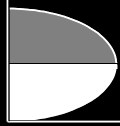

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TEXAS' FISCAL FUTURE

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EXECUTIVE SUMMARY

This paper puts into context a recent report to the Honorable Jim Pitts from John S. O'Brien, Director of the Legislative Budget Board (LBB), entitled "Dynamic Economic Impact Statement". There has been an impression created in the press and embraced by many that the LBB report suggests that adoption of the bill CSHB1 by Texas would cost Texas 272,000 jobs in 2012 and 335,000 jobs in 2013. This answer, at least as interpreted by the press, is wrong and not based on sound economics. The passage of CSHB1 will not cause less jobs in Texas relative to any other option at hand. In fact, **I can think of no response to the current Great Recession that the Texas state government could do that would be better for state employment than CSHB1.**

FULL REPORT

Creating an economic environment conducive to high economic growth and full employment is as important a goal for a state government as is imaginable. And, upon reflecting on this goal, states have seen fit to adopt balanced budget requirements to assure fiscal solvency, limited impediments to job creation, and maximum opportunity for states to achieve prosperity.

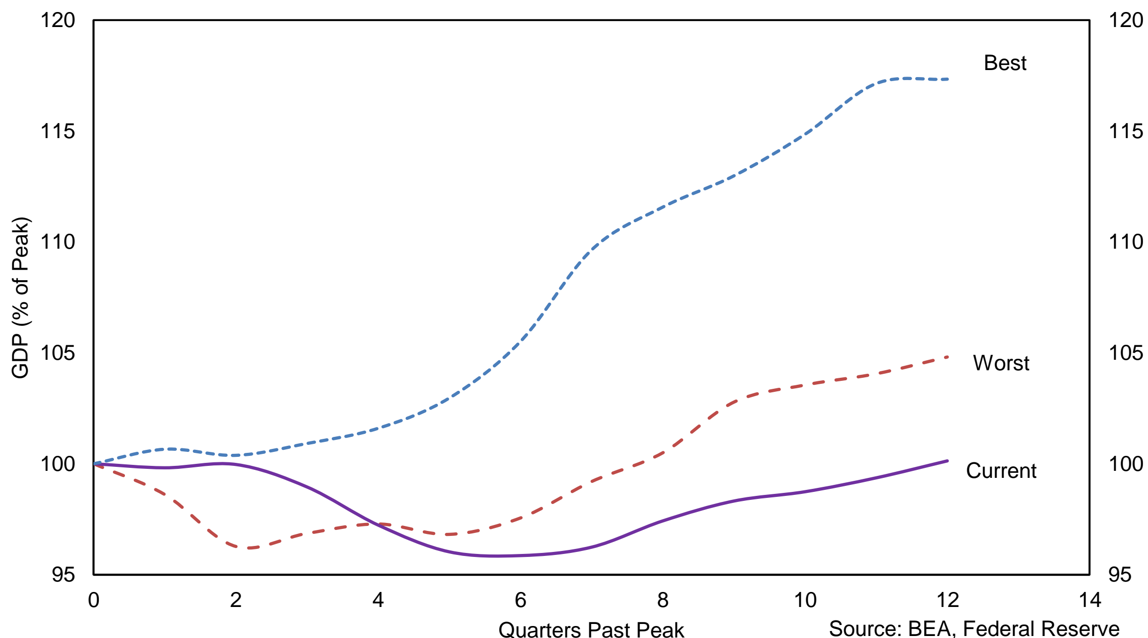
As a result of the Great Recession, however, the state government of Texas must consider its options in providing core services, maintaining a sound tax system, and generally augmenting a framework for state prosperity. The recovery from the U.S. Great Recession has been the worst single recovery from the previous peak in economic activity since the Great Depression of the 1930s. Its ravages have spared no state, and yet Texas, with its fiscally sound state government, has been among the very best performers among all states, if not the best performer.[1]

To put the current recession in perspective, I have plotted below the recovery of real U.S. GDP from the previous peak since the Great Depression for the best recovery, the worst recovery and the current recovery by quarter (Figure 1 below). As is clear, the current recovery is way below the previous worst recovery and miles behind the best recovery. Today's economy in the U.S. has been nothing short of terrible.

Figure 1

GDP - Path from Peak

(2007Q4 - 2010Q4 vs. Max & Min For All Recessions, By Quarter, Since 1947)



[1] For more on Texas' economic performance, see Donna Arduin, Arthur B. Laffer, Stephen Moore, and Wayne Winegarden, "Competitive States 2010: Texas vs. California, Economic Growth Prospects for the 21st Century", *Arduin, Laffer & Moore Econometrics*, October 2010.

Since the economic trough in the overall U.S. economy, the state of Texas has created more net new jobs than any other state and in fact has created over 25% (279,000 out of a total U.S. figure of 1,010,000 net new jobs) of all the net new jobs in the U.S. from October 2009, when the U.S. unemployment rate peaked, to the present. As a point of comparison, Texas only accounts for some 8% of total U.S. employment.[2] Thus Texas' performance in creating net new jobs is astonishingly good and attests to the excellence of its government policies relative to other states and the U.S. as a whole.

The reason why Texas has performed so well is that Texas' state government has never lost sight of its pro-growth and fiscally sound principles, even as other states and the federal government itself succumbed to unwarranted increases in wasteful stimulus spending and tax increases. States, quite simply, cannot tax themselves into prosperity. And, rest assured, government spending is the ultimate form of taxation.

Now, of course, it's true that all government spending isn't bad. In fact, a lot of government spending is badly needed, serves a useful purpose and makes America the wonderful country she is and Texas the great state she is. What is bad, however, is the notion that government spending per se creates jobs. [3]

Milton Friedman made the point time and time again that government spending is taxation. And it is. To see why government spending is, in fact, taxation, imagine a world that is comprised of only two farmers. If one farmer receives unemployment benefits, whom do you think pays for those benefits? The answer is the other farmer has to pay for them. Government spending is a tax on output and therefore reduces output and employment now. Neither poor people nor poor countries can spend themselves into prosperity. And states are no exception, not even Texas.

If an economy has total production of 100 apples and 10 of those apples are given away by government edict to people who didn't produce them, then the workers and producers who produced the 100 apples will now have 10 apples less for the apples they produced. With less incentive to produce apples, output will fall not rise—no matter how the taking of the 10 apples is financed, whether via taxes, debt or the printing of money.

To illustrate the negative effects of government spending, I have plotted below the decade metrics for Texas' performance relative to the average of all states and the highest and lowest spending states, all ranked by state and local expenditures as a percentage of Gross State Product, from 1997 to 2006 (Table 1).

[2] Source: BLS

[3] Many studies have found a significant and negative relationship between higher government burdens/taxes and lower rates of economic and job growth including: Barro Robert J. and Redlick Charles J.(2010) "Macroeconomic Effects from Government Purchases and Taxes* *Working Paper,* May; Scully, Gerald W. (2006) "Taxes and Economic Growth" *National Center for Policy Analysis*, NCPA Policy Report No. 292, November; Robert J. Barro (1991) "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics*, Vol. 106, No. 2 May; Landau, Daniel L. (1983) "Government Expenditure and Economic Growth: A Cross-Country Study" *Southern Economic Journal*, 49: January; Mitchell, Daniel J. (2005) "The Impact of Government Spending on Economic Growth" *Heritage Foundation,* Backgrounder #1831, March 15; Gwartney, James, Lawson, Robert and Holcombe, Randall (1998) "The Size and Functions of Government and Economic Growth" *Joint Economic Committee, U.S. Congress*, April.

Table 1
Local & State Expenditures as a Percentage of GDP & 10 Year Real GDP Growth Rate

Bottom 10 Spenders	2006 Local & State Expenditures as % GSP	10 year Real GSP growth rate (1997-2006)
Delaware	14.65%	30.74%
Virginia	14.89%	41.32%
Connecticut	14.97%	24.00%
Nevada	15.11%	62.68%
Texas	**15.25%**	**34.87%**
South Dakota	16.05%	42.42%
New Hampshire	16.10%	36.00%
Colorado	16.12%	41.62%
North Carolina	16.69%	37.21%
Illinois	16.81%	19.51%
Bottom 10 Average	15.66%	37.04%
Top 10 Average	23.08%	21.58%
Top 10 Spenders		
Ohio	21.48%	10.91%
Montana	21.54%	28.60%
West Virginia	22.37%	11.41%
Maine	22.42%	24.31%
Vermont	22.71%	33.24%
New Mexico	22.73%	30.03%
South Carolina	22.94%	22.86%
New York	23.10%	30.60%
Mississippi	25.67%	16.52%
Alaska	25.82%	7.36%

Source: Census, BEA

Once again the numbers tell the story loud and clear. Those ten states with the least government spending way outperform those ten states with the most government spending—and by a wide margin.[4]

Excessive government spending is not only a drag on state growth, it is a drag on country growth as well. In the table below I have listed those ten countries of the Organization of Economic Growth and Development (OECD) with the least government spending as a share of GDP and also those ten countries with the largest government spending as a share of GDP, along with each country's growth in real GDP over the period 2003 to 2009 and the averages for each group (Table 2).

[4] For more on state economic performance as compared to state economic policies, see Arthur B. Laffer, Stephen Moore and Jonathan Williams, Rich States, Poor States: ALEC-Laffer State Economic Competitiveness Index, (3rd edition) *American Legislative Exchange Council*, 2010.

Table 2

National Expenditures as a Percentage of GDP & Real GDP Growth Rate

Bottom 10 Spenders	Expenditures as a % of GDP (2009)	% Change Real GDP (2003-2009)
Sw itzerland	11.33%	41.93%
Mexico	11.97%	38.93%
Chile	13.36%	45.63%
Turkey	14.69%	74.21%
Korea	16.02%	36.77%
Luxembourg	16.75%	53.82%
United States	17.30%	26.64%
Australia	18.01%	36.55%
Poland	18.44%	57.76%
Ireland	19.47%	28.12%
Bottom 10 Average	15.73%	44.04%
Top 10 Average	25.73%	31.42%
Top 10 Spenders		
Norw ay	22.39%	53.92%
United Kingdom	23.43%	22.21%
Israel	24.16%	38.14%
France	24.63%	27.86%
Belgium	24.67%	24.89%
Finland	25.28%	30.79%
Iceland	26.55%	31.48%
Sw eden	27.77%	26.83%
Netherlands	28.44%	31.15%
Denmark	29.97%	26.90%

Source: OECD

The above picture is pretty clear. There is little by way of cross country analysis that would suggest increasing government spending as a share of GDP will increase a country's (or state's) economic growth.

Even the post World War II experience of the U.S. economy casts doubts on the efficiency of government spending to stimulate the economy. For example, right after World War II government spending fell dramatically as a share of GDP while the private economy performed well.

Then from the mid 1960s to the mid 1970s (1967 – 1975) total government spending rose by some 6½ plus percentage points of GDP (The Great Society et al) while real GDP grew on average by only 2.71%, less than the long-term growth average. And yet under President Clinton total government spending fell by over 4½ percentage points of GDP (1992 – 2000) while real GDP grew on average by 3.82% per annum, well above the nation's long term average.[5]

But the deal clincher at last for the overall U.S. experience is the most recent period of U.S. economic history. From 2006 through 2010 government spending has risen by over five percentage points of GDP and real GDP has grown by less than 1% per year. And there you have it. Both economic theory and data indicate that government spending negatively affects economic growth.

All of this background puts into context a recent report to the Honorable Jim Pitts from John S. O'Brien, Director of the Legislative Budget Board (LBB), entitled "Dynamic Economic Impact Statement". There has been an impression created in the press and embraced by many that the LBB report suggests that adoption of the bill CSHB1 by Texas would cost Texas 272,000 jobs in 2012 and 335,000 jobs in 2013. This answer, at least as interpreted by the press, is wrong and not based on sound economics. The passage of CSHB1 will not cause less jobs in Texas relative to any other option at hand. In fact, I can think of no response to the current Great Recession that the Texas state government could do that would be better for state employment than CSHB1.

[5] Source: BEA. Real GDP growth rates provided are arithmetic average of annual growth rates in real GDP.

In order to represent the report correctly, I quote: "Correct interpretation of the results in Table 1 [the table where the 272,000 job losses for 2012 and 335,000 job losses for 2013 appear] is essential to properly understand the effects of CSHB1 on the Texas economy. For instance, **the negative 272 thousand change in jobs predicted for 2012 does not imply the state will lose that many jobs from our current employment level upon enactment of CSHB1**. Rather, that figure **implies Texas will have 272 thousand jobs less than a baseline scenario where state expenditures remained constant relative to 2010-11 levels and available revenue matched these spending levels**. Since **available revenue for the 2012-13 biennium is predicted to fall well below that amount, in large part due to the national economic recession, many of these job losses can be attributed to the steep downturn of the Texas economy** during the past several years."

In short, the LBB summary does not say that Texas will lose 272,000 jobs if CSHB1 is adopted. What it does say is that because of the Great Recession Texas' employment will be 272,000 jobs below trend even if CSHB1 is passed. In other words CSHB1 will not cure the Great Recession experienced by all states of the U.S. and the entire world economy. This is not surprising. Whoever would expect Texas policies by themselves would cure the world's economic collapse? No one whom I know.

Unfortunately, many have interpreted this report as evidence that the state should simply ensure that expenditures remain constant relative to 2010-11 levels, thus necessitating a tax increase. This option—raising taxes to maintain spending—is simply an attempt to balance the state government's budget by unbalancing the budgets of the citizens of the state of Texas. And, why on earth would a government whose job it is to serve the people want to impoverish its people by raising taxes so that it can spend more than it receives in current tax revenues? And, in addition to that, to me it makes no sense to expect that raising tax rates on workers and producers in order to continue payments to non-workers and to non-producers will increase the number of workers and producers. It won't.

This approach is indicative of a mistaken belief that government spending creates jobs and represents a failure to understand that government doesn't have a single entry accounting system. Government can't bail someone out of trouble without putting someone else into trouble. For every transfer recipient there's a transfer payer. It's as simple as that. Neither borrowing nor taxing to overspend helps the economy.

In more technical terms, in an economy the income effects of a transfer sum to zero. The people who receive the transfer do spend and employ more, that's true, but it is equally as true that the people who pay the transfer spend less and employ less. The net of all the income effects of government spending is therefore zero. The substitution effects, however, accumulate to discourage production everywhere. Just imagine what would happen to total Texas output if the government transferred 100% of GSP, so that everyone who worked and produced received nothing and all those who didn't work and didn't produce received everything. Output and employment would be zero.[6]

Texas has an obligation to balance its state budget pure and simple. It's the law! Since revenues to the state under current tax legislation are forecasted to fall way below the amount needed to keep spending at its current levels, Texas has a clear choice: it can either cut spending down to the available revenues (i.e. CSHB1) or it can raise taxes and attempt to reduce spending by less.

In my opinion raising taxes to maintain spending levels would do immense harm to the Texas economy and would not provide the tax revenues government forecasters would predict. Raising tax rates never raises tax revenue by the same proportion and can at times actually yield less revenue. The "Dynamic Economic Impact Statement" as described does not take into account the impact increased taxes would have on the Texas economy in order to balance the budget with spending at its current level. Unfortunately Texas doesn't own a "tooth fairy" to provide the Legislature costless revenues. Texas should not succumb to the illusion that something for nothing is available. For whenever governments believe they can get something for nothing, they invariably end up with nothing for something.

Texas has been on the right track and shouldn't change now. Texas is the example others should follow, not the reverse.

[6] See also: *Gwartney James and Stroup Richard (1983) "Labor Supply and Tax Rates: A Correction of the Record"* The American Economic Review *Vol. 73, No. 3 (Jun), pp. 446-451.*

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