect economic change means expanding them to services. Florida and Massachusetts both did so on a large scale and then repeated most of them. There are a number of objections to extending sales taxes to business services: The sales tax is a tax on consumers and should not be levied on components of production; it could cause "pyramiding" since the taxes would likely be passed on through sales to ultimate consumers; and it could affect interstate competitiveness.

  Sales taxes on consumer services are less likely to involve such disadvantages. In many states, substantial numbers of consumer goods have been excluded from sales tax bases over the years, and those exemptions can cost more than they are worth. For example, some tax experts point out that the exclusion of groceries from sales tax is an expensive way to benefit the poor since affluent people receive a greater gain.

- **Expand personal income taxes.** Again, legislators should review exemptions, deductions and exclusions of income, asking whether the advantages offered to some are worth their cost in terms of equity and the higher tax burden that others must bear. Tax breaks for the elderly without adjustment for income levels need reconsideration. They will pose increasingly difficult questions of fairness across age groups as the number of elderly increases, and they will be more and more expensive in terms of lost revenue.

Reform for Reform's Sake
Legislators hardly ever attempt tax reform for its own sake. Reforms are more likely to accompany changes in tax rates because the change in rates conceals the shifting tax incidence that reforms produce. Reform for its own sake has high political costs and few friends. Anyone whose taxes will increase because of reform will doubt its value, and people who are promised tax relief through reform will be skeptical of the promise. A recent study that found some sort of tax reform in 39 states from 1990 through 1993 found only one state in which the reform was intended to be revenue neutral. Change for the sake of improving the system is rarely ventured.

But the accumulated distortions that a generation of structural economic change has caused in state tax systems require such efforts. If policymakers are to avoid continual patching and tinkering with state taxes, they need to look at fundamental issues and assumptions, and make fundamental revisions.

CONTINUE THE CUTS

A Sober Case for Tax Cut Policies

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Framing the Issue

The moral appropriateness and practical effects of tax cuts, particularly individual tax cuts that lower marginal tax rates, have been topics of significant public policy debate over the last two decades. This is also a period of time in which we have had significant experience with tax cuts at both a national and state level, including here in Arizona, from which we can learn.

The case for tax cuts is in part moral. This is a nation expressly founded on a concept of individual liberty and natural rights, including the right to keep and control the fruits of one's labor. Excessive taxation is a deprivation of individual liberty and a violation of individual natural rights.

The case for tax cuts is in part moral. This is a nation expressly founded on a concept of individual liberty and natural rights, including the right to keep and control the fruits of one's labor.

The case for tax cuts is also in part practical: that tax cuts encourage and create productive economic activity whose beneficial effects are broadly experienced within the body politic.

Unfortunately, much of this public policy debate has occurred at the theoretical level, a battle of competing econometric models. Model A says that tax cuts do not stimulate the economy or produce beneficial economic activity, but do rob the government of revenue and increase governmental debt, thereby actually damaging economic performance. Model B says, au contraire, tax cuts increase the GNP, increase incomes, and stimulate economic activity, thereby actually providing government with increased revenues. (Although, in fairness, most advocates of Model B would not find the prospects of a government deprived of some of its revenue a particularly unfortunate event.)

It is well past time for laymen to realize that these models, indeed any specific prediction of an economic future, are utterly useless. The outcomes of the models are predicated by their assumptions, which are largely driven a priori by the modeler's beliefs about economic behavior. There is one thing about which we can be confident regarding almost any economic prediction or projection: It will be wrong, and probably grossly so.

Given the nature of a free economy, this should be surprising only to professional economists. An economy is the amalgamation of millions of individual decisions, billions or trillions at the national level, made daily about economic matters: Do I buy this or that? Do I take this job or the other one? Do I purchase this stock or bond? Do I buy a new home or do I put away money in my 401(k)? Trying to guess the cumulative outcome of the millions, billions, or trillions of individual daily decisions made over any future time period is a fool's errand.

Indeed, the case for tax cuts does not truly rest with such econometric models, although advocates have cobbled a few together so as not to be completely disarmed in this futile soothsaying competition. Instead, the case for tax cuts is rooted in an understanding of the complexity of economic activity, and how markets and human behavior interconnect and interact.

While we cannot project with any precision future economic activity on a macro level, we can reasonably expect that if we change incentives, rewards, and punishments, we can change behavior. The practical case for tax cuts is easily stated and easily understood: If we increase the financial rewards of economically beneficial behavior hard work, entrepreneurship, innovation, thrift we will get more of it. While any tax cut that increases revenue left in the private sector will have beneficial economic effects and the moral advantage of restoring to individuals a larger measure of the fruits of their labor, tax cut advocates generally give primacy to cuts in individual income taxes, particularly ones which lower marginal tax rates.

The reasons for this are more complicated than usually thought. Such cuts in individual income taxes will do the most to encourage and stimulate the desired economically beneficial behavior by individuals hard work, entrepreneurship, innovation, and thrift. Additionally, a large segment of small businesses, which have been the driving force behind economic growth and expansion over the last couple of decades, choose forms of corporate governance, such as Subchapter S corporations, in which the business income flows to the owners and is taxed as individual income, not as corporate income. Therefore, cuts in individual income tax rates also directly affect the economic activity of some of our most creative and innovative corporations.

Therefore, cuts in individual income tax rates also directly affect the economic activity of some of our most creative and innovative corporations.

This is not to say that cuts in other taxes are not valuable. The double taxation of corporate income and taxing the inflation-driven increment of capital gains are particularly deleterious to beneficial economic activity. But it is to say that it is appropriate for primacy to be given to individual income tax cuts, particularly those that lower marginal rates.

Then there is the issue of the effect that tax cuts have on government revenue. Most tax cut advocates, if they were honest, would confess that they don't care. If the result of tax cuts is to reduce government revenue, resulting in a smaller and less intrusive government, that is simply an added benefit. But many of our fellow citizens are concerned about the effect tax cuts have on government revenue and therefore government programs. So this has become very much part of the debate.

Usually the effects of tax cuts are calculated based on what is known as a "static" analysis. In other words, if these tax cuts had been in effect over the last year, and economic behavior did not change as a result, the government would have gotten this much less revenue. However, economic behavior does change as a result of tax cuts, a concession made by even the most ardent opponent of tax cuts as public policy. The question is: How much does economic behavior change, and what are the consequences of that change for government revenue.

Tax cut advocates believe Americans are significantly overtaxed, which suppresses economically beneficial behavior. The result of tax cuts, therefore, will be to stimulate economically beneficial behavior in a way that increases economic growth and activity, which in turn increases the yield the government gets from taxes.

Too often, this "dynamic" view of the effect of tax cuts on government revenue is caricatured as claiming that "tax cuts pay for themselves" in terms of short-term government revenue. And indeed, there are some incautious tax cut advocates who do claim exactly that.

More cautious advocates (including me) do not claim that this so-called "feedback" effect fully restores government revenue in the short term. For one thing, since it is impossible to know what the economic future actually holds, it is impossible to know whether tax cuts have fully restored government revenue, since we do not truly know what it would have been.

The more cautious claim is that a "static" analysis will significantly overstate the adverse effect on government revenue from tax cuts, as well as significantly overstate the increase in government revenue from tax increases. Additionally, in the long term, government revenue will indeed be more than otherwise would have been the case if, in an overtaxed economy, taxes were not reduced. Not that this is necessarily a good outcome; just that it is a likely one.

Another issue in the debate is whether states can affect the performance of their own local economy through tax cuts, or whether such state changes are overwhelmed by national and regional economic trends and federal tax policy. Tax cut advocates do not deny the significant influence of larger economic trends and federal tax policy on the performance of local economies, but do believe that local tax policy can make material differences in local economic performance.

As mentioned, there is now significant experience with tax cuts at both a national and state level, including Arizona, over the last two decades. Here is what that experience, properly analyzed and understood, tells us.

National Experience

Much to the amazement and consternation of the liberal academic, media, and political establishments, Ronald Reagan was elected President of the United States in November of 1980. He was inaugurated in January, 1981, and the Reagan tax cut plan was enacted in October of that year.

To be sure, much was added to the bill that went beyond the central idea on which Ronald Reagan ran, and which had been intellectually developed and popularized by Jack Kemp over the course of the latter part of the 1970s: Significant, across-the-board cuts in individual income tax rates. But to a tax cut, limited-government advocate, it was kind of refreshing to see Congress in a feeding frenzy to give taxpayers back their money rather than to spend it.

The Reagan tax cut era was ended with the budget agreement of 1990, in which George Bush agreed to an increase in marginal individual income tax rates. In the interim, there were a number of tax changes enacted, some of them quite significant, such as the *Tax Reform Act of 1986*. Tax increases also were enacted, particularly in 1984. However, until the *Budget Reconciliation Act of 1990*, none of the interim tax changes repudiated the heart of the Reagan tax cut program, significantly lowering marginal tax rates, and some including the *Tax Reform Act of 1986* even advanced the cause a bit.

The personal income tax reductions contained in the 1981 law were phased in over three years, with very small cuts in the initial year. As a result of increases in social security taxes, previously enacted, and the effect of "bracket creep" (inflation placing taxpayers in a higher tax bracket), most Americans did not experience a reduction in federal taxes on their personal income until 1983.[1]

The Reagan tax cuts followed one of the most dismal periods in American economic history. In 1980, inflation was 13.5 percent, and the prime interest rate hit 21.5 percent.[2] In the decade preceding the full implementation of the Reagan tax cuts, the economy grew at a rate of only 1.6 percent per year, and in four of those years real gross national product actually declined.[3]

Nor, contrary to the common caricature, did this growth accrue entirely or even disproportionately to upper-income Americans. If you divide Americans into fifths based upon annual income, each quintile saw real increases in income during the Reagan tax cut era.

During the seven years of the Reagan tax cut era,[4] gross national product (GNP) grew 31 percent in real terms 3.8 percent a year. Real disposable income per capita grew by nearly a fifth.[5]

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At the end of the Reagan tax cut era, there were 3.8 million fewer Americans living in poverty, and the percentage of Americans living in poverty dropped from 15.2 percent at the beginning of the Reagan tax cut era to 12.8 percent at its inglorious end.[7]

Was it a "decade of greed"? Actually, it was only seven years, and charitable giving grew 5.1 percent a year, compared to an average of 3.5 percent over the previous 25 years.[8]

What happened to federal government revenues during this period? Sadly, they grew at an average rate of 8 percent a year.[9] Nominal GNP growth during the seven-year period was 102 percent. Nominal federal tax receipts grew by 99 percent during the same period.[10]

So, if one is to argue that the Reagan tax cuts deprived the federal government of essential revenue, one must argue that the federal government needed to absorb a much larger percentage of national resources than it confiscated in 1982. One can argue that, just don't expect much applause.

There was one significant change in federal income tax receipts during the Reagan tax cut era: higher income Americans paid a greater percentage of federal personal income taxes than they had before. In 1982, the top 5 percent of income earners paid 36 percent of federal income taxes. In 1989, they paid 44 percent. The portion of federal income taxes paid by the top 1 percent of income earners increased from 19 percent to over 25 percent.[11]

And what about those soaring deficits? Well, they weren't caused by a deprivation of revenue, witness the 8 percent growth per annum in federal tax collections. In fact, tax revenues were at approximately 19 percent of GNP at the beginning of the Reagan tax cut era and remained at approximately that figure at its end. Federal spending, however, increased from approximately 21 percent of GNP at the beginning of the Reagan tax cut era to approximately 23.5 percent during much of it, and rose even further, reaching as high as 25 percent, under George Bush.[12]

The rate of increase in federal government spending did indeed decrease under Ronald Reagan. But, sadly, in an otherwise remarkable record of achievement, taming or reforming the federal-spending machine was one that the Gipper didn't win.

The National Experience among the States

Most critics of tax cut policies will concede that, on a national level, tax cuts can stimulate economic activity in some circumstances. However, the claim is often made that tax cuts cannot have a meaningful effect on a state's economic performance; that other factors national and regional economic trends, climate (really) overwhelm the influence of any state-specific tax policy.

I have often been amused by the fact that many of the same people who argue that state tax cuts cannot have a meaningful influence on local economic performance also argue that state spending on favored government programs usually education or social services can. Apparently the tide of national economic trends that swamps the effect of state tax cuts recoils and recedes when confronted with tax expenditures.

There is no denying the large influence of national economic trends on the performance of local economies. But for those who are alert and fair-minded, there is also no denying that within the contours of national economic trends, states can meaningfully improve their economic performance through tax cut policies.

Nor is this a recent discovery. In 1981, the congressional Joint Economic Committee[13] accumulated a decade's worth of research and published some original research of its own. The report compared the 16 states whose economies grew the fastest during the 1970s to the 16 states whose economies grew the slowest.

The study found that states with a low tax burden (measured as taxes as a percentage of personal income) that was falling grew the fastest: 14.5 percent above the national average. However, states with a relatively high tax burden that was decreasing grew nearly as fast, 12.5 percent above the national average. States with a relatively low tax burden but which was rising did better than the national average, but barely (1.5 percent greater growth). States with high and rising tax burdens had economies that grew 3 percent more slowly than the national average.

So, there were meaningful differences in the relative performances of state economies based upon tax policies. Low tax states did better than the national average, but states with declining burdens did significantly better than the national average regardless of where their tax burden began.

There were meaningful differences in the performance of state economies based upon their tax mixes as well. The high growth states relied far less heavily on personal income taxes, corporate income taxes, and property taxes all of which are taxes on economic productivity. Growth was most closely correlated to changes in personal income taxes and high-growth states had lower marginal personal income tax rates than slow-growth states.

The study also compared the correlation between tax burdens and the changes therein to the other factors, ones that opponents of tax cut policies often cite to explain away relative differences in economic performance among the states (such as climate, geography, federal spending, and the extent to which the local economy is dependent on manufacturing). Only relative tax burdens and the rate of change thereof, along with local saving rates, were found to be strongly correlated with growth.

The 1990s have been a particularly good period in which to study the influence of state tax policies on local economic performance. During the 1990s, federal tax policy has been in hasty retreat from the Reagan tax cut advances. The highest nominal personal income tax rate has increased from 28 percent to 39.5 percent. The actual marginal rate is even higher, since the value of some tax exemptions and deductions has been reduced for high-income filers, and they have been denied certain other tax advantages (such as tax deferred contributions to IRAs). In fact, in combination with state income taxes, the highest marginal tax rate in this country is back up to about 50 percent.

Tax cut policies have, however, rapidly spread to the states during the 1990s, including to such historically high tax bastions as New York, New Jersey, and Massachusetts. The Cato Institute recently published a study comparing the economic performance of the ten states that cut taxes the most from 1990 to 1995 to the ten state that raised taxes the most.[14]

The economies of tax cutting states grew faster than those of tax-increasing states (32.6 percent growth vs. 27 percent). Tax cutting states had faster growth in per capita personal income (23.4 percent vs. 21.8 percent) and less unemployment (4.7 percent vs. 6.0 percent).

The most startling finding had to do with job creation. Tax cutting states had over a ten percent increase in jobs. Tax increasing states had no net increase in jobs during a period in which the national economy experienced nearly a six percent increase.

Over the course of time, these small increments of improved economic performances resulting from low tax and tax cutting state policies become very meaningful. A recent update of the Joint Economic Committee report [15] found that over a three-decade period, the economies of low tax states had grown one-third faster than those of high tax states, resulting in higher per capita income growth of $2,300, or over $9,000 a year for a family of four.

The Arizona Experience

Arizona offers an excellent case study in how state tax policy can influence the performance of the local economy. In 1978, the passage of Proposition 13 in California, sharply limiting property taxes, ushered in at least a brief period of fiscal restraint among state governments across the country. Arizona had already taken the first step toward fiscal restraint with the passage of a constitutional limitation on state spending in 1978.

In 1980, the legislature referred to the voters, who in turn approved, a constitutional property tax limitation and an extension of the spending limit concept to local government. By 1983, the era, or perhaps episode would be more accurate, of restraint was over. That year the legislature "temporarily" increased the state sales tax by 25 percent, an increase that was made permanent the following year.

Various tax increases followed during the 1980s, including increases in personal income taxes. In several of those years, mid-term tax and budget adjustments were required, when revenues failed to meet expectations or the spending appetites of lawmakers. By the end of the decade, lawmakers and fiscal policymakers were muttering about a thing they called a "structural deficit": an alleged permanent and growing gap between what existing tax rates would produce and what state government needed to spend.

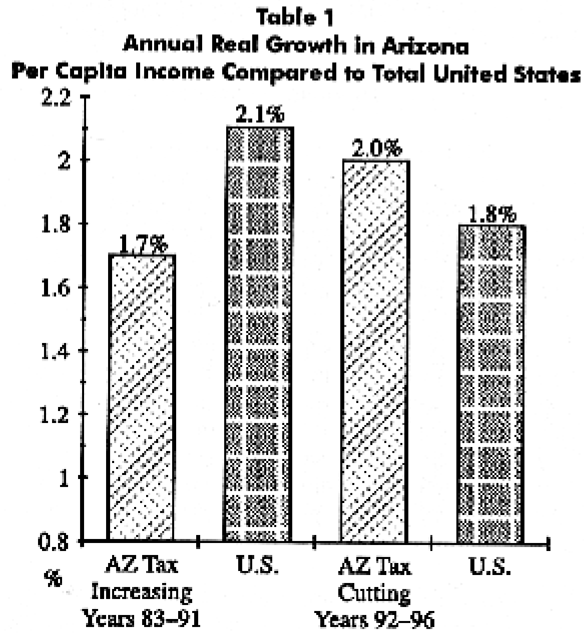
A blue-ribbon committee was convened to bless this point of view with a mammoth study called "Fiscal 2000," which engaged in a variety of intellectual contortions to demonstrate that Arizonans were undertaxed compared to residents of other states. Moreover, Arizona state government relied too extensively on the sales tax (which, despite being over relied upon, nevertheless needed to apply to more transactions), and needed to tax income and property more heavily.

This was pretty much the state of affairs when Fife Symington was elected governor in a run-off election in January of 1991. Symington didn't take office until March of that year, and therefore had minimal influence on that year's tax policy and budget.

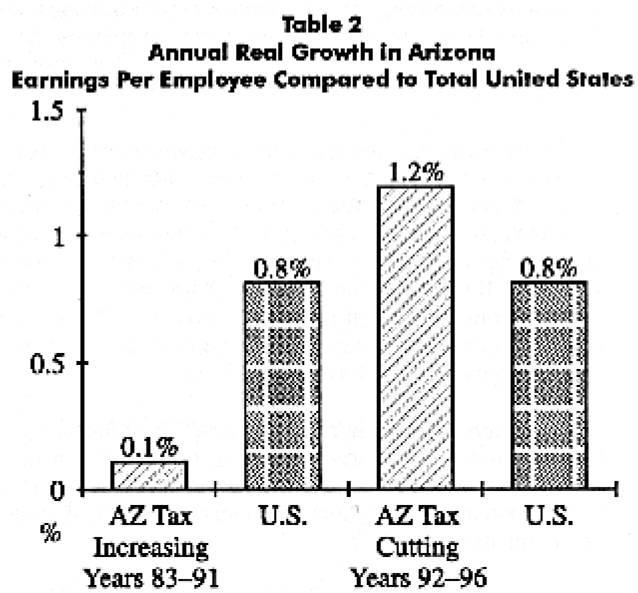
But 1992 was the beginning of a tax cutting era in Arizona. Since 1992, individual income tax rates have been reduced more than 25 percent across the board and major property tax reductions have been enacted as well.

So, 1983 1991 can be described fairly as a period in which taxes were increasing and the expectation was that they would continue to increase, while 1992 1997 can be described fairly as a period in which taxes have been cut and the expectation has been that they will be cut further.

Comparing the relative performance of the Arizona economy during these two periods yields what should by now be a familiar story. During the tax cut period, real per capita income has grown faster (2.0 percent a year) than during the tax increase period (1.7 percent).[16] More dramatically, real earnings per employee have grown 1.2 percent a year during the tax cut period, compared to virtually no growth (0.1 percent) during the tax increase period[17] (see Tables 1 and 2).



Source: Calculated from *State Personal Income*, U.S. Department of Commerce, Bureau of Economic Analysis, 1996.



Source: Calculated from *State Personal Income*, U.S. Department of Commerce, Bureau of Economic Analysis, 1996.

These comparisons actually understate the economic benefits of Arizona's tax cut policies. The early years of the tax cut period were relatively timid and did not directly target marginal income tax rates. Substantial reductions in marginal income tax rates came in the latter years of the tax cut period, and the improvements in economic performance have accelerated as they have gone into effect.

Lest these differences in economic performance be thought trivial, a mere 1 percent per year increase in earnings over a five-year period, for example, means over $6000 in cumulative additional income for a family making $40,000 a year at the beginning of the period.

Most revealing is the comparison of the performance of Arizona's economy to the national economy during these two periods. During the tax increase period, the Arizona economy lagged behind the national average in real per capita income growth and in increases in earnings per employee. During the tax cut period, however, Arizona has outperformed the national average in both categories.

It must be remembered that most of Arizona's tax increase period overlaid a period of tax cuts at the national level, while our period of tax cuts have occurred during a period of tax increases at the national level. So, Arizona's economy performed worse than the national economy when we were raising taxes while the feds were cutting, and performed better when we were cutting taxes and the feds were raising theirs. At some point, the accumulated evidence becomes so overwhelming that only the willfully stubborn and the ideologically blind can deny that state tax cutting policies improve local economic performance.

So, what has happened to state revenues during this period of tax cuts? The cuts have occurred primarily in personal income taxes. Overall, despite over a 25 percent decrease in rates, personal income tax collections have increased 20.2 percent since 1991. The combined rate of population growth and inflation during the period was 29.3 percent.[18] So, one could perhaps argue that the tax cuts have cost the state about 9.1 percent in annual revenue from what might have been expected without the tax cuts. But that's a far cry from the gargantuan sums static analyses claim that the tax cuts have cost state government in revenue.

Moreover, once again, the "feedback" effect has accelerated over time. Based upon the most recent estimates of current year increased tax collections, the loss of state revenue over what would have been projected based upon intervening population increases and inflation will be less than one percent.

And even this may overstate the loss, since 1991 was an unusually high year for personal income tax collections. Real per capita personal income collections in 1996 were below what they were in 1991, but above what they were in 1990 and any other year during the tax increase period.

And this also ignores the effect improved economic performance has on tax collections from other sources. Total state revenue from local sources has grown faster than population and inflation during the Symington tax cut era.

Often the benefits of tax cuts to individuals are also subjected to an unfair static analysis. This takes the form of assuming that an individual makes the same amount of money after a tax cut as before and concluding that the only benefit of a tax cut to that individual is the difference in taxes paid under the lower rate compared to the higher previous rate. Following such an analysis, critics dismissed the value of the early Symington tax cuts, when the rate reductions were rather small to the average Arizonan.

For some reason, when opponents want to dismiss the value of tax cuts to individuals, they always measure them in terms of six packs of beer or steak dinners. Never mind for a moment that six packs and steak dinners are meaningful and valuable commodities to many people. Reductions in tax liability are only part of the benefit individuals derive from tax cut policies. The evidence is overwhelming that tax cut policies increase incomes, create jobs, and expand entrepreneurial opportunities.

But even using a static analysis, the cumulative benefits of the Symington tax cuts on reducing state income taxes for individuals has become meaningful to all but the most obdurate of critics. At a taxable income of $25,000, the annual savings is now $255 a year; taxable income of $40,000, $458 in savings; and at $75,000, the savings is $1068 (see Table 3).

Table 3
Annual Savings from Symington Tax Cuts

Income	Annual Tax Savings
$25,000	$255
$40,000	$458
$75,000	$1,068

That's a lot of six packs and steak dinners.

Conclusion

The lessons of the last several decades are clear:

- Tax cuts, particularly reductions in marginal personal income tax rates, can meaningfully improve economic performance;
- The benefits of improved economic performance are felt broadly throughout the body politic;
- The tax load isn't shifted to lower income taxpayers;
- States can improve the economic performance of their local economies by pursuing tax cut policies; and
- The governmental revenue loss from tax cuts is likely to be significantly less than projected (as the increase in revenue from tax increases is likely to be greatly overstated).

This, of course, is the practical case for tax cut policies. An even more powerful moral case can be made. Sadly, it is rarely made, because the language of liberty, which propelled our country into being, seems to have no place in the political discourse of today.

Ours is a nation founded explicitly on the belief that we have a natural right to liberty, including the right to keep and control the fruits of our own labor.

The level at which taxation becomes a deprivation of liberty is something which is felt, intuited, not something that is deduced from abstract principles. However, there is a remarkable shared sense among Americans as to where this line might lie.

In 1996, *Reader's Digest* sponsored a public opinion poll that asked what was the maximum percentage of a family's income that should be consumed by taxes from all sources, regardless of how much money the family makes.[19] The answer was remarkably consistent across all demographic categories age, income, sex, level of education, ethnicity: government taxes from all sources should not consume more than 25 percent of a family's income, even if that family makes more than $200,000 a year. The reason: It just isn't right.

Well, actual tax levels vastly exceed what the American people regard as morally right, and for average families, not just the wealthy. The average American family pays more than a third of their income in taxes.[20]

Existing marginal tax rates are also a deprivation of liberty. With the Bush-Clinton increases in the federal marginal tax rates, the government asserts the right to confiscate about 50 percent of each additional dollar some Americans make. I don't care how rich someone is, that's just not right.

Our founding fathers, who took to the bushes over tea and stamp taxes, would have their muskets cocked and loaded.

The architects of the federal income tax would be dumbfounded. For 137 years in this country, a federal income tax was unconstitutional. During congressional debate on the constitutional amendment establishing the federal income tax, a provision limiting the maximum levy to 10 percent of income was rejected, on the basis that if such a cap was included, some future Congress might actually think that such a ridiculously high figure was acceptable. Oh, to be able to turn back the clock and remake that decision!

This is, of course, a different era, with different expectations of government. It is beyond the reach of this paper to examine whether government programs are efficiently achieving their intended purposes. A serious case can be made, for example, that low-income Americans are hurt more than they are helped by government programs designed to assist them.

Irrespective, however, of whether government programs are efficient or accomplishing their purpose, an America true to the principles on which she was founded would recognize limits on the amount of government we can decide to purchase through our democratic processes. And one of those limits would be the point at which the cost starts meaningfully to deprive Americans of the right to keep and control the fruits of their labor.

We are well past that point in America today. The tax cut policies pursued by Ronald Reagan and Fife Symington not only have had beneficial practical effects, they also restored an important measure of liberty.

More, much more, is needed.

Notes

1. Robert L. Bartley, *The Seven Fat Years: and How to Do It Again*, (New York: Free Press, 1992), p. 167.
2. Bartley, p. 163.

3. Bartley, p. 26.
4. Opponents of tax cut policies often quarrel with 1983 as the beginning point for an analysis such as this, since it fails to account for the 81 82 recession. However, as unfair as it might be to saddle policies that hadn't even taken effect yet with that period's performance, even doing so does not change the broad trends and directions of economic performance discussed herein. See William A. Niskanen and Stephen Moore, *Cato Policy Analysis No. 261: Supply Side Tax Cuts and the Truth about the Reagan Economic Record*, (Washington, DC: Cato Institute, 1996).
5. Bartley, pp. 4, 6
6. This and the remarkable mobility between strata are probably the most under told and misunderstood aspects of the Reagan tax cut record. See Niskanen and Moore, pp. 24 26. Also Alan Reynolds, "Upstarts and Downstarts," *National Review* (August 31, 1992): p. 25 and Ed Rubinstein, "Moving Up," *National Review* (August 31, 1992): p. 47.
7. Ed Rubinstein, "Race and Poverty," *National Review* (August 31, 1992): p. 42.
8. Bartley, p. 5. See also Richard McKensie, "Decade of Greed," *National Review* (August 31, 1992): p. 36.
9. Norman Ture, "To Cut and to Please," *National Review* (August 31, 1992): p. 36.
10. Bartley, p. 5.
11. Bruce Bartlett, *Cato Policy Analysis No. 192*: *The Futility of Raising Tax Rates*, (Washington, DC: Cato Institute, 1993), p.3.
12. Budget of the U.S. Government, 1992, Historical Tables, Table 1.2.
13. *State and Local Economic Development Strategy: A Supply Side Perspective*, (Joint Economic Committee, Congress of the United States, October 26, 1981).
14. Stephen Moore and Dean Stangel, *Tax Cuts and Balanced Budgets: Lessons From the States*, (Washington, DC: Cato Institute, 1996).
15. Richard Vedder, *State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform*, (Joint Economic Committee, Congress of the United States, December 1995).
16. Calculations from data contained in State Personal Income, U.S. Department of Commerce, Bureau of Economic Analysis, 1996.
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19. Rachel Wildavsky, "How Fair Are Our Taxes," *Readers Digest* (February 1996): pps. 57 61.
20. *Increased Income Means Increased Taxes for Median Family in 1996*, Tax Foundation. Actually, the Tax Foundation puts the average family tax burden at above 38 percent of income. Certain liberal think tanks challenge the Tax Foundation's methodology, but even their own approach puts the average tax burden at above a third of family income. See Richard Kogan, *What Do People Pay in Taxes?* (Washington, DC: Center on Budget and Policy Priorities, 1996).

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The Arizona Legislature and Tax Cuts

Marc Spitzer, Senator
Arizona Senate

Each year I have served in the legislature, Arizona's political parties have debated the philosophy and economics of tax reductions. Proponents of tax cuts argue that income presumptively belongs to those who earn it and that reducing the marginal tax rate creates economic dynamism, new jobs and, ultimately, more tax revenues. Tax-cut opponents adopt a statist economic model which posits that tax reductions reduce revenues, with cataclysmic consequences for governmental services and programs. I am amused to observe that those who have consistently opposed our tax and fiscal policies are now holding weekly press conferences to score political points from the budget surplus they had predicted would never exist. They feign mock horror at how we have allowed the budget carryforward to grow to a record $508 million in fiscal year 1997. They refuse to learn from history.

Not once have those so anxious to spend taxpayer money acknowledged the entrepreneurial ("supply-side") policies that have created these record budget surpluses. The past 10 years in Arizona have provided a test case for supply-side economics. When state government raised the tax rate, anticipated revenues decreased. Conversely, when state government reduced taxes, revenues increased far greater than expected.

From 1988 through 1990, the Arizona Legislature increased the tax burden by more than $1 billion. This bitter medicine was administered to provide adequate revenue to balance the annual budget. But each year the state raised taxes, actual revenues fell short of estimates, requiring midyear budget cuts. According to the 1997 *Fiscal Facts* report of the Joint Legislative Budget Committee (JLBC), the actual increase in state revenues during fiscal years 1989 to 1991 was only $832.9 million. That is about $175 million less than what the tax hikes were projected to provide to the state treasury.

Starting in 1993, the Republican majority in the legislature and Governor Fife Symington embarked on a fiscal policy to reduce taxes, restrain spending, and streamline the legislative process to mandate midsession approval of the state budget. The key ingredient was the reduction of the marginal income tax rate from 7 percent in 1992 to 5.17 percent in 1997.

The effect has been an unanticipated surplus each and every year. For example, upon enactment of the fiscal year 1996 budget, total revenues were expected to be $4.54 billion. In fact, revenues came in at a figure $377 million higher.

But reducing taxes particularly the marginal tax rate is more important than its impact on the state budget. Tax reductions encourage savings and investment. Tax reductions foster a positive economic climate that creates opportunities. Since the majority of Arizona's small businesses are organized such that they file personal income tax returns, the reduction in the marginal rate has allowed many of these small businesses to expand plant and equipment and hire more employees. In fact, Arizona has ranked at or near the top in the nation for job growth during the past few years. Finally, the government has sent the people a message that they are entitled to the fruits of their labor. The message is loud and clear that tax policy can reward hard work and the entrepreneurial spirit.

Perhaps the best measure of our fiscal success is found by examining per-capita personal income adjusted for inflation. According to JLBC, in fiscal years 1987 through 1992, the years when Arizona increased taxes, Arizona personal income fell compared with the national average. For example, in 1989 per-capita income in the U.S. increased 2.6 percent while in Arizona per-capita income increased by only 0.2 percent. However, in each year that we have reduced taxes, inflation-adjusted per-capita income in Arizona has grown substantially faster than the national rate. In 1995, for example, the national increase was 2.4 percent, while Arizona's per-capita income grew by 4.1 percent. There is no more noble goal for political leaders than to ensure adequate reward for labor.

Critics soundly ridiculed the initial tax reductions as providing the average Arizona family with no more than enough money to buy a hamburger meal or chicken dinner. These critics of course ignored the broader implications of this sea change in fiscal policy. But after six years, we have reduced income taxes across the board by 28 percent, provided Arizona families with substantial tax savings, and reversed all of the negative effects of the tax increases of the late 1980s. As a result, our residents are less taxed, our businesses have more income to expand their operations, and our children have more opportunities in which to pursue their dreams.

Why Tax Income?

Thomas P. McGovern, Special Assistant Attorney General
Office of the Attorney General

On July 4, 1861, President Abraham Lincoln called the U.S. Congress to a special session. In his remarks, Lincoln warned against a secessionist movement determined to undo the Union. Congress reacted quickly. They enacted the first income tax ever levied by the U.S. government.

If the rule of self-preservation existed then to justify government's forcible confiscation of individual property, then surely that same logic could apply to the current age. Only this time, the necessity is found not in a call to suppress a rebellion, but to prevent one.

In Arizona and across the U.S., workers today who are less than 40 years of age probably will see their earnings taxed at 50 percent or worse. The average taxpayer already works five months just to pay his/her yearly tax liability. Private enterprise has always been incentive driven. It meant taking risks for greater gains. It meant having rewards for self-confidence in one's own ideas. When the incentive to earn is surpassed by the obligation to pay, no risk will be worth taking.

After 136 years of expansion and convolution, the behemoth federal tax code and the Internal Revenue Service might come closer to threatening our Republic than General Lee's Army of Northern Virginia did running around the Pennsylvania countryside. The concept of an income tax, once thought of as the only means to save the Union, now stands as the biggest threat to it.

Several states operate successfully without an income tax. Evaluated against the nation's annual Gross Domestic Product (GDP), a modest national sales tax would generate as much or more revenue as taxing income. The only reason a sales tax or at least a simplified lower flat income tax concept hasn't received more attention in Washington is because legions of special interest groups, lobbyists, accountants, and the IRS itself have a "thing" about letting this Kervorkian idea spend any time with their golden goose.

Under the current tax code, federal or state, the largest industries now operating in the nation pay nothing to the tax collector. Larger than any consortium of banks, high-tech firms, or oil companies, the illegal black markets of this country continue to enjoy tax-free status while "earning" billions in an illicit drug trade. Add to that the millions of Americans who go to great lengths to not pay some or all of the taxes they owe, and there exists in the culture of lawlessness an untapped reservoir of tax revenue sufficient to negate the national debt.

Under a sales-tax system, however, every time that drug dealer goes to buy jewelry, luxury clothing, a Lamborghini, or a beachfront mansion he pays his taxes on time and in full. That's because he is and always has been a consumer of goods and services. He just doesn't volunteer to the IRS that he works for a living. Moreover, instead of Uncle Joe burning the midnight oil trying to figure out how he can claim his toupee as a dependent, he will be forced to pay his legal taxes every time he trades up for that new hairpiece at "Heads R Us."

Under the tax code we currently have, the vast majority of Americans who try to pay their correct tax might find it easier to try quantum physics than to keep abreast of the ever-changing tax code. What can be said on behalf of a system where the top five percent of our most educated citizens have to hire someone else to figure out what they owe? Under a simplified pay-as-you-go sales tax instead, the physicist in you could continue to ponder the origins of the universe while Shirley at the cash register swipes the bar code on your new atom separator, calculating your total tax due in a fraction of a nanosecond. Sorry H & R Block.

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With a national sales tax, instead of "death by 1040" every April 15th, there would be no tax forms, tax loopholes, or tax calculations to conjure. If the income tax were eliminated overnight, what would become of the IRS, its staggering and costly infrastructure, its thousands of investigators and bureaucrats? Can you say: "Last one out turns out the lights?" Consider the befuddled private sector that will have to figure out what to do with the billions it spent every year hiring tax experts to devise tax strategies or pay lawyers to fend off the audit resulting from last year's expensive tax plan.

Forget the effect on the IRS and consider the effect on the average worker and his or her family. What would they do with an additional 20 percent in every paycheck throughout the year? There are only two choices and both fuel a healthy economy. One family might spend 100 percent of its newfound wealth thereby contributing all of it back to the government. Or one family might decide to engage in the only remaining form of legal tax avoidance: saving and investing. (Remember, interest income would not be taxed in the post-income tax era.) Not every taxpayer would or could opt to save or invest. But the decision not to save the additional money should delight the local retailers in his community, Uncle Sam's kinder and gentler tax collector. With this unprecedented surge in both consumption and investment, lending institutions should be in a position to provide much needed monies as loans for new businesses, for business expansions, or to fund home mortgages.

The arguments against the sales-tax system, or more accurately the arguments for the income-tax system, don't have relevance except as effective campaign demagoguery. Critics will point out that the sales tax will increase the cost of goods and services which will disproportionately affect the poor and working poor. But nothing so disproportionately affects the poor as having less income or no work.

For a head of household earning only $18,000 per year, net take home pay would increase from $540 biweekly to $700. But won't that new income be consumed by the rise in costs of goods? Not necessarily. Many items, such as foods, baby items, and certain clothing, could be exempted from the tax or taxed at lesser rates. Competition in an exploding free market will ensure moderate prices on most essentials for families. Every head of household must still make prudent decisions on where to shop, what to buy, and what not to buy just as they do today. But the individual, rich or poor, will spend his money more wisely than the federal government. Letting the individual keep more of it is more noble than the income-tax structure that prevails today.

Another argument will assert that a value-added sales tax imposes a significant bookkeeping burden on the business owner who will be obligated to calculate the correct tax, collect it, report it, and transmit it to the government. This threat rings pretty hollow to anyone who has ever run a business, big or small, in the past 30 years. The business community already calculates and transmits many collections and fees for local and state taxing authorities. They are set up to collect a tax and are doing so right now. Besides, under the sales tax, if it ever becomes burdensome to take money from the customer, it must mean that the business is burdened by sales. A ringing cash register is rarely a burden.

Another argument against the sales tax is that consumer-purchasing trends are too volatile for Congressional estimating. But has Congress performed any better under the more "reliable" income-tax system? If only one maxim outlives the IRS, the Grand Canyon, and Elvis impersonators, it just might be the reality that Congress will spend exactly 150 percent of what it has available however the revenue is collected. After replacing income tax, the personal wealth and spending of all Americans will yield sufficient fruit for the federal alligator to feast on as usual.

When President Lincoln addressed Congress 136 years ago and pleaded for the means to save the Union, he stood just a few miles to the north of Bull Run. Maybe the drums down the road in our times are not as foreboding as the ones he heard, but it would be a tragedy of great irony if the tax that was once needed to save the free Union turns out to be the driving force in its disintegration.

The States Move to the Supply Side

Stephen Moore, Director of Fiscal Policy Studies, Cato Institute

Can the government really cut taxes and balance the budget all at the same time? For Washington, it's clearly a Herculean task given the meteoric rise in the budget over the past 20 years. But ask Gov. Christine Todd Whitman of New Jersey how tough it is to cut tax rates and balance expenditures and receipts at the end of the year. Or ask Fife Symington of Arizona. Or John Engler of Michigan. Or even ask a Democratic governor like Zel Miller of Georgia.

These and 20 other governors have cut state taxes in recent years while not only managing to keep the budget in the black, but jump-start their state economies. The dirty little secret about Bob Dole's tax-cut proposal is that while supply-side tax policies seem to be in great disrepute in Washington, in the rest of America they've become standard operating procedure. Even many Democratic governors, such as Evan Bayh of Indiana, acknowledge that states have to "cut taxes or fall further behind economically."

The facts support that proposition. For example, in recent years tax-cutting states have substantially outperformed tax raisers. At Cato, we compared the economic and fiscal results in the 1990s in the 10 states that increased taxes the most with the results in the 10 states that cut taxes the most (see Table 1).

- The tax-cutting states have not only balanced their budgets; they also have much larger budget reserves (7.1 percent of state expenditures) than the 10 tax-increasing states (1.7 percent). Moody's bond ratings are higher for the states that cut taxes than for the states that raised them. Cutting taxes at the state level improves the fiscal condition of the state, contrary to predictions of higher deficits.
- The tax-cutting states have economically outperformed the tax-raising states in the 1990s. The economies of the tax-raising states grew by 27 percent (in current dollars) from 1990 to 1995. The economies of the tax-cutting states grew by 33 percent over that period. Even on a per-capita basis, the tax-cutting states saw a faster rise in income than the tax raisers.
- Income for a family of four grew by $1,600 more in the tax-cutting states than in the tax-raising states.
- Americans continue to vote with their feet against tax hikes. In the 1980s roughly 1,000 people every day left the highest tax states for the lowest tax states. In the 1990s the population has grown by 4.2 percent on average in the 10 tax-raising states. But population has grown by 7.4 percent in the tax-cutting states two percentage points above the national average.
- Jobs are much more prevalent in the 1990s in the tax-cutting states. The 10 tax-raising states created zero net new jobs from 1990 to 1995. The tax-cutting states gained 1.84 million jobs, an increase of 10.8 percent.

The states' experience with reducing taxes is of special relevance to the current debate in Washington, because many states have reduced income tax rates across the board as Bob Dole proposes. The top 10 tax-cutting states reduced taxes as a share of total state tax collections by about 6 percent 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 (adjusting for higher economic growth from the tax cut).

Arizona is perhaps the most compelling study in the dynamic effects of tax cuts. Under Fife Symington, taxes have been cut by $1.5 billion since 1992. The top income tax rate has fallen from 8.7 percent to 5.6 percent. Over that 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 cuts. "In Arizona, tax-cutting is an economic issue and a freedom issue," declares Symington.

In New Jersey two-thirds of the 150,000 jobs lost under Gov. Jim Florio's soak-the-rich policies have been recovered under Gov. Whitman. "Income tax cuts were the spark plug for the economic revival in New Jersey," boasts Whitman.

Not surprisingly, these kinds of supply-side success stories are rarely, if ever, reported by Dan Rather or Peter Jennings on the nightly news. But the lessons to be learned from tax-cutting governors are quite unmistakable: on pro-growth tax policy, the states have demonstrated they will lead. Why does Washington lack the good sense to follow?

Top Ten Tax-Increasing States, FY 90-96		
	Employment Growth 1990-95 (Percent)	**1995 Unemployment Rate (Percent)**
1. Rhode Island	-6.7%	7.0%
2. West Virginia	4.5	7.9
3. Connecticut	-7.1	5.5
4. Vermont	5.8	4.2
5. Maine	0.6	5.7
6. Montana	8.7	5.9
7. California	-0.8	7.8
8. Kentucky	5.9	5.4
9. Massachusetts	-1.2	5.4
10. Arkansas	11.0	4.9
Tax Hikers Average	**0.0%**	**6.0%**
Top Ten Tax-Cutting States, FY 90-96		
1. Hawaii	2.3%	5.9%
2. Michigan	5.8	5.3
3. Oregon	11.6	4.8
4. Utah	19.9	3.6
5. Idaho	22.0	5.4
6. Wisconsin	11.1	3.7
7. Arizona	18.3	5.1
8. Virginia	7.7	4.5
9. New Hampshire	2.6	4.0
10. Colorado	19.5	4.2
Tax Cutters Average	**10.8%**	**4.7%**
U.S. Average	**5.9%**	**5.6%**

The Price of a Civilized Society

"Taxes are what we pay for civilized society."

Oliver Wendell Holmes, Jr.

Carol Kamin, Executive Director
Children's Action Alliance

During the 1990s, without significant public debate, Arizona eliminated more than $1 billion per year in taxes one fifth of our tax base. Although tax cuts are often politically satisfying, the extent of our cuts, which are among the biggest multiple-year tax cuts in the nation, have been too extreme.[1] Furthermore, they are dangerously shortsighted and threaten the well-being of tens of thousands of Arizonans, particularly children.

In the political arena, pointing out problems with the depth of Arizona's tax cuts invites the marginalizing and simplistic label of "tax-and-spend liberal" a sound bite that immediately cuts off reasoned discussion. However, in the real-life arena, Arizonans want to get beyond labels to what really matters to them. Has their quality of life improved? What did the tax cuts buy for them and their kids?

Arizona's tax cuts did not buy economic growth. Experts agree that the economic impact of state tax cuts is minor when compared with the influence of swings in the national economy. Hawaii, South Dakota, and Vermont raised taxes in 1996, and their economies continued to grow as fast or faster than the national median.[2] Colorado kept taxes stable and had the best record in the nation in unemployment trends.[3] Utah, with no significant tax cuts, had the highest growth in wages.[4]

Arizona's tax cuts have not lifted the well-being of our low income, working families. In fact, the biggest benefits of our tax cuts have accrued to higher income families, business owners, and shareholders many of whom don't even live in Arizona. Indeed, tens of thousands of Arizona's parents work as hard as they can, yet still earn less than $17,000 per year.[5] These families don't buy much and don't earn enough to owe state income taxes, so income tax cuts and business tax cuts do them little or no good. They can't afford to own a car, their children lack health care coverage, and they make do with low-quality child care or no child care at all at tremendous cost to them and to us all.

Arizona's tax cuts have not lifted the well-being of our low income, working families.

Arizona's tax cuts won't buy us a secure future. No matter how much we brag about Arizona's growth, we cannot repeal the business cycle. We should have learned a lesson from our last economic downturn. Vibrant growth comes crashing down when there are no plans for the future. We've been like a homeowner who has neglected a leaky roof. We've avoided spending some money in the short run, but we are poorly prepared to deal with the inevitable storm. And the problems we have deferred the foundation we have neglected will only worsen and erupt into expensive crises that we will lack the resources to resolve.

Finally, and most importantly, Arizona's tax cuts have not bought us healthy, safe children. Scores of uninvestigated reports of child abuse and neglect have left thousands of children at unconscionable risk. Too many of our children, who go to under funded schools in dilapidated and dangerous buildings, are being denied the opportunity to reach their full potential. Almost 200,000 children of working families have no health care coverage at tremendous long-term cost.[6] Thousands of children are waiting for mental health services they desperately need. Juvenile offenders are back on the street before they get the help they need to stay out of trouble.

Indeed, despite our economic growth, Arizona continues to rank near the bottom of all states when it comes to our national ranking on indicators of child well-being a crucial measurement if we truly care about our future.[7] In our rush to cut taxes, we have forgotten that children are the major reason we plan for that future.

The bottom line is that after we add up all of the tax cuts, the quality of life for far too many families in communities all across our state has gotten no better and, in many instances, has actually gotten worse. And that is what matters. We pay taxes to do together what we cannot do alone to maintain a "civilized society." Few Arizonans believe that in a civilized society a child's opportunity for achievement should be limited to what his or her own private family resources can buy.

Do people like having more money in their wallets? Of course. Are these few dollars worth neglecting our infrastructure and hurting our children? No. The cost to our future is much too high.

Notes

1. Elizabeth I. Davis and Donald J. Boyd, "Tax Cuts Slowed Healthy Revenue Growth in 1996," *State Fiscal Brief* (January 1997). Steven D. Gold and Elizabeth I. Davis, "Tax Cuts Slow Revenue Growth," State Revenue Report (November 1995). Elizabeth I. Davis and Donald J. Boyer, "Second 'April Surprise' Pushes FY '97 State Revenues Even Higher," *State Revenue Report* (August 1997).
2. Davis and Boyd, "Second 'April Surprise' Pushes FY '97 State Revenues Even Higher." Elizabeth I. Davis and Donald J. Boyd, "State Budgetary Assumptions for 1997 and 1998: States Predict Continued Moderate Growth," *State Fiscal Brief* (April 1997).
3. Davis and Boyd, "State Budgetary Assumptions," "Tax Cuts Slowed Healthy Revenue Growth in 1996," and "Second 'April Surprise' Pushes FY '97 State Revenues Even Higher"; and Gold and Davis, "Tax Cuts Slow Revenue Growth."
4. Ibid.
5. Edward Lazere, *The Poverty Despite Work Handbook*, (Washington, D.C.: Center on Budget and Policy Priorities, 1997).
6. *Children with No Health Insurance: The Widening of the Gap in Arizona*, (Phoenix: Children's Action Alliance, 1997)
7. *KIDSCOUNT Data Book 1997*, (Baltimore: The Annie E. Casey Foundation, 1997).

Arizona's Investment Opportunities

George Miller, Mayor
City of Tucson

According to information prepared by the Governor's Office of Strategic Planning and Budgeting, the State of Arizona finished the 1996 97 year with a budget surplus of over $900 million, of which approximately $594 million was in the general fund. This surplus was realized despite the cutting of state property and income taxes by $664 million since 1992. The underlying theory for the tax cuts is that they stimulate the economy by allowing for greater private investment and are therefore good for the state. It seems to me that a sense of balance needs to be brought to this policy debate. Other investment opportunities besides cutting state taxes and maintaining large rainy-day surpluses need to be considered. A wise investor doesn't rely on only one or two investment strategies. Consider the following examples of how we could stimulate the economy and strengthen our state through the public investment of available funds.

Other investment opportunities besides cutting state taxes and maintaining large rainy-day surpluses need to be considered. A wise investor doesn't rely on only one or two investment strategies.

Expand the Economic Base, Create Good Jobs, Put People to Work, Reduce Poverty

Available government funds could be invested in public infrastructures like streets, mass transit, parks and recreation facilities, libraries, and schools. These public investments are necessary to attract and retain high-quality businesses that will create good-paying jobs and expand the state's economic base. Improved streets and transportation systems make it easier for business to operate and for people to get to work. Parks and recreation facilities and libraries help to transform a city into a vibrant, caring community that business will want to be a part of and people will want to live in. Investments made in our public school system, community colleges, technical schools, and universities will provide the opportunities for people of all ages to obtain the skills and knowledge to perform the jobs of the future. Additional public investment can also make possible more partnerships among business, education, and government.

Foster Neighborhood and Family Values

Local governments must get back to basics and invest more in building/rebuilding and maintaining neighborhoods so that families can develop, grow, and enjoy their lives together. To those ends, public investment could provide for new sidewalks, street lights, traffic calming features, trees, graffiti abatement, neighborhood clean-up, and improving or removing vacant abandoned houses. Greater public investment would provide funds for expanding community policing and crime-prevention strategies. Schools and public facilities such as recreation centers and libraries could be open more hours and provide more services. Youth programs could be provided so that young people can be productively employed, given caring guidance, and encouraged to stay in school and graduate.

Protect the Environment

All citizens are concerned about making our communities safer by reducing crime and violence, and by ensuring clean air and drinking water. To ensure clean air and water, investments could provide for expanded mass transit, more rigorous vehicle emissions testing, and the increased protection of our streams and groundwater.

Improve Government Productivity

Everyone decries bureaucratic waste, but to make government more productive investment is needed in communications technology, computer systems, and access to the Internet. Government employees need to be trained in customer service, modern-management methods, and the application and use of the new technologies.

Final Comment

As a retired businessman and as mayor of the state's second largest city, I appreciate the need to set aside some cash in a rainy-day fund. I also understand that money wisely invested will yield a large return. Therefore, I believe that state budget surpluses in excess of the amount deemed prudent for the rainy-day fund should be used for nonrecurring infrastructure investments. Also, instead of automatically pursuing tax cuts, options for the public investment of available funds, such as the previous examples, should be carefully studied and, wherever possible, implemented. As investors in our community's future, taxpayers deserve the greatest return on their money.

Spend Today — Or Invest in Tomorrow?

Jim Kiser, Editorial Page Editor
The Arizona Daily Star

Arizona's tax-cut binge is irresponsible and harmful. I regret having to say that. It would be so much more fun to glory in Arizona's great prosperity. In fact, like the Republican leaders who run state government, I do benefit, personally and professionally, from the state's prosperity. Where they and I differ, however, is fundamental. There are two key differences.

First, former Governor Fife Symington appeared convinced that his tax cutting fueled the state's prosperity. I think that is absolutely backward. The prosperity made the tax cutting possible.

The truth is that neither the governor nor the legislature had much, if anything, to do with the state's prosperity, as the governors and legislatures in other states have had nothing to do with their prosperity. Arizona's economic strength is a function of a national economy that is going through an unprecedented period of moderate growth with high employment and low inflation. You can debate the causes of that national economic strength, but the consequence, as The New York Times reported in late July, is that "the nation's governors are presiding over such prosperous states these days that they find themselves with an enviable problem unheard of a few years back: What to do with all their money."

Arizona's prosperity is wonderful. But it is not unique among the states.

And it is not the result of tax cuts or of any special wisdom or virtue that we in Arizona share.

Second, the state's Republican leadership, including new Governor Jane Hull, if her early statements are an accurate indication, wants to distribute the fruits of the prosperity to those who already are the most prosperous or to put it more kindly, to those who pay the highest taxes. I think we should use the money to improve the lives and opportunities of the less fortunate and needy. Obviously, you can build a respectable intellectual case that those who pay the most should get back the most.

But equally obviously, you can build a respectable intellectual case that one function of government is to provide for the social and economic well-being of all its citizens. You can build a case, too, that investing in the lives of the needy is not "do-gooderism," but a long-term investment in improving the quality of the state's work force, reducing crime rates and reducing the social dysfunction that so frequently accompanies poverty. In this sense, tax cuts are here and in the present. They are spending today. Helping the needy is an investment in the future.

It need not be an either-or between tax cutting or investing in the needy.

But the leadership's idea of a fair balance has seemed to be 90 cents for tax cuts and 10 cents for investment. My idea tends toward the other extreme. Partly that is the result of a perhaps exaggerated sense of fairness my parents instilled in me when I was young. But it partly also is a calculated investment in what is best for Arizona.

Just look at the lives we could improve, the opportunities we could make available, and the problems (welfare, jail terms, dysfunctional lives) we could reduce by investing wisely in preschools, all-day kindergartens, health care for the poor and near poor, better mental health services, sex education programs, Child Protective Services, better school buildings, lower student/teacher ratios in the early grades.

I know this sounds like the typical liberal agenda. But liberals have adopted this typical agenda not out of ideology, but out of recognition that these social programs help solve real problems for real people.

For all their emphasis on being realistic, Arizona's political leaders, in my opinion, are not being realistic at all.

Probably the single greatest factor exacerbating Arizona's especially pernicious social problems is its exceptionally high population churn. We celebrate that Arizona is one of the nation's fastest growing states. What we too seldom see is that for every person who comes here and stays, traditionally two more have come, stuck around a while, and then left.

Every businessman or businesswoman knows what problems are created for their business by that level of customer churn. It drives up marketing costs, sales costs, distribution costs, credit costs, customer service costs, to name only a few. It does terrible things to education, one of my special interests, with some teachers seeing complete turnover of the students in their classes during the school year.

Yet Arizona government seems oblivious to the costs being imposed on the state by its population churn. That churn means Arizona should be spending more than the average on social and health programs, yet Arizona is consistently among the very lowest spending of all the states.

That is unrealistic and irresponsible.

Responsible, forward-looking leaders would not use our burgeoning resources for tax cuts. They would use them to make Arizona a better state by helping provide the needy the skills and opportunity to improve their lives.

It's a choice every conservative understands: Spend today or invest in tomorrow.

Tax Cuts at Whose Cost?

Monsignor Edward J. Ryle, Executive Director
Arizona Catholic Conference

Over the past six years Arizona has cut taxes quite vigorously. Cuts in the most recent legislative sessions add up to nearly $776 million for the current fiscal year and to over $1 billion for next year.[1] The cumulative total since former Governor Symington took office in 1991 is almost $2.6 billion.[2]

Politically, cutting taxes has a venerable history. "A ruler," Paul Veynes wrote of the Roman Emperors, "could win the gratitude of his subjects in no better way than by abolishing a tax, reducing temporarily the fiscal burden of a province, or remitting taxpayers' arrears of payments due to the Fiscus."[3] Nero, Julian the Apostate, and Hadrian are among Veynes' examples. Nero, for example, a lover of Greece, granted it "independence and immunity from taxation" when it was facing hard times.

Certainly, one can agree with those Roman Emperors who eased taxes on provinces that were experiencing hard times, or, as Veynes puts it, on the need "to avoid shearing the sheep too closely, lest they be flayed alive...."

But there are other ways of looking at the matter. Taxpayers in the U.S. and in Arizona are a long way from being flayed alive. And, sheep can also be harmed by neglect and indifference. Young lambs are even more vulnerable. Arizona's treatment of its poorest mothers and children exemplifies such neglect.

The maximum TANF payment for a family of three today is $347 per month, 36 percent of the 1992 poverty line. This is an element in the fact that poverty in Arizona increased from 1993 to 1995 and continues to rise now, while it declines nationally.

From Fiscal Year 1993 through FY 1998, the state's refusal to honor its legislative commitment to mothers and children on Aid to Families with Dependent Children (AFDC, now Temporary Assistance for Needy Families or TANF) to provide them cash assistance at 36 percent of the federal poverty line has contributed $45 million to the $2.6 billion in tax cuts. The maximum TANF payment for a family of three today is $347 per month, 36 percent of the 1992 poverty line. This is an element in the fact that poverty in Arizona increased from 1993 to 1995 and continues to rise now, while it declines nationally.

In a press conference on September 5, 1991, Governor Symington said that Arizona "cannot tolerate a 5 percent decrease in the AFDC benefits for the poorest of the poor." He made good on his word, calling a special session of the legislature to see that AFDC benefits did not fall below 36 percent of the poverty line. The legislature agreed with him. Since then, neither the governor nor the legislature have been unwilling to tolerate the subsequent erosion of the purchasing power of welfare payments by inflation.

Arizona's refusal to increase cash-welfare assistance as it cuts taxes exuberantly reflects the same pattern we have seen in Washington in the past 12 months. The *Personal Responsibility and Work Opportunity Reconciliation Act of 1996* reduced spending for current welfare services by $55 billion over six years, with $23 billion coming from food-stamp cut backs, $23.8 billion from restricting benefits for legal immigrants, as much as $6 billion from SSI benefits, and the remainder from various other sources. The Urban Institute has estimated that welfare reform will add 1.1 million children and 1.5 million adults to the ranks of the poor.

The July 1997 budget agreement between Congress and the White House reduces taxes some $85 billion over the next five years. Seventy-eight percent of the cuts go to the top 20 percent of households, and 32.3 percent to the top 1 percent. The poorest quintile may see a slight increase in its taxes.

While the budget agreement restores some SSI and Medicaid benefits to legal immigrants and offers help for some 18 to 50 year old food stamp recipients, it does not significantly change the direction of the recent policy directions in Washington, cuts in cash assistance for the poor and tax cuts for the rich.

Since Arizona set out on this path before Washington, perhaps it is blazing a trail, one in the wrong direction if Dr. James Gilligan is correct. He writes that one of 11 policies that lead to crime and violence is:

Manipulating the tax laws and other economic policies so as to increase the disparity in income and wealth between the rich and the poor, for that also stimulates crime and violence, by maximizing the degree to which the poor are subjected to experiences and feelings of being shamed, humiliated and made to feel inferior.[4]

Reducing violence is not the highest motivation. I would prefer to build a case for decent cash assistance for poor mothers and children and for the indigent, disabled Arizonans who have been denied General Assistance the past few years by the legislature along the lines of the medieval canonist, Joannes Andreae, who said that "Poverty is not a type of crime." But that argument is not easy to make in a brief article, nor might it have much political efficacy today.

Notes

1. *Joint Legislative Budget Committee, Budget Status Report, FY 1997, FY 1998, FY 1999 and FY 2000*, Joint Legislative Budget Committee, State of Arizona, July 1997, p. 27.

2. News release, Office of the Governor, Fife Symington, Governor, August 12, 1997.

3. Paul Veynes, *Bread and Circuses*, (London: Allen Lane the Penguin Press, 1990), p. 359.

4. James Gilligan, *Violence: Our Deadly Epidemic and Its Causes*, (New York: G.P. Putnam's Sons, 1996), p. 188.

Back-to-Basics Government

At state and local level, they know taxes and government won't just go away.

E. J. Dionne Jr.,
Columnist, *The Washington Post*

Denver—"I've had people questioning my sanity," says Sen. Tom Norton, the Republican leader in Colorado's state Senate.

There is, in fact, nothing crazy about Norton, an 11-year veteran of the state legislature. He and the Republican leader in the House, Rep. Norma Anderson, simply decided earlier this year to take on an impossible issue: the matter of how Colorado pays for its public schools.

The bill they proposed would have shifted school costs away from the local property tax by increasing corporate income and sales taxes. It failed, but they started an argument. They say that was their goal all along.

The Colorado episode is not an isolated event. It reflects what is happening in many states around the country. Instead of indulging in empty gasbaggery about how awful government and taxes are, politicians and voters are trying to figure out what they want governments to do, and how they should pay for it. The top issue in most places, as in Colorado, is public education. The politicians sense that, however unhappy voters are with taxes, the electorate is willing to shell out some money to make sure their kids can read, write and count.

This realization crisscrosses party lines, and Norton and Anderson are not the only Republicans to risk criticism from anti-tax purists. Another Republican who has shown courage on the school financing issue is Gov. George W. Bush of Texas. Bush proposed a big shift in education spending away from the property tax by proposing a package of statewide tax increases.

Bush argues, fairly, that his plan would result in a net tax cut because the tax increases would be more than outweighed by property tax reductions. Bush would make up the difference by tossing some of the state's current budget surplus to local schools.

But that didn't satisfy the most conservative Republicans, including national anti-tax groups that went after Bush's plan. When Democrats in the state House of Representatives rewrote the Bush proposal, the Republican governor had the temerity to support the Democratic bill, saying it met his objectives. When the House vote came, a narrow majority of Republicans voted against their governor, and the bill passed only because of overwhelming Democratic support. It's now tied up in negotiations with the state Senate, which passed a less bold version.

If Norton and Anderson risked being considered crazy in Colorado, Bush is risking his opportunity to follow his father into the White House by making some important enemies. The anti-tax groups he has taken on are influential in Republican presidential primaries.

The specifics of any tax plan can be debated, and the proposal here by Anderson and Norton drew criticism even from people who respected their courage. But it was serious about government. What's striking is that the politics of taxing-and-spending look saner and less ideological at the local level than they do in Washington. National politicians can say education is the overriding issue. The local pols have to pay for the schools. Washington politicians can cry their lungs out about crime. The locals have to pay the cops.

In a state like Colorado, no politician, Democrat or Republican, wants to sound like a friend of big government. Taxes aren't popular. Norton and Anderson had to go through their intricate dance to redesign school financing because of tough tax limitation measures imposed by the voters. Neither expects the limits to be repealed any time soon.

But unlike so many of their Washington counterparts, state and local politicians do not talk as if government and taxes can be made to disappear. Norton, the Republican, hopes to run for governor next year, as does Lt. Gov. Gail Schoettler, a Democrat. They are likely to argue a lot about land-use planning and environmental issues, Norton being the critic of regulation and Schoettler the environmentalist.

Yet they both defend a back-to-basics role for government. Norton says government has three essential purposes: education, public safety and infrastructure, the policy junkie's word for roads, bridges and sewers. Schoettler says state officials need to ask three questions: "What is it states should be doing and what will it cost to do it well? And what is the tax structure you need to do it?"

That is a remarkably sane approach to government. Washington politicians speak glowingly about the genius of state government. They might consider dropping the usual antigovernment patter for a year or two and learn the virtue of simple questions from their state counterparts. They'd still argue a lot, but about real things.

Finding the Money

Penelope Lemov

The stakes are higher than ever: To survive in a global economy, states and localities need to move goods, services and people around with ever-increasing efficiency, economy and speed. Whether it's a high-tech highway or a low-odor sewer plant, facilities need to be built, maintained and modernized even while the once-generous public purse snaps shut.

It comes as no earthshaking news that federal grants and responsibilities are shrinking, that existing trust funds are under pressure to do more than was originally expected of them, and that local taxpayers are exceedingly reluctant to rubber-stamp billion-dollar borrowings for public works even as they demand less congested highways, cleaner water and more speed bumps on neighborhood streets.

There aren't any major breakthroughs on the fiscal front: No one's come up with a brand new source of cash for infrastructure or a whole new field of donors willing to put up the money to build bridges, even if their names were to go on them. National commissions meet and U.S. congressional committees debate about such newfangled financing variations as public purpose bonds and infrastructure banks. So far, little has come of their reports and hearings.

Despite these fiscal obstacles and drawbacks, however, infrastructure is moving ahead on the state and local level. Several states are making bigger commitments to infrastructure spending. Oklahoma, for instance, recently announced it would spend an extra $1.3 billion on new roads in the next five years. And Ohio started tying infrastructure expenditures to economic development four years ago. In order to attract specific companies, the state has been coordinating state and local spending to widen roads, to put in water-line connections and even to make sure there was a new stop sign at a local railroad crossing. The 1991 federal transportation law known familiarly as ISTEA also has encouraged and made possible new flexibilities in financing, which quite a few states are taking advantage of.

As to bonds, much of the debt that is being issued is in the form of revenue bonds that are repaid through user fees rather than general funds. The Massachusetts Turnpike Authority, for instance, is calling on Wall Street to borrow $1.3 billion to help pay some of the outstanding debts for Boston's Big Dig. The bonds for this major project, which burrows beneath the city to bury its highways, will be repaid by tolls collected at both the new Ted Williams tunnel, which is part of the Big Dig, and at other toll roads and bridges around the state. That's business as usual. But some localities, such as DeKalb County, Georgia, have figured out a palatable way to assess taxpayers to pay for public works by linking an infrastructure fund to property tax relief.

What most public works projects that get financed in the "devolutionary" era have in common is a cobbling together of old and new financing techniques, along with an ever-widening range of partners.

On the Fast Track

It takes four hours to drive from Miami to Orlando and that's at 1 a.m., when congestion on I-95 has eased and commuter cars are nestled safely in their carports.

If Florida's Department of Transportation has its way, the overland trip from one major tourist and business center to another will be pared down to just over an hour and a half on a high-speed train, that, like the French TGV, barrels along the track at 200 miles per hour.

"We're not dealing with the romantic aspects of rail travel," says Charles Smith, who's managing the high-speed transportation program for the Florida DOT. "We're looking at future travel and have to have alternatives to highways and airlines.

Financing a dramatic project such as high-speed rail the present price tag is $5.3 billion is well beyond what any single state could hope to manage on its own. That's why Florida officials, from the governor down to DOT administrators, are crafting a delicate balance of private, state and federal contributions.

The latest attempt to build a high-speed rail system that will eventually link Miami to Orlando to Tampa is far from a done deal, but progress is being made. Here's where things stand.

A private partner is in place. The state held a competition for the contract last year and chose a consortium of four private companies the group is known as Florida Overland Express. The private partners are ponying up $349 million a significant amount of cash for private companies to put at risk.

At the state level, Florida has pledged $70 million a year from its transportation trust fund to back the issuance of tax-exempt revenue bonds. Once the rail system is operational, train fares will be used to repay bondholders.

The borrowings, which are a key to financing the venture, are dependent on whether Congress passes legislation providing federal credit enhancement for the bonds. Without such a federal commitment, the bonds are not likely to be marketable. If Congress turns down the enhancement idea, the state will have to go back to the drawing board and rethink how it can finance a high-speed rail system.

Sibling Rivalry

The price tag is $22 million. That's what it will take to rehabilitate Cleveland's deteriorating but irreplaceable Viaduct Bridge. The bridge carries trains over the Flats the city's entertainment district that's the home to the Rock and Roll Hall of Fame and new restaurants.

"It's a high priority for us," says Taras Szmagala of the Greater Cleveland Regional Transit Authority. The RTA got federal grant money to start the first part of the project, but when officials were ready to go ahead with phase two, the structural rehab of the viaduct, they doubted federal money would be there when they needed it.

"That's why they looked around for sources of low-cost cash to borrow, and Ohio's fledgling State Infrastructure Bank was just the ticket. SIBs, which were authorized as a demonstration program by 1995 federal legislation, are a variation on the revolving-loan-fund structures the federal government put in place in the states to help finance wastewater facilities.

In setting up transportation SIBs, the original program called for 10 states to volunteer. (It has since been expanded.) The first group of states was allowed to take up to 10 percent of its federal gas money, match it by at least one state dollar for every three federal ones, and use the proceeds to seed a "bank" to lend money to localities that need help financing transportation infrastructure.

Few states have their banks up and running. Ohio is one of the first to the mark. The original federal funds for the bank came to $35 million, and the legislature more than met the minimum match with $30 million from the general revenue fund. The first project was a $35 million loan to Butler County for up-front expenses on a regional highway. The second was for construction of an underground parking facility near a science center in Cleveland, and the third is to rehab the bridge.

What's helped Ohio put its money to use so quickly and for such a wide range of projects, says Gary Joseph, the deputy director for economic development at Ohio's Department of Transportation, is the way the enabling legislation was written. It gave the SIB permission to do a variety of projects not just highways and it gave the bank revenue-bonding authority so it could leverage its money.

"Ohio's sitting here with $8 billion in new construction needs. We don't get that kind of money from gas taxes," Joseph says. "So the leveraging gives us another tool to get projects constructed, especially projects other than highways that don't have an opportunity to get done through grants."

Hot Stuff

When the San Diego Association of Governments signed on to turn carpool lanes into toll lanes for solo drivers, its goal was simple: relieve congestion on one of its most important commuter roads, I 15. The idea was to tap the unused capacity of I 15's high-occupancy vehicle lane and, in so doing, lure cars out of the crowded freeway lanes.

What SANDAG is also getting for setting up what drivers have dubbed "Lexus Lanes" is the use of toll dollars to pay for transit and other transportation improvements. So far, SANDAG has approved the use of $1.8 million to fund new express bus service that will begin its runs on I 15 in December.

Does this mean that conversion of HOV lanes to HOT (as in high-occupancy toll) is a way for other localities to raise revenue for infrastructure projects?

That remains to be seen. San Diego, as a test case, is fortunate enough to have $8 million in federal money to pay for the operational costs and physical improvements needed to get the toll system started. And the HOV lane was already in place, so there were no costs to pay off there. For San Diego's HOT lane program to go beyond its three-year demonstration period, SANDAG will have to figure out whether revenues from the tolls are enough to cover toll-collection operations. After all, carpoolers still drive the lane free of charge, and SANDAG doesn't want to oversell capacity so that the HOV-HOT lane becomes as clogged up as the rest of I 15. One other point: Since the HOT program started, the number of carpools on I 15 has increased by 15 to 20 percent. Now that there's a price on the lane, do drivers see value in it? And will that leave SANDAG without enough capacity to sell?

A Sewer Story

First, there's the $30 million that a private company will invest to update and improve Cranston, Rhode Island's wastewater plant.

Then, there's the $48 million that same company will plop right into the city's purse for the privilege of bringing the latest technologies to a plant that's antiquated and inefficient.

And that's not all. By signing a 25-year lease, Cranston guaranteed its ratepayers that they would not have to pay more for service between now and 2022 than they would have if the city had continued to run the sewer system.

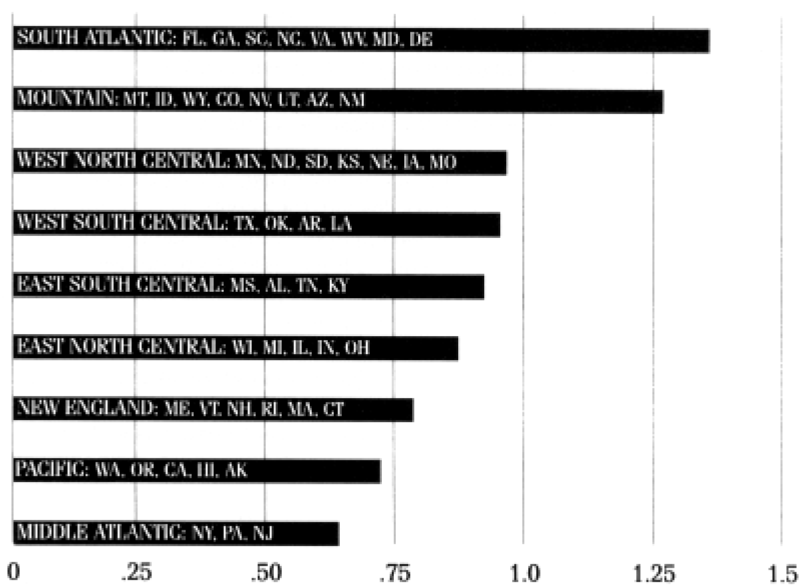
As of September, Cranston is the first city to turn over to a private company for a 25-year period the operation, maintenance and upgrading of its wastewater system. (Until recently, federal rules precluded any contract that went beyond five years.) Given the particulars of the deal and the amount of money the private sector will pump into Cranston's sewer system, it's not surprising that Peter Alviti, the city's public works director, fields two to three calls a week about the $78 million deal.

What he can tell them is that it got done the old-fashioned way. The contract was competitively bid, and the city worked simultaneously with three companies until a winner was picked.

The final deal provides the city with assurances that, over the course of 25 years, it will not lose control of a major asset that it will be able to guard against underperformance of service and overcharging of ratepayer fees and still leave the private sector enough leeway to make it worth its while to invest in capital improvements and maintain operations efficiently.

Putting Money into Public Works

Infrastructure spending as a percentage of personal income, 1995–96



Sources: National Association of State Budget Officers; Bureau of Economic Analysis, Regional Financial Associates Inc.

A Study of the Arizona State Tax Reduction Program

Frank J. Sackton, Professor Emeritus
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Taxes always generate controversy. Some people argue that tax cutting is good for the individual and stimulates the economy. Others contend that tax cutting in Arizona has gone too far resulting in the reduction of essential services to unacceptable levels.

Tax cuts are popular among people because they provide additional spending opportunities and a feeling of increased well-being. Some economists argue that tax cuts, particularly reductions in marginal personal income tax rates, can meaningfully improve economic performance. Further, they argue that states can improve the economic performance of their local economies by pursuing tax-cut policies.

The prevailing contrary view is that essential services should be funded by a government before undertaking tax reductions. Also, a determination should be made of the relative tax burden of that government entity before the tax reduction takes place.

This study explores the tax reduction program in Arizona from FY 1993 through FY 1998. The study covers the extent of tax reduction and how tax cuts were funded.

Extent of Tax Reduction

From FY 1993 and projected through 1998, tax cuts amount to $2.56 billion (see Table 1). These cuts reflect the efforts of the administration of Governor Fife Symington to reduce the burden of taxes on Arizona citizens. The reductions amount to permanent tax cuts. Thus, the tax reductions continue to occur in each year subsequent to enactment. Note the buildup of tax reductions in the years 1996, 1997, and 1998. Perhaps a term more descriptive than tax cut for what is happening is "reduction of the revenue stream." Beginning in 1998, a total of $2.56 billion will be eliminated each year from what would have been the normal revenue stream. Senator George Cunningham (D-Tucson) argues that this huge loss of revenue has compromised the effectiveness of state government, and that we have ignored critical needs, principally education.[1]

Table 1
Tax Cuts ($ in Millions)

Category of Tax	FY93	FY94	FY95	FY96	Proj. FY97	Proj. FY98	Total	Percent of All Tax Reductions
Sales	$0.6	$7.8	$59.0	$85.7	$146.2	$213.8	$513.1	20.0%
Income								
Individual	8.1	30.0	159.2	382.8		553.1*	1547.6	60.4
Corporation					414.4			
Tax Added			(3.1)1				(3.1)	
Tax Cut				28.4	41.5	45.2	115.1	4.5
Property		0.2	1.8	6.7	143.5	151.3	303.5	11.8
Luxury				6.3	8.1	8.8	23.2	0.9
Insurance								
Tax Added		(0.8)	(0.9)	(0.9)	2.7	2.8	(2.6)	0.2
Tax Cut							5.5	
Other (not identified) Tax Added Tax Cut			(0.6)				(0.6)	
	0.4	0.6		4.8	19.3	35.8	60.9	2.4
Total Tax Reduction	$9.1	$37.8	$215.4	$513.8	$775.7	$1,010.8	$2,562.6	100.0%**

* Includes $110.0 million which is shown in JLBC report as "reserved for tax cuts."

** Does not add due to rounding.

1 Tax increases in parenthesis offset tax cuts/ Figures should be subtracted from sum of tax cuts to obtain the total for each fiscal year.

Source: Joint Legislative Budget Committee Staff

Senator Scott Bundgard (R-Glendale), current chair of the Senate Finance Committee, counter argues that much of the tax cuts went back into the economy, contributing to the economic growth of the state. This "supply-side economics" argument was offered also by Representative Mike Gardner (R-Tempe). Senator Cunningham rejects that argument, pointing out that supply-side economics (the Laffer Curve) is not a proven economic concept and did not work when tried at the federal level.[2]

Representative Sue Gerard (R-Phoenix) arguing against permanent cuts, expressed the concern that the state will have difficulty coping with a downturn in the economy. She believes that instead of permanent tax cuts, the administration should have considered yearly tax rebates in order to keep the base revenue stream intact.[3]

Along the same lines, a March 18, 1997 memorandum to Senator Edward Cirillo (R-Sun City) by Ted Ferris, then director of the JLBC staff, stated that there is a "large and growing shortfall for both Fiscal Year 1999 and Fiscal Year 2000." He identified the combined projected deficit for both years at $600 million.[4] (See * page 96.)

How Tax Reductions Were Funded

Use of the K-12 Rollover

When the Symington administration took office in FY 1991, it inherited an indebtedness of $143 million which had been used to balance the budget by delaying state-aid payments to school districts, and making the payments in the following fiscal year. Instead of paying the debt as a first priority, the governor and the legislature elected to retain the debt while establishing the priority to cut taxes. The rollover was maintained at $143 million in 1992, 1993, and 1994. The rollover was reduced to $54 million in 1995, and finally eliminated. During this period, the administration used the rollover to balance the budget and provide tax cuts. Thus, the administration had no difficulty in balancing the budget in 1992, 1993, and 1994, while funding the $9.1 million tax cuts in 1993 and $37.8 million in 1994. The K-12 rollover was "borrowed" money on which the state paid $3.5 million in interest.

Savings from Project SLIM

Project SLIM (State Long-Term Improved Management) was initiated in 1992 by the Symington administration. It was aimed largely at the lower-priority agencies which meant all agencies other than Education-K-12, Higher Education, AHCCCS, Economic Security, Corrections, Courts, and Health Services. The intent of Project SLIM was to improve management and reduce the cost of state government. Initially, the program was successful in cutting costs thus providing some offset to reduced revenue. After the apparent success in slimming down these agencies in the early years of the program, Project SLIM went into reverse (see "All others," Table 2). After 1995, Project SLIM was not instrumental in providing any savings to assist in the tax-reduction program. In fact, it had become a drain on the General Fund. At the start of the program in 1992, the expenditures were $289.0 million. They jumped to $438.8 million in 1997, and are projected to $771.6 million in 1998.

Table 2
State of Arizona Expenditures:
General Fund FY 1991 to FY 1998
($ in millions)

Agency	1991	1992	% Change 1991-92	1993	% Change 1992-93	1994	% Change 1993-94	1995	% Change 1994-95	1996	% Change 1995-96	1997	% Change 1996-97	1998[3]	% Change 1997-98
K-12	$1,207.3	$1,312.6	9%	$1,371.5	5%	$1,515.7	11%	$1,709.3	13%	$1,791.6	5%	$1,972.7	10%	$1,889.0	-4%
Higher Ed.[1]	603.3	607.4	1	619.3	2	627.1	1	679.1	8	662.7	-2	745.8	13	781.5	5
AHCCCS	333.2	420.5	26	455.9	8	453.0	-1	486.7	7	420.8	-14	479.0	14	496.9	4
DES	315.9	343.2	9	366.6	7	351.7	-4	379.3	8	387.8	2	394.7	2	378.0	-4
DOC[2]	273.4	277.8	2	282.3	2	275.6	-2	374.0	36	375.4	0	478.0	27	454.7	-5
Courts	66.7	72.6	9	78.9	9	84.3	7	96.0	14	103.7	8	116.3	12	135.2	16
DHS	139.1	179.3	29	200.3	12	191.7	-3	218.0	12	204.7	-6	216.3	6	232.2	7
All others	282.5	289.0	1	293.5	2	255.4	-13	326.4	28	270.0	-17	438.8	63	771.6	76
TOTAL*	$3,221.4	$3,502.4	1	$3,668.3	5%	$3,754.5	2%	$4,268.8	14%	$4,216.8	-1%	$4,814.4	15%	$5,223.0	8%

* Figures may not add up due to rounding.
1 Higher Education includes universities, community colleges, and Boards of Regents, but excludes U of A Hospital.
2 Department of Corrections includes Department of Juvenile Corrections
3 Appropriated amount
AHCCCS - Arizona Health Care Cost Containment System; DES - Department of Economic Security; DOC - Department of Corrections; DHS - Department of Health Services

Source: State of Arizona, Annual Budget for various years, and Senate Bill 1001, 1997 (for 1998 data)

Added Revenue in a Growth Economy

In the last several years, the growth in the state economy provided additional revenue (see Table 3). The increase in revenue in 1994 was 8 percent over 1993; it was 14 percent in 1995 over the previous year; then, 11 percent in 1996, and projected as 9 percent in 1997 and 5 percent in 1998. Clearly, the added revenue helped, but by itself, was not sufficient to accommodate funding the high-priority agencies, increasing the funding of the "all other" agencies, and for the tax reductions.

	FY 1993 Actual	FY 1994 Actual	FY 1995 Actual	FY 1996 Actual	FY 1997 Projected	FY 1998 Projected
Balance Forward	$5.2	$86.0	$229.2	$269.5	$399.9	$347.9
Revenues - Before Tax Reductions						
Sales	1,632.0	1,800.0	2,027.6	2,189.0	2,365.2	2,498.8
Income						
Individual	1,375.2	1,490.0	1,663.1	1,893.9	2,032.0	2,186.8
Corporation	239.2	302.5	413.6	476.4	561.5	542.9
Urban Revenue Sharing*	(183.7)	(185.4)	(205.6)	(218.5)	(257.8)	(291.2)
Federal Retiree Program*	--	(55.2)	(25.0)	(17.5)	(56.2)	(6.2)
Property	203.2	186.4	180.5	195.0	190.8	193.0
Luxury	73.1	73.3	74.0	79.5	76.5	72.6
Insurance Premium	103.0	109.9	110.8	113.2	127.9	138.9
Motor Vehicle License	103.1	115.9	132.1	149.4	165.5	170.7
Other Revenue	248.8	272.9	307.9	314.2	421.5	382.5
BSF Transferred to GF Due to 5% Cap	0.0	0.0	1.8	2.2	3.7	6.4
Total Base Revenue	$3,793.9	$4,111.1	$4,680.8	$5,176.8	$5,631.6	$5,895.2

* These denote reductions in revenue.

Source: Joint Legislative Budget Committee Staff

Reduction in the General Fund Appropriations for Education

Historically, education (K-12 and Higher Education) has received over 55 percent of the General Fund. The problems of under funding the growing K-12 system have received widespread publicity; i.e., withholding the inflation increment from the K-12 budget over several years, the continuing challenge to the Arizona Supreme Court decision of July 1994 requiring equity in funding for schools statewide, and the attempt by the administration to solve the problem with a piecemeal approach (the ABC plan Assistance to Building Classrooms) in 1997. However, none of these measures approach the $835 million required for emergency repairs alone, as determined by a legislative-sponsored study.[5]

The U.S. Department of Education reported that for fiscal year 1992, the average expenditure per pupil in public elementary and secondary schools was $5,594 nationally and $4,510 for Arizona. Arizona was 40th in amount of funding. Only 10 states had a lower expenditure figure.[6] The pupil-to-teacher ratio in fall 1993 was 17.1 nationally and 18.9 in Arizona, the sixth highest pupil-to-teacher ratio among the states.[7] The average annual salary of teachers in public elementary and secondary schools in FY 1994 across the country was $36,846 and $32,711 in Arizona.

In the period FY 80 to FY 95, after adjusting for inflation, Arizona teachers received pay increases amounting to 10 percent compared with the U.S. average of 19.4 percent. Only 12 of the 50 states received a lower rate of increase than Arizona.[8]

As Table 4 indicates, higher education received a smaller share of General Fund revenues from FY 1991 through projections for FY 1998. Its share of the revenue dropped from 18.7 percent in 1991 to 15.0 percent projected for 1998. Thus, it has not kept pace with other agencies in General Fund increases.

Table 4
Higher Education General Fund Allocation

Year	Funding ($ in Millions)	Percentage of Total General Fund Allocated to Higher Education	Percentage Change in Expenditures for Each Year from Previous Year
1991	$603.3	18.7%	--
1992	607.4	17.3	1%
1993	619.3	16.9	2
1994	627.1	16.7	1
1995	679.1	15.9	8
1996	662.7	15.7	-2
Projected 1997	745.8	15.4	13
Projected 1998	781.5	15.0	5

Source: Joint Legislative Budget Committee and State of Arizona Annual Budget

Conclusions

In the early to mid 1990s, before most of the state tax cuts became effective, Arizona's tax burden already was a little below the national average. For the fiscal years 1993 to 1996 and for the projected (appropriated) years 1997 and 1998, state government has engaged in a tax reduction program that totals $2.56 billion. The tax cuts are permanent and will reduce the base revenue stream annually by $2.56 billion in 1998 and beyond. An alternative view on tax cuts is to give tax rebates in revenue surplus years, thus preserving the base revenue stream.

The major forces that contributed to the tax reductions were the:

- K-12 rollover, for 1993 and 1994 only
- economies generated by Project SLIM for 1993, 1994, and 1996 only (The project since has become a drain on state funding, thus negating any contribution it made previously.)
- added revenue in a growth economy
- reduction of the General Fund appropriations for education

A view held by proponents of tax reduction is that the tax cuts will maintain and improve the growth of the state's economy, thus generating more revenue for the treasury. The opposing view is that this is not a proven economic concept, and that the state will have funding problems in the next downturn of the state's economy notwithstanding the tax cuts. Economic activity cycles are part of our free-market system. There will continue to be peaks and valleys in the cycle of economic activity. Although Arizona is currently enjoying a period of prosperity, it should prepare now for the next economic recession.

Notes

1. Quoted in "GOP Counts $2.5 Billion in Tax Cuts," *The Arizona Republic*, March 27, 1997, p. A-1.
2. Ibid.
3. Ibid.
4. Ibid.
5. Liz Montalbano, "Lives Hang in Balance Due to Poor Education Laws," State Press, February 21, 1996, p. 5.
6. National Center for Education Statistics, *Statistics of State School Systems*, May 1995, U.S. Department of Education *Digest of Education Statistics* 1995, Table 164, p. 165.
7. *Digest of Education Statistics 1995*, Table 65, p. 76.
8. *Digest of Education Statistics* 1995, Table 77, p. 85.

* Revenue projections were revised upward significantly in June and September 1997, thus eliminating the deficits previously projected for FY 1999 and FY 2000. However, at the November 1997 meeting of the Arizona Tax Research Association, the JLBC's new director, Richard Stavneak, projected an out year deficit in 2001 of approximately $300 million under a scenario of moderate economic growth and a further $200 million tax cut in the next legislative session.

Blue-chip times

States benefiting from a booming economy are taking a cautious approach to spending so far. Such caution is well justified by history.

Hal Hovey, Editor, *State Budget & Tax News and State Policy Reports*

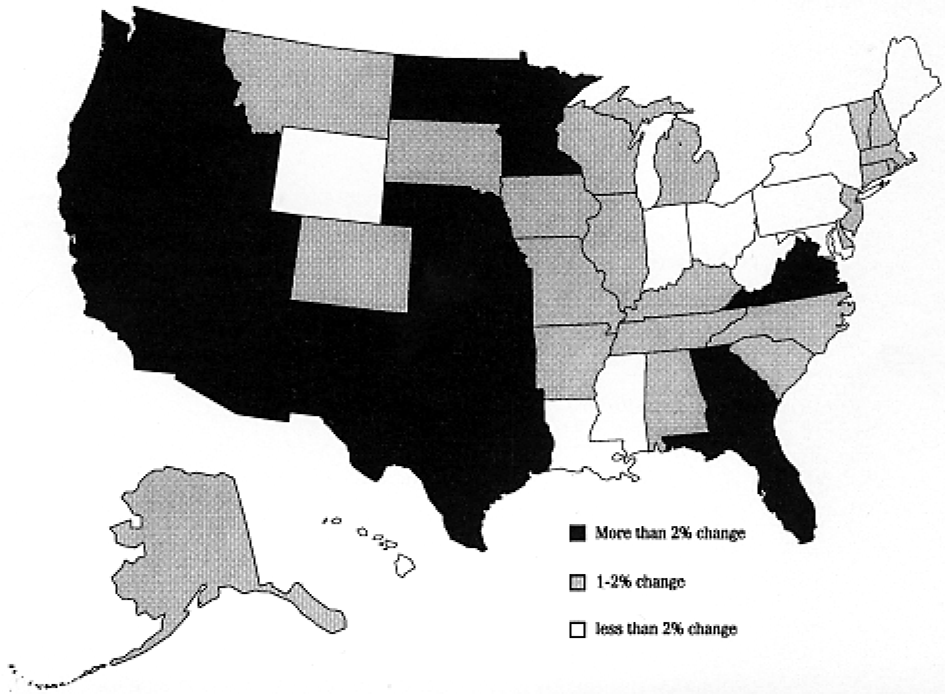
State finances are in outstanding shape.

Everything seems to be going right. Revenues are up, spending is down, balances and rainy-day funds are growing faster than expected, and the outlook is for more of the same. The whole situation seems too good to be true. It probably is.

There are always a few examples of states with self-inflicted fiscal problems. But mostly states run into fiscal problems because of circumstances state officials can't control recession, federal actions, and demographic and economic factors affecting taxes and spending. Right now, each one of these is bringing good news.

The economy: The nation's economy is on a roll a long one at that. The economy has grown smoothly for a longer period without a recession than all but twice since 1945. The consensus economic forecasts are for more of the same for at least another year. Certain aspects of recent economic growth have particularly favorable effects on state finances. One is the concentration of gains in activities states tax the heaviest wages and salaries rather than pensions or benefits, purchases of durable goods like vehicles and furniture rather than services, corporate profits and capital gains. Another aspect is the strong growth in employment. Employment has been growing at about 1.9 percent a year, about twice as fast as population nationally. The results are beautiful fiscally more rapid growth in taxpayers than tax users, fewer unemployed, fewer people eligible for welfare and other programs with means-tests for eligibility. Also, the good news is widely spread geographically, with Hawaii the only state that is in recession. Figure 1 shows the recent job growth for each state. While Western states are showing the strongest economies and state fiscal positions, 37 states have comfortable job growth of 1 percent or better. Even some of the other 13 states, such as New York, are reporting revenues well above estimates. The good news has resulted in state tax collections in fiscal 1997 that are about 2 percent higher than states anticipated when they adopted budgets early in 1996. Besides adding to the surpluses, this unanticipated revenue provides new, higher tax bases as states estimate their new budgets.

Figure 1
Percent Change in Employment, December 1995 to December 1996



Federal actions: In 1995, 1996 and early 1997, state officials expected the worst from the federal government. States anticipated dramatic federal aid cuts in current and future budgets because of federal budget-cutting plans and the proposed balanced budget amendment. States also feared federal tax reforms would have adverse impacts on state taxing authority. Instead, the balanced budget amendment and sweeping tax reforms appear dead until at least 1999. Moreover, the federal deficit has dropped without federal aid cuts. Welfare reform has provided windfalls to states, and the partisan competition that developed in passing the current federal budget produced extra aid for education and other grant programs.

Cost of government: There also has been good news concerning state costs. Health-care inflation is now about the same as the general inflation rate, down from twice that rate in the first half of the 1990s. This produces savings in Medicaid, health care for state employees, and state-paid health costs for inmates, foster children and others. Welfare caseloads have declined dramatically, even before implementation of federal welfare reform. Growth in prison populations has slowed and crime rates are declining. The effectiveness of chemotherapy and changing doctrines of appropriate care are emptying expensive state institutions as community programs serve increasing numbers of developmentally disabled and mentally ill.

News unexpected: Good news affecting state finances is even better news when it comes as a surprise. Expected good news leads states to adjust their finances by making tax cuts and increasing spending. Unexpected good news produces revenues above estimates, swelling surpluses and rainy-day funds, and lapsed appropriations, further swelling balances. State officials didn't anticipate fully the strength of the economy. Feared federal aid cuts didn't occur. States anticipated more inflation in health-care costs than developed. And states didn't expect the windfall revenues and new flexibility of federal welfare reform. Also, a booming stock market produced higher-than-anticipated growth in assets of state pension funds, bringing many states to full funding of these plans.

Cautious Approaches

By a combination of accident and design, state officials have created a cautious, fiscally conservative record in dealing with their good fortune.

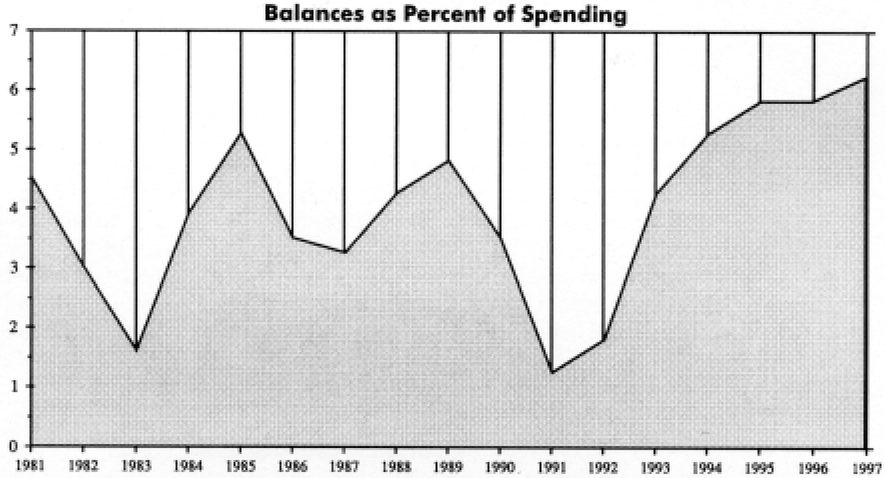
Building hedges against future adversity: State officials used some of their good fortune to rebuild their balances and rainy-day funds. Those balances now exceed 5 percent of spending, a target for some states, and are higher than anytime in the 16 years since 1980. Figure 2 shows what has been happening.

Caution in cutting taxes: With a few exceptions, state officials have not turned their prosperity into deep permanent tax cuts that might impair their future fiscal outlooks. Instead, states held down tax cuts in 1995 and 1996, and likely will hold them to less than 1 percent of spending in 1997. To avoid impairing future fiscal capacity, some states have passed one-time tax rebates rather than permanent tax cuts. Other states have spent extra general fund money to avoid increases in other taxes. Colorado used a surplus to relieve pressures for highway taxes. South Carolina and Wisconsin financed local tax reductions by lowering property taxes. In 1997, the largest tax cuts are appearing in states that are required to stay within constitutional limits on spending or taxes, such as Missouri and Washington.

Cutting spending: States have attempted to curtail costs of their cash welfare and Medicaid programs. These efforts have been particularly vigorous where the benefits provided (and thus state costs) have traditionally been higher than national averages. Examples: cash welfare in California and Medicaid in New York.

Cautious approaches to raising spending: State officials are talking more about "not just throwing money at the problem" and less about "unmet needs." The results appear in many overall policies. These include attempts to reduce state employment and shift selected state functions and programs to the private sector. For example, much of the state emphasis in elementary and secondary education is on relatively inexpensive actions. These include measuring student performance, rewarding successful schools, receiverships for districts that are failing educationally, and promoting competition through choice programs such as charter schools. Much of the new spending is inherently one-time, such as providing computers and Internet links in every classroom.

Figure 2
Balances as Percent of Spending



Balances through fiscal 1995 are those estimated by state budget officers and reported by the National Association of State Budget Officers in its November 1996 Fiscal Survey Of States. Estimates for fiscal 1996 and fiscal 1997 are the author's, reflecting more recent information than that available when the budget officers were surveyed.

The exceptions: Not all states are equally cautious in managing their finances. The most cautious approaches are appearing in fast-growing Western states where the rapid pace of the economy seems too good to be sustainable. Some Northeastern states, particularly New Jersey and New York, have cut taxes aggressively out of fear that their slow economic growth is caused by excessive tax burdens. But state officials seeking corresponding spending cuts, such as Gov. George Pataki of New York, are discovering barriers to their implementation ranging from federal mandates to reluctance to curtail long-established public services.

Risks to State Finances

Historically, in prosperous times states plant and nurture the seeds of future fiscal crisis. Viewing their good fortune as permanent, they spend too much, save too little and cut taxes too much. These actions mature into dramatic fiscal crises when a recession ends a temporary favorable run of fiscal good luck. During the deep midyear spending cuts and steep tax increases of 1983, budget cuts disrupted public programs, and tax increases upset taxpayers by occurring when people could least afford them. The combination destroyed many elected officials' careers. This pattern easily could repeat. Signs are that state officials are starting to take good news for granted anticipating a permanency in reduced welfare dependency, slow growth in health-care costs, increasing federal aid, high returns on pension-fund investments and rapid growth in tax collections. The most worrisome sign is that many proposals would use one-time windfalls to finance permanent cuts in taxes and increases in school aid for property-tax cuts. The temptations are obvious because the short-term advantages are clear and the long-term risks are speculative. In a recent issue, State Policy Reports listed seven risks to state finances: recession, financial market corrections, return to normal tax collections, adverse federal actions, return of familiar spending pressures, overconfidence, and "cascading problems" the tendency of unfavorable developments to build on each other just as favorable developments recently have been building on each other. The overriding fiscal issue of the 1997 legislative sessions is just how much risk state officials can afford to take.

States Control Spending Despite the Tax Windfalls

Anticipating Future Economic Downturns

David Cay Johnston, *The New York Times*

Five years of economic growth have left state governments flush with money. But instead of spending it, they are generally building rainy day funds and letting a little trickle back to residents through rebates and tax cuts.

The trend is a break from what usually happened when the economy boomed, when states often used increased tax revenues to make up for spending cuts or enacted programs postponed by an earlier recession.

The states' new restraint on spending, and the trimming of tax rates, show both the response of elected officials to anti-tax sentiments and efforts to avoid a painful mix of spending cuts and tax increases in the next business decline say officials who study state finances. The states are also wary about future financial aid from the Federal Government, the experts say.

Last year, the states on average held spending increases to 4 percent, not much above inflation, while their revenues grew at more than 6 percent. Over all, states count on personal income taxes for 31 percent of their revenues, while general sales taxes bring in one-third of the total. Most of the rest comes from taxes on corporations, tobacco, alcohol.

Nine states expect their revenues to be 10 percent above the figures projected in their budgets. Texas, Michigan, Minnesota and Indiana expect to pile up surpluses of more than $1 billion each.

This year, tax cuts or rebates will take effect in 27 states. In the last two years, tax reductions had been enacted by 32 states, including New York, New Jersey and Connecticut.

"When you have had this surge in revenue growth in the past, the states spent a good share of it," said Raymond C. Scheppach, executive director of the National Governors Association, who is a former deputy director of the Congressional Budget Office.

While more than half the nation's governors are busy honing images as tax cutters, many of the reductions have been tiny. More than half of the total dollar reductions were in New York and New Jersey, both led by Republican governors. Tax-rate cuts have reduced revenues by $4.2 billion in New York since George E. Pataki became Governor in 1995 and by $2.8 billion in New Jersey since Christine Todd Whitman became Governor in 1994.

State tax cuts in the last three years amounted to less than 1 percent of state government revenues nationwide, according to the Center for the Study of the States in Albany.

The big tax cuts in New York and New Jersey have been the exception to rebates and holding onto surplus revenues. The two states' aggressive tax reductions may put them in sharply contrasting positions to the rest of the country the next time the economy falters and tax revenues weaken.

One state with a conservative approach is Michigan, which had a surplus of nearly $1 billion, but did not cut taxes last year. Budget officials in several states said one reason to build surpluses before cutting tax rates was uncertainty about how to pay for jobless and welfare benefits for people who would be thrown out of work in the next recession.

Minnesota anticipates a $1.4 billion surplus in the current fiscal year and Gov. Arne H. Carlson, a Republican, is proposing to return $261 million in a one-time tax rebate that would be paid just before Christmas, and to cut the tax-rates to bring a $240 million yearly reduction in revenues.

Iowa, with just 2.8 million residents, has $440 million set aside, and is expected to add another $334 million this year. Gov. Terry E. Branstad, a Republican, has proposed a cut in the tax rate that would reduce income tax revenue by $200 million a year, which means the state's surpluses should increase next year if the economy continues to expand.

The states collected 6.2 percent more in tax revenues in the second quarter of 1996 than in the comparable period a year earlier, the Center for the Study of the States said in an analysis of the latest available detailed revenue data.

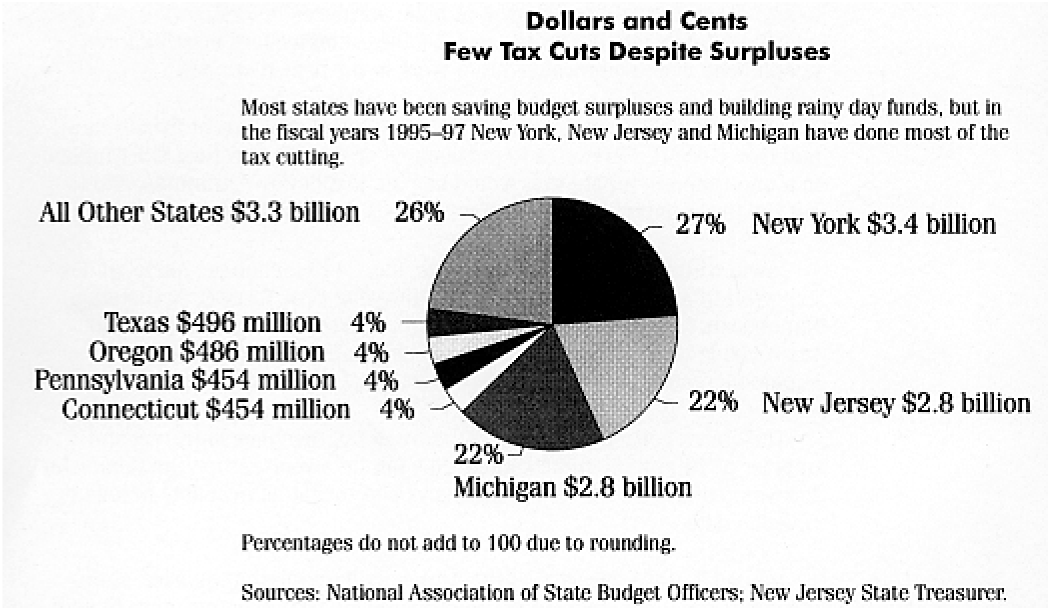
Donald J. Boyd, director of the center, said that in that quarter, state income taxes withheld from paychecks grew at 10 percent or more in nine states California, Colorado, Georgia, Kentucky, Minnesota, Oregon, Utah, West Virginia, and Wisconsin. And, if not for cuts in income tax rates, these tax receipts would have grown by double digits in three more states, Connecticut, New Jersey and New York.

Taxes withheld from pay checks are considered relatively stable revenues. But in some states, including New York and New Jersey, even faster growth is taking place in tax payments on estimated income, which tend to be made by people with higher incomes who get much of it from bonuses and from the sale of stock and other assets. Stock prices are up currently but if they should fall, tax revenues from capital gains could diminish rapidly.

In New York and New Jersey, whose state income tax revenues are highly dependent on earnings of people in the financial services industry in Manhattan, bonuses also appear to be generating extra tax dollars. New York counts on the income tax for half of its revenues, a higher level than most states.

H. Carl McCall, the New York State Comptroller, has criticized the tax cuts backed by Governor Pataki. "He has cut taxes without a plan to get the revenue to make up for the cuts," Mr. McCall said. "The Governor's budget assumes that the boom on Wall Street will continue, but if that doesn't happen New York will be facing a serious problem."

The state expects a $1 billion surplus this year, which Governor Pataki wants to use for further tax cuts, putting aside $65 million in a rainy day fund, the maximum allowed by law. Mr. McCall said more of the surplus should be used to pay down debts or prepay expenses.



New Jersey also relies heavily on Wall Street bonuses for income tax revenues.

Connecticut, where a $200 million state income tax cut takes effect this year, is not as vulnerable to the economic ups and downs as it is to what Richard Netzer, a professor at New York University, calls a "long-term problem because of its enormous dependence on the rapidly contracting defense industries."

Tax revenues are coming in below projections only in Hawaii, where tourism has been flat; Idaho where corporate income taxes are 37 percent below projections, and Tennessee, where overall revenues are 2 percent below projections.

No state is considering raising income, sales, or business taxes, according to the National Conference of State Legislatures.

But eight states are considering higher excise taxes, according to the conference. Higher gasoline taxes are being considered in Pennsylvania, Utah and Wisconsin and higher cigarette taxes have been proposed in Alaska, Florida, Maryland, Oregon and New Hampshire. The Alaska proposal would raise the current 29 cents-a-pack levy by a dollar.

Politicians are heeding the public's change in mood over taxes and spending

Georgia is phasing out one of the most regressive taxes in the country, a sales tax on groceries. Arkansas, Louisiana and Missouri are considering reducing sales taxes on food.

Some state budget officials say that surpluses may invite Washington to avoid helping the states.

"The Federal Government is talking seriously about balancing its budget," said Carol Koch, Iowa Deputy Treasurer, "and if the Federal Government realizes that the states have huge surpluses they are going to look to the states to solve some of Washington's problems."

States Are Cutting Taxes Unless You Smoke

Ann Reilly Dowd, *MONEY*

While the folks in Washington continue to bicker over tax cut details, your state may have some tax relief in store for you in 1997 and '98 if you're married, a homeowner, a student or elderly. But if you're a smoker, you're about to get burned. An exclusive MONEY survey of the 50 states and the District of Columbia finds the wave of tax cutting that swept the states during the past two years is likely to continue in about half the states, propelled by still robust revenue growth. However, expect a strong undertow of tax increases aimed at discretionary items, particularly cigarettes. Twenty states are enacting or are likely to enact new tax cuts this year and next, while six are planning hikes. Another eight are likely to do both; 17 are doing nothing. Here's what to watch for where you live:

Income tax cuts. This year, relief comes in many different forms. If you live in Maryland, your top personal income tax rate will drop 1 percent a year for the next five years, while your personal exemption will gradually double to $2,400 starting in 1998. Connecticut and Rhode Island are also considering across-the-board income tax cuts. Arkansas, Kansas and Mississippi are equalizing the tax rates or exemptions paid by married and single people.

Still other states want to help the elderly. For instance, if you're retired and living in Connecticut, Republican Gov. John Rowland has proposed exempting your Social Security benefits from state taxation. And New Yorkers over age 70 can now deduct as much as $2,500 of the cost of their long-term-care insurance premiums.

Property tax reductions. Kansas recently voted to use its $175 million budget surplus to eliminate state taxes on the first $20,000 worth of property owned while cutting the property tax rate by 23 percent. Meanwhile in Texas, the legislature plans to dole out roughly $2 billion in local residential property tax relief. Voters in New Mexico and Oregon will find Proposition 13-type property tax limitations referendums on their ballots this year and next.

Education incentives. Beginning next year, all Maryland residents will be able to put away as much as $133 a month toward tuition at a four-year college in new tuition-savings plans whose earnings will grow free from state and federal taxes until withdrawn for college. Then the money will be taxed at the student's low rate. In Minnesota, Republican Gov. Arne Carlson has proposed a $1,000-per-child tax credit; for elementary and secondary education expenses for families earning $39,000 or less and a $1,950 deduction for families earning more.

Sales tax creep. "States are expanding the sales tax into services," says University of Georgia law professor Walter Hellerstein. "It's politically easier in some states to add one more category to the sales tax than to raise tax rates, which affect most taxpayers immediately." This trend generally concerns business services but hits consumers as well. For instance, the Texas House has voted to extend the state's sales tax to services such as auto repairs and car washes.

Gasoline and so-called sin taxes on items like cigarettes and alcohol are on the rise too. If you live in Utah, your gas taxes will increase 5 cents this year to 24 cents a gallon. Illinois, Oregon and Vermont are also considering gas tax hikes. Texans may pay higher taxes on alcohol.

But the biggest tax losers this year will undoubtedly be smokers. If you live in Utah, you'll soon pay 25 cents more per pack of cigarettes, for a total tax of 51 & 1/2 cents. At least seven other states are considering or have upped puff taxes. The biggest is Alaska Democratic Gov. Tony Knowles' proposed $1 increase, raising the tax to a hefty $1.29 per pack, to fund children's health care and an antismoking campaign. "Cigarette tax increases are as popular today as no-smoking buildings," says Sally Adams, the state tax expert at CCH Inc., an Illinois-based research group. "They are one of the few tax hikes the electorate will tolerate."

Further Reading

The following options for reading are listed for those who want to delve further into the issue of tax cuts. The selected list below contains books, reports, and articles from a variety of perspectives.

Books

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