JUNE 2012

INSIDE ALEC

A PUBLICATION OF THE AMERICAN LEGISLATIVE EXCHANGE COUNCIL

SPECIAL ISSUE: BUDGET & TAXES

FEATURED ARTICLES

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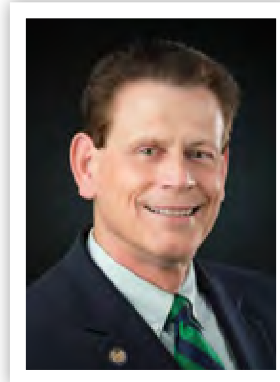


Dear ALEC Members and Friends,

Like many of my fellow ALEC members, I joined ALEC as a new state legislator to be part of an organization committed to free markets, limited government and constitutional division of powers between the federal and state government—principles I believed in as a representative, and principles I knew the Indiana legislature needed.

ALEC provided me with a constructive forum where I could meet with other state legislators and private sector leaders to discuss and exchange practical, state-level public policy issues. And more than fifteen years later, I still use ALEC meetings to stay informed on important state policy issues. Through ALEC's sound policy solutions, member legislators gain tools they need to create jobs, balance state budgets and create business-friendly environments that allow for economic growth.

As we prepare for our 39th Annual Meeting in Salt Lake City, UT, July 25-28th, I thought it appropriate to share a perspective on the most recent phase of ALEC's journey, and to offer some thoughts on what nearly two decades as an ALEC member has taught me.

Despite the small minority that has recently tried to silence ALEC's voice, the role we play in facilitating the conversation around pro-growth, limited government principles and discussing solutions that support free-market ideals has never been needed more than today. In April we announced that ALEC will be redoubling efforts on the economic front, a priority especially timely in the current economic environment.

What a great time to be involved with ALEC as we concentrate on initiatives that spur competitiveness, innovation and put more Americans back to work. Energized by more than 2,000 attendees last year, this year's meeting is shaping up to be our best yet. The meeting will be filled with great speakers, and will also feature workshops on issues relevant and critical to all the states, and also offer time to exchange ideas with fellow legislators from around the country.

I thank you for your continued support of ALEC, and I look forward to continuing my work with you in promoting free enterprise and limited government throughout the states. I am always grateful to hear reports of the impact ALEC's resources are having in assisting legislators across the nation—especially those new to the legislative process. It is because of your energy, dedication, innovation and enthusiasm that free-market ideals are encouraged in every sector of this great nation.

Sincerely,

Dave Frizzell

Representative Dave Frizzell, Indiana
ALEC's 2012 National Chairman

Time to Empower the States and Devolve a Federal Bureaucracy

BY U.S. REP. TOM GRAVES (GA)

President Ronald Reagan once astutely noted, "No government ever voluntarily reduces itself in size. Government programs, once launched, never disappear. Actually, a government bureau is the nearest thing to eternal life we'll ever see on this earth."

Eternal life, indeed. One could even make the case that government bureaucracies tend to take on a life of their own. Decade after decade, federal programs—which government officials often promise will have a limited shelf life—continue to live on in perpetuity. They just don't go away. Rather, they demand more. More money. More resources. More control over the lives of Americans. And taxpayers keep footing the bill, deficits continue to balloon, and no one quite really knows what we're getting in return for sending all of that money to Washington.

Let's take a moment and go back in time to look at one such example. The year: 1956. The location: The storied halls of Congress. The House Ways and Means Committee was debating what was considered to be a new and innovative project—the construction of a nationwide interstate system. The plan before Congress was simple; build six interstate highways. Three highways would run north to south, three highways would run east to west.

Back then, the plan was to collect a federal gas tax of three cents per gallon for 16 years to pay for the whole project. In 1972, the tax was supposed to drop to 1.5 cents per gallon. Congressmen Hale Boggs and George Fallon even noted at the time that once the interstate system was built, there was no obligation for the government to continue imposing the tax on the American people.

The tax never went away. It never dropped to 1.5 cents a gallon. Instead, the tax went up—way up. The federal government currently assesses us 18.4 cents for each gallon we pump into our tanks. And, as you have probably figured out by now, the bureaucracy "managing" this tax money has spiraled out of control. Each year, approximately $400 million goes toward paying for the bureaucracy running the highway system. Millions more go to projects that have absolutely nothing to do with the maintenance of America's interstates; things like bike paths, walking trails, and planting flowers.

What's worse, Uncle Sam is playing "Robin Hood" with 28 states, including my home state of Georgia. These states are called "donor states" because they put in more money to the Highway Trust Fund than they receive from the federal government. For example, during the fiscal years 2005-2009, Georgia lost $839 million dollars in gas revenue, receiving back just 89 percent of what we put into the fund. All totaled, $15 billion from the "donors" went to other states to fund their projects. If you ask me, this gives new meaning to the expression "highway robbery."

The federal government has mishandled our gas tax revenue and mistreated states like Georgia. And it is easy to see why. A big hoard of cash is like catnip for political agendas, earmarkers, lobbyists, and the like.

Congress regularly debates how each state should spend the money, mandating dozens of various projects and bogging down progress with more red tape. It's about as efficient as pulling out a typewriter to send an email.

But now we have the first opportunity to devolve a massive federal bureaucracy—and return the money back to the states. This is what I propose. Let's cut out the federal government as the middle man for most transportation money. Instead, let the states keep the highway dollars they collect, so they can spend the money on highway projects as they see fit.

I've introduced legislation in Washington which does just that. It empowers states to control their own highway programs and strictly limits federal involvement to projects that have a national purpose. Over a five-year transition period, the federal gas tax would drop to 3.7 cents per gallon, which would let the states adjust their own gas tax rates and keep all of the subsequent revenue. It's an opportunity for Washington to take a back seat to the states and take its hand off the wheel.

Like any federal agency, Washington will never give up power on its own. No matter how well-meaning some bureaucrats might be, none has ever willingly relinquished control.

When I was a state representative, I was proud to vote in favor of Georgia's resolution on this issue, which passed with overwhelming bipartisan support. And I am convinced most of the other states would respond in kind, if given the chance.

It's a 21st century solution to a 20th century problem.

U.S. REP. TOM GRAVES was elected to Congress in June 2010 after serving seven and half years in the Georgia General Assembly. He represents Georgia's 9th Congressional District which touches the northern suburbs of metro Atlanta to the northwest corner bordering Alabama and Tennessee. As a state legislator, he served on ALEC's Tax and Fiscal Policy Task Force and was also named 2009 Legislator of the Year.

ALEC Releases 5th Edition of *Rich States, Poor States*

BY DR. ARTHUR LAFFER, STEPHEN MOORE AND JONATHAN WILLIAMS

Amid climbing national debt and a dismally slow economic recovery, it is evident that the solution to our economic woes lies outside of the federal government. Many states have taken the lead in identifying and implementing the policies that lead to prosperity and those states have suffered less as a result of their pro-growth policies.

In this fifth edition of *Rich States, Poor States,* we identify the states that experience prosperity and those which continue to struggle, highlighting the policies that contribute to economic well-being in the 50 states. We also provide the 2012 ALEC-Laffer State Economic Competitiveness Index, based on state economic policies. The states that fare the best are the most pro-growth, forward looking in the nation. Meanwhile, the class warriors have secured their positions in the bottom 10 yet again by demonstrating that you can't tax and spend your way to prosperity.

In Chapter 1, we lay the groundwork for understanding what states must do in order to increase growth and become prosperous. First, we set the stage by identifying the biggest winners and losers in the ALEC-Laffer State Economic Competitiveness Index over the past five years. Next, we provide a lesson in economics 101, discussing the merits of supply side economics, the theory of incentives, and the evidence behind taxpayers voting with their feet—very strongly against high taxes. Finally, this chapter highlights the best policies of the states, from pension reform, to closing budget gaps, to pro-business tax reform, and everything in between. Be on the lookout for Oklahoma, Kansas, and Missouri, where the personal income tax may soon become a thing of the past.

BEST AND WORST OF 2012 IN ECONOMIC OUTLOOK

TOP 10	BOTTOM 10
1. Utah	50. New York
2. South Dakota	49. Vermont
3. Virginia	48. Illinois
4. North Dakota	47. Maine
5. Wyoming	46. Hawaii
6. Idaho	45. Rhode Island
7. Missouri	44. Oregon
8. Colorado	43. Connecticut
9. Arizona	42. New Jersey
10. Georgia	41. Minnesota

> "Our growth as a state stands as a testament to the fact that **low taxes, limited government, and fiscal discipline are a recipe for job creation...**"
>
> *-Gov. Mary Fallin*

Chapter 2 evaluates the influence several policy variables have on state economies. We begin with the personal and corporate income taxes, comparing the states with the highest tax rates to the states with the lowest, or in some cases zero, tax rates. The results speak for themselves. The no-income tax states outperform their high tax counterparts across the board in Gross State Product growth, population growth, job growth, and, perhaps shockingly, even tax receipt growth. Oklahoma governor Mary Fallin understands this lesson well.

"Our growth as a state stands as a testament to the fact that low taxes, limited government, and fiscal discipline are a recipe for job creation," said Gov. Mary Fallin. "Based on the success we have enjoyed enacting pro-growth policies like those championed by ALEC, our state is moving forward with a bold tax reform plan that will represent the most significant tax cut in state history and chart a course towards the gradual elimination of the state income tax."

In Chapter 3, we delve deep into one of the most anti-growth tax policies: The unpopular and economically damaging "death tax." From what not to do to where not to die, we combine anecdotal evidence with the data to show why the death tax is the worst possible tax for state economies.

THE NINE STATES WITH NO PERSONAL INCOME TAX VS. THE NINE STATES WITH THE HIGHEST MARGINAL PERSONAL INCOME TAX RATES (2001-2010)

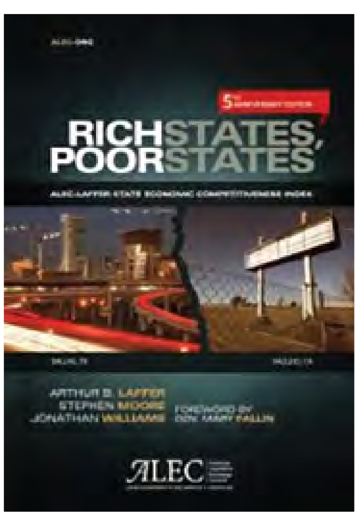
Category	No Income Tax States (AK, FL, NV, NH, SD, TN, TX, WA, WY)	Highest Marginal Personal Income Tax (OH, ME, MD, VT, NY, CA, NJ, HI, OR)
Gross State Product Growth	58.54%	42.06%
Population Growth	13.65%	5.49%
Job Growth	5.36%	-1.68%
Total State Tax Receipt Growth	81.53%	44.88%

Finally, Chapter 4 is the much-anticipated 2012 ALEC-Laffer State Economic Competitiveness Index. The first measure, the Economic Performance Rank, is a historical measure based on a state's income per capita, absolute domestic migration, and non-farm payroll employment—each of which is highly influenced by state policy. This ranking details states' individual performances over the past 10 years based on the economic data.

The second measure, the Economic Outlook Rank, is a forecast based on a state's current standing in 15 equally weighted policy variables, each of which is influenced directly by state lawmakers through the legislative process. In general, states that spend less, especially on transfer programs, and states that tax less, particularly on productive activities such as working or investing, experience higher growth rates than states that tax and spend more.

This fifth edition of *Rich States, Poor States* provides 50 unique snapshots from our 50 "laboratories of democracy" for you to evaluate. Study the rankings, read the evidence, and learn about the proven principles that lead to economic growth, job creation, and a higher standard of living for all Americans.

Find out where your state ranks in the ALEC-Laffer Economic Competitiveness Index and learn more about the policies that will lead to growth and prosperity in this year's edition of *Rich States, Poor States*. The full-text PDF is available for free on ALEC's website: **www.alec.org/RSPS.**



DR. ARTHUR LAFFER is the founder and chairman of Laffer Associates, an economic research and consulting firm, as well as Laffer Investments, an institutional investment firm.

STEPHEN MOORE is an editorial board member and senior economics writer at *The Wall Street Journal.*

JONATHAN WILLIAMS is the Tax and Fiscal Policy Task Force Director and also serves as the Director of the Center for Competitive State Fiscal Policy.

Personal Income Tax Reform in the States: Lower, Flatter, and Fairer?

BY BARRY W. POULSON

Personal income taxes are the largest source of tax revenue for state governments, generating more than 34 percent of total tax revenue. Since 2000 however, the trend throughout many states has been toward reforming personal income taxes to make them lower, flatter, and possibly fairer.

Over the period from 2000 to 2012, the trend in most states was toward lower top rates for personal income taxes. Of the low tax states, seven reduced their top rate while only two increased that rate. Seven high tax states with top rates in excess of 5 percent also reduced their top rate. Over the same period 10 high tax states with top rates in excess of 5 percent increased that rate. This includes four states with very high or extremely high top income tax rates, California, Hawaii, New Jersey, and Vermont.

Thus, there appears to be a large and growing divide in the way that states impose the personal income tax, a division we will refer to as the east and west coast versus the heartland. The coastal states would appear to be at a growing disadvantage in interstate tax competition compared to the heartland states. These states with high and rising personal income tax rates penalize earnings, savings, and investment, imposing a drag on economic growth.

The trend toward lower personal income tax rates has accelerated in recent years especially in the heartland of the country. In the past year, 14 states reduced personal income taxes, only three states raised personal income taxes.[1] In 2012, at least nine states have proposed reducing and or eliminating their personal income tax including: Arizona, Idaho, Indiana, Kansas, Oklahoma, Missouri, Nebraska, New Jersey, and South Carolina.[2] It is no coincidence that most of the latter states are in the heartland where tax competition among the states is especially fierce.

These proposals to lower personal income tax rates and broaden tax bases are defended as reforms designed to create incentives for productive activity to promote economic growth.[3] However, recent research shows that some base broadening measures can actually reduce the efficiency of the tax system and reduce economic growth.[4] Reducing tax rates and broadening the base may also change the distribution of the tax burden among income classes.[5]

Several questions must be addressed regarding the trends observed in the states toward lower rates, often accompanied by broadening the personal income tax base. One question is whether these tax reforms have promoted greater efficiency and economic growth. Another question is how these reforms have shifted the tax burden among different income groups and whether or not this results in a fair tax system.

Fortunately, recent research on tax reform in the states is beginning to provide us with empirical answers to these questions.[6] We will focus on recent research on tax reform in Colorado and Kansas. Colorado was one of the first states to replace a graduated personal income tax with a low flat rate tax in 1987. That reform was accompanied by a broadening of the base, and adoption of a more generous personal exemption and standard deduction. In 1992 Colorado enacted the most effective tax and expenditure limit in the country, the Colorado Taxpayer Bill of Rights (TABOR). Colorado's fiscal reforms set a precedent for more recent fiscal reforms in the states, such as that proposed for Kansas.

COLORADO'S FLAT RATE INCOME TAX

The *Federal Tax Reform Act* of 1986 significantly reduced federal income tax rates from the top rate of 50 percent to 28 percent. Because the rate reductions were offset by base broadening, the federal tax reform left effective rates and work incentives roughly unchanged for the economy as a whole. The federal reform was implemented to be roughly revenue neutral.

The federal tax reform in 1986 would have created a windfall of revenue for Colorado because the state income tax base is linked to the federal income tax base.[7] In 1987 the Colorado legislature used federal tax reform as an opportunity to replace the states graduated personal income tax rates with a flat rate, reducing the top rate from 8 percent to 5 percent. The top rate for personal income taxes was again reduced to 4.75 percent in 1999, and 4.63 percent in 2000. The 1987 legislation also phased in a flat corporate income tax rate at 5 percent, replacing a graduated corporate income tax with rates above 5 percent.

As in the case of federal tax reform, Colorado's flat rate income tax was designed to be roughly revenue neutral. The broadening of the federal income tax base automatically broadened the Colorado income tax base. These tax reforms improved efficiency of the tax system and created one of the best business tax climates in the country. Colorado attracted a high rate of business investment accompanied by rapid growth in employment.

By the late 1990s Colorado achieved one of the highest rates of economic growth in the country, and this was accompanied by a high rate of growth in state revenues.[8]

> *As in the case of federal tax reform, Colorado's flat rate income tax was designed to be roughly revenue neutral. The broadening of the federal income tax base automatically broadened the Colorado income tax base.* ***These tax reforms improved efficiency of the tax system and created one of the best business tax climates in the country.***

Colorado's flat rate income tax had a significant impact on the tax burden distribution across income classes. Colorado adopted the more generous federal standard deduction and personal exemption, which meant that low income families paid little or no state income tax.[9]

The table on the next page shows the share of total state income taxes paid by low and high income families over the period since 1982. The share of total income taxes paid by the lowest income group fell from 10.8 percent to 0.5 percent. The share of total income taxes paid by the high income group increased more than threefold, from about 25.7 percent to 79.4 percent.

The distributional effects of the tax reforms are measured by the effective tax rate, or the share of state income taxes in money income for each income class. From 1982 to 1994 state income taxes as a share of money income decreased for the lowest income group from 1.36 percent to 0.82 percent; that share then increased from 1994 to 2000 when it was 1.19 percent. The effective tax rate for the high income group increased throughout the period from 2.63 percent in 1982 to 3.49 percent in 2000.

Progressivity of the tax system is measured by the percent of income paid by the lowest income group in taxes as a ratio of the percent paid by the high income group. This measure shows increased progressivity from 1982 to 1994, followed by decreased progressivity from 1994 to 2000.

Thus, the initial impact of the flat rate income tax was to increase progressivity of the tax system. Over the period as a whole, Colorado's flat rate income tax shifted a significant share of the tax burden from low income families to high income families; by the end of the period the tax system was more progressive than it was prior to the flat tax reform in 1986. What this evidence reveals is that a rising tide does indeed lift all boats.

TABOR

Perhaps the most interesting evidence on the distributional impact of Colorado's tax system is the impact of the Taxpayer Bill of Rights (TABOR). TABOR was enacted in 1992, but was not triggered until 1997 when state revenue growth exceeded the TABOR limit. From 1997 to 2000 $3.25 billion in surplus revenue was refunded to Colorado taxpayers. At that time the legislature enacted tax

PROPORTION OF STATE PERSONAL INCOME PAID BY LOW AND HIGH INCOME CLASSES

YEAR	LESS THAN $10,000	MORE THAN $50,000
2000	0.5%	79.4%
1994	0.8%	63.8%
1982	10.8%	25.7%

Source: Colorado Tax Profile Studies, 1982, 1994, and 2000, Colorado Department of Revenue

STATE PERSONAL INCOME TAXES AS A SHARE OF MONEY INCOME FOR LOW AND HIGH INCOME CLASSES, AND PROGRESSIVITY INDEX.

YEAR	LESS THAN $10,000 (A)	MORE THAN $50,000 (B)	PROGRESSIVITY INDEX (A/B)
2000	1.19%	3.49%	.34
1994	0.82%	3.15%	.26
1982	1.36%	2.63%	.52

Source: Colorado Tax Profile Studies, 1982, 1994, and 2000, Colorado Department of Revenue

STATE AND LOCAL TAXES AS A PERCENTAGE OF MONEY INCOME BY INCOME CLASS BEFORE AND AFTER TABOR REFUNDS

	LESS THAN $10,000	$10,000 TO $19,999	$20,000 TO $29,999	$30,000 TO $39,999	$40,000 TO $49,999	$50,000 TO $59,999	$60,000 TO $69,999	$70,000 TO $90,000	$90,000 AND OVER	TOTAL
State & Local Taxes Before Refund	16.02%	9.00%	8.20%	8.31%	8.32%	8.31%	8.11%	7.93%	6.40%	7.44%
State & Local Taxes After Refund	10.84%	6.62%	6.69%	7.08%	7.28%	7.32%	7.29%	7.18%	5.92%	6.57%

Source: Colorado Tax Profile Study 2000, Colorado Department of Revenue reforms designed to offset surplus revenue, including reductions in the personal income tax, the sales tax, the business personal property tax, and a variety of other taxes and fees.[10]

Colorado chose to refund surplus revenue based on estimated sales taxes paid by each income group. What the following table shows is the impact of TABOR on the total state and local tax burden by income class. TABOR shifted the total tax burden from low to higher income groups; in effect, the progressivity of the TABOR tax refunds just about offset the regressivity of the state sales tax.

PROP 103

Ever since the flat rate income tax was enacted in Colorado, various interest groups have proposed an increase in the state income tax and a return to graduated income tax rates. In 2011 a measure was placed on the ballot, Prop 103, to temporarily increase the state personal and corporate income tax and sales tax. This proposed tax increase provided an opportunity for John Merrifield and me to test a new dynamic scoring model to measure the impact of tax changes on the state economy.[11] We simulated the proposed tax increase over the period 2007 to 2011, a period of time comparable to the number of years that Prop 103 would be in effect. In this research we used an estimate of the impact of increased marginal tax rates on state economic growth from an earlier study that I published with Jay Kaplan.[12] Using an endogenous growth model we estimated that every one percent increase in the marginal tax rate of a state relative to the average marginal tax rate for the states as a whole reduced the annual rate of economic growth in that state between 0.25 and 0.374 percent.

These simulations revealed that the proposed tax increase in Colorado would cause a cumulative reduction in personal income over the period as a whole equal to between $2.0 billion and $3.2 billion. This decrease in income would be accompanied by a loss in jobs estimated between 7,400 and 11,600. The total cost of the tax increase per family, including higher taxes and lost income, was estimated between $2,169 and $2,711. It is not surprising that Prop 103 was soundly defeated at the polls.[13]

For more than two decades Colorado citizens have benefited from the rapid economic growth that has accompanied Colorado's flat rate income tax. Lowering the top tax rate by half has clearly had positive incentive effects on earnings, savings, investment, and entrepreneurial activity. It is not surprising that higher income groups were the most likely to respond to these positive incentives, as reflected in the rapid growth in their income. However, that rapid growth in income was more than matched by a rapid growth in their personal income tax burden. With a broadening in the tax base and closing of loopholes, the share of taxes paid by the highest income group grew more rapidly than their share of income. The generous standard deduction and personal exemption introduced along with the flat rate tax meant that low income groups paid little or no state income taxes. Over the period since the flat tax was introduced, the personal income tax has become more progressive. Further, the tax refunds mandated by the TABOR Amendment have offset the regressivity of state sales taxes, resulting in even greater progressivity of the tax system.

Citizen support for Colorado's flat rate income tax, and for the TABOR Amendment, is higher today than when these measures were introduced. There is perhaps no better measure of whether or not a tax system is fair.

BARRY W. POULSON is a retired Professor of Economics from the University of Colorado Boulder. He also acts as an Advisor for the American Legislative Exchange Council's Task Force on Tax and Fiscal Policy.

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An "Original" Solution to Taxation of Online Sales

BY ANDREW MOYLAN

All across the country, legislators and businesses are under increasing pressure to confront issues arising from differences in sales tax collection obligations between traditional "brick-and-mortar" and "remote" retailers. A sales tax authority can only require a business to collect and remit its tax if that business has a legitimate physical presence in the state. The result is that online sellers, who have fewer physical locations across the country, only collect sales taxes under limited circumstances and the "use tax" that consumers technically owe in lieu of sales tax is virtually impossible to uniformly enforce.

Unfortunately, much of the response to this pressure has manifested itself in federal and state efforts to dismantle the important and long-established "physical presence standard," which protects businesses and taxpayers from aggressive, overzealous revenue collectors. This vital safeguard is something that ALEC supports in the realm of sales and income taxes because it prevents other states from harassing your citizens and businesses. The good news is that there is a solution to help address perceived challenges with remote sales, while maintaining the strong taxpayer protection of the physical presence standard: Shift to an "origin-based" sourcing rule for sales taxes.

A destination-based sourcing rule requires businesses to collect sales tax defined by the physical location of the buyer, whereas an origin-based sourcing rule would require sales tax collection defined by the physical location of the seller. This subtle difference seems like little more than an obscure, boring technocratic change, but it would have the effect of dramatically altering the current debate while helping us tackle some of the most vexing issues in sales tax collection with a fiscally conservative approach.

The destination-based sourcing rule that many "tax fairness" advocates support for online sales require Internet companies to quiz their customers about their residence, look up in which of the nearly 10,000 separate taxing jurisdictions they reside, and then collect and remit taxes to that distant authority based on its own complex and ever-changing dictates. An origin-based sourcing rule, on the other hand, would require those companies to levy only one tax based on the laws of the jurisdiction in which their business is located.

This change would fairly address the "level playing field" concerns raised by brick-and-mortar retailers without imposing excessive compliance burdens, all while protecting taxpayers and long-standing ALEC principles. Online companies would have to begin collecting taxes on every sale, but instead of thousands of different rules, they would simply comply with those of the single jurisdiction in which they are sited. That's a dramatically less complicated system than an onerous destination-based rule, and it bears a strong resemblance to the one under which brick-and-mortar retailers already operate.

While many states technically have destination-based sourcing in place today, they operate just like an origin-based system as it applies to traditional retail sales. That's because the rules are constructed in such a way as to simply assume that a good is consumed in the same place it is sold, thus preventing traditional retailers from having to suffer the burden of determining their customer's residence and the associated rates and rules of thousands of different taxing authorities. This bit of maneuvering to mimic origin-based sourcing in destination-based states protects brick-and-mortar businesses from crushing tax compliance obligations and the associated harm to commerce.

Perhaps the most important advantage of origin sourcing, however, would be the infusion of tax competition it could engender. Under such a system, businesses would have an incentive to invest in lower-tax jurisdictions so as to attract price-conscious customers. Sales taxes in Missouri for example, are more than two percentage points lower than in Kansas. An origin-based system would encourage a business to locate on the Missouri side of that border in order to benefit from the lower tax collection obligations.

Origin-based sourcing is not a "silver bullet" solution. It would still require additional action to keep taxpayers from bearing heavier loads. Switching to origin sourcing would effectively expand the tax base, so state legislators must act to reduce rates commensurately at the same time to ensure that net burdens do not increase. It would also require careful contemplation on the proper role of Congress, as federal guidance might prove necessary to encourage a smooth transition without impeding interstate commerce.

Taxation of remote sales is a thorny issue, but origin-based sourcing can help policymakers arrive at an equitable resolution that respects the rights of businesses and taxpayers while upholding limited government.

ANDREW MOYLAN is Vice President of Government Affairs for the 362,000-member National Taxpayers Union (NTU), a grassroots taxpayer advocacy organization founded in 1969 to fight for limited government, lower taxes, and more economic freedom at all levels. NTU is a member of the ALEC Tax and Fiscal Policy Task Force.

Protecting Taxpayers in Iowa

BY JOHN HENDRICKSON

Across the nation governors and state legislators are confronted with the task of implementing sound economic policies that create jobs and attract businesses. The difficulty of this responsibility has increased in the aftermath of the weak recovery of the "Great Recession," as unemployment remains high and states, like the federal government, face tremendous fiscal challenges. Many states across the nation have led the way in restoring pro-growth economic policies that consist of tax reform, reduced spending, and reforming state government. These are the policies that are needed in order for economic growth to take place. The policy of both low taxation and spending is a blueprint for economic success.

In examining specific pro-growth economic policies, policymakers in Iowa should consider a Taxpayer Bill of Rights measure, or TABOR. Colorado was the first state to implement a TABOR provision, which voters adopted in 1992 in response to high levels of spending and taxation. The purpose of TABOR was to bring spending and taxes under control by requiring voter approval of spending and tax increases. Under TABOR, state spending was slowed by population growth and inflation, and greater government accountability was established.

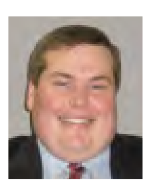
The state legislature in Iowa is currently faced with the challenge of implementing both tax and spending reform. As policymakers in Iowa debate a variety of policy ideas to bring about economic growth while honoring a prudent use of taxpayer dollars, they should consider TABOR. Whereas the TABOR provision in Colorado was passed through the process of a citizen initiative, Iowa does not have such a system in place. Any effort to get a TABOR amendment to Iowa's constitution would have to go through the legislative process. The Iowa House is currently considering two constitutional amendments to limit spending and taxes. These proposed amendments would place limits on spending as well as require a three-fifths majority vote of the entire legislature to revise both income and sales taxes or create new taxes.

The Tax Foundation, using government finance data from the U.S. Census Bureau, demonstrates that a TABOR provision in Iowa would have saved taxpayers billions. Using the "TABOR Calculator" from the Tax Foundation, actual spending in Iowa from 1981 to 2009, adjusted for inflation, was $241.8 billion. If Iowa had enacted a TABOR measure in 1980, spending from 1981 to 2009 would have been $163 billion, or $78.8 billion less. Further, a TABOR provision would bring more accountability to spending and tax policy in Iowa and allow taxpayers to have more responsibility in holding the legislature accountable.

Beyond TABOR, the legislature should also consider other pro-growth policy solutions. Some of these ideas include priority-based budgeting, tax reform, spending reform, eliminating unnecessary regulations, and implementing free-market reforms. Tax reform ideas such as across the board tax cuts in the supply side tradition would be a good policy solution. Several states have implemented or are considering sound tax reform ideas. During the last session the legislature in Iowa considered both a 20 percent across the board income tax cut and cutting the 12 percent corporate tax in half. Each of these actions would create a strong signal for economic growth. Some states are also considering phasing out their state income taxes altogether because they are witnessing the economic growth of states that have already terminated their state income taxes. Texas, as an example, has had an impressive record of economic growth using sound economic policies. It appears that many states are pushing hard to implement supply side economic policies.

> *"The principles for prosperity are simple and timeless: promote economic freedom."*

The battle for pro-growth economic and fiscal policies will not be an easy process as demonstrated by the massive debates occurring in states such as Wisconsin and Ohio, among others. Governors such as Scott Walker (R-WI), John Kasich (R-OH), Rick Scott (R-FL), and Chris Christie (R-NJ) are leading the way in implementing sound economic policy reforms to bring about not just economic growth, but also fiscal discipline. In the end this is a battle of political philosophy between those who believe in constitutional limited government as symbolized by President Ronald Reagan versus the progressive statist model symbolized by the policies of President Barack Obama. In *Rich States, Poor States,* Art Laffer, Steve Moore, and Jonathan Williams wrote: "The principles for prosperity are simple and timeless: promote economic freedom. Do this by keeping taxes low, operating based on a lean and efficient budget that neither wastes money nor provides unwarranted subsidies, and minimizing regulation."



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Taxing Times in Illinois

BY KRISTINA RASMUSSEN AND TED DABROWSKI

The Great Recession devastated state budgets across the nation.

The good news is many states tackled their fiscal challenges with sensible reforms and growth-oriented policies. Dire news headlines warning of catastrophe have largely given way to headlines indicating a return to stability.

But for those who didn't follow this path—for state leaders who rejected Jeffersonian principles—the outlook remains grim. Illinois was one of those states, and the result has been utter failure.

Rewind to one year ago. Illinois' budget faced major shortfalls. Billions in unpaid bills were piling up. With no cash on hand, the annual pension contribution was borrowed. The state's credit rating was on a downward slide and everyone was catching on to Illinois' pension crisis. The biggest problem for Springfield, though, was that it had run out of ways to finance its spending habits.

But there was one way out for Gov. Pat Quinn and the liberal-dominated legislature—lame-duck tax hikes of historic proportions. The General Assembly passed the increases with the barest of majorities, thanks only to the support of retiring lawmakers and those who lost re-election bids.

Illinois' personal income taxes were increased by 67 percent and the average household was asked to give up an extra $1,000 in hard earned income each year. Corporate income taxes climbed 46 percent, leaving the state with one of the highest business tax rates in the nation.

In exchange for this mandatory sacrifice, backers promised that the revenue—combined with an austere budgeting approach—would clear a backlog of unpaid bills, put the budget back on the right track, and help strengthen Illinois' economy.

None of that came true. In fact, it all got worse.

The gusher of new revenues went straight to the state's out-of-control pension costs, with nothing left to pay down the billions in unpaid bills. Plans to reform pensions and Medicaid fizzled as pressure dissipated. Even more, the growth of big programs led to an overall budget of record size.

Illinois was one of only four states in the nation to increase its unemployment rolls in 2011. The state was forced to hand out hundreds of millions of dollars in tax breaks to keep companies from fleeing the state. And to sum it all up, the state's credit rating was knocked to the lowest level in the nation, even worse than California.

This mismanagement isn't going unnoticed. As ALEC's Rich States, Poor States reminds us: People vote with their feet. In December 2011, the Bureau of Labor Statistics reported that Illinois lost 66,000 residents to other states between June 2010 and June 2011. That continues Illinois' 15 year trend of losing residents to other states at a rate of one person every 10 minutes. That's simply not sustainable.

What Illinois needs is to reverse its decade long culture of spending and deficits. It needs to reform spending and significantly pay down billions in unpaid bills. Unfortunately, the budget proposal Gov. Quinn released in February does just the opposite. Long story short, the governor's budget grows spending even as it underestimates expected liabilities.

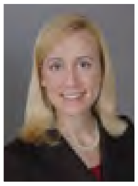
This is the story of Illinois' fall. It is a narrative that your state can and must avoid.

We'd much prefer to tell you the story of Illinois' rise, however, and we have good news to share even now. The failure of government-centric budget "fixes" has opened a new door for liberty-inspired policy solutions in Springfield. Reform ideas that ALEC's Illinois public sector members have long supported are gaining traction.

"What Illinois needs is to reverse its ***decade long culture of spending and deficits****."*

For example, Sen. Chris Lauzen and Rep. Mike Fortner are leaders in the ongoing pension reform debate. Sen. Kirk Dillard is working for greater transparency in spending. Rep. Patti Bellock is coming at the Medicaid crisis from all angles, and Rep. Renee Kosel is advancing legislation to nip the idea of a federal bailout of state debt in the bud. In fact, Rep. Kosel's bill recently passed the Illinois House of Representatives with broad, bipartisan support. This vote signals that Illinois may be ready to take the steps necessary toward fiscal reform.

At the Illinois Policy Institute, we have a bold vision: To make Illinois first in economic outlook and job creation, and to become a free enterprise leader for the rest of America. With good people inspired by Jeffersonian principles, we can turn this state—and this country—around.



KRISTINA RASMUSSEN serves as the Executive Vice President of the Illinois Policy Institute, where she directs the Institute's operations, policy research, and legislative outreach. **TED DABROWSKI** serves as the Vice President of Policy at the Illinois Policy Institute, where he develops and recommends solutions to the state's economic and fiscal problems with a focus on Illinois budget and tax policy, health care, pension reform, education policy and job creation. Both authors are members of ALEC's Tax and Fiscal Policy Task Force.

Greater Economic Freedom is Coming to Oklahoma

BY REP. LESLIE OSBORN (OK) AND SEN. CLARK JOLLEY (OK)

Oklahoma is clearly a state where anyone can experience economic freedom and better enjoy the fruits of their labor. But we believe we should not be just "a" state, but "the" state for such freedoms. So we are working to responsibly phase out Oklahoma's personal income tax.

Oklahoma's economy has improved in recent years as we have increased our appeal to employers and entrepreneurs—job creators. We used to be among the poorest states nationally. Yet, after reducing our state income tax rate while other states raised theirs, we are now beating the national average in many economic indicators. Still, Oklahoma should strive to be not just better, but the very best.

Oklahoma's personal income tax is our biggest obstacle when competing against other low-tax states for business and jobs. However, since repealing the income tax is not a silver bullet guaranteeing prosperity, Oklahoma is also addressing most of the other factors that have held us back. We are now a right-to-work state, we're phasing out our state's death tax, and we're implementing serious tort and pension reforms and agency modernization efforts.

Our focus now is on phasing out our personal income tax, a transformational move that will spark long-term private sector expansion and robust job growth for generations to come.

We know—based on evidence from other states, federal tax policy, and other nations—that incentives matter. People will go where they can receive the greatest return from their work and have access to better opportunities.

Joined by more than 30 of our colleagues, we have introduced legislation this session to phase out Oklahoma's personal income tax without raising or expanding other tax rates or cutting revenues to core government services. At the end of the process, Oklahoma will have the lowest overall tax burden of any state but Alaska.

Our proposal will:

- In 2013, clean up the tax code by eliminating virtually all personal deductions, exemptions, credits and loopholes. This allows for a "revenue-neutral" reduction in the personal income tax rate from 5.25 percent to 3 percent.
- Next, also in 2013, lower the rate further, from 3 percent to 2.25 percent, by trimming a modest amount of nonessential state spending.
- Every year thereafter, lower the rate an additional quarter percentage point, until the tax is fully phased out by 2022.

After 2013, any income tax revenue shortfalls will be offset by dynamic revenue growth. As people in the private sector have more of their own money to invest and spend, and as more job creators are drawn to Oklahoma by our improved tax climate, the increased economic activity within our state's borders will result in increased revenues from other sources.

By phasing out the income tax over 10 years, we allow time for revenue to build up enough to adequately support core services such as education, transportation, public safety, and the safety net for the truly needy.

Our proposal is based on a collaborative study released last year by the Oklahoma Council of Public Affairs, the state's premier free-market think tank, and the econometrics firm of Dr. Arthur Laffer, former advisor to President Ronald Reagan.

Their findings show that under the proposal Oklahomans should see dramatic increases in personal income growth, gross state product growth, job growth, and even state and local tax revenue growth. Unsurprisingly, those who despise attempts to allow people to keep more of their own money say we can't dynamically forecast those impacts.

Yet recent history of tax cuts enacted in Oklahoma exhibits these dynamic effects. For example, prior to cuts in the state personal income tax rate beginning in Fiscal Year 2005, the annual state sales tax growth rate was 2.7 percent the preceding four years. Once the personal income tax cuts began in FY2005, annual sales tax growth for the next five years was 6.6 percent.

Moreover, cuts in the personal income tax rate for FY2007 were projected to cost $150 million, but individual income tax collections actually grew by $305 million, and state sales tax collections grew by $243 million.

As Oklahoma has regularly cut income tax rates over the last decade, growth in sales tax collections has been robust, annually growing to $500 million a year more than before the income tax cuts—even after the recession. This growth has absorbed a majority of the static losses in income tax revenues some had predicted.

It's a historic time in Oklahoma. In her "State of the State" address in February, Gov. Mary Fallin stated that a plan to phase out the state's personal income tax was her top priority.

The goal behind phasing out Oklahoma's personal income tax is simple: Bring robust prosperity to Oklahoma, bring sustained job growth to Oklahoma, and transform Oklahoma into the best economic climate in America. Not just better—the best.

REP. LESLIE OSBORN serves in the Oklahoma House of Representatives. **SEN. CLARK JOLLEY** serves in the Oklahoma State Senate and chairs the Senate Appropriations Committee.

Michigan's Pension Reform Model

BY RICHARD DREYFUSS

In 1997 the pension plan for the Michigan State Employees' Retirement System (MSERS) underwent a significant change as a result of state legislation. State employees who qualified for MSERS and were hired on or after March 31, 1997, were placed in a "defined-contribution" retirement plan (think 401k). Under this system, the state employees were provided with individual retirement savings accounts to which the state government made mandatory contributions and employees could make voluntary contributions.

This retirement savings plan which defines state deposits to the retirement account but not the level of future retirement benefits, stands in contrast to MSERS' ongoing "defined-benefit" pension plan for state employees hired before March 31, 1997. Under that traditional plan, the state government promises employees a defined annual retirement income. To finance these future pension benefits, the state government sets aside money and invests it annually, using the assets accrued over time to pay employees' retirement benefits as they come due. The investment risk for the defined-benefit plan lies with the state—and ultimately, with taxpayers.

In a June 2011 policy brief for the Mackinac Center for Public Policy, I analyzed state pension data to determine if state taxpayers saved money because lawmakers decided to close the MSERS defined-benefit plan to new members and place them in the MSERS defined-contribution plan instead. The policy brief reviewed three areas of potential cost-savings: annual "normal costs," unfunded liability, and "political incentives."

POTENTIAL COST SAVINGS AREA 1: ANNUAL NORMAL COSTS

The "normal cost" of a defined-benefit plan is the annual cost to state government of prefunding the future retirement benefits employees enrolled in the plan earned in that particular year. The average normal cost of the MSERS defined-benefit plan from fiscal 1997 through fiscal 2010—i.e., from the first year of the MSERS transition through the most recent year for which complete data is available—was 8.1 percent of the previous year's payroll. (The previous year's payroll is typically used by the state when measuring this cost.)

In contrast, the state's annual benefits cost cannot exceed 7 percent of the current year's payroll for employees enrolled in the defined-contribution plan. Data from Michigan's comprehensive annual financial reports shows that from fiscal 1997 through fiscal

2010, state government saved a total of $167 million by switching new employees to the defined-contribution plan. This estimate includes an adjustment for the increased normal costs that can result from the closing of a defined-benefit plan.

POTENTIAL COST SAVINGS AREA 2: UNFUNDED LIABILITY

A second potential area of savings involves the defined-benefit plan's unfunded liability. This liability occurs whenever contributing the normal costs proves insufficient to ensure that a defined-benefit plan remains on track to meet its future pension obligations. As of September 30, 2010, the MSERS defined-benefit plan had an unfunded liability of approximately $4.1 billion. This shortfall exists for two reasons. First, the plan's assets have not been growing at the actuarially assumed rate of 8 percent annually. And second, the legislature did not make the annual required contributions needed to finance the unfunded liability once it arose. If new employees had continued to enter the MSERS defined-benefit plan, the plan's unfunded liability would almost certainly have been $2.3 billion to $4.3 billion higher, given a proration based on state data.

Some contend that there is one other cost consideration related to Michigan's unfunded liability. Generally speaking, when a defined-benefit plan is closed to new entrants, as MSERS was in 1997, the Government Accounting Standards Board (GASB) requires that contributions toward reducing the plan's unfunded liability be made on a level dollar basis rather than a level percent of payroll. This will result in higher contributions initially, which some describe as a "transition cost."

However this "transition cost" argument is dubious. The switch to a level dollar amortization pattern does not alter the benefits ultimately paid. Furthermore, the state has generally failed to make the level dollar amortization payments.

Arguably, these higher contribution levels are appropriate. Public sector pension amortization periods are frequently too long. Additionally, contributions are back-loaded. Higher initial contributions to the unfunded liabilities reduce the amount of intergenerational cost transfers — that is, current liabilities are inappropriately shifted to the next generation of taxpayers. To consider these funding reforms as "undesirable costs" — or incorrectly, as "new costs" — mistakenly implies that more timely contribution schedules are fiscally inappropriate.

It is also difficult to argue that the shift to level dollar payments constitutes an extra "cost" from closing the MSERS defined-benefit plan during the years studied. The MSERS defined-benefit plan did not have an unfunded liability when it closed in 1997, and when an unfunded liability later developed, the state usually failed to make the required contributions on that liability. Also of note, the change from level percent to level dollar payments had no impact on the actual benefits ultimately to be paid.

POTENTIAL COST SAVINGS AREA 3: POLITICAL INCENTIVES

A final area of cost analysis involves the change in political incentives that occurs with the creation of a defined-contribution plan. A defined-benefit plan can carry considerable unfunded liabilities, while the legislature can enact retroactive benefit increases and significantly defer necessary funding. Indeed, since proper funding of a defined-benefit plan requires taxing current voters to provide pension benefits that may not be paid out for years, sound funding policy can be unappealing to legislators seeking re-election and hoping to provide visible benefits now.

In contrast, a defined-contribution plan cannot be legally underfunded, and any increase in the plan's benefits must essentially be paid for when the change is made. A defined-contribution plan thus reduces the political opportunities to defer funding of pension benefits to a future generation of taxpayers and avoids placing a questionable burden on taxpayers who may have been too young to vote when benefits were granted and funding postponed. While it is difficult to quantify the savings from improved political incentives, this category may be the single largest area of savings over time.

Designing employee pensions involves more than a traditional debate between defined-benefit and defined-contribution plans. Both types of plans have inherent advantages and disadvantages. For the record, defined-contribution plans have suffered asset downturns over the period studied, as well. Any such losses are the responsibility of the individual participant, however, rather than current and future taxpayers as a group.

Nevertheless, it is reasonably certain that the MSERS defined-contribution plan has cost taxpayers less over the period studied than had this same group enrolled in the MSERS defined-benefit plan. The legislature failed to make the annual required contributions to the defined-benefit plan even after the plan was closed, so it seems unlikely the legislature would have made the larger annual required contributions necessary if the plan had continued to receive new entrants. Thus, continuing only with the defined-benefit plan would have likely placed that plan in worse financial condition than it exists in today; the truly debatable question is the magnitude of the additional unfunded liability.

Thus, from fiscal 1997 through fiscal 2010, the MSERS defined-contribution plan is estimated to have saved state taxpayers $167 million in pension normal costs, $2.3 billion to $4.3 billion in lower unfunded liabilities, and important but unquantifiable sums by improving the political incentives of pension funding. These considerable savings and the fact that the plan is predictable, affordable, and current in its obligations make it a model for reform of other state government pension plans.

RICHARD C. DREYFUSS, a business consultant and actuary, is an adjunct scholar with the Mackinac Center for Public Policy and a senior fellow with The Commonwealth Foundation for Public Policy Alternatives (Harrisburg, PA).

What Is a Budget Shortfall?

BY BOB WILLIAMS

Although there are signs that the worst of the Great Recession is behind us, state governments still face serious budget problems. In order to return to normalcy—not to mention encourage job creation and economic growth—states need to understand and accurately measure their budget shortfall.

What is a real budget shortfall? In order to answer this question, you need to start by defining it. This is not as easy as it sounds—different organizations use different definitions. At State Budget Solutions, we agree with the Cambridge English definition that a "state budget shortfall is the amount of extra money that the government of a state needs because it has spent more money than it received in taxes." On the other hand, however, the Center for Budget and Policy Priorities (CBPP) defines a budget shortfall as "the extent to which states' revenues fall short of the cost of providing services."

Using CBBP's definition distorts the true size of budget shortfalls. CBPP develops the new budget baseline by adding caseload increases and inflation. As a result, CBBP's budget projections fail to show the big picture. For example, CBPP claimed that 42 states have closed shortfalls in 2012, totaling $103 billion, but this figure is not rooted in reality. States certainly faced budget shortfalls in 2012 but it amounted to far less than $103 billion.

Even though the state budget shortfall information developed by CBPP is inaccurate, news media and many national organizations widely cite it. Consequently, state officials believe that the budget shortfalls are much higher than they are in reality. For instance, Washington Gov. Christine Gregoire claims her administration cut more than $10 billion over the past three years. In reality, total state spending in Washington increased by nearly $4 billion during that same time period.

In order to forecast accurate budget shortfalls and to fix the problems causing them, state legislators must realize that the business-as-usual conventional budgeting system no longer works. Instead, legislators should consider using a priority-based budgeting system. By prioritizing state government's key functions, taxpayers can receive effective services at the best possible cost.

PROBLEM: CONVENTIONAL BUDGETING

A conventional budgeting system assumes that all existing spending is necessary. Conventional budgeting also does not consider performance outcome measures or what has actually been accomplished with the current level of spending. This system closely resembles an iceberg, with decade's worth of spending unexamined under the water while the debate rages year after year over the small portion visible above the water's surface. The longer legislators continue to use the cost-plus model, the more "hardwired" their deficit problems will become. The problems get worse when typical budget debates focus on program intentions, not results, and when most of the attention is focused on who spends the money, not who benefits.

Furthermore, conventional budgeting never truly considers how to maximize every tax dollar spent. It does not analyze the efficiency, effectiveness, or necessity of existing state programs or spending. It rarely asks how a service can be improved or purchased differently. It virtually guarantees overspending. Legislators may be able to get away with this in good economic times, but it is unsustainable in the long term. This is the situation many legislators find themselves in today.

Under a conventional budgeting system, legislators begin their budget process by focusing almost entirely on "inputs" (i.e., how much needs to be put in to sustain current programs and expenses). To create their baseline budget, legislators take existing programs, adjust costs for inflation, add caseload increases, and splice in a few new initiatives.

Legislators who use this conventional budget approach become "enablers" for programs that may have outdated or flawed designs, and that may even be providing services or spending resources in direct conflict with lawmakers' policy views. When legislators discover their conventional baseline budget is higher than estimated revenue forecasts, they often focus exclusively on how to fill the budget gaps. Discussion turns towards program cuts, tax increases, and accounting gimmicks until spending lines up with expected revenue.

Addressing long-term disparities in spending and revenue with accounting gimmicks and one-time money sources is a recipe for disaster. Quick fixes may postpone pain for a time, but they do not resolve the deeper, structural problems. Eventually there are no more quick fixes left to try, which leaves two options: Legislators can raise taxes or cut spending. Today, most state economies are too weak to sustain tax increases. Furthermore, as ALEC's *Rich States, Poor States* publication outlines, tax increases come at the cost of state economic competitiveness. Reducing spending is another option, but typical across-the-board program cuts ignore important considerations such as performance outcomes, and may hurt the most vulnerable citizens.

Legislators can choose to continue using broken conventional budgeting systems, which will result in increasing budget gaps and increasingly desperate scrambling for short-term "solutions." Or legislators can accurately account the depth of the budget problem and restructure state spending. It is not really much of a choice. Albert Einstein defined insanity as "doing the same thing over and over again and expecting different results."

SOLUTION: PRIORITY AND REALITY-BASED BUDGETING

State Budget Solutions recommends that legislators take action this year to resolve their serious financial crises by changing their budget focus from inputs to performance outcomes. In other words, they should junk the old conventional model and start designing budgets based on priorities and performance.

These are simple concepts. Priorities are determined by analyzing what the government is responsible for achieving, and measuring how effectively those priorities are delivered (i.e., return on investment). No legislator should get away with advocating tax increases without first being able to clearly articulate the state's priorities and how the state is achieving the best possible results at the best possible price. This is, very simply, the job they were hired by their fellow citizens to do.

HOW IT WORKS

Priority-based budgeting views all of state government—all of its agencies and functions—as a single enterprise. New proposals are evaluated in the context of all that state government is responsible for doing, and the strategies for achieving the best results are developed with an eye on all of the state's resources. Agencies and services are not sealed in fortified towers where they siphon large portions of state revenue with few questions asked; they are all under one tent where they can be constantly evaluated to ensure they are delivering the highest priorities as efficiently and effectively as possible. Nothing is sacrosanct.

Priority-based budgeting assumes the rules can change and barriers can move if that is necessary to maximize results for citizens. It prompts governors and legislators to ask four key questions at the start of each legislative session:

1. What must the state accomplish?
2. How will the state measure its progress and success?
3. How much money does the state have available to spend?
4. What is the most efficient and effective way to deliver essential services within available funds?

Priority-based budgeting serves citizens well by ensuring government delivers essential services as efficiently and effectively as possible. This new budget system maximizes the value of each hard-earned tax dollar, which is an important responsibility of legislators. It also provides a logical place for legislators in cash-strapped states to restructure spending.

Legislators should view the current economic difficulties and resulting budget shortfalls as an opportunity to reform their state budget process from an input system to an outcome and priority-based system.

More information on priority-based budgeting can be found in ALEC's *Budget Reform Toolkit* or at State Budget Solutions' website: www.statebudgetsolutions.org and www.alec.org/toolkit.

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Michigan: A Leader in Tackling State Liabilities

BY REP. ARIC NESBITT (MI)

Ballooning unfunded liabilities for state and local public employee pensions and health care liabilities total more than $3.1 trillion nationally. As states continue to face fiscal challenges from overspending and economic uncertainty, dealing with these long-term unfunded liabilities will require true leadership and long-term thinking. Whatever the cause, it is clear that reform is necessary in order for states to remain solvent. Failure to address unfunded pension liabilities will result in higher taxes, less money in classrooms and a diminished state credit rating, which will increase government spending on interest costs.

In Michigan, the reform process began in the late 1990s when the state embarked on efforts to stem the tide of unfunded liabilities. The thrust of these earlier reforms meant transitioning state employees over to 401(k) defined-contribution plans by having all new state employees participate in these pre-funded, personal retirement accounts instead of the old unfunded, defined-benefit pension plans. Currently, about half of Michigan state workers are in 401(k) style defined-contribution plans, like most of the private sector. The Mackinac Center for Public Policy estimates that these reforms have saved the state nearly $4 billion in unfunded liabilities.

Though Michigan accomplished great pension reforms, the fiscal problems relating to public employee health benefits in retirement had yet to be addressed. Last year, Michigan's governor Rick Snyder issued a Citizen's Guide to Michigan's Financial Health, citing nearly $50 billion in unfunded long-term liabilities for the state and identifying key areas in which reform is needed. For instance, state employees' retiree health care was a pay-as-you-go system, but this system put massive stress on the state's fiscal stability. With rising health care costs and the former administration's short-term budget solution of one-time accounting gimmicks and early retirement for state employees, Michigan was facing increasing problems and pressures to reform the system. One symptom was that retired state employees were only required to pay 10 percent of the cost of their retirement health care benefits, and the state's share was not pre-funded. At the same time, private sector benefits across the state decreased and those who had employer sponsored plans paid three times the amount paid by retired Michigan public employees for their health insurance. The state of Michigan spent nearly $387 million in state employee retiree health care benefits this past year, up a staggering 133 percent from merely a decade ago.

One of the major goals of Michigan's new leadership was to cut into the tens of billions in unfunded liabilities that still existed. Thankfully, House Bills 4701 and 4702 were proposed to help Michigan pay down the huge debt accrued by previous administrations. One major component of these bills was to transition state employees from defined-benefit retiree health care benefits to defined-contribution benefits through health retirement accounts (HRAs). This means employees participate in saving for their retirement health care and the state provides matching funds. Such plans operate like the popular medical savings account, but are specifically for retirement health care.

The two bills enacted last year deal with the nearly $14 billion in unfunded liabilities for the state's public employee retiree health care at last. The statutes require state employees who were still in defined-benefit plans to contribute to the funding of their pensions, and introduced a new retiree health care reimbursement program by creating HRAs. Those in the defined-benefit plan were offered a choice: they could remain in the pension system and contribute 4 percent of their salary to the fund or enter into the defined-contribution system (401k). This reform helps encourage those who remained in the under-funded defined-benefit pension plan to pay into the plan, something that was not required in the past. This also helps to stabilize the system for current and future retirees by increasing payments into the system, while allowing those who are near retirement to continue to plan for their retirement without a drastic change to their expected benefit.

The HRAs created by these bills mean employees hired after January 1, 2012, no longer receive traditional state-funded retiree health insurance. Such benefits had placed $14 billion in unfunded long-term costs on Michigan taxpayers. Now instead of payments toward traditional premiums, the state will match 2 percent of an employee's salary for their new HRA. Beyond fixing Michigan's long-term unfunded liabilities problem, these HRAs have several benefits

It took courage to make reforms now and invest in long-term savings and fiscal sanity, but it was necessary.

to employees. The most important is that retirees will have a broader range of insurance and medical provider choices in the open market rather than the very limited options available in the previous system of state-sponsored health insurance. Also, this provides employees the opportunity to take their savings for retirement health care with them if they switch jobs, making it their money. These two bills passed the House along party lines and all but three Republicans supported it in the Senate. Gov. Snyder then signed the bills in December 2011 (PA 264 and 265).

With the stroke of a pen, Gov. Snyder and the Michigan legislature immediately eliminated $5 billion in unfunded liabilities, while also creating the path to eliminate an additional $9 billion of unfunded retiree health care liabilities over the next 25 years. Paying down debt and unfunded liabilities are hallmarks of the current legislature.

This reform reflects exactly what needs to happen in all levels of government. One size fits all pensions and other retiree benefits of the past resulted in unsustainable debt. This is the system leading states that refuse to embrace reform toward insolvency. We have seen several countries in Europe refuse to confront these long-term liabilities, along with several states in the United States, and we see the results. But Michigan is headed in another direction. We are providing a blueprint for public employee reforms to better provide certainty to civil servant retirees and prevent mounting fiscal pressures on the state. The economic reality is that government grew too large over the past several decades, and it is our generation's responsibility to make it the right size for the well-being of our children and grandchildren. This will prevent future tax increases, sustainably fund core state services, and help increase the state's credit rating. In fact, Fitch Credit Ratings has already given Michigan a positive outlook in its credit rating in response to many of the legislature's reforms.

The Michigan legislature led and took its own medicine first by ending retiree health care for legislators and adopting 401(k) style plans like the private sector. But even with these far-sighted reforms addressing long-term liabilities, there remain large problems. This is a reform process. A lot has been accomplished toward fixing Michigan's long term liability issues and saving taxpayers billions of dollars, but more is required.

For example, the state's education community is still in the old defined-benefit pension plans with unfunded liabilities amounting to more than $17.6 billion, according to the Mackinac Center. The result is that local school districts have to pay an additional 24 percent of employee salaries into the state pension fund for public school employees, the Michigan Public School Employees Retirement System (MPSERS). This number is expected to increase to 27 percent next year. In the 1990s, when the legislature passed the transition to defined-contribution for state employees, it did not have the votes to deal with the unfunded liabilities among public school employees.

Today, legislative work groups continue to meet as the legislature and the administration deal with these long-term liabilities. The results of these groups should produce a reform package later this year. Between the last budget and the current budget proposal $330 million has been set aside to help pay for the upfront transition cost to the new system. Instead of handing money directly into the educational establishment, this will help keep teachers on the job, and get dollars into the classrooms, by lessening the financial pressures on local school districts and the long-term fiscal health of all school districts across the state by containing pension costs.

It took courage to make reforms now and invest in long-term savings and fiscal sanity, but it was necessary. These decisions must be made today to avoid future generations being burdened with crushing debt and insolvency tomorrow.

As we know, any change effecting pay and benefits is a challenge. Yet if states don't start addressing unfunded liabilities today, these will become even more expensive, more entrenched, and more difficult to reform. One need only look to the federal level, where they continue to avoid making the needed reforms to entitlements as costs escalate and tough decisions become tougher. Courage is required and Michigan's political leadership is answering the call. I encourage other state legislators to step up and work on addressing these huge generational costs.

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Why America Needs A Balanced Budget Amendment

BY CONGRESSMAN ALAN NUNNELEE

"I wish it were possible to obtain a single amendment to our Constitution. I would be willing to depend on that alone for the reduction of the administration of our government; I mean an additional article taking from the Federal Government the power of borrowing." - Thomas Jefferson

During my three years as Appropriations Chairman in the Mississippi Senate, we balanced the budget every time. We did so because we believed putting our bills on a credit card for the next generation to repay was not the right thing to do. I believe that men and women all across America are making tough decisions in their family budgets, and they have every reason to expect the same thing of their government. When challenged, my response was that families and businesses are making tough decisions and state and local governments are living within their means; Washington needs to do the same.

One of the primary goals of this historic freshman class was to change the culture in Washington. I believe we have succeeded so far by changing the conversation from "how much can we spend?" to "how much can we cut?" One tool that is not in our arsenal is a requirement that the budget must be balanced. As a result, the tough choices between how much to tax and how much to spend often do not get made because there is a third option available to borrow or print the money.

In the case of true national emergency and war, some borrowing by the federal government can certainly be justified, just as infrastructure bonds can be a prudent use of borrowing at the state level. The problem today is that these are obviously not the only things Washington borrows money for; we punt on the tough decisions. We could have a healthy debate about taxes and spending if the American people actually felt the costs of all federal spending. One side may argue that we need more money for a certain program. The other side may oppose tax increases. Too often we borrow the money so the liberals get their spending, the conservatives prevent the tax hike, and everybody gets to declare victory.

States are the great laboratories of democracy, and the difference between budgeting in Washington and in the states could not be starker. Across the country, governors and state legislatures are proving that budget deficits can be brought under control with innovative reforms and fiscal discipline. The structural reality of balanced budget requirements strengthens the hand of fiscal conservatives. We can make our case to the taxpayers and say, "We have two choices: cut spending and find ways to make government smarter, or raise your taxes." The pain cannot be delayed and the tough choices papered over when you must balance the books.

America needs a balanced budget amendment. There is much debate about what exactly it would entail. For example, it is important to not structure the amendment in a way that activist judges could use it to force tax increases. However, a well-written constitutional amendment would stack the deck in favor of fiscal restraint and limited government in much the same way that current "baseline budgeting" rules rig the game in favor of ever higher levels of spending.

We do not cut spending for sport; we do so because we know that smaller government and low taxes are essential to a strong economy and a free people. As ALEC's "*Rich States, Poor States*" so aptly points out, states with sound fiscal management, low tax rates, and business friendly regulatory climates are recovering from the recession much more successfully than others. States that either ignore their balanced budget requirements or choose to raise taxes are facing a much tougher time, but the genius of our federalist system allows people to see the difference between the two approaches.

States can and must play a critical role in ensuring the fiscal stability of the country. Balancing budgets, enacting necessary reforms, and cultivating the next generation of leaders are just some of the critical functions of state capitols from coast to coast. Effective, conservative governance at the state level strengthens our republic and the case for similar approaches at the national level.

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