Fiscal Health Through Fiscal Restraint: A Lesson From New Jersey

A JOINT ECONOMIC COMMITTEE REPORT

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Abstract

For the first time in a generation, the federal government and many states are faced with the possibility of budget surpluses. With this possibility, policy makers will be tempted to raise the line on government spending. Using a lesson from New Jersey, this report cautions against such policy and examines the potential economic effects of reducing taxes and restraining government expenditures.

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INTRODUCTION

The federal government is entering a startling period of unprecedented budgetary prosperity. For the first time in a generation, the federal budget is likely to be very near balance with a small budget surplus. For policy makers, this is the first opportunity to make budgetary decisions without the constraint of a large deficit. Faced with the prospect of a zero deficit, policy makers may be tempted to increase spending and expand programs faster than when they were faced with deficits. Increasing the rate of growth of government through unwarranted spending is fraught with potential problems that may undermine the current healthy economy.

The same budgetary scenario is faced by many state and local governments. The same healthy economy that produces a large revenue stream for the federal government also fills the coffers at the local and state level. These localities are also faced with the temptation to rapidly increase expenditures.

The lessons of economic history warn against a large increase in government expenditure. Our current economic expansion is partly the result of sound economic budgetary decisions made in the 1980s. The federal government decided to lower taxes and slow the growth of spending. The result is 15 years of economic prosperity, the longest in American history. State governments have, in many instances and with similar results, lower taxes and restrained expenditures. A good example is New Jersey.

A NEW JERSEY EXAMPLE

In 1993, Christine Todd Whitman ran for the governor of New Jersey on a campaign promise to lower income taxes by 30 percent. Soon after taking office, she began to implement her tax-cut promise. Along with her commitment to lower taxes, she also pledged to restrain the growth of state spending. Under the previous New Jersey governor, Jim Florio, appropriations grew at an average annual rate of 6.3 percent. If Whitman had maintained that level of growth in state expenditures, she would have been faced with large deficits, or she would have been forced to abandon her tax-cut pledge.

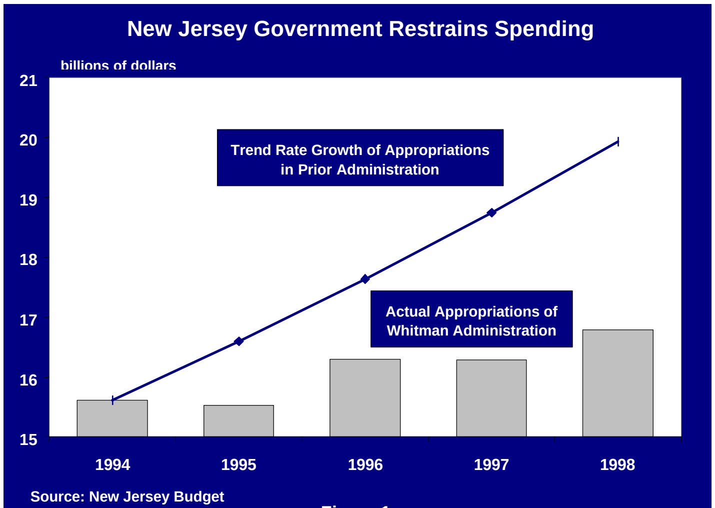

Figure 1

Figure 1 shows the difference between the prior trend of spending and actual spending by the Whitman administration. Current expenditures are $3 billion less than the prior administration's trends. In Whitman's first term, appropriations grew at an average annual rate of merely 1.8 percent. With tax cuts and spending restraint, how has the economy of New Jersey performed?

NEW JERSEY'S ECONOMY

The paradox of government spending is that restraining current government spending will allow for economic growth that will provide greater government revenues in the future. New Jersey helps illustrate that example. With lower tax rates on corporations and individuals, New Jersey policy makers were faced with the necessity of controlling government expenditures. In the budgets immediately following the tax cut, appropriation levels were restrained; however, the short term budgetary consequences do not tell the whole story.

When New Jersey lowered corporate and personal income tax rates, the cost of living and doing business in New Jersey fell. These lower costs signaled to businesses and individuals that their current income would produce greater profits and well being. These signals induced more businesses and families to make New Jersey their home. The increase in business activity increased the jobs available in New Jersey and generated higher tax revenues.

The economy of New Jersey has performed in a manner that justifies the predictions that were made by supporters of lower tax rates. During the 1990 recession, New Jersey was particularly hard hit partly because of the tax increases enacted by the government. The unemployment rate in New Jersey soared to above 9 percent. For the rest of

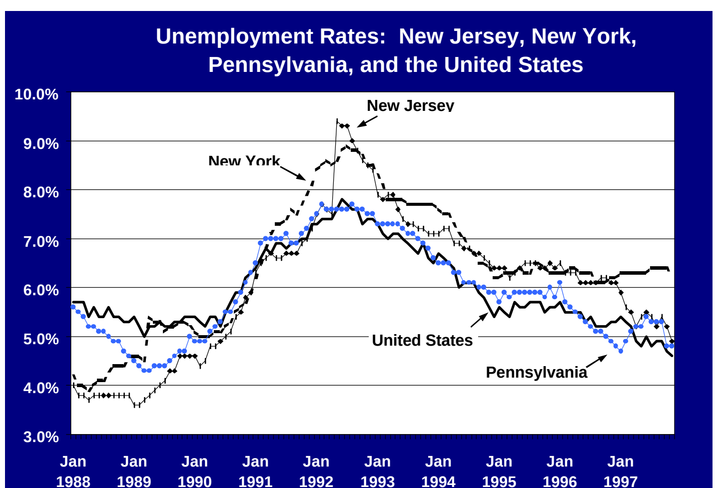

Figure 2

the United States, the recession was relatively minor with the unemployment rate only reaching 7.8 percent (see Figure 2). The other states in the mid-Atlantic had different experiences. New York was similar to New Jersey with rapidly rising unemployment, but Pennsylvania had an unemployment rate that was relatively better when compared to its neighbors. Now New Jersey is experiencing growth in employment and personal income. New Jersey looks even better when compared with its northeastern neighbors. The New Jersey unemployment rate is currently below 5 percent. Businesses are relocating to New Jersey and business incorporations are high (see table).

U.S. BUSINESS RELOCATIONS (1991-95)

Rank*	State	Business Net Gain
8	New Jersey	591
49	Pennsylvania	-510
53	New York	-3,561

*Includes Puerto Rico, Virgin Islands, and District of Columbia

Source: Dun and Bradstreet

With this positive economic news, policy makers appear to have an easy time making budget decisions; however, there is a large, potential problem. With high revenues, governments are tempted to increase state expenditures. However, increasing state expenditures will kill the golden goose. Expenditure restraint leads to a healthy economy which will increase the resources available to the government. When government increases expenditures, the results are to dampen the economy, lower tax receipts and provide fewer resources for the government. The paradox of government finance is that over the long run, the government can provide more services if it restrains current spending. That is the problem facing the state of New Jersey and the federal government. After years of fiscal restraint, tax cuts and a healthy economy can policy makers maintain fiscal discipline to keep the golden goose, the American economy, alive?

INSTITUTIONAL BARRIERS TO LARGE GOVERNMENT

Government at all levels rapidly increased their size and scope in the twentieth century. New Jersey is not an exception to this trend. However, with the success of Whitman's program to lower taxes, many people want to insure the gains from lower taxes will continue. Whitman has proposed an institutional safeguard to fight against the trend of ever-expanding government. She proposes to limit the ability of local and state governments to raise revenues.

At the local level, Whitman proposes to require that local governments receive voter approval for any tax increase that exceeds the rate of inflation. At the state level, she proposes to require a super majority, two-thirds of each house of the legislature, to raise revenues. If her proposals were enacted in the previous administration, Jim Florio, the previous New Jersey governor, would not have been able to enact his tax increase. Florio's tax increase was enacted while New Jersey was in the midst of a harsh recession. Government should take exceeding care not to further harm the economy.

Institutional safeguards to make taxing citizens more difficult for government would compel it to focus on efficiency and providing core services. Reducing the growth of government helps the economy. New Jersey is a prime example of the benefits of slowing the growth of government.

WHY LOWER SPENDING?

There are two major reasons why less government spending benefits society. First, lowering government spending means that the government will require less taxes now and in the future. Taxes on income, at the margin, reduce the activities that produce income. Labor supply will decrease. Workers may refuse overtime hours. High income earners, like lawyers, doctors and executives, may take remuneration in the form of perquisites or increase vacations. Higher taxes encourage the creation of investment vehicles to shield income so that investment decisions are based upon tax considerations, not economic efficiency. Individuals and corporations will be less likely to save if interest income is taxed. Lower tax rates encourage work, savings, and investment.

Beyond the tax argument, lower spending is an economic benefit even if taxes are not lowered. As taxes discourage activities that produce income, government spending will encourage activities that increase the likelihood that government services are spent on certain constituents. The increase in activities to increase government spending and sway government spending decisions has two problems.

First, the economy suffers losses in efficiency when the public sector grows. Economic efficiency is a process where goods and services are sold at the prices and quantities determined by supply and demand at the lowest possible cost. However, economic efficiency is difficult to determine because supply and demand for a good or service cannot be observed rather, the firm infers efficiency through price and profit signals. Rising profits are a signal to entrepreneurs that they are operating closer to efficiency than when the firm's profits are falling. Falling profits signal entrepreneurs that either costs need to be controlled or the consumer no longer wants the good or service at the price requested by the firm. These price and profit signals are vital to a dynamic, expanding economy. Unfortunately for government policy makers, profit signals require the private market. Without the information provided by the market, the government may produce too many services or excessively costly services.

Second, government spending begets more government spending. High government spending creates an industry that seeks larger and larger government budgets. The process of paying for and providing government services is biased against limiting government spending. The benefits of government services are concentrated while the costs are diffused. The costs of government services are spread across all taxpayers. For example, the National Endowment of the Arts (NEA) cost per taxpayer is very small yet the benefits accrue to a small group of artists and their supporters. The general public receives little benefits from the NEA. The attempt to eliminate the NEA rallied the small group of beneficiaries. Opposition by taxpayers to eliminate the NEA was not worthwhile because the tax-rebate value of eliminating the NEA is very small.

CONCLUSION

The federal government and many states are faced, for the first time in a generation, with budget surpluses. Many government officials are tempted to increase government spending to take advantage of the unexpected revenues. However, caution needs to be exercised.

The government of New Jersey demonstrates that restraining government spending lays the framework for a healthy economy, an economy that generates large revenues for the government. The prudent course for the future requires increased vigilance against unwarranted government expenditure.

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