



States broke? Maybe they cut taxes too much

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WASHINGTON — In his new budget proposal, Ohio Republican Gov. John Kasich calls for extending a generous 21 percent cut in state income taxes. The measure was originally part of a sweeping 2005 tax overhaul that abolished the state corporate income tax and phased out a business property tax.

The tax cuts were supposed to stimulate Ohio's economy and create jobs. But that didn't happen once the economy tanked. Instead, the changes ended up costing Ohio more than \$2 billion a year in lost tax revenue; money that would go a long way toward closing the state's \$8 billion budget gap for fiscal year 2012.

"At least half of our current budget problem is a direct result of the tax changes we made in 2005. A lot of people don't want to hear that, but that's the reality. Much of our pain is self-inflicted," said Zach Schiller, research director at Policy Matters Ohio, a liberal government-research group in Cleveland.

Schiller's lament is by no means unique. Across the country, taxpayers jarred by cuts to government jobs and services are reassessing the risks and costs of a variety of tax reductions, exemptions and credits, and the ideology that drives them. States cut taxes in hopes of spurring economic growth, but in state after state, it hasn't worked.

There's no question that mammoth state budget problems resulted largely from falling tax revenues, rising costs and greater demand for state services during the recession. But questionable tax reductions at the state and local level made the budget gaps larger — and resulting spending cuts deeper — than they otherwise would have been in many states.

A 2008 study by Arizona State University found that that state's structural deficits could be traced to 15 years of tax cuts, mainly income tax reductions that "were not matched by spending cuts of a commensurate size."

In Texas, which faces a \$27 billion budget deficit over the next two years, about one-third of the shortage stems from a 2006 property tax reduction that was linked to an underperforming business tax.

In Louisiana, lawmakers essentially passed the largest tax cut in state history by rolling back an income tax hike for high earners in 2007 and again in 2008.

Without those tax reductions, Louisiana wouldn't have had a budget deficit in fiscal year 2010, the 2011 deficit would've been 50 percent less and the 2012 deficit of \$1.6 billion would be reduced by about one-third, said Edward Ashworth, the director of the Louisiana Budget Project, a watchdog group.

These and similar budget problems nationwide are symptoms of a larger condition, said Timothy J. Bartik, senior economist at the Upjohn Institute for Employment Research in Kalamazoo, Mich.

"If state and local taxes were at the same percentage of state personal income as they were 40 years ago, you wouldn't have all these budgetary problems," Bartik said.

Before California's Proposition 13 triggered a nationwide tax-cut revolt in the late 1970s, state and local taxes accounted for nearly 13 percent of personal income in 1972, Bartik said. By 2007, it was 11 percent.

State corporate income taxes have fallen as well. Once nearly 10 percent of all state tax revenue in the late '70s, they accounted for only 5.4 percent in 2010.

"It's a dying tax, killed off by thousands of credits, deductions, abatements and incentive packages," according to 2010 congressional testimony by Joseph Henchman, the director of state projects at the Tax Foundation, a conservative tax-research center.

Even now, as states struggle to provide basic services and ponder job cuts that threaten their economic recovery, at least seven governors in states with budget deficits have called for or enacted large tax reductions, mainly for businesses.

Four are newly elected Republicans in Florida, Maine, Michigan and Wisconsin. The others are Republicans Jan Brewer of Arizona and Chris Christie of New Jersey and Democrat Beverly Perdue of North Carolina.

Their willingness to forgo needed tax revenue is hard to fathom, as states face a collective \$125 billion budget shortfall for the coming fiscal year, said Jon Shure, the deputy director of the State Fiscal Project at the Center on Budget and Policy Priorities, a respected liberal research institute in Washington.

"To be cutting taxes when you're short of revenue is like saying you could run faster if you cut off your foot," Shure said.

"States have suffered an unprecedented collapse in revenue, and they are at the bottom of a deep hole looking up, and these governors are saying, 'You need a ladder to climb out, but I'm going to give you a shovel instead, so you can dig the hole deeper.' "

Tax Foundation President Scott Hodge said the governors were simply trying to improve their states' business climates by lowering the tax burden.

"They're trying to increase their market share and their attractiveness to business," Hodge said. "And also, more importantly, they're trying to prevent the attrition of business and investment to other states" that have lower tax rates.

Republican lawmakers and pro-business groups have long maintained that tax cuts help stimulate economic activity, while keeping businesses and wealthy individuals from leaving the state for lower taxes elsewhere. They also argue that business and personal spending increases after tax reductions, broadening the base to be taxed at the lower rate, which partly offsets the lost tax revenue.

So calls to balance lean state budgets through spending cuts as well as modest, revenue-boosting tax hikes haven't resonated with Republican governors, who see tax relief as the key to reversing job losses in the Great Recession.

"Raising Ohio's taxes even higher won't bring those jobs back. Reducing costs so we can start reducing taxes is the key to our revival," said Rob Nichols, Kasich's press secretary. Extending the state's personal income tax cut will cost \$800 million over two years.

Business tax reductions may be overrated as an economic stimulus because they're so low on the totem pole of expenses. For most businesses, the cost of labor is probably 15 times the cost of all state and local taxes, said Bartik of the Upjohn Institute.

In his own research, Bartik found that a 10 percent across-the-board cut in state and local business taxes might boost employment by 2 percent, but it could take up to 20 years.

"Most studies indicate you might get 30 percent of the effect after five years and maybe 60 percent after 10 years," Bartik said. "It takes a while because investment decisions are quite lagged and take place gradually."

Compounding Ohio's budget woes are 128 state tax exemptions, credits and deductions that drain more than \$7 billion a year in would-be revenue. These loopholes make Ohio miss out on one of every four dollars it would otherwise collect in taxes, said Schiller of Policy Matters Ohio.

In Missouri, business and individual tax credits cost the state \$521.5 million in fiscal year 2010, compared with \$103 million in 1998, according to a state report.

Louisiana's 441 individual and corporate tax breaks cost the state \$7.1 billion last year. That nearly matches the \$7.7 billion that all state and local taxes brought in.

Some of the breaks provide sales tax exemptions on groceries, prescription drugs and residential utilities that saved Louisiana taxpayers \$717 million last year. But another allows Louisiana companies to keep 1 percent of the state sales taxes they collect — about \$34 million statewide — just for filing their tax returns on time.

Hodge, a conservative, said that closing loopholes and exemptions was less harmful to the economy than tax increases were. The Tax Foundation supports scaling back or closing tax loopholes, while lowering tax rates across the board.

"My argument to state lawmakers is that lower rates for everybody are better than tax incentives for some," Hodge said.

That incentive-free philosophy was behind Michigan Gov. Rick Snyder's call for a flat 6 percent corporate income tax to replace the current business tax system. But Snyder's flat tax amounts to a \$1.5 billion tax cut for businesses, paid for in part by education cuts, personal income tax increases and taxing public and private pensions.

“We think that’s the way to rebuild our state, and to get it on a path toward economic prosperity,” Snyder’s top economic development official, Michael Finney, said during a recent trip to Washington.

History suggests otherwise, however. After the nation recovered from the 1990-91 recession, 43 states made sizable tax cuts from 1994 to 2001 as the economy surged. Twenty-eight states, in fact, reduced their unemployment insurance payroll taxes after 1995.

But states that cut taxes the most ended up with the largest budget shortfalls and higher job losses when the economy slowed again in 2001, according to research by the Center on Budget and Policy Priorities.

To be sure, states have made bad budget decisions on the spending side as well, said Robert Ward, deputy director of the Nelson A. Rockefeller Institute of Government, a state-government research center at the State University of New York at Albany.

Part of the problem is that the public wants everything but doesn’t want to pay for anything, Ward said.

“People want something for nothing. They want big increases in education and health care spending. They want good roads. They want lots of parks, and they don’t want to pay more taxes,” Ward said. “But at the federal, state and local levels, we are hit with the reality that there is no free lunch.”

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