Tax Cuts and Balanced Budgets:
A Tour of Lansing and Trenton

Introduction

The national debate has been refocused on the need to cut taxes. Presidential candidate Bob Dole's economic proposal is framing the debate. He has proposed an economic package that includes a fifteen percent across-the-board marginal rate reduction, a $500 per-child tax credit, and a capital gains tax reduction that includes a virtual elimination of capital gains taxes on the sale of homes. Another integral part of his economic plan is for a balanced-budget amendment and a balanced budget by the year 2002.

Opponents of the Dole economic plan have been quick to criticize it. They challenge the assumptions of economic growth that would result from enacting the plan. Furthermore, they question whether a tax cut is compatible with a balanced budget in the year 2002.

While the debate continues to rage over the Dole plan, it is worthwhile to look at other experiences where balanced budgets and tax cuts are compatible, i.e. the states. While the issues facing state and national governments are different in significant ways, the challenges of balancing the budget are mainly challenges of political will. Governors all across America, particularly Republican governors, are cutting taxes and balancing budgets. From Arizona to New Hampshire, governors are demonstrating that political will is all that is required to make balanced budgets and tax cuts compatible. Two states of particular interest are Michigan and New Jersey.

The governors of those states, John Engler (MI) and Christine Todd Whitman (NJ), were elected because of strong promises to cut taxes. Unlike Clinton, who promised a middle-class tax cut and a five-year balanced-budget plan, Engler and Whitman kept their promises. Critics of the Engler and Whitman plans voiced the same criticisms that are being heard today concerning Bob Dole's plan. But both governors demonstrated that tax reduction and balanced budgets are compatible.

Cutting Taxes

A centerpiece to the election of Governors Whitman and Engler was their commitment to reduce taxes. Governor Whitman made a pledge to reduce income taxes by thirty percent in three years. To general amazement, Governor Whitman not only met her pledge, but she did it one year ahead of schedule. The marginal tax rate on the median income has fallen from 2.5 percent to 1.75 percent . The top marginal rates have fallen from 7 percent to 6.37 percent. The average family now saves nearly $200 per year in income taxes.

Critics of Governor Whitman claimed that local taxes would rise to compensate for lower state taxes. Two issues need to be made clear. First, Governor Whitman does not control local councils. If local government cannot control its own spending and this higher spending leads to tax increases, the blame must lie with the local officials. Second, the possibility that the critics were most concerned about, a state budget deficit, is not impacted by the local decisions about taxes. It required a strong political will and effort by the governor and state legislators to reduce the growth of spending to meet the requirements for a balanced budget with a tax cut. Also, their fears have proved groundless.

A recent study by two economists from the Manhattan Institute, Timothy Goodspeed and Peter Salins, shows that most New Jersey localities did not raise property taxes after the Whitman tax cuts. A few localities raised taxes. On average, for every dollar cut in state income taxes, local taxes rose by only twenty-two cents. A typical household saved over $200 per year in state taxes. Households still witnessed a net tax cut of $156 dollars. The well-being of the New Jersey family is that much better by controlling more of their own resources.

In Michigan, Governor Engler presided over a drastic restructuring of the tax structure. Under Engler's administration, property taxes were almost completely eliminated, and taxes have been cut twenty-one times. Although sales taxes were raised to partially replace revenues generated by property taxes, Michiganders have more money in their pockets and are sending less money to Lansing. State and local taxes took more than eleven percent of personal income before Engler took office. Now taxes only take 10.4 percent of personal income. The tax burden is expected to continue to fall, to ten percent, when the impact of tax law changes are fully realized.

Controlling Spending

The major criticism leveled at Engler's and Whitman's and other plans to cut taxes is that they are "dangerous." Critics claim that tax cuts risk harming the government's ability to generate revenues to provide essential goods and services without creating an exploding deficit. The problem with this criticism of tax cuts is that it ignores the history of government spending. The twentieth century has witnessed an explosion in the scope of government. The solution to reducing deficits is not raising taxes but controlling spending. The critics of tax cuts view government's role as ever-expansive. The argument that tax cuts will harm the government treats government spending as sacrosanct while the family budget is seen as less important. This argument also ignores the fact that government spending can still grow with tax cuts.

Revenues increase as the economy grows. Expanding revenues for the government are "baked in the cake," they rely only upon economic growth. However, tax cuts make it necessary for government spending's rate of growth to be reduced.

In Michigan, we have a good example of achieving tax cuts and balanced budgets. Upon taking office, Governor Engler had to immediately deal with a projected deficit of $1.5 billion. Now, the state of Michigan has a surplus of $1.2 billion. Even with the elimination of the shortfall, appropriations have grown an average of eight percent a year while Engler has been governor. How can taxes be cut, spending grow and the deficit removed? Simply, the economy grows fast enough to provide additional revenues.

It is a simple fact of economics that when you tax an activity you get less of that activity than otherwise have been the case. If the government taxes incomes, income growth will suffer. It is obvious that the government requires revenue to meet its obligations; however, it is important that the government minimize its obligations. Only by controlling government spending can the economy minimize the dead-weight loss of taxation.

The results have been the same in New Jersey as in Michigan. Appropriations continue to grow in New Jersey. With spending growing approximately two percent per year, the state still manages to pass balanced budgets every year and provide tax relief for New Jersey's families. Both Governor Whitman and Engler realize that the way to improve the well-being of the citizens of their states is to control government spending.

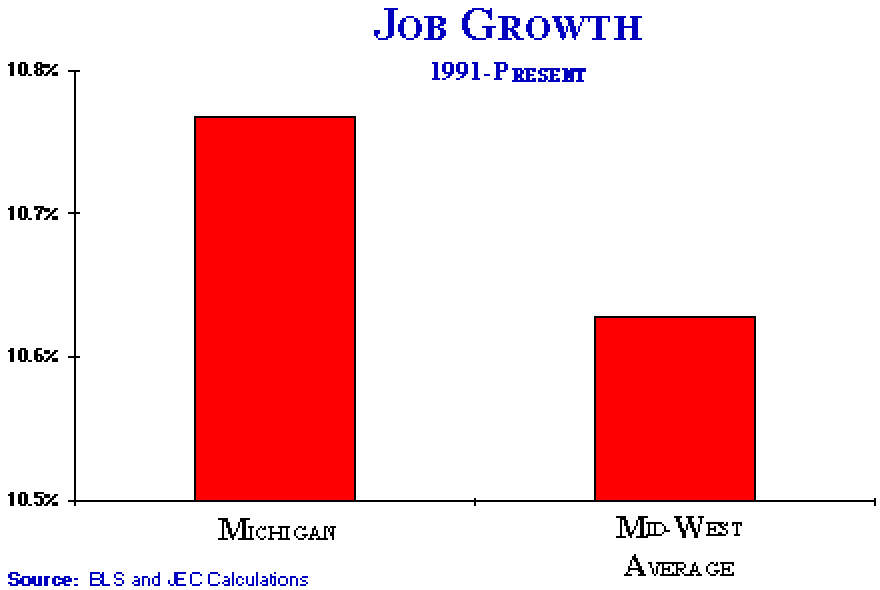
Requiring Balanced Budgets

The first item in Bob Dole's economic plan is a proposal to amend the Constitution to include a balanced-budget amendment. With presidential support, it is likely that a balanced-budget amendment will be sent to the states for ratification. Only one vote in the U.S. Senate stopped the momentum of the balanced-budget amendment in 1995.

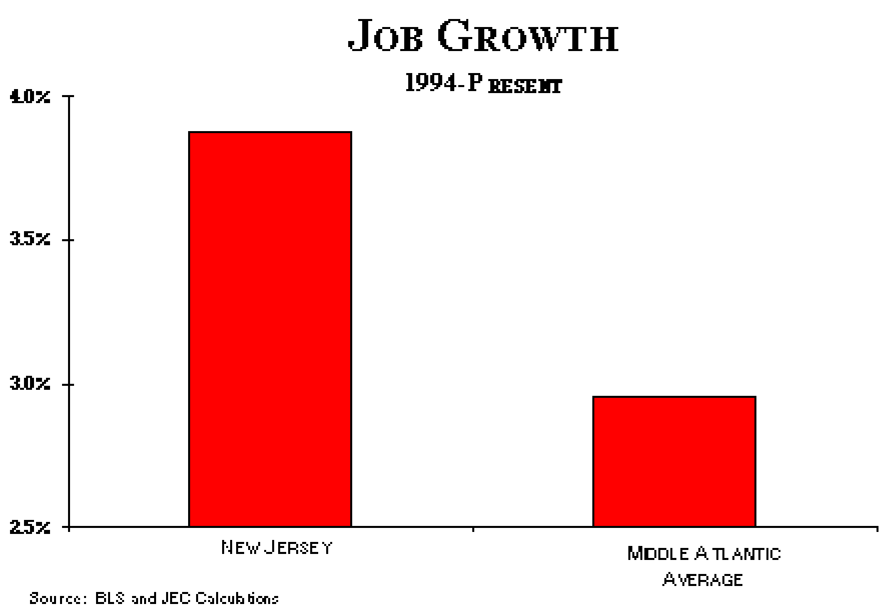
Both states provide an example of the importance of balanced-budget rules. In Michigan and New Jersey, there is a constitutional provision that prohibits the state government from running budget deficits. As a result, neither Governor Engler nor Governor Whitman could be tempted with funding the tax cuts through borrowing. They had to finance their tax cuts with spending restraint. These two states demonstrate that any demand to cut taxes is incomplete without the commitment to balanced budgets. This commitment is expressed in support of constitutional provisions that prevent politicians from running deficits.

Helping the Economy

Critics of tax cuts often imply that cutting taxes has no relation on economic growth or that it will harm economic growth by increasing deficits or harming government investments. Clearly, the states of Michigan and New Jersey demonstrate that tax cuts do not harm economic growth. In Michigan, the economy has a history of under performing the U.S. economy for several years. From 1966 to 1993, the unemployment rate for Michigan was higher than the national average. Yet in the third year of Engler's administration (1993), it fell below the national rate. The current unemployment rate in Michigan is 4.5 percent.



Likewise with New Jersey, the economy is doing relatively well with tax cuts. The economy of the Northeast suffered from federal income tax hikes. The Northeast bore the brunt of pain in the recession of 1990-91. One-third of the job losses in that recession were in New York state alone. The high tax policies of the Federal government and the Democratic Northeastern governors are hurting the local economy. However, Republican governors have begun to repair the damage by lowering taxes. However, the region is still suffering with a slower rate of employment growth than the nation as a whole. Job growth in the Mid-Atlantic is one-third the national average. Even saddled with a slow regional economy, New Jersey's economy has proven better at creating jobs than its neighbors.



The state and national economy are very intertwined. Decisions made by the federal government can hurt or help a local economy. The tax hikes imposed by the Democrats and Presidents Bush and Clinton have hurt the whole country including Michigan and New Jersey; however, both states have performed better than their neighbors in creating jobs.

Conclusion

The critics of tax cuts have missed the mark. The appropriate policy is not a question of economic reality but a question of political will. The Republicans have demonstrated that they are capable of balancing the budget by the year 2002; however, President Clinton has not demonstrated an equal commitment to balanced budgets. His veto was a serious setback to the cause of balanced budgets. His vociferous opposition to the balanced-budget amendment also makes it more difficult to achieve the political will necessary to deal with the problems in the Federal government's budget.

New Jersey and Michigan demonstrate that government can cut taxes and balance the budget without serious declines in government services. Washington politicians have said that we need the states to be "laboratories of democracy." Well, Trenton and Lansing have both experimented with tax cuts and balanced budgets. Their successful results should encourage all Americans who are seeking to gain more control of their lives and their family's budget.

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