Center on Budget and Policy Priorities

POLICY POINTS

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SPECIAL SERIES | **Dealing with Deficits: How States Can Respond**

FOUR HELPFUL HINTS FOR STATES DEALING WITH DEFICITS

States, facing their worst fiscal problems in five years, should consider the following four policy options when dealing with deficits: (1) protect their revenues from the effects of federal tax changes, (2) tap their "rainy day funds," (3) don't rule out revenue increases, and (4) avoid "stimulus" tax cuts.

At least 25 states, including several of the nation's largest, face budget shortfalls for fiscal 2009; projected deficits total $37 billion for the year and are still rising. States commonly respond to such shortfalls by starting to cut expenditures, but this approach alone -- if taken too far -- runs the risk of undermining health care, education, transportation, public safety, and other services that a state needs for long-term prosperity.

Fortunately, states have other options. Please see, below, a discussion of the four policy options listed above, with links to reports with more detail on each topic.

Protect State Revenues From the Effects of Federal Tax Changes

Because most state tax codes are based on federal law, state tax revenues may decline when federal tax cuts are enacted. This is a particular problem when federal tax cuts enacted to stimulate a weak economy worsen state budget problems during a downturn. States can avert this revenue loss by "decoupling" the relevant parts of their tax code from the federal code.

- **Prevent corporations from claiming "bonus depreciation."** The "bonus depreciation" provision of the recent federal stimulus package allows a business to deduct the cost of new equipment immediately rather than over the equipment's useful life. Some 23 states stand to lose $1.7 billion in revenue in the current and upcoming fiscal years from this provision, which is retroactive to January 1 — unless they act to decouple from it. In 2001-2004, when a similar provision was in effect, more than 30 states decoupled fully or partially, preserving tens of billions of dollars in revenue. *http://www.cbpp.org/2-13-08sfp.htm*

- **Disallow a new federal tax break for certain corporate profits.** Scheduled to take full effect in 2010, the "domestic production deduction" (sometimes known as the "qualified production activities income" [QPAI] deduction) allows corporations a tax deduction if they can show profits from certain types of activities, ranging from manufacturing to filmmaking to oil and gas production.

The QPAI deduction is unjustified as state economic policy; its main beneficiaries are large profitable, multi-state corporations, which can benefit even if they have no in-state employees. Yet while 18 states have decoupled from the tax break, 29 other states affected by it have not. Decoupling could save these states close to $2 billion a year. *http://www.cbpp.org/1-2-07sfp.htm*

Tap the State's "Rainy Day Fund"

Over the last several years, many states began preparing for a possible economic downturn by setting aside "rainy day funds," or reserve accounts designed for use when revenues decline or expenditures increase unexpectedly because of downturns or other events. Now that a downturn has arrived, this is the appropriate time for states to tap these funds.

- The use of reserve funds can help a state minimize the tax increases and program cuts needed to close an emerging budget gap. Unlike those other measures, both of which worsen a downturn by reducing demand, tapping a state's reserves helps maintain demand by injecting savings into the economy.

- Tapping a reserve fund also allows a state to preserve needed services while it devises sensible policies to close any remaining budget gaps. Often, the budget cuts and tax increases that a state can make *most quickly* to close a mid-year budget gap are the *least appropriate* measures to take in a recession, such as hikes in sales taxes or other measures that fall most heavily on the people who can least afford it. *http://www.cbpp.org/2-21-08sfp2.htm*

Don't Rule Out Revenue Increases

Economists recognize that tax increases and other revenue measures, if well-designed, can be a reasonable alternative to spending cuts, and can actually be less harmful for a state's economy than big spending cuts. *http://www.cbpp.org/1-8-08sfp.htm*

- **Income tax surcharges.** Raising income taxes temporarily, especially on wealthy households, is an effective, efficient, and equitable way to raise funds quickly in order to mitigate large cuts in services. Even a relatively small surcharge can generate a substantial amount of revenue. For example, states could generate $13 billion if every state with an income tax raised its tax rate for taxpayers over $200,000 by one percentage point. And administrative costs are near zero.

  Such increases tend to cause less harm to a state's economy in a recession than cuts in services. This is partly because every $1 reduction in state spending on services results in a $1 reduction in overall demand, while every $1 increase in taxes (particularly on high-income families) reduces demand by *less than* $1 because some of the additional tax payments will be made from savings, not from funds that would otherwise be spent.

  Another benefit of an income tax increase is that state taxpayers do not bear its full cost. Because taxpayers who itemize on their federal tax return can deduct their state income taxes, up to one-third of the cost of a state income tax increase would be offset by a drop in these taxpayers' federal income taxes. *http://www.cbpp.org/2-21-08sfp.htm*

- Changes in corporate tax rules. Nineteen states allow businesses to offset current-year losses by claiming refunds for taxes they paid in previous years. During recessions, when business tax payments tend to fall in any case, such refunds can make state revenue shortfalls even larger.

  It is reasonable to allow a business to average its income over profitable years and loss years; new businesses often need several years to become profitable, and many businesses experience temporary losses in an economic downturn. But states already allow businesses to do this. In every state, a business can use current losses to offset *future* profits — a policy that is not nearly as disruptive to states as using current losses to offset *past* profits.

  States that wish to avoid an unnecessary revenue loss in fiscal years 2009-2010 should disallow the "carryback" of businesses' operating losses during calendar year 2008.
  http://www.cbpp.org/2-21-08sfp3.htm

Avoid "Stimulus" Tax Cuts

Since states — unlike the federal government — must balance their budgets, they cannot boost the economy through a deficit-financed tax cut. Instead, states must fully pay for new tax cuts with cuts in state spending (or increases in other state taxes).

- At best, the trade-off of cutting spending in order to pay for more tax cuts would be a wash for the state's economy. The people who receive the tax cut would have more money to spend, but the people affected by program cuts would have less.

- At worst, such a trade-off could harm the state's economy. Funds spent on state services are more likely to stay in the state than tax cuts, part of which will go to multi-state corporations or higher-income people with no obligation to spend the money locally.

- Instead of short-term measures, states should strengthen their economies over the longer term, such as by improving education, rebuilding infrastructure, and protecting residents' health.
  http://www.cbpp.org/2-29-08sfp.htm

This Policy Points draws from *Dealing with Deficits: How States Can Respond,* a series of analyses from the Center's State Fiscal Project.

The full series can be found at: http://www.cbpp.org/pubs/sfp.htm#series.