CENTER ON BUDGET AND POLICY PRIORITIES

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THE STATE FISCAL CRISIS IS IMPEDING ECONOMIC GROWTH; FEDERAL AID TO STATES WOULD BE MOST EFFECTIVE STIMULUS

By Iris J. Lav

The state fiscal crisis is impeding economic recovery. The actions states will be taking this year to balance their budgets – spending cuts and tax increases approaching $100 billion -- are likely to reduce economic growth directly by nearly one percent of GDP. Since reductions in state spending and increases in state taxes affect private-sector employment and consumption, GDP growth would be further lowered. The only way this blow to the economy can be mitigated is through federal fiscal relief for the states.

Virtually all states are required by their constitutions or laws to enact balanced budgets, and most are required to maintain budget balance throughout the year. The size of current budget deficits means that drastic actions are necessary to meet these requirements.

- When states enacted their fiscal year 2003 budgets last spring and summer, they took actions to close deficits of nearly $50 billion.

- New gaps of $26 billion have opened up during this fiscal year, according to the National Conference of State Legislatures. These new deficits must be closed either during the current fiscal year or in conjunction with enactment of fiscal year 2004 budgets.[1]

- States also face budget gaps in the range of $70 to $80 billion for fiscal year 2004.[2] Thus approximately $100 billion in unclosed deficits ($26 billion plus $70 to $80 billion) must be addressed in the next few months.

- As Standard & Poor's noted in a recent report, states have few options remaining with respect to how they close these gaps. "With rainy day funds having been depleted rapidly over the past three years, few options remain other than tough cuts or revenue increases."[3]

When states cut spending, they lay off employees, cancel contracts with vendors, eliminate or lower payments to businesses and nonprofit organizations that provide direct services, and cut benefit payments to individuals. In all of these circumstances, the companies and organizations that would have received government payments have less money to spend on salaries and supplies, and individuals who would have received benefits also have less money for consumption. This directly removes demand from the economy. Given current macroeconomic conditions, in which excess capacity to produce goods and services already exists, this reduction in demand causes a decline in economic growth.[4]

A number of leading economists have emphasized that the best way to spur growth in the short run would be to boost demand. State actions, however, are now reducing demand.[5]

Moreover, when a person who loses her job in a business or nonprofit organization because of state funding cutbacks adjusts by purchasing less groceries, gasoline or clothing, or postpones the purchase of a new car, there is a secondary ripple effect on the private-sector economy that affects the employment of workers in the grocery stores, gas stations, and auto plants. All of these people have less money to spend. That, too, lowers economic growth.

Raising taxes similarly reduces demand for goods and services in the economy. Much of the additional taxes are paid from money that residents otherwise would have spent on goods and services. (Note, however, that some additional taxes are paid from money that otherwise would have been saved, so the short-run impact on the economy from tax increases may be somewhat less than the impact from spending cuts, depending on the type of tax increase enacted.[6])

The current size of the U.S. economy is $10.6 trillion. If state spending cuts and tax increases are enacted to close the remaining gaps for fiscal year 2003 and the deficits for fiscal 2004 that together equal $100 billion and that amount is removed from the economy over the next 12 months, the $100 billion reduction in demand would directly lower GDP growth by one percent. The ripple effect would increase this impact. Moreover, this does not take into account additional actions by cities or counties, which also are cutting spending and increasing taxes in response to their own budget shortfalls.

Economists Point to Value of Federal Fiscal Relief

The federal government can run a deficit and does not have to take the actions damaging to the economy that state balanced budget requirements force during an economic downturn. Thus, one of the best ways to stimulate the economy in a downturn – or to prevent additional deterioration of the economy – is for the federal government to provide short-term, additional funding to states. This course of action has been endorsed by a number of prominent economists.

For example, William Gale, a senior fellow with the Brookings Institution, noted in a *Los Angeles Times* op ed, "The best way to boost the economy right now would be to increase federal aid to the states, which are facing their worst financial crisis in decades."[7]

Robert M. Solow, emeritus professor of economics at MIT and winner of the 1987 Nobel Prize for Economics, has made a similar point. Solow recently wrote, "There is urgent need for substantial revenue-sharing from the federal government to the states, cities and counties. The recession and slow recovery have gutted states and local revenues. Since they operate under constitutional balanced budget constraints, governors and mayors are being forced to make drastic cuts in basic and necessary public services. This weakens the economy – states and cities spend twice as much as the federal government – and could spell disaster for many low-income people who are the main beneficiaries."[8]

Alice Rivlin, who has been the director of both the Congressional Budget Office and the Office of Management and Budget as well as the vice chair of the Federal Reserve and who currently is at the Brookings Institution also points to the harm to the economy from sharp downturns in state fiscal conditions. In a recent report, she states:

> The first priority should be finding ways of mitigating cyclical swings in state revenues. Some ups and downs in state revenues are undoubtedly beneficial. Moderate reductions in revenues force states to tighten up program management, increase efficiency, and eliminate outdated or low-priority activities. Moderate increases in revenue during a strong growth period afford states the opportunity to choose whether to expand and improve services or pass the benefits of economic growth back to taxpayers by reducing taxes. On the other hand, large swings in state revenues, especially sharp drops in a weak economy, lead to short-sighted cuts in spending that are especially hard on low-income groups at exactly the wrong time and tend to increase the amplitude of cyclical swings in the economy as a whole.[9]

Federal Stimulus Actions May be Cancelled Out by State Actions

States are just beginning to grapple with how they will close the $100 billion in budget gaps they are facing. In the 34 states in which governors' budgets for fiscal year 2004 have been released, proposed tax increases exceed $14 billion. Additional tax increases are expected to be proposed by the governors in other states, as well as by legislative leadership and fiscal committees in many states.

Most of the remainder of the $100 billion shortfall will be closed through budget cuts. NCSL reports that already in this fiscal year (which ends June 30, 2003 in most states), nine states have enacted state employee layoffs, Medicaid spending has been cut in 13 states, higher education in 12, and nine states have cut elementary and secondary education and corrections spending. The new fiscal 2004 budgets that governors have recently released include large, additional reductions in spending in these and other areas.

As the federal government debates the amount and kind of stimulus that may be appropriate at the current time, it is important to bear in mind that states are taking actions that can offset or cancel much of the contemplated federal stimulus. If, as is currently proposed, the federal government cuts taxes on dividends and lowers the tax rates paid by higher-income people, some of the additional income people will receive will be spent but a significant amount of it will be saved. The portion of the money that is saved will not stimulate the economy in the short run.

By contrast, virtually every dollar that state spending is cut reduces demand by at least one dollar. When states increase sales taxes or other consumption taxes that fall heavily on low-income residents, as many states are proposing, those tax increases also tend to result in close to a dollar-for-dollar reduction in demand. To stimulate the economy, most effectively and efficiently, the federal government should provide significant fiscal relief to help states avoid or reduce the magnitude of the economically-damaging tax increases and program cuts they are instituting or moving to adopt.

Endnotes

[1] National Conference of State Legislatures, February 4, 2003. http://www.ncsl.org/programs/press/2003/pr030204.htm

[2] With two-thirds of the states reporting, NCSL found FY 2004 budget gaps to be a minimum of $68.5 billion. The Center on Budget and Policy Priorities is estimating FY 2004 budget gaps to be in the range of $70 billion to $85 billion. See Iris J. Lav and Nicholas Johnson, *State Budget Deficits are Huge and Growing*, January 23, 2003. http://www.cbpp.org/12-23-02sfp.htm

[3] *No Relief for States Under Bush Proposal: Credit Outlook Remains Bleak*, January 9, 2003. http://www.ratingsdirect.com

[4] As Brookings Institution economist Peter Orszag noted in recent testimony, "In the short run, the key economic difficulty is that the nation is not fully using the capacity it has available to produce goods and services. In December 2002, the capacity utilization rate computed by the Federal Reserve Board of Governors was 75.4 percent, significantly below its average of 81.5 percent for the past three decades. The primary macroeconomic issue in the short run is therefore to boost demand for the goods and services that firms could produce given current capacity. "The Administration's Economic "Stimulus" Proposals" Testimony before the Democratic Policy Committee, Revised January 22, 2003. http://www.brook.edu/dybdocroot/views/testimony/orszag/20030121.pdf

[5] A letter from ten Nobel Laureates and hundreds of other economists that appeared on February 10, 2003 in the *The New York Times* stated that a major objective of a stimulus package has to be to increased demand. The statement said: "To be effective, a stimulus plan should rely on immediate but temporary spending and tax measures to expand demand…."

[6] 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, November 6, 2001.
http://www.cbpp.org/10-30-01sfp.htm

[7] *Los Angeles Times*, December 20, 2002

[8] *Los Angeles Times*, Opinion, Part M, Page 1, December 29, 2002.

[9] Alice Rivlin, *Another Fiscal Crisis: Is There A Better Way?*, WR&B Policy Brief #23, *January2003.* http://www.brookings.edu/es/wrb/publications/pb/pb23.htm