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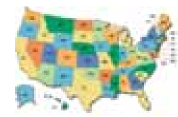
SPECIAL SERIES | Dealing with Deficits: How States Can Respond



BUDGET CUTS OR TAX INCREASES AT THE STATE LEVEL:
Which Is Preferable During an Economic Downturn?

By Nicholas Johnson

Most state economies are struggling. Even if the United States as a whole is not already in a recession, recession-like conditions exist in many states. For example, the research firm Moody's Economy.com argues that 30 states are in recession and another 19 states are at risk of recession.

Economic problems are making it difficult for many states to maintain balanced budgets, as nearly all of them are required to do by law. Roughly half the states have already reduced spending and/or raised revenue to bring their budgets for the current fiscal year into balance, and additional states have indicated they will need to do so to maintain budgetary balance for the current fiscal year and/or the next fiscal year. The budget gaps that will need to be closed in the coming fiscal year could be in the range of $100 billion or more.[1]

The combination of a weak economy and projected budget shortfalls is posing a major challenge for state policymakers: How can they balance their states' budgets with the *least possible harm* to already damaged state economies? One answer is to draw down reserve funds, if possible. Another answer is to seek assistance from the federal government. Those options will help, but are unlikely to solve all of states' problems. Some number of states will have to either (a) cut spending, (b) raise taxes, or (c) enact a combination of tax increases and spending cuts to keep budgets in balance.

Policymakers sometimes contend that the weakness of the economy means that a state should rely solely on cutting spending, rather than raising taxes. The aversion to raising taxes during a recession, however, rests on a misconception of economic effects.

Two highly regarded economists — Nobel Prize winner Joseph Stiglitz of Columbia University, and Peter Orszag, now the director of the Congressional Budget Office — wrote during the last recession that spending cuts could actually be *more* harmful for a state's economy during an economic downturn than tax increases. This assertion still holds true, whether or not the nation is deemed to be in an official recession.

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[1] Elizabeth C. McNichol and Iris J. Lav, "State Budget Troubles Worsen," Center on Budget and Policy Priorities, available at http://www.cbpp.org/9-8-08sfp.htm.

In their analysis (the full text of which is available at http://www.cbpp.org/10-30-01sfp.htm), Stiglitz and Orszag wrote:

"[E]conomic analysis suggests that tax increases would *not* in general be more harmful to the economy than spending reductions. Indeed, in the short run (which is the period of concern during a downturn), the adverse impact of a tax increase on the economy may, if anything, be smaller than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption. For example, if taxes increase by $1, consumption may fall by 90 cents and saving may fall by 10 cents. Since a tax increase does not reduce consumption on a dollar-for-dollar basis, its negative impact on the economy is attenuated in the short run. Some types of spending reductions, however, would reduce demand in the economy on a dollar-for-dollar basis and therefore would be more harmful to the economy than a tax increase….

"Basic economy theory suggests that direct spending reductions will generate more adverse consequences for the economy in the short run than either a tax increase or a transfer program reduction. The reason is that some of any tax increase or transfer payment reduction would reduce saving rather than consumption, lessening its impact on the economy in the short run, whereas the full amount of government spending on goods and services would directly reduce consumption….

"The more that the tax increases or transfer reductions are focused on those with lower propensities to consume (that is, on those who spend less and save more of each additional dollar of income), the less damage is done to the weakened economy. Since higher-income families tend to have lower propensities to consume than lower-income families, *the least damaging approach in the short run involves tax increases concentrated on higher-income families.* Reductions in transfer payments to lower-income families would generally be more harmful to the economy than increases in taxes on higher-income families, since lower-income families are more likely to spend any additional income than higher-income families. Indeed, since the recipients of transfer payments typically spend virtually their entire income, the negative impact of reductions in transfer payments is likely to be nearly as great as a reduction in direct government spending on goods and services.

"*For states interested in the impact only on their own economy rather than the national economy, the arguments made above are even stronger*. In particular, the government spending that would be reduced if direct spending programs are cut is often concentrated among local businesses…. By contrast, the spending by individuals and businesses that would be affected by tax increases often is less concentrated among local producers — since part of the decline in purchases that would occur if taxes were raised would be a decline in the purchase of goods produced out of state. Thus, more of the reduction in purchases that results from tax increases than from government budget cuts falls on out-of-state goods (relative to in-state goods), lessening the adverse impact of a tax increase on the state economy. Reductions in direct government spending consequently could have a larger adverse impact on a state's economy than tax increases, which have a stronger adverse impact on out-of-state goods and services.

"The conclusion is that, *if anything, tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run*. Reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, are likely to be more damaging to the economy in the short run than tax increases focused on higher-income families.

In any case, in terms of how counter-productive they are, there is no automatic preference for spending reductions rather than tax increases."[2] [emphases added]

As legislatures approach their 2009 sessions and begin to consider how to balance their budgets in difficult economic times, they should take seriously the Stiglitz-Orszag admonition that tax increases, particularly tax increases on higher-income families, may be the best available option.

[2] Peter Orszag and Joseph Stiglitz, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?" Center on Budget and Policy Priorities, revised November 6, 2001.