Chapter 8
State Fiscal Policy

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10 Principles of State Fiscal Policy

1. Keep taxes low.
2. Avoid progressive income taxes.
3. Reduce reliance on excise taxes.
4. Create a transparent and accountable budget process.
5. Stop corporate welfare.
6. Remove regulatory barriers to prosperity.
7. Reform public pension and health care programs.
8. Fund school children, not schools.
9. Fix, don't expand, Medicaid.
10. Cap taxes and expenditures.

Introduction

State fiscal policy has grown in importance in step with the rise in state and local government spending. That rise has been rapid:

- State governments spent $1.77 trillion and local governments spent $1.71 trillion in 2016 (usgovernmentspending.com 2017).

- From 1990 to 2014, state government spending grew 277 percent in nominal dollars, by about $1.1 trillion (*Ibid.*).

- Per-capita state spending in current dollars climbed 60 percent from 2001 to 2014, rising from $3,282 to $5,457 (*Ibid.*).

- State and local government revenues grew from about 1.8 percent of national gross domestic product (GDP) in 1960 to 7.8 percent in 2014 (*Ibid.*).

Due to this growth, state fiscal policy now plays a major role in determining which states prosper—as reflected in rising population, strong job creation rates, and rising per-capita income—and which do not. States with unsound fiscal policies also waste money and deliver government services poorly, doing a disservice to their taxpayers and often imposing a burden on taxpayers in other states.

Each state is different and faces unique challenges, but certain sound principles concerning budgets, taxes, economic development, and other policies apply coast to coast. In this chapter we present 10 such principles.

1. Keep taxes low.

Low taxes and tax cuts spur economic growth, while high or rising taxes stunt growth.

American independence was born of a tax revolt. The great American statesman Daniel Webster was right when he argued in a 1819 Supreme Court case, "An unlimited power to tax involves, necessarily, a power to destroy" (17 U.S. 327 (1819)).

During the first century of the country's existence, except in times of war, low taxes and government spending were the American way. The effective tax rate imposed by all levels of government in the United States seldom rose above 5 percent prior to 1916 (Rabushka 2002).

During the past century, however, the nation has moved far from its low-tax tradition. According to Scott Greenberg of the Tax Foundation, in 2016 American taxpayers handed over $3.3 trillion in taxes to the federal government and an additional $1.6 trillion to state and local government. This tax bill of almost $5.0 trillion represents approximately 31 percent of the nation's total GDP. The typical taxpayer must work nearly four months—114 days—a year just to pay his taxes (Greenberg 2016).

High Taxes Stunt Economic Growth

Advocates of raising taxes offer an endless litany of benefits they promise will come about if only taxes were raised "just a little." Sometimes they claim higher taxes will produce more jobs or prosperity by financing needed infrastructure or essential public services. Behind every tax increase proposal stand special-interest groups hoping to benefit from the new revenues.

But there is no such thing as a free lunch. Experience has shown the price of higher taxes almost invariably is slower economic growth. Higher taxes discourage work and risk-taking, reduce demand for goods and services, and distort economic decisions. This means less private investment, fewer jobs, less income, and more demand for welfare spending.

Hundreds of studies have examined the relationship between taxes and economic growth. Here is a brief survey of recent studies with a focus on those looking at taxes and economic growth in U.S. states:

- In 2012, the Tax Foundation's William McBride reviewed 26 studies on the relationship between taxes and economic growth in developed countries around the world, at the national level in the United States, and among the 50 states since 1983. All but three studies found taxes had a negative effect on economic growth, including every one of the studies conducted in the 15 years prior to 2012 (McBride 2012).

- In 2006, W. Robert Reed, an economist at the University of Canterbury in New Zealand, studied the relationship between taxes and income growth from 1970 to 1999 in the 48 continental U.S. states and found "taxes used to fund general expenditures are associated with significant, negative effects on income growth. This finding is generally robust across alternative variable specifications, alternative estimation procedures, alternative ways of dividing the data into 'five–year' periods, and across different time periods and Bureau of Economic Analysis (BEA) regions, though state–specific estimates vary widely" (Reed 2006).

- In 2006, economist J. Scott Moody of the Maine Heritage Policy Center reported the effect of total tax burden for all 50 states from 1994 to 2004 (Moody 2006). Low-tax states saw population growth rates nearly three times greater than population growth rates in high-tax states (17.5 percent versus 6.4 percent); personal income growth rates 32 percent greater (75.6 percent versus 57.3 percent); and employment growth rates 79 percent greater (23.3 percent versus 13.0 percent).

- In 2005, Ohio University economist Richard Vedder found that between 1957 and 1997, real personal income growth was more than twice as high in the states that did not raise their income taxes (or increased them only minimally) as in the states with the biggest increases in income taxes (Vedder 2005).

- In an earlier study published in 2001, Vedder examined a number of measures of taxes and spending in the years 1957, 1977, and 1997. He found, "In every single case, without exception, the results are consistent: High or rising taxes are associated with lower amounts of economic growth. The use of more sophisticated statistical models produces the same sort of result: higher taxes, lower growth" (Vedder 2001).

- In seminal research published in 1991, economists Robert Genetski and John Skorburg found low-tax states that raise their taxes faster than other states experience slower economic growth, even if their total tax burden remained lower than their neighbors'. Change in tax burden *relative* to other states has a greater impact on economic growth than *absolute* tax burden (Genetski and Skorburg 1991).

Research on the impact of national taxes on economic growth in the United States and taxes and economic growth in other developed countries has by and large found the same relationships. Harvard University economists Robert Barro and Charles J. Redlick looked at national income tax and economic growth rates in the United States from 1912 to 2006 and found reducing the average marginal tax rate by one percentage point raised the following year's per-capita GDP by 0.5 percent (Barro and Redlick 2011). A study by the International Monetary Fund (IMF) of 15 developed countries over 30 years found a 1 percent tax increase on average reduced GDP by 1.3 percent after two years (IMF 2010). And in *Rich Nation/Poor Nation: Why Some Nations Prosper While Others Fail*, Genetski examines data on prosperity in 40 countries over many decades and finds they are highest and/or grow fastest in countries that adhere to the classical liberal principles of free markets, private property rights, and limited government (Genetski 2017).

The North Carolina Example

Tax cuts at the state level have led to more rapid economic growth. In 2013, the North Carolina General Assembly passed a pro-growth flat-rate income tax, eliminated the estate tax, and lowered the corporate income, franchise, and sales taxes while broadening the latter tax to include other services. Since the reforms were implemented, the state's economy has grown 30 percent faster than the national average and created a projected $400 million revenue surplus for the 2014–15 fiscal year (Clancy 2015).

A key component of the reform was lowering the corporate income tax rate from 6.9 percent to 5 percent in 2015. Further decreases are scheduled if revenue continues to meet targets. The North Carolina Department of Commerce reports the state's unemployment rate fell from 8.1 percent in July 2013 to 5.4 percent in December 2016. Since those tax cuts, more than 188,000 new jobs have been created in the state. North Carolina also has seen improvements in every category of private-sector employment (Berger 2015).

Policy Agenda

The record is clear: Lower tax burdens and falling tax rates produce more rapid economic growth. State lawmakers should resist the temptation to raise taxes to deal with budget deficits that are usually a problem of overspending. High taxes only make fiscal challenges worse. America's low-tax heritage and the negative economic effects of high taxes confirm the first principle of fiscal policy all legislators should follow: Keep taxes low.

Recommended Readings: W. Richard Reed, "The Robust Relationship Between Taxes and U.S. State Income Growth," *Working Paper* No. 13/2006, University of Canterbury, 2006; William McBride, "What Is the Evidence on Taxes and Growth?" *Special Report* No. 207, Tax Foundation, 2012.

2. Avoid progressive income taxes.

> "Progressive" tax systems are really punitive tax systems that punish many productive efforts and retard economic development.

Progressive taxes, such as income taxes, target the highest earners who tend also to be individuals who produce the most economic value. These taxpayers often are highly educated, technologically sophisticated, and increasingly mobile, and so are able to "vote with their feet" by moving to states with lower taxes. In the 1990s, nearly three million native-born Americans left the 41 states with general income taxes for the nine states without income taxes (Vedder 2001, 2005).

Maryland's tax experience is a case in point. In 2009, Maryland created a millionaire tax projected to raise an additional $106 million. Instead of providing the expected new revenue, by the next year, the number of people in the state reporting incomes of $1 million or more fell by one-third (*Wall Street Journal* 2009). Maryland took in $100 million *less* from millionaire earners than the previous year; the state allowed the tax to expire in 2010.

Failure to Raise Revenue

By increasing taxes on higher-income individuals, progressive tax systems de-incentivize critical economic activities—investment, entrepreneurship, and financial risk-taking—that are the engines of economic growth and more commonly undertaken by those with higher incomes (McBride 2012). The adverse economic effects of progressive taxes appear to be universal. A 2008 Organisation for Economic Co-operation and Development (OECD) working paper reported progressive income tax systems around the world have a negative effect on economic growth (Arnold 2008).

"Soak the rich" progressive taxes often fail in their principal aim to raise more revenue. A study by David A. Hartman found between 1957 and 1997, the tax share paid by those in the top 10 percent of reported income was inversely related to the after-tax income share of the other 90 percent. "In other words, when tax share of the top 10 percent goes up, the after-tax income share of the other 90 percent goes down," wrote Hartman (2002).

Because progressive tax systems rely on a small percentage of higher-income taxpayers for a larger percentage of revenues, large budget gaps can result during economic recessions (Glans 2013). As the economy waxes and wanes, tax revenue received, especially from those in the upper brackets, rises and falls as individuals and corporations move between higher and lower tax brackets. This makes it difficult for policymakers to predict tax revenues and prepare state budgets. Flat tax systems are not as vulnerable to such fluctuations.

Crippling Capital

Taxes on capital gains—generally speaking, the increase in the value of a capital asset (investment or real estate) realized when the asset is sold—also harm economic growth. Capital gains taxes discourage investments and business transactions that make job creation and economic growth possible (Cai and Gokhale 1997; Kotlikoff 1993).

Some states have particularly oppressive taxes on capital gains. California has a 33 percent rate and New York a 31.5 rate (Pomerleau and Borean 2014). An increase in the capital gains tax rate, especially when combined with a hike in dividend taxes and high inflation, dramatically increases the effective tax rates paid by many taxpayers.

According to a study by the Institute for Research on the Economics of Taxation (IRET), "Higher taxes on capital retard capital formation and reduce wages across the board" (Entin 2009). In 2006, IRET Executive Director Stephen J. Entin wrote, "When a tax is imposed on capital, the quantity of capital employed falls until the rate of return rises to cover the tax, leaving the after-tax return about where it was before the tax. The tax is largely shifted to users of capital and those who work with it" (Entin 2006). According to Entin, reducing taxes on capital by 1 percent increases private-sector GDP by about 1.5 percent, with about two-thirds going to labor income and about one-third going to capital income.

Dividend taxes—a tax on money paid regularly (typically quarterly) by a company to its shareholders—also discourage investment and economic growth. Policymakers also should take note that raising the dividend tax doesn't necessarily target the wealthy. A study by Ernst and Young found 65 percent of the 27.1 million tax returns in 2007 that reported dividend income showed total incomes of less than $100,000. Senior citizens would be disproportionately affected by such a tax hike because they make up the majority of dividend-reporting taxpayers (Ernst and Young 2010).

Policy Agenda

All taxes have distorting effects on work, consumption, and investment decisions, but progressive income taxes have the worst effects on economic growth. Higher-income taxpayers are highly motivated by state tax policies to change the locations of their businesses, the banks that hold their savings and may manage their investments, and the locations of their investments. This means policymakers should avoid tax policies that penalize earnings and investment.

Recommended Readings: Walter J. Blum and Harry Kalven Jr., *The Uneasy Case for Progressive Taxation* (Chicago, IL: University of Chicago, 1952); George Will, "Try as They Might, Progressives Can't Make the Case for Progressive Taxation," *National Review,* December 5, 2015.

3. Reduce reliance on excise taxes.

Taxes on specific goods and services, called excise or "sin" taxes, are often unfair, unreliable, and regressive.

Excise taxes are a type of sales tax applied to specific goods, such as alcohol, motor fuels, and tobacco products. They typically are not calculated as a percentage of the price of the product, but instead are based on ounces, gallons, or some other product measure. Some governments apply these taxes to soda and other sugary beverages, plastic bags, e-cigarettes, tanning beds, hotels, car rentals, and even Netflix rentals.

States have become increasingly reliant on sin taxes (Maciag 2015). According to the National Association of State Budget Officers (NASBO 2015), between the years 2000 and 2015, states enacted 111 tax increases on tobacco products and another 23 on alcohol. In 2014 alone, states collected approximately $32 billion in tobacco, alcohol, and gambling taxes. Delaware, Nevada, New Hampshire, Rhode Island, and West Virginia rely the most on sin tax revenues as a percentage of total state tax revenues.

Elected officials often impose these taxes because they generally are not paid by a majority of their constituents, and thus are generally less visible than broad-based taxes. Two justifications legislators claim for sin taxes are to combat what they deem unhealthy or immoral behavior, and to increase tax revenues. These goals are contradictory, and those taxes often fail to accomplish either.

Excise Taxes Harm Businesses

Excise taxes originated centuries ago when government revenue needs were smaller, interstate commerce was minimal, and local enforcement was typically easier (Wagner 2005). Today's integrated mass economy makes them problematic and obsolete.

Targeted taxes on specific retail products have a significant detrimental effect on local small businesses. Retailers and wholesalers experience decreased sales because consumers avoid the tax by buying products online or outside the state, city, or county imposing the tax. Increased consumer mobility, thanks to improvements in cars, highways, and ridesharing breakthroughs such as Uber and Lyft, mean the harm to small businesses caused by high excise taxes is much higher than it once was.

Philadelphia's experience with its soda tax should serve as a cautionary tale for state and local governments. John Buhl of the Tax Foundation points out that thanks to a new levy, a 12-pack of flavored sports drinks is more expensive than a 12-pack of beer (Buhl 2017). In less than one year, sales of sports drinks have fallen significantly, and Philadelphia city officials have watched as numerous companies have planned to lay off workers. Canada Dry Delaware Valley planned to cut 30 of its 165 workers. PepsiCo, a major beverage company in the region, also plans layoffs related specifically to the Philadelphia tax.

That tax has harmed small retail businesses as well. Brown's Super Stores, which tend to serve otherwise underserved inner-city communities, have experienced a 50 percent drop in soda sales. Jeff Brown, the chain's CEO, said, "In 30 years of business, there's never been a circumstance in which we've had a sales decline of any significant amount," adding that the result of this decline is "nothing less than devastating." His stores have cut 5,000 to 6,000 hours of employment per week, the equivalent of about 280 jobs (Kaplan 2017).

Excise taxes often encourage illegal activity. Cigarette smuggling from low-tax to high-tax states, for example, is a big business (Drenkard and Borean 2015). Black markets create opportunities for organized crime and can endanger people's health by leading to the circulation of products that have not been inspected for safety. The Washington State Department of Revenue estimated $376 million in tax revenue was lost in 2012 through tobacco tax evasion (Blair 2014).

Most revenue projections for new or increased excise taxes are never met. The National Taxpayers Union Foundation found tobacco tax collections failed to meet initial revenue targets in 72 of 101 recent tax increases (Oprinescu 2013). This is partly because high taxes often lead to tax evasion and, if the tax rate is sufficiently high, to underground markets and counterfeiting.

Unfair and Regressive

Excise taxes often are imposed based on the argument that certain lifestyle choices—smoking, drinking, poor diets—impose costs on taxpayers and the rest of society. In some cases this may be true, but excise taxes are mostly paid by people whose use of these substances does not cause any social harms; for example, social drinkers and people who only occasionally smoke. Excise taxes in such cases are a blunt tool to achieve a social objective.

Excise taxes often bear no relationship to actual social costs, making them unfair. Economist W. Kip Viscusi examined the costs smokers impose on society and concluded, "a comprehensive assessment of these costs suggests that on balance smokers do not cost society resources because of their smoking activities, but rather save society money"

(Viscusi 1994). Note this analysis was conducted *before* major increases in state and national taxes on cigarettes.

The "social costs" arguments fails even worse as lawmakers extend cigarette taxes to e-cigarettes and other vapor products, which are known to be less harmful than traditional cigarettes (Rodu *et al*. 2017). Taxing a less-harmful vapor product the same as traditional cigarettes can mean fewer people will give up traditional cigarettes for this less harmful alternative. The tax on vaping thus can harm public health and impose unnecessary burdens on state budgets. In a report for State Budget Solutions, economist J. Scott Moody wrote, "45 states and D.C. stand to gain more from potential Medicaid savings than through lost cigarette tax collections and tobacco settlement payments" if they do not discourage smokers from switching to vapor products (Moody 2015).

Excise taxes unduly burden moderate- and lower-income individuals since consumption makes up a larger part of their budgets than is the case with persons with higher incomes. A Tax Foundation study, for example, found "from 2010 to 2011, smokers earning less than $30,000 per year spent 14.2 percent of their household income on cigarettes, compared to 4.3 percent for smokers earning between $30,000 and $59,999 and 2 percent for smokers earning more than $60,000" (Callison and Kaestner 2014).

Policy Agenda

Excise taxes are an inefficient, unreliable, and unfair revenue source for state and local governments. They require regular rate increases to keep pace with inflation, whereas income, sales, and property taxes all rise with inflation and economic growth. Instead of trying to hide taxes by creating and increasing excise taxes, states should repeal or lower excise taxes and rely instead on uniform broad-based taxes.

Recommended Readings: Adam J. Hoffer, William F. Shughart II, and Michael D. Thomas, "Sin Taxes: Size, Growth, and Creation of the Sindustry," *Working Paper* No. 13-04, Mercatus Center, 2013; W. Kip Viscusi, "Cigarette Taxation and the Social Consequences of Smoking," *Working Paper* No. 4891, National Bureau of Economic Research, October 1994.

4. Create a transparent and accountable budget process.

A state's budget process should enable policymakers and the public to identify core functions and measure the performance of state agencies.

Budget debates in many states are confusing and unproductive because the public and even elected officials do not have the information they need to make informed decisions. Budgets are often presented as huge tomes with almost-impossible-to-decipher tables and appendices, usually presented to the public after the fact or too late to inform public debate.

Elected officials need to have accurate estimates of total revenues and how they are forecast, the liabilities of public pensions, and public debt and how it is paid for. Often, these key pieces of information are controlled by a governor or by a few legislative leaders and are manipulated or hidden in order to advance their political agendas. In short, few states have budget processes in place that enable legislators and the public to perform their duties.

The good news is that guidelines and models exist for creating a transparent and accountable budget. The American Legislative Exchange Council (ALEC) published a "State Budget Reform Toolkit" in 2011 that offered 25 specific tools for improving budget systems (ALEC 2011). Among its recommendations are the following:

- Define core-governing principles.
- Require nonpartisan revenue forecasts and independent certification of budgets.
- Pass a strong, balanced budget requirement.
- Adopt an effective state spending limit.
- Require preparation of agenda mission statements.
- Adopt performance assessment and management.
- Create a transparent budget website.

- Adopt activity-based costing.

- Adopt a sunset review process for state agencies, boards, and commissions.

In 2012, the Oklahoma Council on Public Affairs offered a state budget reform plan with 10 key recommendations many states could follow:

- Statutorily prohibit budget/spending bills in the last five days of session, just like the constitutional prohibition against passage of revenue-raising measures.

- Statutorily require all budget/spending bills be made available for public review for five legislative days before passage of a budget bill.

- Statutorily require all budget/spending bills have a public hearing with recorded votes for approval in the subcommittee and committee with jurisdiction over that particular spending area.

- Lawmakers should make the commitment to vote on budget and spending bills individually (by agency), rather than as omnibus spending packages.

- Lawmakers should amend statutes to require that any funds specifically directed (in a lump sum without a clear statement for reimbursement of direct and performance-measured services to the state) toward any non-state entity be specifically and plainly written or "earmarked" in the bill providing the funding. Bills containing spending provisions should also include an intent statement, clearly stating that the (or a) purpose of the bill is to provide funding for all intended recipients of the funding.

- Lawmakers should create an oversight committee specifically to review and make recommendations for all state programs utilizing federal funds.

- Lawmakers should begin work on the budget at the beginning of session and pass funding bills for the core functions of government before non-core functions, and weeks prior to the end of session.

- Lawmakers should focus on core functions, reducing non-core efforts and limiting time spent on non-core issues.

- Lawmakers should remove unproductive deadlines.

- Reforms should be adopted to encourage better coordination and reporting of financial data between the House fiscal staff, the Senate fiscal staff, and executive budget staff (Small 2012).

Dealing with Public Pensions

A uniquely troubling part of state and local government budgets involves public pension funds. Lack of transparency and accountability has resulted in gross mismanagement of those funds. According to Bob Williams, president of State Budget Solutions, "Unfunded pension liabilities today are pushing many cities close to bankruptcy; state pension plans are similarly in dubious fiscal health" (Williams 2017). According to ALEC, state public pension funds are now underfunded by nearly $5.6 trillion, a $900 billion increase from a comprehensive report by State Budget Solutions in 2014. The combined price tag for all unfunded public pension liabilities in the United States is $17,427 for every man, woman, and child.

Proposals to reform public pensions are presented later in this chapter (Principle 8). The point to be made here is that many elected officials have little or no idea how large public pension liabilities are. They are fed misleading information by fund managers, bond houses, and union leaders who all have incentives to conceal shortfalls in current fund balances, project unrealistic rates of return on investments, and fail to acknowledge just how unaffordable promised benefits are likely to be.

Policy Agenda

Until a transparent and accountable budget process is put in place, taxpayers and conscientious lawmakers are at a huge disadvantage in their efforts to rein in spending and make their state and local governments more efficient. Lacking information and sufficient advance notice, they cannot ask the right questions or propose the right solutions. For this reason, fixing broken budget processes should be high on the list of priorities for patriots.

Recommended Readings: American Legislative Exchange Council, *State Budget Reform Toolkit* (Washington, DC: ALEC, 2011); Jonathan Small, "10 Steps for Improving the State Budget Process," *OCPA Memorandum*, Oklahoma Council of Public Affairs, November 8, 2012.

5. Stop corporate welfare.

Subsidies or tax incentive programs for businesses do not create jobs or promote economic growth.

State legislators spend between $40 billion and $50 billion a year using their influence over taxes and spending to entice businesses to relocate to their state or to reward businesses already present for creating jobs and not leaving (Peters and Fisher 2004). Research by *The New York Times* in 2012 that included county- and city-level spending produced an estimate of annual spending of $80 billion (Story 2012). This massive spending on selective tax abatement and subsidies to businesses goes under the name of "economic development," but research suggests it is better called "corporate welfare."

According to a 2014 report from Good Jobs First, 514 economic development programs in the 50 states and the District of Columbia granted more than 245,000 awards since 1976, the first year of the study (Mattera 2014). Three-quarters of all state economic development subsidies went to just 965 corporations, and Fortune 500 corporations alone accounted for approximately 16,000 subsidy awards, primarily in the form of tax breaks, at a cost to taxpayers of $63 billion.

How Effective?

Economists have long been skeptical of selective tax abatements and other state economic development efforts (Beck 1987). A 1999 review of state economic performance found "the states that spent the most on economic development programs were more likely to experience slow job and/or income growth than states with the lowest economic development expenditures" (Gulibon 1999). A 2001 review of more than 300 scholarly papers on economic development programs found "studies of specific taxes are split over whether incentives are effective, although most report negative results" (Buss 2001, p. 99).

An examination published in 2002 of the effect of state economic development incentives on 366 Ohio businesses that began large expansions between 1993 and 1995 found the incentives had little or no impact on expected employment growth; the possible small impact was negative (Gabe and Kraybill 2002).

A 2004 survey article by University of Iowa economists concluded:

> The upshot of all of this is that on this most basic question of all—whether incentives induce significant new investment or jobs—we simply do not know the answer. Since these programs probably cost state and local governments about $40–$50 billion a year, one would expect some clear and undisputed evidence of their success. This is not the case. In fact, there are very good reasons—theoretical, empirical, and practical—to believe that economic development incentives have little or no impact on firm location and investment decisions (Peters and Fisher 2004).

In 2012, urbanologist Richard Florida used the numbers produced by the *New York Times* investigation, mentioned above, and compared them to economic growth rates in individual states. He found "there is virtually no association between economic development incentives and any measure of economic performance. We found no statistically significant association between economic development incentives per capita and average wages or incomes; none between incentives and college grads or knowledge workers; and none between incentives and the state unemployment rate" (Florida 2012).

Why Tax Incentives Don't Work

Even if robust evidence of a positive effect of targeted financial incentives were to be found, it would not tell us if the tax dollars given away would have produced better returns if put toward new roads, schools, or crime prevention, or left in the pockets of taxpayers. All of these activities have been shown by at least some researchers to have a positive impact on economic growth.

Tax abatements don't work for a number of reasons. First, state elected officials are unlikely to know which businesses are the most promising ones to subsidize or selectively exempt from tax or regulatory burdens. There is little reason to believe elected officials are better at picking winners than private investors, who have "skin in the game" and probably have more experience in making investments.

The presence of economic development programs encourages private firms to allocate their resources to lobbying efforts rather than to market analysis or productive efforts. This effort, called "rent seeking" by economists, can consume millions of dollars directly, in the form of paying lobbyists and making campaign contributions, and billions of dollars indirectly, by distracting investors and business owners from what they ought to be doing, which is coming up with ways to satisfy customers.

Location decisions are distorted because private firms locate on the basis of subsidy rather than markets, meaning inefficient enterprises are favored at the expense of efficient ones. This might produce some jobs in the short term, but in the long term it can only destroy jobs by putting business in the wrong places, or propping up companies that should probably have failed or been forced to innovate to survive.

Policy Agenda

Instead of offering corporations tax abatements, low-interest loans, subsidies, and the like, policymakers should focus on keeping general taxes low and providing public services efficiently. As the John Locke Foundation notes:

> Unlike the maintenance of low across-the-board tax rates or the provision of core public services such as education, highways, and public safety, corporate welfare doesn't benefit everyone. It requires public officials to intervene in private markets to decide which businesses or regions are worthy of support. This sets the stage for increased special-interest lobbying, strings-attached campaign contributions, and unethical behavior in public office (John Locke Foundation 2004).

The Pew Charitable Trusts has been working with state legislatures to better manage their economic development programs (Pew Charitable Trusts 2017). It recommends states "put processes in place to regularly evaluate the results of major tax incentives," use "high-quality evaluations [to] carefully assess the results of incentives for the state's budget and economy," and adopt "a formal process that ensures lawmakers will consider the results—for example, by holding legislative hearings on evaluations."

According to Pew, "27 states and the District of Columbia have made progress in gathering evidence on the results of their economic development tax incentives" and 10 are leaders in tax incentive evaluation: Florida, Indiana, Iowa, Maine, Maryland, Minnesota, Mississippi, Nebraska, Oklahoma, and Washington.

Recommended Readings: Richard Florida, "The Uselessness of Economic Development Incentives," *CityLab* (website), 2012; Pew Charitable Trusts, *How States are Improving Tax Incentives for Jobs and Growth: A National Assessment of Evaluation Practices* (Philadelphia, PA: Pew Charitable Trusts, May 3, 2017).

6. Remove regulatory barriers to prosperity.

State governments enforce many regulations that erect barriers to investment, job creation, and prosperity. When in doubt, repeal.

Next to taxes, state regulatory policy has the greatest impact on investment, job creation, and prosperity. Many current regulations were first implemented decades ago and were designed for a world that no longer exists. New technologies, institutions, and experience require some regulations be revised and others repealed entirely. Four most promising areas for regulatory reform are forced unionization (or Right to Work), prevailing wage laws, minimum wage laws, and lawsuit abuse.

Increase Worker Freedom

A good place to start using regulatory reform to expand prosperity is to adopt right to work (RTW) laws. These laws are popular and fair, and they have a proven record of promoting economic growth.

Passage of the Taft-Hartley Act in 1947 enabled states to adopt laws prohibiting "closed shop" arrangements whereby union leaders and employers agree to force workers to join a union and pay dues as a condition of employment. Opposition to this practice, on the grounds that it gave unions too much power relative to employers and the workers they claimed to represent, led many states to adopt RTW laws banning closed shops. In 2017, 22 states were not yet right to work states (NRTW 2017).

Opponents claim RTW laws, by making it more difficult for unions to organize, force wages down and lower people's standard of living, but this is unlikely. Labor economist James Sherk explains, "Economic theory holds that unions operate as labor cartels. Unions only raise wages for their members by raising prices and reducing job opportunities for nonunion workers. Few economists believe unions increase overall living standards" (Sherk 2015).

Researchers have found RTW laws affect union organizing activities, plant location decisions, manufacturing employment, and the rate of business formation (Tannenwald 1997). Surveys find employers and investors prefer to locate new facilities in states with RTW laws (see references in footnotes 11, 12, and 13 of Sherk 2015).

Researchers also find a positive impact of RTW on wages and economic growth, although the analysis is often complicated by when states adopted RTW laws and their level of prosperity and growth rates prior to doing so. New Zealand economist W. Robert Reed controlled for those differences and found:

> Using state-level data, I estimate that, *ceteris paribus,* RTW states have average wages that are significantly higher than non-RTW states. This result is robust is [sic] across a wide variety of specifications. An important distinctive of this study is that it controls for state economic conditions at the time states adopted RTW. States that adopted RTW were generally poorer than other states. Failure to control for these initial conditions may be the reason that previous studies have not identified a positive wage impact for RTW (Reed 2013).

More anecdotally, a study by the Mackinac Center for Public Policy found, "right-to-work states showed a 42.6 percent gain in total employment from 1990 to 2011, while non-right-to-work states showed gains of only 18.8 percent" (LaFaive and Hicks 2013). The study also found inflation-adjusted gross personal income in right-to-work states increased 86.5 percent between 1990 and 2013, versus 51.3 percent for forced-unionization states.

Repeal Prevailing Wage Laws

Repealing prevailing wage laws is a second way to promote prosperity. The national Davis-Bacon Act of 1931 requires contractors and subcontractors working on federal construction contracts, or federally assisted contracts in excess of $2,000, to pay workers no less than the currently "prevailing wage" paid in the area in which the construction project is carried out. Thirty-two states have their own prevailing wage laws, which affect state taxpayer-funded projects. According to the U.S. Department of Labor, 20 states do not have prevailing wage laws, and 11 states have repealed such laws by legislative action or court decision (DOL 2017a).

The federal government and many state governments use voluntary surveys to determine the wage that "prevails" (DOL 2017b). Those surveys tend to produce results skewed in favor of the higher wages paid to union contractors. Union contractors have a strong incentive to respond to wage surveys, while nonunion or smaller contractors have little reason to do so. As a result, the prevailing wage is most often equal to the union wage, even though only a few construction workers are union members.

Prevailing wage laws are really “super minimum wage” laws. They are used by elected officials to purchase political support from unions rather than to purchase the best bargains in road construction, bridges, schools, and other infrastructure for the taxpayers whose money they are using in the first place.

State prevailing wage laws impose a huge and unnecessary cost on taxpayers and consumers. The additional cost attributable to the prevailing wage has been estimated at 22 percent of labor costs and 9.91 percent of overall construction costs, for an annual excess expense to taxpayers of $8.6 billion a year (Glassman *et al*. 2008). A 2013 study by Anderson Economic Group estimated Michigan’s prevailing wage law increased expenditures for construction of K–12 and higher-education facilities in the state an average of $224 million per year (Anderson Economic Group 2013). When Ohio exempted public school construction projects from its prevailing wage law in 1996, it saved nearly $500 million, about 10.7 percent of school construction costs, in the first five years alone (Lundell 2002). A 2011 study by the Nevada Policy Research Institute estimated the state’s prevailing law increased the cost of public works projects by $625 million in 2009 and $346 million in 2010 (Lawrence 2011).

Oppose Minimum Wage Laws

A third way to promote economic growth and prosperity is to resist proposals to mandate a higher legal minimum wage. Having the government order businesses to pay their workers more might sound like a good way to promote prosperity, but the real world doesn’t behave this way. Very few people rely on the government to guarantee their wages, and raising the minimum wage destroys jobs and opportunities for those who need both.

The minimum wage is the lowest hourly wage employers may legally pay employees. With passage of the Fair Minimum Wage Act of 2007, the national minimum wage was raised gradually, from $5.15 an hour to $7.25 an hour in 2010. Only Georgia and Wyoming have set minimum wages below the national minimum, while six states set no minimum wage (NCSL 2017).

Proponents of minimum wage laws say they protect workers from exploitation by employers and reduce poverty. But in a 2010 study, economists at Cornell University and American University found no reduction in poverty in the 28 states that raised their minimum wages between 2003 and 2007 (Burkhauser and Sabia 2010). This can hardly be surprising, since although governments can set minimum wages, a worker’s compensation is largely determined by his or her productivity.

Most people earn more than the minimum wage—not because a government law requires people to be paid more, but because businesses compete vigorously for workers. The Bureau of Labor Statistics reported in April 2015 that only 2.3 percent of the nation's 131.5 million wage and salary workers earned at or below the minimum wage in 2014 (BLS 2015). A worker who produces significantly more value to a company than he or she is being paid has a strong incentive to work for other companies willing to pay more, and those companies will see the opportunity to profit by hiring that worker at a higher wage.

Raising minimum wages destroys jobs at the bottom of the employment ladder, those requiring the fewest skills and most likely to be filled by young people and new immigrants (Balis 2007). Economists at the University of California–Irvine and the Federal Reserve Board examined the body of work on the subject and found 85 percent of credible studies demonstrate minimum wage laws cause job losses for less-skilled employees (Neumark and Wascher 2007). Without a way to enter the workforce, these people remain unemployed and may place greater demands on welfare and other social services.

End Lawsuit Abuse

A fourth way to promote prosperity is to reform a state's tort system to discourage lawsuit abuse. Lawsuit abuse imposes billions of dollars of unnecessary costs on businesses and citizens every year and can be a major job killer.

A state's tort system—the subset of laws governing questions of liability in the event of injury—helps protect the safety of individuals, but its cost influences the competitiveness of businesses operating within its borders. Importantly, in an increasingly global economy, American firms must compete with businesses in other countries that operate under different tort systems. "European courts," wrote Northwestern University law professor Stephen Presser (2002), "are much less likely to hand out unpredictable and disproportionate damage judgments—unlike American courts, where ruinous verdicts are a potential in too many lawsuits."

During the 1980s and 1990s, many states reformed their tort systems to discourage lawsuit abuse. Ten states—Arizona, California, Florida, Georgia, Indiana, Louisiana, Oklahoma, Rhode Island, Tennessee, and West Virginia—adopted reforms in the past several years. Of this group, Oklahoma was the most successful, adopting reforms in 16 areas of tort law (ATRA 2009).

States can implement several common-sense tort reforms states to limit lawsuit abuse:

- Establish a limit on noneconomic tort damages, such as pain and suffering, which are a major source of lawsuit abuse.

- Limit punitive damages or ban them altogether. Like noneconomic damages, this is an area of frequent abuse, and it creates a windfall for trial lawyers.

- Limit contingent fees. Lawyers, as fiduciaries for their clients, should have a legal duty to turn over to their clients any attorneys' fees in excess of amounts that are reasonable and risk-based (Horowitz 2001).

- Move away from the "American rule" of litigation where each side bears its own legal fees, win or lose, and toward the "English rule," under which the loser pays the other side's legal fees.

- Establish stiffer sanctions against frivolous claims. In many states, the prevailing parties in cases found to have been frivolous can recover their legal fees. State legislatures can give judges the authority to levy additional monetary sanctions against parties, lawyers, and law firms that file frivolous claims.

Recommended Readings: U.S. Chamber of Commerce, *2015 Lawsuit Climate Survey*, September 2015; Brian M. Johnson and Todd Hollenbeck, *2009 Index of Worker Freedom: A National Report Card*, Alliance for Worker Freedom, 2009; Ryan Balis, "Employment: Do Minimum Wage Increases Benefit Workers and the Economy?" National Center for Public Policy Research, 2007.

7. Reform public pension and health care programs.

Reform public pension and health care programs to make them financially sustainable and fair to taxpayers and retirees.

State and local government workers routinely are able to retire in their 50s, a decade or more earlier than can most private-sector workers, with pension and health insurance benefits exceeding what most private sector workers receive. The burden on taxpayers to fund public-sector retirement programs is skyrocketing, forcing elected officials to consider raising taxes, borrowing, cutting other government services, or using a combination of those strategies. According to Moody's Investors Service, states' adjusted net pension liabilities totaled $1.25 trillion in fiscal year 2015 and are likely to increase by an additional $500 billion in the two next years (Kilroy 2016).

Unfunded and Abused Pensions

Under many traditional defined-benefit plans retirees receive a predetermined monthly benefit based on their earnings history and years on the job, regardless of returns on money invested in their pension funds. Such plans contain key flaws and are open to abuse.

Many public-sector employees enrich themselves through "double-dipping" by taking another public-sector job after retirement and working toward a second pension. Public-sector employees also can engage in "benefit spiking," when an employer dramatically increases an employee's salary at the end of his or her career, thus increasing the pension payout, which is often based on a salary average for the final few years of employment. A Milken Institute study found if pension payouts were based on employees' compensation over five years or a whole career, instead of the abuse-prone final year, the overall cost of funding pension plans could be 30 percent lower (Zeidman *et al*. 2010).

Another major expense for public pension plans is automatic cost of living adjustments (COLAs). Such increases are supposed to reflect inflation and higher living costs. But in many state pension systems, COLAs are implemented automatically without regard to the government's ability to pay for them or the condition of the economy.

State policymakers and regulators often overestimate the future rates of investment into pension funds and the rate of return on those investments. Optimistic assumptions of strong investment returns allow them to reduce yearly government contributions to the funds and buy labor peace by promising more generous retirement benefits. But when these estimates prove wrong, the level of unfunded obligations increases.

Defined Contribution Approach

Lawmakers should begin the process of replacing defined-*benefit* pension plans with defined-*contribution* plans, under which retirees receive benefits based on the actual investment returns on contributions they and their employers make. Newly hired public-sector workers should be automatically enrolled in a defined-contribution plan; current workers should be given the option of transferring into one.

Workers with defined-contribution plans own and control their pensions and can change employers without losing their accrued benefits. Defined-contribution plans also benefit taxpayers: The pension plan burden does not rise automatically because of COLAs and is more transparent, avoiding the accounting gimmicks governments currently use to hide the true liability.

Unhealthy Health Care Plans

Public-employee health care costs have also grown quickly out of control. The Cato Institute estimates state and local governments spent $117 billion on health insurance in 2010, up from $70 billion in 2001 (in 2012 dollars). Cato found the real increase amounted to roughly $2,400 per state and local government employee, or $150 per U.S. resident (Clemens and Cutler 2014).

In a study of public-employee health care costs in Michigan, the Mackinac Center found the average family health plan cost school districts $17,692 in 2011, whereas the average private-sector plan cost businesses $10,988 (Hohman 2013).

The small share public employees contribute to their own health insurance coverage is a major part of the problem. According to the American Enterprise Institute, state and local government employees pay 13 percent of their total health care premiums on average, compared to 20 percent for private-sector workers in establishments of more than 100 employees. The study also found 30 percent of state and local government employees make no contribution to their health care coverage at all, compared to only 13 percent for private-sector employees (Biggs and Richwine 2014).

Indiana offers a model for how states can bring their public-employee health care spending under control. Indiana offers public employees a traditional health insurance plan with a health savings account (HSA) tied to it. The health insurance plan has a deductible of $2,500 for individual coverage and $5,000 for a family, and preventive services are not subject to the deductible. State employees pay nothing toward the plan premium, and Indiana deposits $1,500 for individuals and $3,000 for families into the employee's HSA annually. The employee can add to the account tax-free (Cheplick 2009).

State officials estimate the HSA program had saved the state more than $42 million from 2005 to 2009. According to an evaluation of Indiana's HSA plan by Mercer Consulting, the reforms have helped reduce the state's total health care costs for employees by 11 percent (Cheplick 2016).

Policy Agenda

In the short term, pension finances can be stabilized by capping per-year pension payouts, raising retirement ages, prohibiting double-dipping and benefit spiking, requiring realistic rate of return assumptions, and protecting pension systems from borrowing and fund raids (Nothdurft

2013). In the longer term, public employees should be moved from defined-benefit to defined-contribution pension plans.

To address escalating public-employee health care spending, states should consider implementing an HSA-based health care plan similar to Indiana's.

Recommended Readings: John Nothdurft, "The Municipal Debt Crisis," *Policy Brief*, The Heartland Institute, June 2013; Dan Liljenquist, *Keeping the Promise: State Solutions for Government Pension Reform*, American Legislative Exchange Council, 2013; Richard Dreyfuss, "Fixing the Public Sector Pension Problem: The (True) Path to Long-Term Success," *Civic Report* No. 74, Manhattan Institute, February 2013.

8. Fund school children, not schools.

States intent on improving the quality of K–12 education and getting more value for taxpayers must embrace parental choice in education.

Spending on elementary and secondary schools is second only to Medicaid programs in most states. When that investment fails to produce an educated citizenry able to be self-sufficient and productive members of society, prosperity suffers.

An earlier chapter of this book (Chapter 2) addressed the need for transforming education in the United States, so we won't repeat it here. Suffice it to say that per-pupil spending is at historically high levels while the academic achievement of U.S. students is below that of their counterparts in many developed countries.

An Antiquated Model

The current system of public education in the United States is built on a nineteenth-century model emphasizing seat time rather than mastery of subject matter. For the most part, students progress from one grade to the next merely by attending classes for the school year, not by proving they've learned grade-level content. This focus on seat time rather than subject mastery means educators teach to the middle, preventing the accelerated learner from reaching his or her potential and leaving behind those with greater needs.

Societies, economies, and technologies have changed dramatically since the nineteenth century. In the twenty-first century, we expect to be able to make choices narrowly tailored to meet our individual wants and needs. Compared to our nineteenth-century ancestors, today we choose relatively easily where to live, what occupation to work in, and what transportation we use.

To respond to the new circumstances of the twenty-first century, K–12 education needs to be transformed. Parents must be empowered to choose the schools their children attend. They should be given the information they need to make wise choices, and schools must compete for their loyalty. Choices, not uniformity, and accountability, not top-down mandates from distant bureaucracies, ought to define how K–12 schooling is organized today.

Successful Choice Alternatives

The 1990 adoption of the Milwaukee Parental Choice Program marked the beginning of the modern "school choice" movement. All forms of school choice—including charter schools, private scholarship programs, tax-credit scholarships, voucher programs, education savings accounts (ESAs), and homeschooling—have grown since then. EdChoice reports there are now 52 school choice programs in 28 states and the District of Columbia, commanding $2 billion in public financing and offering three million scholarship opportunities (EdChoice 2017). According to EdChoice, approximately 446,000 students will utilize vouchers, tax-credit scholarships, and ESAs in the United States in the 2016–17 school year (*Ibid.*).

School choice improves educational outcomes for all children, even those who remain in traditional public schools. In Milwaukee, for example, competition from the choice schools is forcing the Milwaukee public schools to improve. Research conducted by Patrick J. Wolf (2009) at the University of Arkansas shows the Milwaukee Parental Choice Program "has led to increased achievement for the children who remain in Milwaukee's public schools while saving the state millions of dollars."

Education Savings Accounts

Twenty-one years after the Milwaukee voucher program was adopted, Arizona in 2011 became the first state to pass an education savings account (ESA) program. ESA programs for students with special needs went into effect in Florida in 2014, in Mississippi and Tennessee in 2015, and in North Carolina in 2017 (Benson 2017).

By the end of February 2016, nearly all students in Nevada were eligible for an ESA program that pays at least $5,000 per pupil for educational expenses. While a Nevada Supreme Court decision upheld the program's constitutionality, the court required the state to find a different way to fund the program (*Schwartz* v. *Lopez* 2016). Nevada lawmakers were unable to achieve that in 2017, and the thousands of families who signed up for ESAs will have to wait until the legislature reconvenes in two years to learn of the program's fate (Mull 2017).

ESAs enable families to customize their children's education. The state establishes an individual account for each child who qualifies for the program, and it funds that account with 80 to 90 percent of what the state would otherwise spend to educate that child in a public school. Parents control their child's ESA and can use the money for any approved educational expenses such as tuition, tutoring, books, class enrollment fees, and computers. They must submit receipts to document their expenses, and the accounts are subject to quality control audits. An EdChoice survey conducted in 2013 by Jason Bedrick and Jonathan Butcher found "65 percent of parents [in Arizona] used the accounts for private school tuition, 41 percent accessed education therapy, and more than one-third of respondents used the accounts for a tutor for their child" (Bedrick and Butcher 2013).

Tailored to Students

ESAs are the ultimate "funding-follows-the-student" reform. They allow parents great flexibility in designing their children's education portfolio. Some providers might be conventional, such as tutors or foreign language instructors, but others might be unconventional, such as entrepreneurship training or local businesses that arrange foreign travel for language immersion. Providers could team up with each other or with schools to provide students a portfolio of services offering a full learning experience (Bast 2005).

Research shows parents who have school choice options tend to be more satisfied with their children's education, which leads to more parental involvement in student learning. Seventy-one percent of Arizona parents whose children participate in the ESA program reported being "very satisfied" with their children's education. The remaining 29 percent of parents were either satisfied or somewhat satisfied, and no parents reported being unsatisfied (Bedrick and Butcher 2013).

ESAs are especially valuable to low-income families, whose educational options in the traditional public school system are generally limited to the failing neighborhood public school. Not only are ESAs more empowering for parents, they are also a more cost-effective way to educate children.

Policy Agenda

States intent on improving the quality of K–12 education and getting more value for taxpayers must expand parental choice in education. See Chapter 2, on transforming education, for best practices and other guidance for expanding parental choice.

Recommended Readings: EdChoice, *The ABCs of School Choice: 2017 Edition* (Indianapolis, IN: EdChoice, 2016); Greg Forster, *A Win-Win Solution: The Empirical Evidence on School Choice: Fourth Edition* (Washington, DC: American Federation for Children, 2016); Tim Benson, "Education Savings Accounts: The Future of School Choice Has Arrived," *Policy Brief*, The Heartland Institute, June 2017.

9. Fix, don't expand, Medicaid.

Medicaid, the largest single item in state budgets, delivers low-quality care. The program needs to be fixed, not expanded.

Medicaid accounts for 26 percent of all state spending, ahead of K–12 education, postsecondary education, transportation, public assistance, and corrections. Total state spending on Medicaid reached more than $475 billion in fiscal year 2014, 71 percent higher than it was a decade earlier (Sigritz 2015). By 2025, that number is expected to grow to $588 billion (Congressional Budget Office 2015).

Medicaid is an expensive program on an unsustainable fiscal path that provides poor quality care (Blase 2011). Yet the Affordable Care Act (ACA), also known as Obamacare, gives states an incentive to expand their Medicaid programs by offering a large federal subsidy for opening eligibility to all individuals with incomes between 133 and 138 percent of the federal poverty level. The allure of federal dollars has proven difficult for most states to resist, with 31 having signed on to expansion as of early 2016.

Contrary to expansion supporters' depiction of the new federal funds as "free money," Medicaid expansion is expensive, creating new costs not only for the federal government but also for states. The states that have expanded Medicaid have seen enrollment numbers much higher than they anticipated, exceeding maximum projections by 61 percent.

Not a single state had enrollment numbers below its maximum projection (Ingram and Horton 2015). This inundation of enrollees threatens to swamp state budgets once the federal government starts dropping its matching rate.

Block-granting Medicaid

The failure of Congress to repeal and replace Obamacare offers states the opportunity to take the initiative on Medicaid. Specifically, they can seek from the Secretary of Health and Human Services (HHS) waivers from the current federal program and a block-grant of Medicaid funds. This would give states flexibility in how they run the program and manage its costs. States would receive a set, finite grant from the national government to spend on Medicaid. Although the state programs would have to abide by several guidelines, the states would be allowed to customize their programs to fit their needs and goals. If a state decided to expand its Medicaid program to a larger population, it would be able to do so, but if the costs of the program exceeded the grant, the state would pay the difference.

To encourage states to support the block-grant reforms, the federal block grants could incorporate the funds Obamacare promised to states that expanded their Medicaid programs. Such a block-grant proposal would likely be scored by the Congressional Budget Office as a sharp reduction in federal Medicaid costs. According to Peter Ferrara, senior fellow for budget and entitlement policy at The Heartland Institute:

> States could then use their new control over Medicaid to provide benefits in the form of health insurance vouchers the poor could use to help buy the health insurance of their choice, including health savings accounts. That would vastly improve health care for the poor, who today cannot get timely, essential health care through Medicaid because the government so badly underfunds payments to doctors and hospitals for health care provided under the program. Private insurers, by contrast, must adequately compensate doctors and hospitals in order to attract health insurance customers in the competitive marketplace (Ferrara 2015).

The Rhode Island Approach

Since January 2009, Rhode Island has been experimenting with a Medicaid block grant initiated under a waiver from HHS. Highlights of that experiment include the following (Alexander 2010):

- The traditional federal matching grant for Medicaid was replaced by a grant capped at $12.075 billion through 2013. In exchange for accepting the capped grant, the state was given more flexibility in administering its Medicaid program and an incentive to keep its costs down.

- The state requires able-bodied people with incomes above 150 percent of the poverty level to contribute toward their health coverage. The state helps pay all or part of the cost of employer-sponsored health insurance for Medicaid-eligible families who have access to employer plans.

- The program brought impressive reductions in spending: By 2010, the state's Medicaid spending was $1.34 billion below the budget-neutral target of $2.4 billion.

- The state also reduced waiting times for long-term care services and provided additional home care and physical therapy services.

The Florida Approach

Florida also has a pilot program that can address the problems with Medicaid. Known as the "Medicaid Cure" (Bragdon 2011), the program provides Medicaid recipients with a range of health insurance plans and premiums from which to choose, dramatically improving health care competition and consumer choice.

The results have been promising: a 64 percent improvement in health outcomes over managed care and an 83 percent satisfaction rate among enrollees. The program saved $118 million a year in the five counties where it was implemented (Florida Agency for Health Care Administration 2012).

Avoid *Faux* Free-market Reforms

Legislatures in some states, including Indiana, Tennessee, Utah, and Wyoming, have attempted to address the concerns of their conservative legislators and constituents by adding "free-market" components to Medicaid expansion proposals, such as using Medicaid funds to purchase private insurance or imposing premiums or copays to ensure recipients have "skin in the game."

Many of these so-called free-market models have shortcomings. The programs still represent an expansion of the failed Medicaid system, where multiple aspects of the insurance plan are dictated by the federal government and the beneficial elements of real market competition are lost. Although many of the models proposed by the states included more substantive reforms, such as copays and employment requirements, the

Centers for Medicare and Medicaid Services largely rejected those reforms.

Policy Agenda

Without significant reforms, Medicaid will remain fiscally unsustainable, costly, deliver subpar health care, and shift more power to the national government. State lawmakers should not expand a failing program. Instead, they should focus on reform options like those piloted in Florida, which reduce costs and offer better care. See Chapter 1, on health care, for a detailed reform agenda.

Recommended Readings: Peter Ferrara, *The Obamacare Disaster* (Chicago, IL: The Heartland Institute, 2010); Katherine Baicker, *et al.* "The Oregon Experiment—Effects of Medicaid on Clinical Outcomes," *The New England Journal of Medicine* **368**: 1713–22.

10. Cap taxes and expenditures.

States should adopt constitutional tax and expenditure limitations as a way to avoid excessive spending during good economic times and hardship in bad times.

As a matter of basic fiscal responsibility, every state should consider adopting a tax and expenditure limitation (TEL). This is a sound way to protect elected officials from public pressure to raise spending during good economic times instead of conserving revenues for use in the inevitable downturns.

The Spending Temptation

During good economic times, elected officials come under enormous pressure to spend every available tax dollar. Rising property values, strong retail sales, and other factors that drive up government revenues are often used as an excuse to expand government. During bad economic times, the beneficiaries of new programs oppose any spending cuts. Thus state and local governments across the country struggle to balance their budgets when the economy slows.

Other forces also push up government spending. Government's powers to tax and regulate can be used to concentrate benefits on a small number of beneficiaries while spreading the cost across large numbers of taxpayers, without much protest (Olson 1971). The legislative practice of "logrolling"—trading votes for one another's favorite projects—also results in more spending being approved than any individual elected official might otherwise support (Buchanan and Tullock 1962).

Government spending is not free, however. An additional dollar of government spending increases GDP by significantly less than one dollar. The National Bureau of Economic Research has found government spending has a "multiplier effect" on total GDP of approximately 0.5 (Ramey 2013). That is, an increase in government spending does not generally stimulate the economy but instead results in half as much economic activity as a dollar spent by the private sector. As a result, high taxes reduce economic output and, as noted in Principle 1, states with lower taxes outperform those with higher taxes.

Cutting Spending

In response to mounting debt, lawmakers are increasingly considering tax and expenditure limitations, pension reforms, privatization (see Chapter 5), and other cost-cutting measures to fix their short- and long-term budget problems. Since 1978, 30 states have enacted formal limitations on taxes, budgets, or outlays to strengthen their fiscal discipline (Zycher 2013). Several approaches have proven effective:

- Require supermajority votes for tax increases and spending.
- End expensive economic development schemes such as selective tax abatement and subsidies to favored industries (Nothdurft 2009).
- Privatize public services.
- Adopt public-sector workforce reforms.

Expensive and excessive government workforces are putting great pressure on state budgets. Long-term solutions must focus on reforming public-sector pensions and health care systems, which now constitute a trillion-dollar unfunded liability states clearly cannot afford. Necessary reforms to these and other areas of state government spending appear in other principles in this chapter and in other chapters of this book.

A Constitutional Cap

The surest way to counteract the spending-cycle problem is a constitutional provision limiting growth of taxes and spending to the sum of inflation and population growth, so the public sector grows no faster than the private sector. Any revenue collected above this limit is either saved in a rainy day fund or returned to taxpayers. Colorado's Taxpayer

Bill of Rights—TABOR—passed in 1992, offers a good model of such a limitation.

A tax and expenditure limitation (TEL) breaks the spending cycle because voters and lobbyists cannot force elected officials to spend money they cannot constitutionally collect or spend. Thus, it effectively keeps more money in the pockets of families and job creators. The best TELs are enshrined in the state's constitution, because lawmakers can evade statutory limitations. TELs also should apply to local governments to avoid cost-shifting from the states to local governments. TELs typically allow voters to override the limit in a special election, to address emergency situations.

Lew Uhler, president of the National Tax Limitation Committee, and Independence Institute Senior Fellow Barry Poulson report successful TELs have four key features:

- Annual increases in expenditures are limited to the growth in inflation and population.
- Tax revenues in excess of allowable expenditures must be refunded to taxpayers as soon as possible.
- The government is required to create an emergency fund equal to some share of the state's total personal income.
- The TEL establishes limits on local property tax rates to prevent local governments from simply filling the perceived expenditure gaps created by the state-level limitations (Uhler and Poulson 2004).

Policy Agenda

Legislators as well as civic and business leaders must reexamine their habits in setting budget priorities. Spending should be limited to the amount of money lawmakers can realistically expect to have—and lower than that, if possible. John Nothdurft recommends starting by totaling up the required spending and matching it to revenue. "What's left over should go not to new projects outside the core functions of government but to a rainy day fund or tax relief. That's the way to set spending priorities, consolidate agencies, get rid of redundant programs, eliminate non-core programs, etc.," he wrote (2009). Implementing a constitutional tax and expenditure limitation is a key part of this plan.

Recommended Readings: Barry Poulson, *Tax and Spending Limits: Theory, Analysis, and Policy*, Independence Institute, 2004; Lewis K. Uhler and Barry Poulson, *How to Limit Taxes and Spending*, Oklahoma

Council of Public Affairs, 2003; John Nothdurft, “The Best And Worst Ways To Eliminate A Budget Deficit,” *Research & Commentary*, The Heartland Institute, February 2009.

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Additional Resources

Additional information about state fiscal policy is available from The Heartland Institute:

- PolicyBot, The Heartland Institute's free online clearinghouse for the work of other free-market think tanks, contains thousands of documents on state fiscal policy issues. It is on Heartland's website at https://www.heartland.org/policybot/.

- https://www.heartland.org/topics/government-spending/ is a website devoted to the latest research, news, and commentary about government spending, taxes, and related fiscal policy matters. Read headlines, watch videos, or browse the thousands of documents available from PolicyBot.

- *Budget & Tax News* is The Heartland Institute's monthly newspaper devoted to government regulation, spending, and tax issues. Subscriptions with digital delivery are free, print subscriptions are $36/year for 10 issues.

Directory

The following national organizations offer valuable information and resources concerning state fiscal policy.

Alliance for Worker Freedom, http://www.atr.org/authors/alliance-worker-freedom

American Legislative Exchange Council, https://www.alec.org/

Institute for Research on the Economics of Taxation, http://iret.org/

Heartland Institute, https://www.heartland.org/

John Locke Foundation, https://www.johnlocke.org/

NASBO – National Association of State Budget Officers, http://www.nasbo.org/home

NBER – National Bureau of Economic Research, http://www.nber.org/

NCPPR – National Center for Public Policy Research, http://www.nationalcenter.org/

NRTWF – National Right to Work Foundation, http://www.nrtw.org/

NTLC – National Tax Limitation Committee, http://limittaxes.org/

NTU – National Taxpayers Union, http://www.ntu.org/

Oklahoma Council of Public Affairs, http://www.ocpathink.org/

Pew Charitable Trusts, http://www.pewtrusts.org/en

State Budget Solutions (a project of the American Legislative Exchange Council), https://www.facebook.com/StateBudgetSolutions/

Tax Foundation, https://taxfoundation.org/

Truth in Accounting, http://www.truthinaccounting.org/

U.S. Chamber of Commerce, Institute for Legal Reform, http://www.instituteforlegalreform.com/