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FISCAL STIMULUS AT THE STATE LEVEL?

By Nicholas Johnson

Policymakers in many states are proposing tax cuts or rebates that they hope will “stimulate” their economies. Such proposals have been issued by governors and/or leading legislators in Alabama, Arizona, Connecticut, Florida, Illinois, Pennsylvania, and Wisconsin, among others. The proposals vary, but many are modeled at least partially on the business tax cuts and individual rebates contained in the federal economic stimulus package enacted earlier this month. And many advocates of such proposals explicitly cite the federal stimulus bill — and its widespread, bipartisan support — as a reason to support such a plan in their state.

But state tax cuts would do little or nothing to boost a state’s economy. In fact, they reflect a misunderstanding of how state governments can best respond to a recession. A state that attempts economic stimulus akin to what the federal government has enacted will experience some or all of the following:

- **Diminished state funding for services (or increased taxes).** States, unlike the federal government, must balance their budgets. Therefore, *for every dollar a state spends on new tax cuts, it must cut state spending (or raise other state taxes) by a dollar.* That means less money for important services such as education, health care, transportation, and public safety — more specifically, less money for teacher and police salaries, road maintenance, and payments to doctors and hospitals. As described below, this can be the case even if the state is using reserve funds or accelerating future revenues to finance the tax cut.
- **No net benefit to the economy.** People who receive a state tax cut will have a bit more money to spend, but the teachers, construction workers, and health-care workers who lose their jobs or contracts with the state as a result of cutbacks in services will have much less to spend.
- **The risk of a net *loss* to the state economy.** Cutting services to finance a poorly designed tax cut or rebate can actually harm a state economy. This is because cuts in state services will generally reduce overall demand on a dollar-for-dollar basis. But tax cuts will not *increase* overall demand on a dollar-for-dollar basis, because taxpayers (especially those with higher incomes) will save rather than spend part of any tax cut they receive.

- **Worse fiscal problems later.** If the national economy goes into a recession or the current economic weakness is prolonged, the budget crunches that many states are now experiencing will get worse. If so, states that have depleted their surpluses or reserves to pay for tax cuts or rebates, as some states have proposed doing, will face deeper cuts in services — or a heightened need for tax increases — than they otherwise would. Given the prospect of further economic and fiscal problems, reserve funds are best used to avert spending cuts — not to finance new tax cuts. States’ experiences show clearly that unaffordable tax cuts now can make it harder to respond to fiscal problems later.
- **Less flexibility to assist the families who most need help during the downturn.** Money spent on broad-based tax cuts or rebates will not be available for targeted assistance to those families hardest hit by economic problems— those who are losing their jobs and their health insurance, losing their homes to foreclosure, or facing other specific economic problems.

Nevertheless, state policymakers have important roles to play in strengthening their economies. They can help families and communities weather the recession, for example, by strengthening income supports for needy families or expanding health coverage for those who have lost employer-based coverage. And they can invest in education, infrastructure, health care, public safety, and other areas that have been shown to pay off in future economic growth. State attempts at fiscal stimulus through tax cuts or rebates risk undermining such efforts.

Unlike the Federal Government, States Must Pay for Tax Cuts

In January, a number of leading economists and policymakers from across the political spectrum agreed that short-term federal fiscal stimulus — designed to maintain consumer spending in the face of an impending recession — was both feasible and advisable. The final stimulus package signed into law included both tax cuts for businesses and one-time credits or rebates to households, although other forms of economic stimulus (some of which arguably would have been more effective) were also considered.

At the state level, fiscal stimulus proposals are taking various forms. In some states, such as Connecticut, Illinois, and Pennsylvania, proposed tax rebates are closely modeled on the individual portion of the federal stimulus package: tax credits and rebates, in a flat dollar amount per person or family.

In other states, such as Alabama and Arizona, the tax cuts proposed under the guise of “stimulus” do not resemble the federal proposal at all, but advocates nonetheless have linked them to the federal package. For example, in advocating for a tax cut related to health care, Alabama Governor Bob Riley said, “[T]he chairman of the Federal Reserve ... said to keep us from sliding into a recession, the first thing we need to do is cut taxes” at the federal level. “That is exactly the same thing we need to do in the state of Alabama.”¹

¹ “Riley pushes for health insurance deductions to stimulate economy,” *Mobile Press-Register*, January 19, 2008.

Many states are also considering whether to conform their corporate income tax codes to the changes in federal depreciation laws that were part of the stimulus package. If a state does conform, businesses that pay taxes to that state receive *both* a federal tax cut *and* a state tax cut. The cost to states in the current calendar year could exceed 9 percent of corporate income tax collections — equivalent to a month-long corporate income tax holiday. Moreover, states would be giving businesses a tax break for investments they made anywhere in the country, not just in that state.²

What works at the federal level, unfortunately, simply *won't* work at the state level. Unlike the federal government, which can run a deficit to cover the cost of its stimulus package, 49 of the 50 states are required by constitution or statute to balance their operating budgets each year (or every two years, if the state has a two-year budget). This means that states cannot simply enact new expenditures or tax cuts to be financed by increased borrowing.³ A reduction in revenue typically must be accompanied by a reduction in the spending that otherwise could occur.

Since roughly four-fifths of all state spending comes in just four areas — education, health care, transportation, and public safety — it is likely that tax cuts would come at the expense of one or more of those services. Alternatively, states might need to raise new revenues to continue to balance their budgets.

Cuts in Services Typically Would Negate Any Positive “Stimulative” Impacts

Cutting services to pay for “stimulus” tax cuts would not only harm the people who depend on those services, but also negate the stimulative impact on the economy. Recipients of the tax cut would have a bit more money to spend. But the recipients of state expenditure dollars, including public employees and contractors (e.g., teachers, construction workers, and health-care workers), would have *less* to spend. In terms of aggregate economic impact, the result likely would be a wash.

Indeed, such a tradeoff could actually hurt the economy. The lost jobs and income resulting from the spending cuts would outweigh the stimulus from the tax cuts if recipients save their tax cut or spend it out of state rather than injecting it into the local economy. This might occur, for example, if the recipients are multi-state corporations or relatively well-off individuals.

Tax Cuts or Rebates Could Cause Future Fiscal Problems

“Stimulus” state tax cuts or rebates could also set the stage for future fiscal problems. Some of the current stimulus proposals would be financed by selling (“securitizing”) a future stream of revenues; Illinois’ governor, for example, has proposed paying for tax cuts in part by securitizing the state’s tobacco settlement revenues. Other proposals would be financed from state reserves or

² For more detail, see Center on Budget and Policy Priorities, “New Federal Law Could Worsen State Budget Problems: States Can Protect Revenues by ‘Decoupling.’” February 2008, <http://www.cbpp.org/2-13-08sfp.htm>.

³ Some states do permit borrowing under certain circumstances. For instance, the securitization of tobacco funds — described later in this paper as the proposed funding mechanisms for an Illinois “stimulus” — technically amounts to borrowing. But such mechanisms are by far the exception rather than the rule, and may be problematic for other reasons.

surpluses; Pennsylvania's governor and Connecticut Senate Democratic leaders have proposed paying for one-time tax rebates out of reserves.

Such proposals would eliminate an ongoing stream of revenues that are essential to funding ongoing services or would deplete surplus or reserve funds that states will need if the current economic slowdown turns into a recession. For example:

- Connecticut is projecting a budget shortfall to arise by fiscal year 2010, which begins in just 16 months. Spending a surplus now on one-time rebates would make it harder for Connecticut to fill that gap.
- Illinois is widely recognized as having a structural budget deficit — an ongoing gap between available revenues and the normal annual growth in expenditure costs. Securitizing tobacco settlement funds and using the proceeds for one-time rebates would make the task of reconciling revenues and expenditures much more difficult in the long term.

Of course, it is entirely appropriate to use reserve funds or surpluses during an economic downturn, but the sensible use of those funds is to fill budget gaps so that states minimize the need to curtail services or raise taxes.

Recent history should remind states of what happens when they go too far in cutting taxes. When the last recession hit in 2001, states that had been cutting taxes the most — Colorado, Michigan, and New Jersey, for example — had bigger budget problems, and bigger economic problems, than other states. Five years after the last recession ended, the 16 states that cut taxes the most in the years leading into the 2001 downturn *still* lagged behind their more responsible counterparts, creating jobs at half the rate of the other states and experiencing slower income growth.⁴

Conclusion: What States *Can* Do

States should leave short-term stimulus measures to Congress, which has cut taxes, and to the Federal Reserve, which has cut interest rates more than once in recent weeks in a parallel effort to boost the economy. But states should not simply sit on the sidelines and fail to confront the economic slowdown. Rather, states could (among other things):

- Strengthen income support systems targeted to the families hit hardest during the economic downturn, such as unemployment insurance and public health insurance.
- Assist communities where economic problems are the worst, such as those where large numbers of foreclosures are threatening to blight entire neighborhoods.
- Maximize federal dollars entering the state by maintaining strong Medicaid programs and other matching-grant programs.

⁴ Nicholas Johnson and Brian Filipowich, "Tax Cuts And Continued Consequences: States That Cut Taxes the Most During the 1990s Still Lag Behind," December 2006.

- Focus on the kinds of long-term investments in both human capital and physical capital that research has shown can improve state economies. Areas of potential investment range from K-12 and higher education to infrastructure.
- Reform tax systems so they are not overly burdensome to struggling families, and eliminate tax loopholes and tax exemptions that undermine economic growth by favoring some businesses or industries over others.
- When possible, accelerate infrastructure projects that are already in the pipeline, to take advantage of excess construction-industry capacity and to put construction workers who may have lost jobs because of the housing crisis back to work.

In short, state policymakers have plenty of ways to protect their state in an economic downturn and should not waste resources on short-term stimulus efforts that are likely to be unsuccessful.