The State of the States

State Capitol: Lansing, Michigan
It's 2010, and state lawmakers once again are navigating difficult economic landscapes and hoping for signs of recovery. Countless challenges remain. Wall Street's financial chaos and the massive loss of wealth from the crash in housing values and stocks sent states into a financial tailspin worse than any time in recent memory.

On the heels of an economically brutal 2009, when almost every governor and state legislator was forced to tackle a budget shortfall, and more than half the states raised a bevy of taxes, taxpayers now are facing an increase on every imaginable tax—from fees on hunting, fishing, and drivers' licenses, to income, sales, and cigarette taxes. States in fiscal year (FY) 2010 were confronted with another miserable budget year. Lawmakers already have closed collective budget shortfalls of $89.8 billion in FY2010, while $18.9 billion in budget gaps remain. For fiscal years 2011-2012, states face additional budget gaps totaling $117.2 billion. A new Government Accountability Office (GAO) report to Congress outlines the significant long-term fiscal problems facing states—and they're not pretty.

One study by the Rockefeller Institute of Government found that 2009 state revenues fell "more sharply than at any time in the last fifty years." Just in the first quarter of FY2010, tax collections were already down 8.3 percent from the year before. Early numbers for the second quarter of fiscal 2010 show collections are off 4.1 percent and the slight improvement from the previous quarter isn't something for which legislators should be proud. The Rockefeller Institute points out revenue improvements "were often driven by legislated tax increases rather than growth in the economy and tax base."

Many states used budget gimmicks, accounting tricks, and one-time revenue raisers to get through last year's tough times. But they are running out of magical fiscal rabbits to pull out of their hats. State rainy-day funds were heavily utilized to reduce cuts in fiscal 2010 budgets, but those funds are quickly being emptied.

Further, federal stimulus funds for state budget stabilization will soon run out, leaving states between a rock and a hard place. New York's Lt. Gov. Richard Ravitch explains how the federal aid to the states was not the panacea it was made out to be:

"The net result is this: The federal stimulus has led states to increase overall spending in these core areas (transportation, education, and health care), which in effect has only raised the height of the cliff from which state spending will fall if stimulus funds evaporate."

"If the stimulus funds evaporate," the lieutenant governor says? In an ideal world, such a bailout would and should have never occurred. And still, some big spenders in Congress are looking to spend billions more on another bailout of the states. In Chapter 4, we point out how more federal aid will not solve the fiscal problems of the states, but in fact, further exacerbate their long-term challenges.
States Spent and Spent and Spent, Now the Bills Are Due

The major driver of the state fiscal meltdown is that states partied hard during the bull-market expansion of the 1990s and then again during several years of the past decade. The spending splurge in state government has not been well publicized but was very real, especially between 2004 and 2008 when state governments dramatically expanded. We warned in previous editions of this publication that the good times would not last forever. They never do. As the great Yogi Berra would say, “This is like déjà vu all over again.”

State lawmakers and governors could not resist loading up spending while revenues poured into state coffers. When the times were good, states added new programs for fully funded pre-kindergarten, expanding Medicaid to those with incomes often double the poverty level, building space launch programs, providing laptops to every public school student, while building convention centers, sports stadiums, and casinos. Nothing was unaffordable.

“We thought the good times would last forever,” is what state legislators have told us in recent months. Others said that it was “impossible to say ‘no’ to special interest groups with all that money pouring in.”

And the spending totals confirm this “spend and forget about tomorrow” mentality. Data from the U.S. Census Bureau show that total state and local spending, in inflation-adjusted 2007 dollars, grew an average of 41.5 percent from 1997 to 2007.

Unsurprisingly, California made the list of big spenders this year, and as we address at greater length in Chapter 3, the Golden State has long served as a laboratory experiment on how states shouldn’t budget. Just to preview, California relies heavily on income taxes on the wealthy and on businesses to pay its bills. When revenues surged during the middle of the decade, thanks to huge increases in capital gains revenues, the state budget rose to $99 billion from $75 billion, a 31 percent increase between 2003 and 2007. That was almost double the 17 percent increase in population plus inflation. When revenues from the rich collapsed, the state found itself roughly $40 billion in the red—while issuing $3.2 billion in IOUs.

Even more alarmingly, Jamie Dimon, chairman of JP Morgan Chase, warns that California now poses a greater risk of default than Greece. The Tax Foundation explains what states should take away from the Golden State’s tragic fall into debt:

“The lesson to be learned from California is twofold: States should not assume that revenue surges in good times will continue indefinitely, and the more reliant a state is on high-income earners, the bigger hit they sus-

<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>Biggest Spending States: Total State and Local Expenditure Growth, 1997-2007</th>
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<tbody>
<tr>
<td>State</td>
<td>Growth (%)</td>
</tr>
<tr>
<td>Arizona</td>
<td>73.1</td>
</tr>
<tr>
<td>Nevada</td>
<td>67.8</td>
</tr>
<tr>
<td>Wyoming</td>
<td>65.1</td>
</tr>
<tr>
<td>Florida</td>
<td>61.1</td>
</tr>
<tr>
<td>California</td>
<td>54.9</td>
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</tbody>
</table>

Source: U.S. Census Bureau

FIGURE 1 California Tax Revenue: The Boom and Bust Cycle

Source: California Department of Finance
tain when those revenue surges end. Therefore legislators should adopt wise spending and tax policies that recognize and prepare their states for these realities.”

However, some states rarely learn, as evidenced by California’s tax hikes on the rich in 2009. These tax increases will only exacerbate the boom-and-bust cycle of revenues that has plagued the Golden State for years, as Figure 1 shows.

**America’s Protected Class**

We also note that states have done little to cut back on their bloated payrolls or their extravagant pay packages, which have led to the colossal problem of overpromised and underfunded state pension systems described below. In fiscal year 2008, even as the fiscal storm was gathering and unemployment was rising, states and localities added 338,000 employees. Remember, this was as the private sector lowered its employment levels by 289,000. States were in denial of the financial troubles ahead. As our friend Chris Edwards, an economist at the Cato Institute, put it:

“Government debt has soared during good times and bad. During recessions, politicians say that they need to borrow to avoid spending cuts. But during boom times, such as from 2003 to 2008, they say that borrowing makes sense because an expanding economy can handle a higher debt load.”

What is even more remarkable is the surge in pay and the increasing gap between public and private-sector compensation. In 2008, wages and benefits of $1.1 trillion accounted for half of total state and local government spending. This is not surprising, considering that government employees now earn more than 45 percent more a year on average than private-sector workers. Working for state and local governments has become so lucrative that one Ohio resident recently compared it to “winning the lottery.”

To properly understand the magnitude of the problem, we turn to none other than the liberal, former California Speaker Willie Brown:

“The deal used to be that civil servants were paid less than private-sector workers in exchange for an understanding that they had job security for life. “But we politicians, pushed by our friends in labor, gradually expanded pay and benefits to private-sector levels while keeping the job protections and layering on incredibly generous retirement packages that pay ex-workers almost as much as current workers. “Talking about this is politically unpopular and potentially even career suicide for most officeholders. But at some point, someone is going to have to get honest about the fact that 80 percent of the state, county and city budget deficits are due to employee costs. “Either we do something about it at the ballot box, or a judge will do something about it in Bankruptcy Court. And if you think I’m kidding, just look at Vallejo.”

We couldn’t have said it better ourselves.

**Benefits for Government Workers: The Ticking Fiscal Time Bomb**

As Speaker Brown points out, the high costs of public employment do not stop at wages. We stress that if policymakers do not properly address the crisis in public pensions, current state budget problems will begin to look trivial. Legislators have overpromised public pension and healthcare benefits for years. For instance, California’s pension obligations have risen by 2,000 percent in the past decade, according to Gov. Arnold Schwarzenegger. As the governor put it, “We are about to get run over by a locomotive.”

For years, employers in the private sector have been moving in the direction of versatile, 401(k) style retirement accounts. However, a vast majority of the 20 million state and local government workers in the United States have kept their generous, defined-benefit pension plans. Despite the
lofty promises made by policymakers, public employee retirement plans have been neglected over the years and have become huge liabilities that severely threaten the financial health of many states. In fact, as of 2006, states had accumulated nearly $360 billion in unfunded pension obligations, according to a new ALEC study of the 50 states, “State Pension Funds Fall off a Cliff.” Other estimates place the obligations significantly higher.

The authors of the ALEC study, Dr. Barry Poulson at the University of Colorado, and Dr. Art Hall at Kansas University, sampled state data for 2008 in an attempt to measure the current magnitude of the problem. According to their findings, only 9 percent of state pension plans met the government standard as “safe.” Defined-benefit pension plans are considered safe by government standards if they have enough assets to support at least 80 percent of pension benefit obligations.

Illinois wins the dubious award of having the worst funded pension system in America—at a meager 46.1 percent funded level. Keep in mind, the private sector deems defined-benefit pension plans to be “critical” if the funded portion of the plan is less than 65 percent. This is bad news for taxpayers throughout the United States, especially for residents of Colorado and Kansas. According to the ALEC study, these two state pension plans have the highest per-capita unfunded pension liabilities in the nation at $3,624 and $2,962 respectively. The problems in Colorado are so acute that legislators predict they cannot fund payments to retirees beyond 2031.

Much of the current data regarding liabilities in public employee pensions was taken before the recent economic downturn, and the ALEC study’s authors warn the problem is much worse today since stock market losses have not been fully realized in many official government pension statistics. A new GAO report shows that state and local pension assets realized an average 27.6 percent loss in value in just one year’s time!

A study conducted by the Pew Center on the States shows which state pension funds took the hardest financial losses from the economic downturn.

Unbelievably, some Far Left fringe groups, such as the “Progressive States Network,” actually try to convince legislators there is no pension crisis fac-

**TABLE 2 | Investment Losses in 2008 for Select State Pension Plans**

<table>
<thead>
<tr>
<th>State</th>
<th>Plan Name</th>
<th>Investment Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pennsylvania</td>
<td>Pennsylvania State Employees’ Retirement System</td>
<td>-28.70%</td>
</tr>
<tr>
<td>Ohio</td>
<td>Ohio Public Employees Retirement System</td>
<td>-26.80%</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>Pennsylvania Public School Employees’ Retirement System</td>
<td>-26.50%</td>
</tr>
<tr>
<td>California</td>
<td>California Public Employees’ Retirement System</td>
<td>-23.00%</td>
</tr>
<tr>
<td>Illinois</td>
<td>Teachers’ Retirement System of the State of Illinois</td>
<td>-22.30%</td>
</tr>
<tr>
<td>Oregon</td>
<td>Oregon Public Employees Retirement System</td>
<td>-22.20%</td>
</tr>
<tr>
<td>Indiana</td>
<td>Indiana Employees’ Retirement Fund</td>
<td>-21.00%</td>
</tr>
<tr>
<td>Virginia</td>
<td>Virginia Retirement System</td>
<td>-21.00%</td>
</tr>
<tr>
<td>Maryland</td>
<td>State Retirement and Pension System of Maryland</td>
<td>-20.00%</td>
</tr>
<tr>
<td>Missouri</td>
<td>Missouri Public School Retirement System</td>
<td>-19.30%</td>
</tr>
<tr>
<td>New Jersey</td>
<td>New Jersey Division of Pensions and Benefits</td>
<td>-19.00%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>North Carolina Retirement System</td>
<td>-14.00%</td>
</tr>
<tr>
<td>Georgia</td>
<td>Georgia Teachers Retirement System</td>
<td>-13.10%</td>
</tr>
</tbody>
</table>

Source: Pew Center on the States
ing states, calling it “Right-wing fear mongering.”

How can they say that with a straight face?

Elected officials need to properly monitor the status of their pension funds and bring more accountability to the process. As the chairman of ALEC’s Tax and Fiscal Policy Task Force, Indiana Sen. Jim Buck, put it, “If legislators continue in their state of denial towards pension and retiree health care obligations, they will quickly face overwhelming financial odds in these areas.” Utah Sen. Dan Liljenquist put the problem this way: “This is like a chemical spill. … [T]he first thing you have to do is contain it. Then you need to clean it up. This is a disaster that’s already happened. We’ll be in cleanup for a long time.”

The first step is for states to increase transparency by meeting the guidelines established by the Governmental Accounting Standards Board (GASB). States should be required to show how they plan to eliminate unfunded liabilities in pension plans within a 30-year time frame. Also, the budget gimmicks which have raided pension funds for years must come to an end.

However, the only long-term solution will be to replace current defined-benefit plans with 401(k) style defined-contribution plans for new employees. Michigan and Alaska have transitioned newly-hired state employees into defined-contribution plans and other states are moving in that direction. This essential reform would constrain the growth of unfunded liabilities and would establish a portable defined-contribution plan for new employees that, over time, would reduce the government’s dependence on expensive and less predictable defined-benefit plans.

If state lawmakers fail to enact fundamental reforms in the area of public employee pensions, the long-term financial health of the states could be compromised—and taxpayers will certainly be left on the hook.

Government Health Care Benefits: Busting Budgets

If you think state underfunding of pensions is chilling, health care and other post employment benefit (OPEB) plans for government workers are in complete disrepair. The Pew study estimates that states have a collective unfunded liability of more than $550 billion in these OPEB plans. Sadly, only two states (Alaska and Arizona) had more than 50 percent of the assets needed to meet their OPEB liabilities.

Consider the example of Maryland, one of our favorite breeding grounds for liberal policies. According to the state’s most recent Consolidated Annual Financial Report (CAFR), OPEB benefits are 99.2 percent unfunded. In fact, Maryland’s overpromised and underfunded plan falls behind by an additional $1 billion per year.

What can lawmakers do to curtail the massive liabilities state health care benefits place on the books? As we have come to expect from one of our favorite governors, Indiana’s Mitch Daniels has developed a free-market solution to tackle the problem. As Gov. Daniels recently penned in The Wall Street Journal, the Hoosier State has given state workers an option to transition into flexible Health Savings Accounts (HSA). Today, 70 percent of Indiana’s 30,000 state employees have chosen to take advantage of these consumer-driven reforms—and taxpayers are already realizing millions in savings.

The colossal problem of unfunded liabilities for government pensions and health care benefits isn’t limited to the state level. In fact, in some cases, the problem is even more acute at the local level—crippling municipal budgets throughout America. In towns like Everett, Mass., former employees with as little as six years of service can receive lifetime health care benefits—costing taxpayers up to $1 million for each retiree.

As the chief financial officer in Lynn, Mass., put it, “It has got to be dealt with—or we will all go bankrupt.”

The status quo of states severely underfunding pensions and health care benefits for government employees is clearly not sustainable. If lawmakers do not undertake fundamental reforms to transition away from current defined-benefit plans and toward private-sector plans, the gargantuan lia-
bilities will threaten the financial viability of the states indefinitely.

**Asking for More from Taxpayers:**

**America’s Forgotten Special Interest Group**

Nearly every state has a balanced budget requirement within their constitutions, and furthermore, unlike Washington, D.C., state treasuries cannot print money. With these constraints and the additional restrictions placed on states by accepting so-called federal “stimulus” funds, how are state lawmakers able to avoid economically damaging tax increases?

Well, for starters, some don’t even try. If the fiscal stimulus plan was meant to circumvent higher state taxes, then it was a grand failure, because most states raised taxes and fees in 2009. In response to the state fiscal crisis, 29 states raised taxes and fees last year by nearly $24 billion, according to a study from the National Governors Association (NGA) and National Association of State Budget Officers (NASBO).\(^4\) On top of that, the National Association of State Workforce Agencies reports that businesses in a minimum of 35 states will see their unemployment insurance taxes rise in 2010.\(^5\)

To give you a more in-depth look at which states are asking more from taxpayers—and in the process making their states less competitive—we have put together our very own top 10 list of biggest state losers for 2010.

The tax hikes in California, Hawaii, New Jersey, New York, and North Carolina are supposed to be “temporary.” We’ll believe that when we see it. In too many cases, as lawmakers get addicted to the promise of more revenue, these so-called “temporary” tax hikes soon enough become permanent fixtures in state tax codes.

### TABLE 3 | The 10 Biggest Losers

<table>
<thead>
<tr>
<th>State</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>Raised its personal income tax rates across the board by 0.25%. The state also raised its sales tax to 8.25% from 7.25%—with local add-ons the combined sales tax rate now exceeds 10% in some localities.</td>
</tr>
<tr>
<td>Connecticut</td>
<td>Raised its income tax to 6.5% from 6% on individuals with incomes above $500,000, and it increased cigarette taxes.</td>
</tr>
<tr>
<td>Delaware</td>
<td>Raised its highest income tax rate by one percentage point to 6.95% on all earners with incomes above $60,000 and also increased cigarette taxes.</td>
</tr>
<tr>
<td>Hawaii</td>
<td>Raised its income tax to 11% on earnings over $200,000 and also increased taxes on smokes. Hawaii is now tied with Oregon for the nation’s highest statewide income tax rate.</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>Raised its sales tax to 6.25% from 5%.</td>
</tr>
<tr>
<td>New Jersey</td>
<td>Raised three income tax brackets, with the highest rising to 10.75% on millionaires, increased cigarette taxes, and increased the tax on spirits and wine by 25%. This is after New Jersey just raised its income tax two years earlier.</td>
</tr>
<tr>
<td>New York</td>
<td>Raised income taxes again, along with taxes on beer and wine. The highest income tax rate is now 8.97% for those state residents who earn more than $500,000. Because New York City imposes an add-on income tax, the Big Apple now applies the highest income tax in the country at 12.35%.</td>
</tr>
<tr>
<td>North Carolina</td>
<td>In addition to raising taxes on cigarettes, beer, wine, and spirits, lawmakers added a 2% income tax “surcharge” for those who earn more than $60,000 and a 3% surcharge for those earning more than $150,000. Legislators also increased the state sales tax to 5.75% from 4.5%.</td>
</tr>
<tr>
<td>Oregon</td>
<td>In addition to raising fees and an assortment of other taxes, the state income tax was hiked to 11% on income over $250,000, which puts the state in a tie for the highest in the nation.</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>Raised its income tax rate to 7.75% on incomes above $225,000 and also increased cigarette taxes.</td>
</tr>
</tbody>
</table>

Source: Americans for Tax Reform, Tax Analysts, Tax Foundation
Return of the Class Warriors

In 2009, class warfare was declared in state capitals. In the face of a rising tide of red ink, state legislatures from Trenton to Honolulu—that chose not to live within their means—took aim at the wallets of the rich to pay their bills and fill budget shortfalls.

This was a record year for tax increases on the “rich,” and we suspect these fights will be played out once again in 2010. Many other states indeed tried to raise income tax rates on high-income earners but failed. Before the tax revolt of 1978 started in California with Proposition 13, some states like Delaware had tax rates as high as 19.8 percent. It’s a good bet that “progressive” legislatures will continue to try to raise rates on businesses and high-income residents in an effort to soak the rich. However, because high personal income tax rates are also paid by small business owners and operators, this will be a job killer.

In Chapter 3, we explain in greater detail why taxing the rich has always been economically disastrous and a failure in terms of raising revenues. But for now, we would like to point out Maryland’s recent follies.

Politicians in Annapolis created a millionaire tax bracket, raising the top marginal income-tax rate to 6.25 percent. And because residents in such cities as Baltimore and Bethesda also pay local income taxes, the combined state and local tax rate can go as high as 9.3 percent.

Already, Maryland has seen a one-third decline in tax returns from millionaire households. The rich have literally disappeared from the state tax collectors’ sights. Instead of the state coffers gaining the extra $107 million the politicians predicted, millionaires paid $257 million less in taxes than they did last year—even at higher rates.

A Bank of America Merrill Lynch analysis of federal tax return data on people who migrated from one state to another found that Maryland lost $1 billion of its net tax base in 2008 by residents moving to other states. That’s income that’s now being taxed and is financing services in Virginia, South Carolina, and elsewhere.

The experience in Montgomery County (one of the crown jewels of Maryland’s progressives) is worthwhile to note. The county—one of America’s wealthiest—lost a whopping $4.6 billion in taxable income between 2007 and 2008 alone! County Executive Isiah Leggett says some wealthy residents who own homes in other states are establishing residency elsewhere. Officials believe the state’s millionaire tax is a factor. That’s “progressive” policy in action.

Of course, the majority of that loss in millionaire filings is the result of the recession. This only reinforces our argument that depending on the rich to finance government is ill-advised: Progressive tax rates can create mountains of cash during good times, but that cash can certainly vanish during recessions. For additional evidence, consult California, New York, and New Jersey.

No one disputes that some rich Marylanders moved out of the state when the tax rates rose. It’s easier than the redistributionists think. Christopher Summers, president of the Maryland Public Policy Institute, notes, “Marylanders with high incomes typically own second homes in tax friendlier states like Florida, Delaware, South Carolina, and Virginia. So it’s easy for them to change their residency.” The situation in Maryland is now so bad, even committed liberal class warriors like Gov. Martin O’Malley are opposing the extension of the millionaire’s tax.

State lawmakers almost always overestimate how popular tax hikes on the rich are. A recent poll from Scott Rasmussen shows that only 34 percent of Americans support hiking taxes on those who earn more than $100,000 per year.

In the 1990s, tax-hiking governors all over the country were thrown out of office, including Mario Cuomo of New York, James Blanchard of Michigan, James Florio of New Jersey, and Lowell Weicker of Connecticut. Most recently, Jon Corzine of New Jersey was defeated after raising tax rates twice on the rich. Voters were angry at the way Mr. Corzine had failed to create jobs, failed to balance the budget, and failed to ease one of the highest property tax burdens in the nation.
Ironically, New Jersey’s income tax was created in 1976 to reduce the same property taxes that have increased every year since 1978. These massive tax increases have driven residents out of the Garden State in droves—with their wealth not far behind. A new study by the Boston College Center on Wealth and Philanthropy found that New Jersey lost an estimated $1 billion in charitable giving between 2004 and 2008 alone. According to Hans Dekker, president of the Community Foundation of New Jersey, this was “a result of a significant decline in the amount of wealth moving into the state and an increase in the amount of wealth leaving.” Mr. Dekker goes on to write:

“All serious discussion on this problem and its solution must, therefore, include a careful look at those elements of New Jersey’s tax structure that impact charitable giving. This includes the lack of a state tax deduction for charitable giving, an estate tax exemption that begins taxing a family’s life savings at $675,000, and our income tax rates including the ‘millionaire’s tax.’ As one attorney explains, ‘the income tax raises the issue of leaving the state and the estate tax seals the deal.’”

This is a sad reminder of the unintended—and devastating—consequences of punitive tax rates. Unfortunately, these unmitigated political and economic disasters don’t seem to dissuade the current crop of politicians from continuing down the same road.

**Predatory Taxes**

The political Left is not content in just going after high-income earners—in many cases they are attempting to use the tax code to change social behavior through what some call “sin” taxes. Once again, in 2009, one of the most popular revenue raisers for state lawmakers was increasing the tobacco tax. At least 14 states and the District of Columbia raised their cigarette taxes in 2009.

However, as states attempt to use “predatory” tax policy on certain politically unpopular products, they often find the promise of higher revenue goes up in smoke. Case studies from the states show us that tobacco tax increases are an extremely poor method of increasing revenue, as high tobacco taxes at the state level often simply encourage smokers to avoid the tax by buying tax-free cartons. Take the case of New Jersey: In fiscal year 2007, the state’s cigarette tax not only missed its revenue projection by $52 million, but the state actually collected $22 million less than it did in the previous year. In other words, they actually lost money after their massive tobacco tax increase. The Garden State ran headfirst into the Laffer Curve: Raising the cigarette tax led to diminishing returns in tax collections and more red ink in Trenton.

Anti-smoking advocates exalt that this proves that high taxes on cigarettes reduce smoking. Yes, when you tax something you get less of it; however, much of the revenue decline came from people changing their buying habits, including purchasing...
ing cigarettes on the Internet, Native American reservations, and in cross-border exchanges from lower-tax states.\textsuperscript{[57]}

New Jersey residents are still lighting up; they’re simply buying fewer Camels and Marlboros at stores located inside the Garden State. Retailers in Delaware ought to be sending thank-you notes to lawmakers in Trenton, since smokers can save about $20 in taxes per carton by stocking up when they’re in Delaware. While the number of smokers predictably decreased after Maryland doubled its tax to $2.00 per pack, cigarette purchases increased in Pennsylvania, West Virginia, and even D.C.\textsuperscript{[58]} Avoiding Maryland’s high cigarette taxes has become a big business. According to researchers, Maryland may now be the number one smuggling destination in America.\textsuperscript{[59]}

In New York City, where the combined city and state tax is more than $4.00 a pack, smugglers sell bootlegged cigarette packages and cartons on street corners much like drug dealers. It’s estimated that the city fails to collect taxes on half the cigarettes smoked in the Big Apple.\textsuperscript{[60]} Californians smoke 300 million untaxed packs of cigarettes a year thanks to the Internet, smuggling, and out-of-state sales.\textsuperscript{[61]} For consumers, tax-free on-line sales of cigarettes are only a mouse click away, and these purchases now cost the states more than $1 billion a year in lost tobacco tax revenues, according to the Campaign for Tobacco Free Kids.\textsuperscript{[62]}

Many high tobacco tax states, says Patrick Fleenor of the Tax Foundation, aren’t losing revenues from their high tobacco taxes yet, “but they are getting close to that tipping point.”\textsuperscript{[63]} One state near the tipping point is Kansas. Currently, Gov. Mark Parkinson is advocating a major tax increase in the Sunflower State, which would push the tax cost per pack to $1.34, while quadrupling the tax on other tobacco products. One small problem though—Kansas’s neighbor, Missouri, levies a tax of only 17 cents per pack of cigarettes, the second lowest cigarette tax in America. Therefore, the hundreds of thousands of residents in Johnson County (Kansas’s most heavily populated) would be only a short drive away from significant savings on tobacco products.

Kansas House Majority Leader Ray Merrick recently told the story of QuikTrip store #227, which occupies land on the Kansas-Missouri state line. The company has decided to cease operating on the Kansas side of the line and build a new location 100 feet away—in Missouri. Why? According to store manager Doug Chmiel, “There are certain economic advantages to being on the Missouri side.”\textsuperscript{[64]} Lower taxes and regulation costs will save the store an estimated $1 million per year—and this is even before the proposed cigarette tax would make Kansas even less competitive.\textsuperscript{[65]} Meanwhile, Kansas is foregoing $1.4 million in revenue per year as QuikTrip moves 100 feet to escape high taxes.\textsuperscript{[66]}

Utah lawmakers recently passed a hefty cigarette tax increase. The official fiscal note showed a modest increase in revenue; however, the projected revenue was overshadowed by the predicted cost to businesses. As it turns out, the fiscal note was correct. Almost immediately after the ink dried on the tax increase, Utah’s oldest smoke shop in downtown Salt Lake City announced it would close its doors before the tax goes into effect.\textsuperscript{[67]}

Another problem with cigarette taxes is that many states, including Maryland and Wisconsin, are raising cigarette taxes to pay for expanded health care coverage. This is a recipe for fiscal disaster because states are then relying on a steeply declining revenue source to pay for health care programs with exploding future costs.

State cigarette tax collections also are going to fall even faster because the U.S. Congress recently raided this tax source and raised the federal cigarette tax to $1 a pack from 39 cents per pack to offset the costs of the children’s health care expansion (SCHIP). The Heritage Foundation calculates that to make those budget numbers add up, some 22 million Americans are going to have to take up smoking—and soon.\textsuperscript{[68]} And here we thought governments were trying to discourage people from smoking.

Beyond the proposal to significantly increase
tobacco taxes in Kansas, Gov. Parkinson has told state lawmakers all possible budget cuts have already been made, therefore “requiring” a bevy of tax increases. An 18 percent increase in the state sales tax, taxes on alcoholic beverages, and even the “Slurpee tax” (on sugary drinks) have been proposed by those who believe there is no other way. This paternalism through the tax code has hit a record pace. “I have never seen it work where a government tells people what to eat and what to drink,” said Coca-Cola Chief Executive Officer Muhtar Kent. “If it worked, the Soviet Union would still be around.”

When you see cigarette taxes hiked in Tobacco Road, N.C., and alcohol taxes increased in Bourbon Country, Ky. (as was the case in 2009), you know states are on a desperate money grab. This reminds us of the famous line from Ronald Reagan, “If it moves, tax it; if it keeps moving, regulate it; and if it stops moving, subsidize it.” As budget shortfalls continue to deepen, nearly every state has proposed a bevy of these targeted revenue raisers, practicing what we like to call “tax adventurism.”

**Necessary Tax Increases?**

If you listen to some politicians and pundits today, you may believe that states have cut all the fat and have absolutely no option other than to increase taxes to solve their budget shortfalls. Nothing could be further from the truth. Predictably, pro-tax lawmakers often threaten to cut the most popular (and visible) areas of the state budget in order to pressure other lawmakers into raising taxes. This is what we like to call the Washington Monument theory of budgeting (named after the infamous incident where the U.S. Park Service threatened to reduce the operating hours for the popular tourist attraction if funding wasn’t restored: in the end though, they kept their funding).

The Washington Monument budgeting strategy is intended to perpetuate the myth that tax increases are the only solution to a budget problem. We all have witnessed this strategic tactic where politicians propose cuts to the most popular spending programs first in hope the public believes there is no fat in government. The most heinous example of this ploy comes from the Detroit school district, which “due to budget reductions” actually asked parents of schoolchildren to provide toilet paper for the schools. We couldn’t make this up if we tried.

Some on the political Left seem to think that every state budget problem was caused by “reckless” tax cuts, but in the light of the massive increases in state spending over the past decade, we think it’s fairly clear for an objective observer to see where the real problem lies. To augment our case, a report from Americans for Tax Reform shows us that “despite the fact that overall tax cuts did take place in FY2007 and FY2008, states have raised taxes and fees by nearly $23 billion (on net) since the last recession.”

**The Solution: Reasonable Spending Limitation**

To further document the fact that current budget shortfalls are the result of state overspending, consider this: If states would have simply allowed their spending to grow at the rate of population plus inflation (PPI) growth, they would (almost without exception) be sitting on budget surpluses instead of facing deficits. According to a study by two policy analysts at the Reason Foundation, on average, state general fund spending doubled PPI between 2002 and 2007. Only one state (Wisconsin) grew its spending less than PPI during that period.

The implications are quite clear, according to the Reason study:

“If legislatures had chosen to be responsible, they could have maintained all current state services, increased spending to compensate for inflation and population growth, and still enacted a $500 billion tax cut.”

Researchers at the Beacon Hill Institute at Suffolk University show that Massachusetts could have avoided its current fiscal turmoil through limiting spending growth to PPI. If the Bay State
would have implemented this system a decade ago, it could have eliminated its structural deficit and avoided the recent $1.32 billion tax hike while maintaining inflation adjusted spending per capita. Additional research from the Beacon Hill Institute has shown the significant economic benefits of state spending limitation. Using data from 1997 to 2004, their research shows that states could have utilized spending limitation to increase their gross state product per capita by anywhere from 2.72 to 6.68 percent.

The concept of limiting the growth of taxes or spending to PPI is not new. For decades, academic researchers have promoted the benefits of having an institutional constraint on the growth of government. In last year’s edition of this publication, we discussed one of the early attempts at meaningful spending restraint, the Gann Amendment, which was passed by California voters in 1979. The most recent example of a state that successfully implemented meaningful spending restraint is Colorado. The Centennial State was able to restrain government spending and tax burdens beginning in the early 1990s through its Taxpayers’ Bill of Rights (TABOR), limiting the growth of government to a reasonable formula of population plus inflation growth. Taxes could be increased, but it took a vote of the people to do so.

Following the low-tax-plus-limited-government formula, Colorado has developed one of the most competitive business climates in the nation, not to mention giving taxpayers back billions of their hard-earned dollars through refunds and lowering tax rates across the board. Between fiscal years 1997 and 2007 alone, Colorado taxpayers received $6.7 billion in TABOR-provided tax relief. The economic growth followed, as Colorado boasted one of the most competitive and fastest growing economies in the nation, as shown in Figure 2.

However, even in the face of this tremendous economic success story, the progressives have spent tremendous resources trying to demonize Colorado’s TABOR. Fully documenting the disingenuous attacks against TABOR could take years. Why are liberals so scared of TABOR? It’s because constitutional spending limitation in the model of TABOR restricts the wild spending increases which funds their constituency—big government.

Despite the barrage of misleading attacks from the Left, lawmakers from Texas to New York are calling for responsible state spending caps to prevent the next crisis in state overspending.

**Priority-Based Budgeting**

Another spending reform is gaining traction as a responsible alternative to tax increases. It is actually rather simple for most individuals and businesses: prioritize in order to avoid spending beyond your means.

As it turns out, even with lobbying by public employee unions against necessary budget reductions to correct for state overspending, most taxpayers want government to live within its means. Even residents in the liberal havens of California and New York overwhelmingly prefer spending restraint over tax increases, with polls coming in at 50 to 13 percent and 58 to 30 percent, respectively. And because these taxpayers may be the most experienced in modern history at taking it on the chin during rough budget times, we suggest you pay close attention.
State lawmakers in Washington proved that you can eliminate budget shortfalls by prioritizing government spending. In the wake of the 9/11 recession, lawmakers in Olympia found their budget $2.4 billion in the hole, which at the time was the largest shortfall in state history.

Democrat Gov. Gary Locke (now serving as Secretary of Commerce in the Obama Administration) worked with the legislature to develop what they called the “Priorities of Government” reform for the state budget. Washington’s priority-based budgeting required budget writers to ask and answer the following questions:

1. How much money does the state have?
2. What is the existing and forecasted revenue?
3. What does the state want to accomplish?
4. What are the essential services we must deliver to citizens?
5. How will the state measure its progress in meeting those goals?
6. What is the most effective way to accomplish the state’s goals with the money available?

Another important element of priority-based budgeting is called the “yellow pages test,” which follows the premise that government shouldn’t be in the business of providing services that the private sector can provide. Because the yellow pages test almost always results in services being delivered at a lower cost and higher quality, this is a win-win option for cash strapped states.

With the priority-based budgeting approach, Washington lawmakers developed the core functions of government and closed the large budget shortfall—without having to ask for more from taxpayers. As Gov. Locke explained:

“We exhaustively studied all that we do—examining some 1,400 state government activities. Then, like a family on a very tight budget, we sat down and looked at how we’ve typically spent our money. We decided how we now need to spend it to get the results we want.”

Already, in 2010, several states have introduced legislation to create a system of priority-based budgeting to replicate the success of the Washington model. If only every state would follow that approach.

**Some Cheerful News**

After all the doom and gloom about budget shortfalls, pension liabilities, and tax increases, it’s important to look at the glass half full. The one silver lining from all of these state tax actions is that several actually cut taxes and many others are working toward tax relief to enhance their competitiveness during these tough times.

**TABLE 5 | 2009 Tax Relief**

<table>
<thead>
<tr>
<th>State</th>
<th>Tax Relief</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vermont</td>
<td>Lowered income tax rate to 9.4% from 9.5%.</td>
</tr>
<tr>
<td>North Dakota</td>
<td>Reduced its personal income tax rates to 4.86% from 5.54%, while reducing property taxes.</td>
</tr>
<tr>
<td>Louisiana</td>
<td>Adjusted its tax brackets to provide tax relief.</td>
</tr>
</tbody>
</table>

Source: Tax Analysts, Tax Foundation

One very notable absence from this list is the state of Ohio, which was scheduled to implement the last remaining installment of legislation to reduce the state’s personal income tax. Unfortunately for taxpayers in the Buckeye State, Gov. Ted Strickland led an all out effort to suspend this important tax relief. While the governor brags of leading the nation in “green jobs” creation, the state’s anti-growth policies have taken their toll on the state’s economic outlook—ranking a meager 42nd in this publication. In the last decade alone, on net, more than 350,000 Ohioans have picked up and left the state.

**Other Tax Cutting Efforts**

One of the near misses for tax cutters in 2009 took place in Georgia. Sponsored by ALEC member and former Rep. Tom Graves, the (appropriately named) JOBS Act aimed to provide econom-
ic stimulus through meaningful tax relief. As Rep. Graves explained:

“We recognize that the greatest stimulus for a robust economy comes from an economic environment that encourages opportunity, productivity, and innovation. It’s the hard-working people of Georgia—not big government—that are the key to our economic prosperity.”

Among other things, this pro-growth legislation would have phased out the corporate income tax and eliminated the burdensome inventory tax on businesses. Alas, in one of the worst vetoes of the year, Gov. Sonny Perdue axed this promising legislation. However, Rep. Graves and others have introduced similar legislation in 2010.

So far in 2010, the leaders for increasing state competitiveness seem to be in South Carolina. Recently, the South Carolina House of Representatives voted (105-9) to eliminate their corporate income tax in an effort to rebuild their state’s economy. As House Speaker Bobby Harrell pointed out, “Our state’s future hinges on the strength of our economy and the private sector’s ability to grow and create jobs.”

This will send a clear message to businesses looking to move or expand: South Carolina is open for business.

Reducing corporate taxes infuriates the class warriors who want to soak big business. However, the truth is, when states tax businesses, there is nothing they can do but pass the burden on to individuals. Businesses don’t pay taxes, people do. Real people—not inanimate business entities—pay the true burden of business taxes. This transfer happens in three ways. The first to pay are the employees—people who make lower wages or perhaps lose their raises, or even their jobs. Next are the millions of Americans who have investments in corporations—people who earn a lower return in their 401(k). Finally, and inevitably, millions of consumers pay more for products they purchase.

Numerous states are considering the elimination of their personal or corporate income taxes to promote economic growth. Ohio Rep. John Adams recently explained why his economically beleaguered state needs fundamental, pro-growth reform:

“Some naysayers are perfectly happy with this economic status quo, but I believe Ohio deserves better. The only way to reenergize the state economy is to eliminate the job-killing income tax and revamp the way our state does business.”

As we fully explain in this year’s section on Missouri, efforts to repeal state income taxes would drastically move states in the direction of economic competitiveness.

Americans Still on the Move

The U.S. Census Bureau revealed that in 2008, a smaller percentage of Americans moved from their principal residence than at anytime in more than 20 years. In the early 2000s, about 14 percent of Americans relocated each year. In 2008, that number fell to 10 percent, according to demographer Joel Kotkin. The housing recession has kept homeowners pinned to their homes, with few available or willing buyers. Interstate migration was down, too. States that have been migration winners, like Florida and Nevada, saw, for the first time, a reversal of fortune in 2008 and early 2009 because of the housing bubble burst and its aftershocks on commercial real estate and jobs. However, their policy fundamentals remain strong (especially since both states avoid personal income taxes).

But what is still undeniable is that over the past 25 years, tens of millions of Americans have voted with their feet against anti-growth policies that reduce economic freedom and opportunity in states mostly located in the Northeast and Midwest. Some new numbers released by the Census Bureau reveal the full extent to which America has become a nation of movers and shakers (literally). The data show:
• In a typical year, 40 million Americans change their home address.
• This means that more than one in eight Americans moves each year.
• About one-third of all relocators move across state lines.
• Over the last three decades, there has been a 25 percent increase in people residing in a state other than the one in which they were born.

The big winners of this interstate competition for jobs and growth have generally been states in the South and West, such as Texas, Tennessee, Georgia, and Florida. The big losers have been in the rustbelt regions of the Northeast and Midwest. The demoralizing symptoms of economic despair in declining states like New York, Michigan, Pennsylvania, Illinois, and New Jersey include lost population, falling housing values, a shrinking tax base, business out-migration, capital flight, high unemployment rates, and less money for schools, roads, and aging infrastructure.

The decline of California is probably the best evidence we can present of the impact of poor state policymaking on the economic pulse of a state. As Karl Rove points out, for the first time since becoming a state in 1850, California will probably not gain a congressional seat after the 2010 census. Table 6 shows that in the 10 years through 2008, California had the second largest net domestic population outflow of any state in the nation.

There’s an old saying that high taxes don’t redistribute wealth, they redistribute people. That is precisely what we have found in the research that went into writing this book. The lesson from New York and California is that progressive policymakers cannot build a Berlin Wall around their state to keep their taxpayers inside.

**Conclusion**

A recent article in *Forbes Magazine* ought to be required reading for all state policymakers. Do states need to act more like brands? As Mike Linton, the former Chief Marketing Officer for both eBay and Best Buy, explains: Of course they do.

"Like any brand, a state that can’t retain its most valuable customers will inevitably decline. Lose your business base, job generation engines and revenue growth, and you don’t have a good long-term outlook.

"For California, even the presence of Stanford University, Hollywood, Google and Sand Hill Road can’t stop that decline. Fifty years ago, Michigan was a hot brand. Look where it is now. Unlike brands, which can decline over a
mature of years, states that don’t meet their citizens’ needs will decline over decades.”

No lawmaker wants to be saddled with a broken brand like Michigan, California, or New York. With every action state lawmakers undertake, they should ask themselves the question: Does this help or hurt the competitiveness brand of our state?

As we highlight throughout this publication, states do not make policy changes inside a vacuum. If anyone doubts this phenomenon, they should take a drive to the Michigan-Indiana state line, where Gov. Mitch Daniels has put up a billboard that reads: “Come on IN for lower taxes, business and housing costs.” Idaho Gov. C.L. “Butch” Otter just penned a “love letter” to neighboring businesses in high-tax Oregon. After recently passing massive tax increases on individuals and businesses (which Nike’s Phil Knight calls “Oregon’s Assisted Suicide Law II”), Idaho is looking like an attractive option for businesses, and Gov. Otter is quite happy to remind them.

For states to improve their economic brands, lawmakers must navigate these challenging budget times while avoiding the economically damaging tax increases that will assuredly make things worse. While it should be intuitive, states cannot tax, borrow, or spend their way to prosperity.

The ideas in this publication are not about Republican or Democrat—they are about the direction of a state: economic prosperity or malaise. The beauty of the American experiment is that each one of these United States gets to choose which path it will follow.
ENDNOTES

1 According to the National Association of State Budget Officers, 46 states begin their fiscal years on July 1.
3 Ibid.
15 Ibid.
18 Ibid.
30 ALEC’s Tax and Fiscal Policy Task Force has developed model legislation for states looking to transition into defined-contribution pensions.
35 Ibid.
38 Ibid.
40 Ibid.
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55 Ibid.
62 Ibid.
63 Ibid.
64 Glynn, Earl. “Kansas to Lose $1.3 million in Taxes Every Year When Quiktrip Moves 100 Feet into Missouri.” Kansas Watchdog. August 26, 2009.
66 Glynn, Earl. “Kansas to Lose $1.3 million in Taxes Every Year When Quiktrip Moves 100 Feet into Missouri.” Kansas Watchdog. August 26, 2009.
74 Ibid.
76 Ibid.
   Also see: “New York State Voters High on Medical Marijuana, Quinnipiac University Finds; Freeze State Workers’ Pay, Voters Say 3-1.” Quinnipiac University. February 4, 2010.
90 See Ohio Rankings on page 106.
97 U.S. Census Bureau.
101 Ibid.