

## Letter from America: Red Ink and Redistribution

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The dismantling of the Bush administration's economic team is now complete, with the resignation of Glen Hubbard as Chairman of the Council of Economic Advisors, who will return to his position at Columbia University. Hubbard was the architect of the administration's current budget proposal, whose centerpiece is the abolition of taxes on dividends. Remarkably, this measure is being sold as the centerpiece of an economic stimulus package. Republicans are referring to it as the "Jobs and Growth Tax Act" and minimizing its distributional effects by the identification of various worthy groups of beneficiaries, such as the elderly. Hubbard will be replaced by Greg Mankiw, of Harvard, a distinguished macroeconomist and well-known textbook author. The media have been enjoying the traditional sport of digging up published positions that might prove currently embarrassing. In earlier (but not current editions) of Mankiw's principles text, he refers to the tax cutting policies of the Reagan administration as "fad economics," promoted by "charlatans and cranks," charlatans and cranks who have in the last few days been denouncing Mankiw's nomination. The economic theories of the Reagan era are certainly making a comeback in Washington. Deficits are of no consequence, and indeed are welcomed by many on the right as the only effective discipline against spending. President Bush has been enunciating a doctrine that, if not the Laffer curve, appears indistinguishable from it. The new economics team, including Mankiw, all have previously opposed this sort of economics, but it is unlikely that we will hear them expounding these views for some time, or indeed that there will be any change of policy as result of their appointments.

Meanwhile, at the end of February, the Governors of the 50 states assembled in Washington for their annual meeting where the main topic of their discussions was the most severe fiscal crisis for half a century. Deficits in the statehouses are different from the deficits in Washington. No matter what their politics, state politicians are in no position to sit back and enjoy their deficits, because the majority of states have constitutional provisions requiring their budgets to be balanced. Governors all over the US are scrambling to do so, by every sort of accounting gimmick that they can think of (though these are mostly exhausted by now), in a few cases by raising taxes (although only at the last ditch; even left-leaning governors are likely to be voted out of office if they raise taxes), and in nearly all cases by cutting expenditures.

The states face both structural and short term difficulties. In the long term, there is a growing imbalance between states sources of revenue and their expenditure commitments. Most states are dependent on sales tax for a substantial fraction of their revenues; there is no general national sales tax in the US, and competition between the states keeps sales taxes relatively low, less than ten percent. But sales taxes do not cover services, which are a growing share of the economy, nor are sales over the Internet effectively taxed, at least if an online merchant sells to a consumer in a state where the merchant has no physical presence. (If I buy a book from Barnes and Noble, I pay sales tax, because Barnes and Noble has shops in New Jersey. If I buy it from Amazon, no tax is levied by the retailer, and although I am supposed to pay the tax to the state when I file my state tax return, such taxes are rarely collected.) The lost internet taxes are calculated to be around \$13 billion a year, not large in terms of total states' budgets, but a substantial share of the current projected deficit of \$55 billion. On the expenditure side, states (or smaller localities) are responsible for almost all of education expenditure, as well as for a substantial share of government spending on health. Much of the latter is through Medicaid, a federal program that covers healthcare expenditures for people with low incomes, and whose financing is the joint responsibility of the states and the centre. The rising costs of healthcare for an aging population is one of the great fundamentals shaping American political economy.

The state of the economy and the behavior of the stock market are major immediate reasons for state woes. Like many individuals, state governments seem to have believed that the stock market boom was permanent, and increased expenditures and cut taxes in that belief. And, as with private firms, there was a good deal of creative accounting based on booming markets, and the backing for several contingent liabilities (such as state pensions, or state insurance funds) were switched into the market. As the gains undo themselves, the schemes that generated money are contributing to the deficits. Several states have become heavily dependent on capital gains taxes, revenue from which is currently in extremely short supply. And there are less obvious problems: the state of New Jersey is under pressure to help meet the costs of rising malpractice

insurance for doctors, who claim that the enormous rise in their premiums are a result of insurance companies recouping their stock market losses. (Others note that doctors kill and maim large numbers of people, that states rarely discipline bad doctors, or that it's really all the fault of the trial lawyers and their influence in the Democratic party.)

In the end, there will certainly be large cuts in state expenditures, particularly on health and education. The education cuts will further disadvantage state universities relative to private ones. Fees at state universities matter to state legislators and are kept low, so that tuition at a top state university costs about a fifth as much as tuition at a top—or not so top—private university. A resident of Wisconsin who attends the world class state university at Madison would pay \$4,426 for tuition, but \$27,830 if he or she came to Princeton, and \$19,240 at Rider University in nearby Trenton, New Jersey, a less well-known private university. Well-off property owners will bear some of the burden as local municipalities raise property taxes to offset decreased state support for schools. But the cuts in Medicaid spending will affect the poorest. Medicaid is the only source of funding for long-term health care for the elderly—provided they have spent down their assets—as well as for prescription drugs for those on low incomes. And the federal government is offering to lend the states money for Medicaid—an almost irresistible offer in current circumstances—in exchange for moving to a system of block grants in which states will face the full marginal cost of such care. The funds from the tobacco settlement, which were earmarked for healthcare, are being converted to general revenue. In one of the more remarkable schemes, Governor Pataki of New York has proposed closing part of this year's \$11.5 billion shortfall, not from the tobacco money itself, which is only \$420 million a year, but from capitalizing the revenue into a \$4 billion dollar bond issue guaranteed by the inflow from the tobacco settlement, itself funded by taxes on cigarettes smoked by people with below average incomes.

In Washington, there will be deficits for many years to come, in part in response to a weaker economy, but mostly as the result of tax cuts whose beneficiaries are typically very well-off. In the states, most deficits will be closed in a way that protects those who are benefitting from the federal tax cuts. There is no such protection for the elderly, the poor, and the sick.

*Angus Deaton's Letter from America appears every six months in the Royal Economic Society's Newsletter. For more information, visit <http://www.res.org.uk/society/newsletters.asp>.*

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