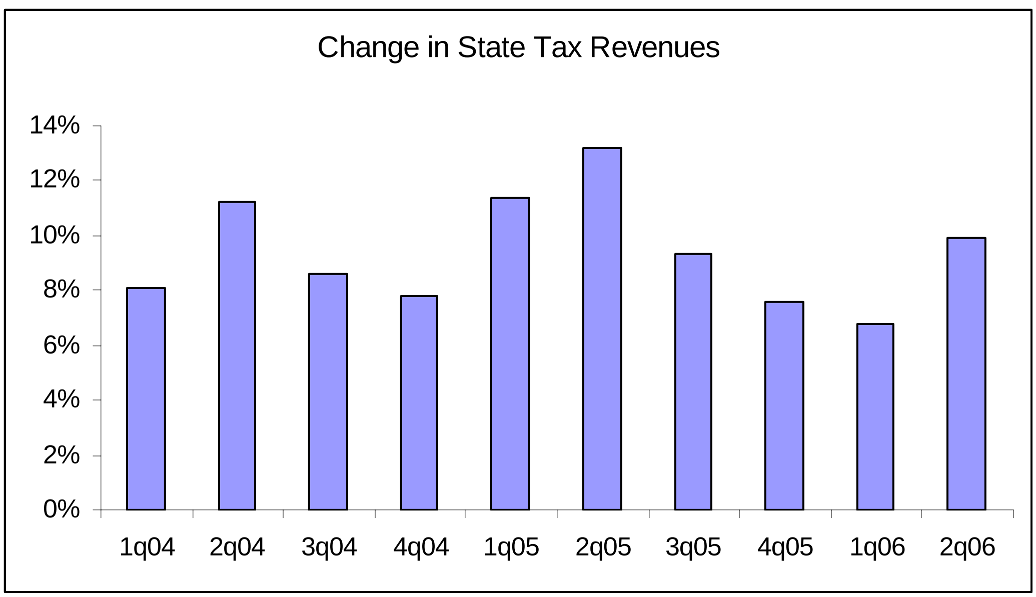
Kudlow's Guest Commentary

Download Options

Another Chapter in the Greatest Story Never Told

September 28, 2006
Thomas E. Nugent* (203) 228-5050

As Americans begin the process of evaluating politicians who might represent them for at least the next two years, consideration should be given to the results of the Bush tax cuts--not only federal tax revenues but also on state and local balance sheets. For many voters, the federal budget deficit is not a cause for immediate concern about individual wellbeing. However, when falling tax revenues force state and local governments to eliminate support programs for local folks, voters take notice. Politicians planning a strategy for either gaining or returning to office this November should pay close attention to the positive impact of the Bush tax cuts on state governments and campaign accordingly. One academic study provides the story for reelection.



Source: Nelson A. Rockefeller Institute of Government

Each year, the Nelson A. Rockefeller Institute of Government, the public policy research arm of the State University of New York, analyzes the financial situation for each of the fifty states. While the latest report through the second quarter of 2006 has not yet been published, the Wall Street Journal was able to provide some important statistics from that expected publication. The substance of these numbers reinforces the effects of the economic boom that has been occurring at the national level. For example, state tax revenues rose nearly 10% in the second quarter of 2006 over the year earlier period. This is not a one-time event. Since the first quarter of 2004, year-over-year percentage gains in state tax revenues have been outstanding.

Even though some state governments are emulating the Bush tax cuts, the Rockefeller report reveals that, "revenues continued expanding even though states enacted net tax cuts during the quarter." In other words, the combination of lower taxes at both the state and local level coincide with higher state tax revenues. The Laffer Curve is alive and well at the state level.

Not only are some states cutting tax rates, but they are also simplifying their tax structures as well. For example, Utah is proposing a dual state income tax system whereby individuals can either choose a complex tax calculation rate or a flat tax rate as the basis for paying state income taxes. Reducing or simplifying taxes at the state level is bipartisan. In July of 2006 Rhode Island, dominated by a Democratic legislature, adopted one of the most sweeping tax reforms. Like Utah, residents can choose a flat tax that cuts the top rate to 5.5% from 9.9% if the taxpayer gives up deductions. According to the WSJ, Rhode Island Democrats cut taxes because "our high tax rates make us uncompetitive."

Other Democratic governors have a similar vision: both governors in Arizona and in Oklahoma have cut income tax RATES albeit somewhat hesitantly while Governor Richardson of New Mexico has cut marginal income tax rates from 8.2% to 4.9% as well as cutting the capital gains tax rate in half. Governor Richardson's rationale: "After all, businesses move to states where taxes are falling, not rising." Incidentally, New Mexico's revenues have risen 27% this year, faster than any other state over the past year according to the Rockefeller Institute. (This guy Richardson could be the dark horse presidential candidate in 2008 if he keeps doing what he's doing!)

Even Massachusetts may be undergoing a transformation. Of the three candidates for governor, two are proposing cuts in the state's flat income tax rate to 5%. Surveys indicate that over 55% of Democratic primary voters support the tax relief plan (shades of JFK). There is a good reason for the Massachusetts tax cutting mentality; tax receipts have climbed 31% since 2003.

Discussions over taxes at the national level seem to fall along party lines: Republicans want to extend the Bush tax cuts; Democrats do not. Charles Rangel, the prospective chairman of the House Ways and Means Committee, said that if Democrats win the House in November, he has no interest in renewing the Bush tax cuts. On the other hand, Republicans continue to press for tax reform and lower tax rates.

Politicians have little time left to attract voters before the November elections. The strongest argument each incumbent must make for reelection is the positive impact of the Bush tax cuts on both the national and local economies. They must also emphasize the fact that most Democrats running for national office won't admit or don't understand that the extension of Bush's tax cuts will keep state government coffers overflowing.

Democrats at the national level resist cutting tax rates even in light of the Bush expansion and the demonstrated successes of Democratic governors who "get it." Additional tax rate cuts at the national level would make the U.S. even more competitive—as many governors already know. Yet, at the national level, tariffs and trade restrictions authored by Charles Schumer and Lindsay Graham are making the rounds. Such policies are not only protectionist but also contribute to a slowing economy.

Republicans have a unique opportunity to play the strong state economy card to maintain or increase their dominance in the House and Senate—and this is another chapter in one of the greatest stories never told!

Thomas E. Nugent is chief investment officer for PlanMember Financial Corp. and a principal of Victoria Capital Management

Kudlow & Co. LLC	**Lawrence Kudlow, CEO**
1375 Kings Highway East	Susan Varga, COO
Suite 260	John Park, Economic Associate
Fairfield, CT 06824	Dan Holland, Research Associate
203-228-5050 (p) 203-228-5040 (f)	www.kudlow.com