Free-Market Reforms Key to States' Recovery

Matt Hurley

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Half a decade after the U.S. economy fell into a recession, 41 states' tax revenues in the third quarter of Fiscal Year 2014 were higher than in the third quarter of Fiscal Year 2013. However, 16 states, including some of those states with higher tax revenues, are projecting budget shortfalls within the next two years.

Although the details of each state's situation mary vary, the solution most often suggested are tax hikes, to close the budget gap. Other states are planning to raid their "rainy day funds," to buy some time without addressing the immediate cause of the problem.

Nicole Kaeding, a budget analyst for the Cato Institute, says these states should instead use the opportunity to make real tax and spending policy reforms to promote economic growth.

Opportunities for Reform

"The shortfalls present an opportunity for states to cut spending, reform programs, and eliminate waste and duplication. These actions when taken together can put a state on a firmer fiscal footing," she said.

Kaeding said economic growth—and, by extension, tax revenue growth—is promoted through free-market policies, instead of economic development plans written by the government.

"Economic growth doesn't come from providing grants or handouts to corporations, it comes from fostering a pro-growth environment," she said "A pro-growth environment is one with limited government intervention. It's an environment where businesses and individuals are able to make the best decisions in their lives with minimal interference from government.

"That means low levels of spending and regulation. It also means a tax code that has low rates, and is neutral, meaning that it doesn't advantage one group over another," she said.

Winning Solutions

Another key to filling budget holes, Kaeding says, is reducing tax rates.

“When state budgets became tight during and immediately following the Great Recession, many states resorted to tax increases to close budget gaps. Their experience demonstrates that this is the wrong approach,” she said. “States didn’t solve the underlying structural issues to state budgets, which is why they are still dealing with shortfall issues. All that tax increases did, was kick the problem several years into the future.”

Kaeding pointed to the success of reforms in Indiana and North Carolina as an example.

“Many states, like North Carolina and Indiana, have started this process in recent years, by cutting taxes and limiting the growth of government. As a result, these states are growing faster than their peers, and adding jobs at higher rates.

“States should copy these successes,” she said. “Comparing Illinois and Indiana is instructive. Indiana is a model of state-level fiscal reform, while Illinois has done the opposite. Indiana’s economy is growing faster than Illinois, and is adding jobs at a quicker rate, but they are geographically similar.”