

Introduction

When we set out to write the first edition of ALEC's *Rich States, Poor States* in early 2007, state revenues were booming. At the time, news reports from across the nation beamed the exciting news that more than 40 states were reporting budget surpluses.¹ Boy, how times can change.

At the time of writing this second edition of the book – just 18 months later – state revenue growth is flat for the first time since 2002,² state coffers have dried up, and more than 40 states either faced budget deficits for fiscal year 2009, or are projecting deficits for fiscal year 2010, which starts July 1 in all but four states.³ Few remain hopeful that state coffers will recover anytime soon, since the worst state budget deficits generally follow national economic downturns.⁴

There is little question many states are in dire financial straits today. However, in the face of state budget pressures, we are convinced that the work of ALEC becomes even more important. ALEC is dedicated to providing innovative solutions for lawmakers to solve budget problems – without increasing taxes. In the subsequent pages, this second edition of *Rich States, Poor States* will give you more than ample evidence to protect the American taxpayer during these difficult times.

Analysts are projecting cumulative deficits anywhere from \$97 billion to \$200 billion for the states through fiscal year 2010.⁵ Even more concerning is the colossal problem of state unfunded liabilities. A recent study conducted

for ALEC by Dr. Barry Poulson of the University of Colorado found that state pension systems alone are now more than \$350 billion in debt.⁶ Furthermore, the Governmental Accounting Standards Board (GASB) recently issued a guideline that requires states to report the full actuarial contributions needed to meet their other post-employment benefit (OPEB) obligations.⁷ Of the 40 states that have complied with the guideline, total unfunded liabilities in this category are estimated at nearly \$400 billion.⁸

During the early months of 2008, many states that were able to avoid the sub-prime mortgage crisis were in comparatively good shape financially. In their respective 2008 state-of-the-state addresses, only 36 percent of governors talked about substantial budget problems, while 58 percent described their state's economy as good or strong.⁹ However, their good times are now coming to a halt.

Even some of the states with strong natural resource production that were hoping to be immune from the recent national downturn are starting to feel the pain. As the price of oil and other commodities fell dramatically in the last half of 2008, the natural resource and agricultural states are now under the gun. "We are clearly in stiff-drink territory," said George Hammond, an economist with West Virginia University. "But just one stiff drink. The national economy is in the two-or-three-stiff-drinks stage."¹⁰

In the words of Yogi Berra, this is like déjà vu all over again.

The “dot-com” boom of the late 1990s fueled large surpluses in the states. Some states took the course of fiscal restraint and returned the money back to the taxpayers, while others ratcheted up spending levels, in many cases spending every last dime! Then we suffered through the devastating attacks of 9/11, and the resulting economic downturn caused states to find themselves in a world of hurt.

Of course, the only reason many of these states faced budget shortfalls was because they spent beyond their means during the good years of the late 1990s. In an attempt to remedy this situation, some state officials conducted a lobbying effort to get Uncle Sam to bailout the states in 2003.

This all seems strangely similar to the situation states find themselves in today, as state budgets have once again ballooned over the past few fiscal years. Let’s take the recent example of FY 2008. Even though overall growth in state spending had begun to decline as a result of the national downturn, some state budgets don’t appear to have felt much pain.¹¹

LARGEST STATE SPENDING INCREASES
2007-2008

| 2008 State General Fund Budget Growth | |
|---------------------------------------|-------|
| Oregon | 27.9% |
| Montana | 21.9% |
| North Dakota | 19.0% |

Source: National Association of State Budget Officers

With state spending increasing at rates like these, it is really no surprise that many states are facing significant budget shortfalls. In the good times over the past few fiscal years, states again had no trouble finding ways to spend the soaring tax revenues that came their way. In the fat years for state budgets, expenditures for education, transportation and health care grew at astonishing rates in many cases. With

the economic downturn worsening in the last half of 2008, tax revenues are beginning to slide and the so-called “structural deficits” are back. Predictably, voices from the political left have already begun talking about the “need to raise taxes.”¹² As the following pages outline, if states wish to remain competitive in the 21st century, they need to avoid tax increases by living within their means. From Saginaw, Mich. to Prescott, Ariz., and from Cumberland, Md., to Umatilla, Fla., hard-working families and businesses are required to live within their means each month.

Why on earth should we hold state governments to a lower standard?

Today, some states have learned their lesson in dealing with budget problems, while others have clearly not. According to the National Association of State Budget Officers (NASBO), “31 states have reported budget gaps totaling \$29.7 billion for fiscal year 2009 since budget enactment.” Out of these states, 22 have already cut their enacted budgets for fiscal year 2009, with more reductions on the horizon.¹³ But even if states manage to make it through FY 2009, the much larger challenge will be finding solutions for budgets in FY 2010. According to recent reports, more than 20 states are expected to face budget shortfalls, which will cumulatively exceed \$65 billion next year.¹⁴

Should the Feds Bailout the States?

As in any time of crisis, Washington is suffering from a predictable case of the “do something” disease. Many state and local elected officials want instant solutions to the budget problems they are facing. Although ALEC led the opposition to the federal bailout of the states in 2003, Congress nevertheless approved Uncle Sam’s \$20 billion bailout check. Proponents of the last federal bailout said it would save states from having to raise taxes. These experts were wrong;¹⁵ 35 states passed net tax increases in FY 2004, as did 24 states in FY 2005.¹⁶

Like we said, this is like déjà vu all over again.

Just recently, the National Conference of State Legislatures (NCSL) and several other groups called on Congress to approve a new federal bailout of the states – as a part of the current bailout mania in Washington. First it was \$700 billion for the financial sector, and then executives from the auto industry pounded a path from Detroit to Washington, seeking billions in taxpayer dollars to assist their ailing companies. Most recently, the National Governors Association (NGA) convened a meeting with President Barack Obama in Philadelphia to discuss the economic downturn and lobby for a federal bailout of the states. Unfortunately for taxpayers, the price tag could be significantly higher than the 2003 bailout, as the governors asked for a cool \$176 billion from Uncle Sam.¹⁷ Not to be outdone, the Democrat governors of New York, New Jersey, Massachusetts, Ohio and Wisconsin have asked President Obama for a staggering \$1 trillion to aid their states.¹⁸

Their attempt to persuade the former state senator from Illinois seemed to get results almost overnight. President Obama outlined his broad ideas for the largest increase in spending on “public works” programs since President Dwight D. Eisenhower built the interstate highway system in the mid-1950s.¹⁹ For those who believe that government should be in the business of “creating jobs” by increasing spending on infrastructure and public works, we suggest they go back and read the history of the Great Depression.²⁰

In response to the idea of a federal bailout, ALEC and the National Taxpayers Union led a coalition of roughly 60 taxpayer groups in opposition to the state bailout. The ALEC-NTU coalition letter to Congress hit the nail on the head. It concluded, “[Approving the federal bailout of the states] would set a horrible precedent, discourage responsible budgeting in the future, and place a greater strain on America’s hard-working families and businesses.”²¹

While the rosy fiscal times enjoyed by states over the past few years have clearly dis-

appeared, important questions need to be addressed before rubber stamping a multi-billion dollar bailout of the states: 1) What were the causes of the current budget problems in the states? 2) Should the federal government spend taxpayer dollars to bailout the states in this economic downturn?

States are not facing budget deficits because they don’t tax enough. The real problem facing states is the fundamental issue of overspending taxpayer dollars. State spending has grown at an unsustainable rate over the past decade. In fact, state spending is up 124 percent over where it was just 10 years ago, and state debt increased by 95 percent during that same period.²²

In many cases, states facing the worst fiscal climates are the very same states that engaged in reckless spending. During his recent testimony before the House Ways and Means Committee in Washington, South Carolina Gov. Mark Sanford noted: “California increased spending 95 percent over the past 10 years (federal spending went up 71 percent over the same period). To bail out California now seems unfair to fiscally prudent states.”²³

Gov. Sanford’s point is quite germane. Why should taxpayers who live in states that were fiscally responsible subsidize states like California that were not? ALEC member Sen. Curtis Bramble of Utah complained that California and other states were “asking for a bailout from their bad spending habits.” He continued, “they’re asking for a loophole to violate living within their means.”²⁴ Over the past few years, many states like California have spent money like drunken sailors on a 48-hour furlough. It’s not right to expect the American taxpayer to pick up the tab. The federal government should not be in the business of rewarding states that have overspent taxpayer dollars. Furthermore, with new estimates from the Congressional Budget Office (CBO) showing Uncle Sam’s own budget deficit reaching \$1.2 trillion, Washington is not in the best financial position itself.²⁵

In last year’s edition of this book, we found

countless instances of states engaging in reckless spending. In fact, we devoted an entire chapter to warning state lawmakers that the spending binge states had enjoyed couldn't last forever. For example, we highly doubt New Mexico will be able to continue funding projects like their recent endeavor to create a "space launch pad for future commuter orbital excursions."²⁶ To the surprise of no one, some of the very same suspects are now racking up frequent flier miles traveling to Washington, D.C. to lobby for a state bailout. The real problem may have been described best by Nobel Laureate (and one of our heroes), Milton Friedman: "Governments never learn. Only people learn."

Whenever the government bails someone out of trouble, it always puts someone else into trouble. In this case, a bailout for the states means big-time trouble for taxpayers. In reality for taxpayers, the talk of a federal bailout of the states is just a slight of hand. As Brian Riedl from The Heritage Foundation recently penned, "Hiking federal taxes to keep state taxes from rising is like running up your VISA card to keep the MasterCard balance from rising. Either way, you'll pay. All that changes is where you send your payment."²⁷

There is another very important reason why state officials should be worried about a federal bailout. When has the federal government ever given money to the states without countless strings attached? ALEC's 2009 National Chairman, Speaker Bill Howell of Virginia, recently stated his objections to a federal bailout of the states:

"At a time when federal spending and debt are soaring, the federal government should not put taxpayers on the hook for yet another bailout. Furthermore, a federal bailout could have dire implications on the proper role of federalism. A more effective approach to help the states would be to free them from costly federal mandates."

In my home state of Virginia, we are dealing with our own budget shortfall. Even though it is tempting to accept a short-term federal handout, I am deeply concerned about the long-term implications a federal bailout would have on state sovereignty."²⁸

Further, a study conducted by ALEC during the post-9/11 economic downturn estimated that "every one dollar more of federal assistance increases state and local budget deficits by over 62 cents."²⁹ It is clear the many strings accompanying federal dollars impose significant burdens on the states.

During his testimony, Gov. Sanford urged Congress to "accept that there may be better routes to recovery than a blanket bailout, including offering states ... more in the way of flexibility and freedom from federal mandates instead of a bag of money with strings attached."³⁰

One disastrous federal mandate that should be eliminated immediately is the equivalent of the Holy Grail to big labor: The Davis-Bacon Act. This burdensome federal law requires states to pay the "prevailing wage" for all federally supported construction projects. While that may sound reasonable to some, studies have estimated that this arduous regulation is responsible for adding up to 38 percent to the cost of construction in some states.³¹

State budgets have faced financial duress many times before because of overspending, and certainly will again in the future. History suggests federal bailouts are not the answer as they decrease state sovereignty, incentivize future fiscal irresponsibility, and reward fiscally imprudent states at the expense of fiscally responsible states. Economist Richard Vedder said it best: "In short, federal bailouts are not a solution. They are the equivalent of giving booze to alcoholics – providing at best some temporary respite, but aggravating fundamental problems, in this case overspending."³²

Unfortunately, the "do something" disease

that plagues Washington will probably do so for the foreseeable future. If this results in spending additional taxpayer dollars to rescue states who mismanaged taxpayer dollars in the first place, it will only spiral them into a cycle of federal dependency, further encouraging fiscal irresponsibility. Let's hope that is not the case.

Taming the Beast

"If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself."

- *Federalist Paper No. 51*

Relying on government to control itself and stop the state fiscal roller coaster can be a bit naive today in most states. However, in our experience, constitutionally limiting the government's ability to grow – through a tax or expenditure limit (TEL) – has proven to be a very effective approach. Colorado, for example, was able to restrain government spending and tax burdens through the Taxpayers' Bill of Rights (TABOR) beginning in the early 1990s, 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.

For years, the political left has attempted to define the taxpayer protection movement by twisting the record of Colorado's Taxpayers' Bill of Rights, for the very reason that TABOR was an effective deterrent to the unbridled growth of government. Following the low-tax plus limited-government formula, TABOR gave Colorado one of the most competitive business climates in the nation, not to mention giving taxpayers back some of their hard-earned money. The economic growth followed, as

Colorado boasted one of the fastest growing economies in the nation.

Some suggest that Colorado enjoys economic growth simply because of the beautiful terrain, tourism and abundant natural resources. However, let's take a look at that theory. Colorado decided to earnestly pursue free-market policies of tax relief and spending restraint in the early 1990s, and the state's economic boom didn't occur until those pro-growth reforms had been implemented. Colorado's economy had not experienced nearly that level of growth in the preceding decades, and believe it or not, the ski slopes full of tourists and natural resources were just as abundant in the 1980s as they are today.

The historical evidence is clear: States that keep spending and taxes low exhibit the best economic results, while states that follow the tax-and-spend path lag far behind. The recent evidence suggests that if you tax and spend enough, you might even end up like California.

Budget Transparency:

A Shiny New Tool to Curb Government Waste

One of the best new tools to shine the light on wasteful government spending is budget transparency. ALEC members have taken the lead, promoting legislation across the country to accomplish this task. You will find ALEC's highly-acclaimed model legislation in Appendix C.

Thomas Jefferson hoped that one day, "we might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress and every man of any mind in the Union should be able to comprehend them, to investigate abuses, and consequently to control them." Today that vision can be a reality for states. With the advance of computer and network technologies, states now have the capacity to publish their yearly budgets on the Internet, providing taxpayers with a searchable, manageable report of all state expenditures from year to year. This is the central principle behind budget transparency legislation.

Budget transparency’s ultimate aim is to see all information on state budget expenditures provided in a readily accessible and structured format so that any interested party can access this information. In the past, government budgets were available in print, but the time necessary to mull through thousands of pages to track down relevant information was very prohibitive. Budget transparency legislation solves this problem by providing taxpayers the ability to see where their tax dollars are going in a detailed, item-by-item manner, across all departments, from any computer, free of charge.

While all budget transparency legislation shares this basic goal, the specifics of the legislation vary among different models. The most basic formulations call on government to do little more than publish budget expenditures online in some format and update the data every year. Stronger models go a few steps further, such as requiring states to publish performance results for state expenditures, listing funding sources per agencies and programs, mandating item-by-item listings, and integrat-

ing advanced search functionality for ease of research and cross-referencing.

Over the last two years, budget transparency legislation has been enacted in numerous states and has enjoyed widespread support on a bipartisan basis.

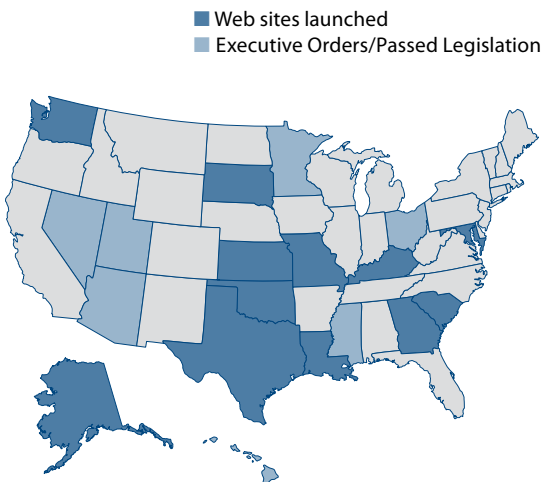
In 2007, six states enacted legislation (or executive orders) which began implementing budget transparency, starting the process of establishing searchable online databases accessible to the general public. One such example is the Missouri Accountability Portal, which was created by an executive order of Gov. Matt Blunt. On the Web site, one can search by agency, category, contract and vendor to track down state expenditures.³³ The portal also contains data on state employee salaries and tax credits issued. The site is easily navigable and lists all expenditures per fiscal year, down to items that cost only a few dollars.

Another fine example is Oklahoma’s OpenBooks Web site.³⁴ This site was created as a result of the Taxpayer Transparency Act, unanimously passed by the Oklahoma Legislature in 2007, and signed into law by Gov. Brad Henry. In addition to expenditure data on agencies, payroll and vendors, this site also lists the funding sources for government agencies and programs. Lawmakers in Kansas created yet another effective budget transparency Web site, which you can peruse at: www.kansas.gov/kanview. In the first few months of operation alone, sites like these have streamlined the process of budget research, reduced the burden of paperwork on state agencies, and generated millions of hits, demonstrating real public interest in such a service.

In 2008, ALEC members in 30 states fought for increased budget transparency. Washington serves as a fine example for 2008, unanimously passing bipartisan legislation that will dramatically improve budget transparency. Mississippi gives us yet another model of enacting comprehensive budget transparency in 2008.³⁵ Guided into law by ALEC member

ACTIVE SPENDING TRANSPARENCY WEB SITES LAUNCHED SINCE 2007

as a result of legislative or gubernatorial action



Source: Center for Fiscal Accountability

Sen. Alan Nunnelee the Mississippi Accountability and Transparency Act of 2008 was enacted with the steadfast support of Gov. Haley Barbour. Given the tremendous success of the budget transparency movement, we expect a significant number of states will consider legislation to establish working databases of their own in 2009.³⁶

Although the success of these sites is impressive, it should be noted that many of the states that recently mandated budget transparency are still in the process of creating their Web sites. Some of the current state budget sites have not implemented keyword search functionality, and some suffer from user interfaces that are difficult to navigate. Nevertheless, it is encouraging to see such progress in such a short time period. Improved functionality will be implemented in the near future on each of the current sites, as well as expanded databases to include all state funding and expenditure information. These examples prove that budget transparency sites can be established within only a few months time after the passage of transparency legislation and can be further upgraded in the future.

One innovative upgrade is applying transparency to K-12 budgets at the school district level. In 2007, legislation was introduced in Texas to require all school districts to post their check registers online. Although this legislation failed in the senate, more than 200 school districts are already posting their records online voluntarily. In 2008, Collin County, Texas, became the first school district in America to post records online in a searchable PDF format.³⁷

Unfortunately, the movement for increased transparency and accountability has suffered some defeats as well. South Dakota Gov. Mike Rounds vetoed budget transparency legislation in his state in 2008 on the basis of its estimated cost of \$600,000. ALEC member Rep. Hal Wick introduced the South Dakota transparency legislation and led a valiant effort to override the

governor's veto. Supporters pointed out that \$600,000 was an exceedingly high estimate of what the real costs would likely be, given the experience of other states.³⁸ The override was hugely successful in the South Dakota House, but failed in the Senate by a margin of only two votes. However, in a dramatic turnaround of events, Gov. Rounds unveiled his own budget transparency Web site in September. This resource makes more than 180,000 pages of information available to the public in a searchable format.³⁹ The site includes more than 106,000 financial records and information about revenue and budget information, as well as vendor and state payroll data.⁴⁰

On the issue of cost, time and again the fiscal impact has been shown to be minimal. The fiscal impact statement from the legislation passed in Oklahoma last year estimated the total outlay for programming and implementation at \$300,000, but it turned out to cost only \$8,000 plus staff time. Missouri's budget office said its site was created "within existing resources."

Technology companies are often able to help set up transparency sites, and there remains the possibility of free assistance with programming and source coding from companies like Microsoft and Google. By partnering with the private sector, lawmakers can further defray the costs associated with these projects. When opponents of transparency talk about the high costs of a budget Web site, their argument is usually a red herring. Time and time again, the actual cost of budget transparency is vastly overstated. And, as ALEC member Sen. Randy Brogdon of Oklahoma stated, "Any cost for implementation is far less than the cost of not knowing where tax dollars are being spent."⁴¹

Taxpayers should be able to easily access and track how their state is spending their tax dollars. Enabling this will act as a cost-effective measure to protect taxpayers and limit the size of government by holding lawmakers accountable for wasteful spending. Judging by the wave

of states that have passed legislation in the past two years, it is encouraging to see there are many throughout the United States who share this belief. In 2009, we are optimistic that ALEC members will continue to support efforts to open government spending records to the general public through budget transparency legislation. Having millions of American taxpayers reviewing state spending projects will be a tremendously valuable asset for cash-strapped states looking to eliminate wasteful spending.

The Great Debate: Increase Taxes or Reduce Spending?

In the face of today's budget pressures, many states are not talking fiscal restraint or budget transparency, but misguidedly looking to target businesses and individuals alike as a strategy to balance the books. As our elected officials think about beginning the annual task of budget writing, it is important they remember that levying tax increases is not a sustainable answer for budget problems. In fact, it comes at a great cost. Whenever a state changes its tax and fiscal policies, it directly and immediately influences that state's competitive position for personal and business investment.

Especially during an economic downturn, states need to be doing everything they can to become more competitive, not less. Policymakers across the nation should be very aware that changes to policy are not created in a vacuum. Today, business capital is increasingly liquid and can easily be shifted between competing opportunities throughout the international marketplace.

Today, many states stand at a crossroads, and it will soon become apparent if lawmakers choose to use history as a guide for their actions. Because states cannot simply print money like Uncle Sam, they are left with two basic choices to solve budget shortfalls: 1) raise taxes, or 2) decrease spending. Of course, many states regularly issue debt, but in reality this simply repre-

sents the potential of a future tax increase – and don't forget the interest on the principal. As we outline in chapter two, choosing your state's future is as easy as a case study of two theories in practice (California vs. Texas).

As we describe in much greater detail in chapter three, Sacramento is in complete disarray, facing more than a \$40 billion budget shortfall over the next 18 months. The Golden State has so mismanaged state finances that a recent *Los Angeles Times* headline asked, "Is California too unwieldy to govern?"⁴² Of course, even dreadful situations can bring about good – providing others use them as an example of what not to do. Such is the case with liberalism run amok in Sacramento. We devote chapter three to the unfortunate tale of the Golden State's financial decay.

The citizens of California are clearly facing a frightening budget deficit, but it's naïve to think increasing taxes will solve the fundamental problem of overspending in Sacramento. The truth of the matter is California doesn't have a budget problem – it has a severe spending problem. California is already behind the proverbial eight ball in terms of economic competitiveness. Increasing taxes would be the worst thing California lawmakers could do today.

Despite the dubious distinction of having both the highest statewide personal income tax *and* the highest state sales tax in the nation, California still finds itself with far and away the largest budget deficit of any state. If simply spending money were the solution to all of government's problems, there wouldn't be a problem left in California today. The Golden State provides us all with a great lesson: You can't tax your way to prosperity.

On the other hand, Texas has proved that (contrary to the opinions of our friends on the left) any state can do without a personal income tax – in fact, they can do so and prosper. Texas Gov. Rick Perry's approach is one worth noting. Not only has he taken an active opposition to the idea of a federal bailout, Gov. Perry is

adamantly opposed to increasing taxes during this economic downturn.⁴³

Today, it is encouraging to note that other states are taking the responsible approach as well, and are looking for ways to balance their budgets by reducing overspending. For instance, Utah Gov. Jon Huntsman, Jr., has proposed a budget that is \$1 billion smaller than the previous year's.⁴⁴ Newly-minted Kansas Speaker Mike O'Neal optimistically remarked: "The good news is we have a two-year window of opportunity to look at doing things fundamentally differently. If we don't have the will to do it now with the budget situation the state is in, then we will have missed a golden opportunity."⁴⁵

Gov. Butch Otter of Idaho recently wrote state agency directors, stating budget cuts "should involve eliminating entire programs if they are not in furtherance of or required by your statutory mission."⁴⁶ This obviously raises the question of why the spending was justified in the first place. However, the governor's action is a worthwhile attempt to correct past overspending and move towards a more priority-based budget.⁴⁷ Sadly, many state agencies across the country are not even required to produce mission statements – let alone observe them.

Former director of the federal Office of Management and Budget (OMB) Indiana Gov. Mitch Daniels has a keen eye for responsible budgeting. In a speech to ALEC members in late 2008, he suggested that the current economic downturn "is a terrific time to shrink government. This is a great time to do those things that probably should have been done before but are easy to let slide or to beat back when times are flush."⁴⁸ Subsequently, Daniels called on Hoosier State lawmakers to decrease state spending by more than \$750 million to balance the budget without a tax increase.⁴⁹ If only more lawmakers followed that approach! Regrettably, it appears that many states will take a vastly different approach to budgeting in 2009.⁵⁰

New York to Taxpayers: Drop Dead

Today states fall into one of two categories. On one hand you have the tax hikers, who are making their states less competitive. On the other hand you have the innovators, who are protecting taxpayers by learning to live within their means. New York may be the worst example of the former, as Gov. David Paterson astonishingly proposed an overall increase in the state's budget, while supporting massive tax increases for New Yorkers.⁵¹ Not surprisingly, Gov. Paterson is also one of the biggest supporters of a federal bailout of the states (New York is estimated to face a budget shortfall exceeding \$15 billion). Additionally, the New York governor just might have broken the record for the number of bad ideas he put forward during a recent 17-minute budget address – most notably, his 137 proposed tax increases come to mind (see box on page 10).⁵²

Paterson's abysmal proposals have given us an unfortunate example of predatory tax policy. (As if New York didn't already have the reputation of a tax purgatory.) Another egregious example from Albany is their new (and almost certainly unconstitutional) "Amazon Tax." This 2008 law looked for revenue outside of New York's borders and imposed the burden of sales tax collection on catalog and online retailers across the nation – with no physical presence in the state.⁵³ The "Amazon Tax" is clearly detrimental to interstate commerce, which puts it at odds with the U.S. Supreme Court's ruling in *Quill Corp. v. North Dakota* (1992). New York's "tax adventurism" has already driven Overstock.com away from doing business in the Empire State while several lawsuits are pending.⁵⁴ This should both reaffirm the importance of protecting interstate commerce in the 21st century and give every New York resident clear evidence of why taxes matter. Not coincidentally, New York earns the dubious distinction of having the worst economic outlook of any state in our ALEC-Laffer 2009 Economic Competitiveness Index.⁵⁵

A SMALL SAMPLE OF NEW YORK GOVERNOR DAVID PATTERSON'S TAX INCREASES

| | | | |
|---|---|---|---|
| "iTunes tax" of 4% on videos, music or pictures downloaded from the Internet | The taxes for beer and wine will both more than double to 51 cents per gallon of wine and 24 cents per gallon of beer | A 4% tax on cable TV and satellite services | Increase the tax on rental cars from 5% to 6% |
| 4% tax on taxi, limo and bus rides | Elimination of the sales tax exemption on clothing and footwear priced under \$110 | Hiking the cost of personal services – including haircuts, manicures, pedicures, massages and gym memberships – by 4% | A new 5% "luxury tax" on the price of cars that cost more than \$60,000, boats and yachts that cost more than \$200,000, jewelry and fur that cost more than \$20,000, and noncommercial aircraft that cost more than \$500,000 |
| Sodas and other fruit drinks containing less than 70% real fruit juice will be taxed at 18% | A 4% entertainment tax on tickets to movies, concerts and sporting events | Elimination of the law that caps the state sales tax on gasoline at 8 cents per gallon | |
| The tax per cigar will rise 16 cents | | | |

Sources: Tax Analysts, New York Post, PolitickerNY

We undoubtedly won't make Gov. Pater-son's Christmas card list, but things are so bad in the Empire State that we just can't make this up. However, we do see a ray of hope for New York – the voters. Maybe it's the appalling "iTunes tax," or the prospect of paying more for their favorite soft drinks, but sky-high taxes are finally beginning to wear on residents. Recent polling clearly shows that New Yorkers are extremely opposed to increasing taxes to balance the budget. The recent poll from Siena College asked respondents about desired solutions to the budget shortfall in Albany. While a full 75 percent supported spending reductions, only 10 percent were willing to consider a tax increase.

Predatory Taxes

Unfortunately, New York is not the only state looking to increase taxes in an attempt to balance its books. One of the perennial favorite targets for tax increases during bad budget times is "big tobacco." Many states have proposed or are considering new taxes on tobacco products in an attempt to solve their budget deficit. Unfortunately for the tax hikers, increasing

taxes on smokers is one of the least effective ways to raise long-term revenue for states.

On paper, tobacco taxes always look attractive to lawmakers as revenue forecasters often show a windfall of projected receipts from the taxes. However, in the real world people respond to incentives, and cigarette taxes have been shown to encourage smokers to avoid high-tax jurisdictions. As state after state has learned, the promise of substantial cigarette tax revenue often goes up in smoke.

Take Maryland, for example. State lawmakers recently doubled the state's cigarette tax to \$2.00 per pack to pay for additional health care and balance the budget. Of course they expected a revenue boom to help fix their state's unstable finances. However, they were sorely mistaken, as *The Wall Street Journal* reports that cigarette sales are down 25 percent.⁵⁶ In fact, nearly 30 million fewer cigarettes have been sold in Maryland since the tax increase this year. Therefore, the cigarette tax, which was supposedly the panacea for the state's budget woes, has come up short, and lawmakers in Annapolis are back to the drawing board.

Retailers in Maryland have seen their ciga-

rette sales plummet because of good old fashion competition – and in this case, specifically tax competition. Just across the Potomac River, Maryland residents can take full advantage of the lower taxes in Virginia. Maryland's neighbor to the south has one of the lowest cigarette taxes in the nation at 30 cents per pack. Such a cost difference with a bordering state has made it profitable for Maryland drivers to venture down Interstate 95 into the Old Dominion, saving \$1.70 a pack in cigarette taxes alone. Maryland has responded with hopeless attempts to control out-of-state cigarette purchases with investigations and searches of suspected “tax evaders” on the border.

As lawmakers in Maryland have painfully learned, states cannot expect that cigarette taxes will raise enough revenue to solve budget problems. Furthermore, states cannot expect smokers to ignore the incentive to purchase their cigarettes in bordering states, especially when that incentive is high enough. The case study of Maryland is not an isolated example, as states across the nation have experienced similar outcomes when they tamper with the law of incentives. New Jersey lawmakers found this out the hard way in 2007, losing revenue when they enacted the nation's highest cigarette tax, and tax revenues fell by \$23 million the next year.⁵⁷ Back in 2005, Washington lawmakers recognized this phenomenon of tax competition and actually *lowered* tobacco taxes to raise revenue and help in-state businesses.⁵⁸

Unfortunately, with politically charged topics such as these, it is easy for some public-policy leaders to lose sight of basic economic realities. However, history has clearly shown us that tobacco tax increases will fail to raise the revenue suggested. Not only will consumers have a greater incentive to purchase their cigarettes across state lines, today they can evade the increased taxes in the comfort of their own home through the Internet.⁵⁹ Politically, tobacco taxes are an easy sell because they target a fraction of society and involve a

socially unpopular activity. However, they are strikingly bad public policy.

Tobacco isn't the only industry with a target on its back in difficult revenue times. During the 2008 presidential campaign it seemed like “big oil” was one of the favorite targets of the class warriors – especially as gasoline prices were front page stories for several months in the first half of the year. Even though prices have drastically retreated, the Obama Administration is supporting the idea of a “windfall profits tax.” This tired policy would take us right back to the disastrous energy policy of the 1970s under Jimmy Carter. Of course, the oil industry is an easy political target for tax increases, but historical studies have shown that “big oil” has paid more in taxes than it has earned in profits – in fact, nearly three times more!⁶⁰

Some states have also looked to capitalize on public scorn and target oil companies with predatory taxes at the state level.⁶¹ Pennsylvania, Wisconsin and California are among the states that have considered such a disastrous policy. As state budget deficits worsen, it will only add to the ill-fated populist temptation to target “big oil.” We could add countless examples of lawmakers hitting a particular industry with discriminatory taxes; however, during tough budget times, being profitable can be a deadly sin.

Conclusion

As budget problems become more severe, states must utilize every cost-saving measure possible to avoid economically damaging tax hikes. Increasing taxes during the current downturn is a non-starter for states that wish to remain competitive. Instead, we hope states will use their current financial problems to put their fiscal houses in order and say no to profligate spending and irresponsible budget practices, which have caused many of the current difficulties.

As lawmakers return to session in 2009, many will be faced with a budget crisis. A

handout from Washington, D.C., might seem to help in the short-term, but as many seem to overlook, dollars from Washington rarely come without costly strings attached. Furthermore, a federal bailout would do nothing to address the fundamental problem of a decade's worth of state overspending. If anything good comes out of the budget problems in the states, maybe it will highlight the key to good budgeting: having the ability to say "no." Hopefully the next time we face an economic downturn, states will have policies in place to avoid another crisis of their own making.

In this second edition of *Rich States, Poor States* you will find countless examples of how tax and budget policy really do matter for states. This year we have added an appendix with a sample of tools that ALEC's Tax and Fiscal

Policy Task Force has developed to protect the taxpayers of this great nation. In Appendix C you will find ALEC model legislation designed to improve budget transparency, accountability, and to protect the hardworking taxpayers in your state.

As Supreme Court Justice Louis Brandeis famously declared, "States are the laboratories of democracy." In the following pages we will highlight what states are doing right – and what they're not.

Rich States, Poor States supplies ample evidence for lawmakers to avoid the mistakes that have caused economic malaise in so many states today. It is our hope that ALEC members across the country will continue to be powerful advocates in the battle to keep their states and our nation competitive in the 21st century.

ENDNOTES

- 1 Prah, Pamela. "41 States Posting Surpluses." *Stateline*. April 19, 2007.
- 2 The Nelson A. Rockefeller Institute of Government. "State Revenue Flash Report." November 6, 2008.
- 3 National Association of State Budget Officers. "Fiscal Survey of the States." December 2008.
- 4 Boyd, Donald and Dadayan, Lucy. "The Damage is Just Beginning." The Nelson A. Rockefeller Institute of Government. State Revenue Report Number 73. October 2008.
- 5 Prah, Pamela. "Budget gap could widen to \$200 billion." *Stateline*. December 15, 2008.
- 6 Poulson, Barry. "Is There a Gorilla in Your Backyard? Pension and Other Post Employment Benefit (OPEB) Liabilities." The American Legislative Exchange Council. December 4, 2008.
- 7 For additional information see: Mattoon, Rick. "OPEB: The 800 Pound Gorilla in the Room." The Federal Reserve Bank of Chicago. February 17, 2008.
- 8 Poulson, Barry. "Is There a Gorilla in Your Backyard? Pension and Other Post Employment Benefit (OPEB) Liabilities." The American Legislative Exchange Council. December 4, 2008.
- 9 Nodine, Thad. "The Governors Speak – 2008." The National Governor's Association. April 2008.
- 10 StateNet. "Capitol Journal" December 15, 2008.
- 11 National Association of State Budget Officers. "Fiscal Survey of the States." December 2008.

- 12 Fehr, Stephen. "States Warned Tax Hikes May Be Needed." *Stateline*. December 15, 2008.
- 13 National Association of State Budget Officers. "Fiscal Survey of the States." December 2008.
- 14 Prah, Pamela. "State budget gaps balloon to \$97 billion." *Stateline*. December 5, 2008.
- 15 Fitzgerald, Thomas. "Despite Federal Windfall, Pennsylvania Governor Still Backs Income Tax Hike." *Tax Analysts, State Tax Today*. June 2, 2003.
- 16 National Association of State Budget Officers. *Fiscal Survey of the States*. 2003 and 2004 editions. Available at <http://www.nasbo.org>.
- 17 Lee, Carol. "Cash-strapped governors ask for aid." *The Politico*. December 2, 2008.
- 18 Hurdle, Jon. "U.S. governors seek \$1 trillion federal assistance." *Reuters*. January 2, 2009.
- 19 Montgomery, Lori. "Obama Team Assembling \$850 Billion Stimulus." *Washington Post*. December 19, 2008.
- 20 Our friend, Amity Shlaes has written a wonderful new book "The Forgotten Man: A New History of the Great Depression", which exposes many of the myths surrounding FDR's New Deal. Also, the Mackinac Center for Public Policy offers a terrific resource on this subject: "Great Myths of the Great Depression," written in 1998 and revised in 2005 by President Emeritus Lawrence W. Reed. Available at: <http://www.mackinac.org/archives/1998/sp1998-01.pdf>.
- 21 Full PDF available at <http://www.alec.org>.
- 22 Sanford, Mark. Testimony before the United States House Committee on Ways and Means. October 29, 2008.
- 23 *Ibid*.
- 24 Fehr, Stephen. "States Warned Tax Hikes May Be Needed." *Stateline*. December 15, 2008.
- 25 Sunshine, Robert. Testimony before the United States Senate Budget Committee. January 8, 2009.
- 26 Laffer, Arthur and Moore, Stephen. "Rich States, Poor States: The ALEC-Laffer Economic Competitiveness Index (first edition)." December 2007.
- 27 Riedl, Brian. "Don't Bail Out the States: Spendthrifts Made Own Mess." The Heritage Foundation. October 31, 2008.
- 28 Howell, William. ALEC Issue Alert. December 12, 2008.
- 29 Vedder, Richard. "Should the Feds Bail Out the States?" The American Legislative Exchange Council. February 2003.
- 30 Sanford, Mark. Testimony before the United States House Committee on Ways and Means. October 29, 2008.
- 31 Williams, Jonathan. "Paying at the Pump: Gasoline Taxes in America." Tax Foundation Background Paper Number 56. October 2007.
- 32 Vedder, Richard. "Should the Feds Bail Out the States?" *Washington Times*. March 3, 2003.
- 33 See: <http://mapyourtaxes.mo.gov>.
- 34 See: <http://www.ok.gov/okaa/>.
- 35 Nunnelee, Alan. "Budget Transparency in Mississippi." *Inside ALEC*. January 2009.
- 36 It should be noted that constitutional officers in many states have set up budget transparency Web sites for their agencies, or in some cases, overall state spending. Additionally, numerous State Policy Network (SPN) groups have initiated budget transparency sites of their own. To learn more about these efforts, see: <http://www.fiscalaccountability.org>.
- 37 Center for Fiscal Accountability.
- 38 Wick, Hal. "Open Records Essential in Honest Government." *Inside ALEC*. January 2009.
- 39 See: <http://open.sd.gov/>.
- 40 Wick, Hal. "Open Records Essential in Honest Government." *Inside ALEC*. January 2009.
- 41 Quoted in: Coburn, Tom and Dutcher, Brandon. "State Spending Website Needed." *The Oklahoman*. October 18, 2006.
- 42 Halper, Evan and Rothfeld, Michael. "Is California too unwieldy to govern?" *Los Angeles Times*. December 15, 2008.
- 43 "Perry warns of need to keep taxes, spending low." *The Associated Press*. December 17, 2008.
- 44 Gehrke, Robert. "Huntsman proposes budget \$1B smaller." *The Salt Lake Tribune*. December 5, 2008.
- 45 LaCerte, Phil. "Speaker urges Legislature to start examining consolidation of school district administrators." *Kansas Liberty*. January 9, 2009.
- 46 "Gov. Butch Otter calls for 2010 cuts of \$169 million." *The Associated Press*. December 17, 2008.
- 47 For additional information, see the excellent work of the Evergreen Freedom Foundation's Stewardship Project. Available at: http://www.ewfa.org/projects/stewardship_series.php.

- 48 Smith, Sylvia. "Daniels: It's time to shrink." *Fort Wayne Journal Gazette*. December 6, 2008.
- 49 Olson, Scott. "Daniels floats tight budget plan." *Indianapolis Business Journal*. January 6, 2009.
- 50 Lambro, Donald. "States Ring in the New Year with Increased Taxes." *Townhall.com*. January 1, 2009.
- 51 Henschman, Joseph. "State Budgets: New York Plans to Raise Taxes and Fees." *Tax Foundation*. December 28, 2008.
- 52 Scott, Brendan. "Govs Tax & Spend Shocker." *New York Post*. December 17, 2008.
- 53 Cooper, Seth and Williams, Jonathan. "An Unconstitutional Internet Sales Tax." *Forbes*. May 14, 2008.
- 54 Cooper, Seth. "Government Killed the Internet Star: How State Sales Taxes Threaten the Online Commerce." *Inside ALEC*. July 2008.
- 55 Spector, Joseph. "New Yorkers say cut spending, don't raise taxes." *The Rochester Democrat and Chronicle*. November 17, 2008.
- 56 "Cigarette Tax Burnout." *The Wall Street Journal*. August 11, 2008.
- 57 "Dope Smokers." *The Wall Street Journal*. September 7, 2007.
- 58 "Cigarette Tax Burnout." *The Wall Street Journal*. August 11, 2008.
- 59 For additional information see: LaFaive, Michael, Fleenor, Patrick and Nesbit, Todd. "Cigarette Taxes and Smuggling: A Statistical Analysis and Historical Review." *The Mackinac Center for Public Policy*. December 2008.
- 60 Williams, Jonathan and Hodge, Scott. "Oil Company Profits and Tax Collections: Does the U.S. Need a New Windfall Profits Tax?" *Tax Foundation Fiscal Fact No. 41*. November 9, 2005.
- 61 Williams, Jonathan. "Why a windfall profits tax on oil companies won't work." *Northeastern Pennsylvania Business Journal*. April 6, 2007.