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Special Series | Dealing with Deficits: How States Can Respond

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BUDGET CUTS OR TAX INCREASES AT THE STATE LEVEL:
Which Is Preferable When the Economy Is Weak?

By Nicholas Johnson

The recent, unusually long and deep recession is making it difficult for states to maintain balanced budgets, as nearly all of them are required to do by law. Almost every state has reduced spending and 33 also have raised revenue to bring their budgets into balance. Additional cuts and revenue measures are being proposed for the next fiscal year. The budget gaps that will need to be closed in the next two fiscal years (2011 and 2012) are estimated to hit $260 billion even after taking into account aid from the federal government.[1]

The combination of a weak economy and projected budget shortfalls poses a major challenge for state policymakers: How can they balance their states' budgets with the *least possible harm* to their still damaged and fragile state economies? One answer is to draw down reserve funds, if possible. Another answer is to seek assistance from the federal government. Those options have helped greatly, but have solved only a portion of states' problems. Most states must (a) cut spending further, (b) raise revenues, or (c) enact a combination of revenue increases and spending cuts to keep budgets in balance.

Some state-level policymakers contend that the weakness of the economy means that a state should rely solely on cutting spending, rather than raising taxes. But this one-dimensional approach is not based on sound economics.

Two highly regarded economists — Nobel Prize winner Joseph Stiglitz of Columbia University, and Peter Orszag, director of the federal Office of Management and Budget — wrote during the last recession that *spending cuts could actually be more harmful for a state's economy during a recession than tax increases*. Stiglitz reiterated the point in a 2008 letter (co-signed by 120 other economists) to New York's Governor David Paterson.[2]

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[1] Elizabeth C. McNichol and Nicholas Johnson, "Recession Continues to Batter State Budgets," Center on Budget and Policy Priorities, available at http://www.cbpp.org/cms/?fa=view&id=711.

[2] The text of the letter, dated December 13, 2008, is available at http://www.fiscalpolicy.org/FPI_Release_EconomistsOnFiscalPolicy_December2008.pdf.

Their assertion still holds true, because unemployment remains very high and the economy is far from operating at full capacity. (See box.)

Maintaining Aggregate Demand by Avoiding Excessive State Spending Cuts Will Remain Important in the Upcoming Fiscal Year

Economic analysts generally agree that the recession – that is, the period of time in which there is a widespread decline in economic activity – ended in 2009. Economic activity has picked up and gross domestic product (GDP) is now growing. But the economy remains very weak. The unemployment rate of nearly 10 percent is almost twice as high as it was when the recession started and there is a substantial "output gap" between actual GDP and the GDP that could be produced if the labor force and the economy's productive capacity were being fully utilized.

In an April 17 speech, Christina Romer, a highly regarded scholar of economic downturns and chair of the President's Council of Economic Advisers, explained that this means the economy still suffers from "a severe shortfall of aggregate demand." She cited budget-balancing actions by state and local governments in response to the recession as a major cause of insufficient aggregate demand.*

Thus, the advice of economists like Joseph Stiglitz and Peter Orszag to address those budget actions in ways that maximize aggregate demand – as described in this paper -- remains entirely relevant, and likely will remain relevant for some time to come, even though the recession technically may be over.

* http://www.whitehouse.gov/sites/default/files/rss_viewer/back_to_a_better_normal.pdf

In their earlier 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….
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> "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….
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> "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."[3] [emphases added]

As legislatures develop their 2011 budgets, they should take seriously the Stiglitz-Orszag admonition that tax increases, particularly tax increases on higher-income families, may be the best available option.

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[3] 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.