TAX FAIRNESS ORGANIZING COLLABORATIVE
29 Winter Street • Boston, MA 02108 • 617-423-2148 • www.faireconomy.org

Solutions that Work for Main Street

Progressive Guidelines for Closing Recessionary State Budget Gaps

In the face of the most daunting budget shortfalls many have seen since the Great Depression, most states have responded in a uniform and wholly counterproductive fashion: by administering budget cuts equal to the shortfalls. With nearly every state facing large budget gaps, totaling as much as $200 billion, and many of these states poised to react with little more than another round of cuts, it is time to acknowledge the ill effects of such an approach, to people's lives and federal economic recovery efforts.

Calls for a more "balanced" approach—designed to mix some cuts with some new revenue—steer us wisely from a cuts only vicious cycle. However, with many jobs, essential public services, and the fate of the economic recovery hanging in the balance, even a balanced approach leaves much room for continued budget cuts that help no one. We are well past the time when such a mix might have been a useful starting point for political compromise or a way to help stave off a mild recession of short duration. The previous rounds of cuts, a recession of this magnitude, and economic soundness all make it imperative that states recognize how they must—and how they can—avoid further budget cuts.

This does not imply that we stop looking for new efficiencies or dismiss concerns for frugality. These efforts must continue, as always. But our governors and state legislatures must be made to realize that they have at their disposal a much sounder and much more productive answer to the current recessionary budget gaps than is commonly acknowledged. In particular, states have ample room for progressive tax reform that raises revenue, underwrites critical public investment, stimulates additional private investment, and maximizes job retention or creation. No state is without this potential.

Naysayers claim that recessions make any state tax increases unwise and counter-productive. Indeed, if states could borrow as extensively during recessions as the federal government, most tax increases would represent a second-best option. But because no state possesses great deficit spending capability or raises revenue as it can or should—generating the maximum revenue with the lowest possible rates in a graduated form—progressive state tax increases stand out as a superior and mostly untapped economic recovery catalyst.

The conventional aversion to tax increases also appears to make sense because states have seldom raised the right kind of taxes in the face of previous recessionary budget gaps. It must be noted: not all taxes are equal in their economic impact. In recent recessions, for example, state tax increases have come typically in the form of increased sales taxes, fees (including higher college tuition), and less visible excise taxes, all of which fall more heavily upon the least wealthy citizens and which dampen the potential for greater economic activity and shared prosperity. Raising taxes in the more conventional and regressive manner does stifle demand, investment, and economic activity, especially if these taxes are raised only to stave off budget cuts and layoffs. Raising taxes in a progressive manner does just the opposite. We must learn to distinguish one from the other and to keep progressive tax policy always in the economic recovery toolbox. In the absence of significant deficit-spending potential, it is a state's most effective anti-recessionary tool.

With progressive tax increases and reform as the centerpiece, listed below are general guidelines for optimum state fiscal policy in a recessionary budget crisis.

The Guidelines

To Close Recessionary Budget Gaps

1. Make more money available

Budget cuts exacerbate recessions and lengthen the period of recovery. Period.

Sound economic policy dictates that when citizens are forced to tighten their belts, our governments should do what they can to loosen theirs. This becomes an absolute necessity when you consider the paradox of thrift, by which individual economizing actually leads to decreased demand and investment and a vicious cycle of ongoing contraction. States should respond to this using several critical approaches, in the following order of significance:

A. Raise New Revenue in a Progressive Manner. Remember Adam Smith's first canon of sound taxation: that it be based on ability-to-pay. This implies that the effective marginal change introduced by any tax increase ought to rise gradually and smoothly with income. This produces the most revenue with the lowest rates, puts more money where it is most useful, builds protection against future economic downturns by underwriting productivity-enhancing investments, and ensures an increasingly stable level of innovation and risk-taking as a result.

Greater equity also comes with progressive tax reform, but we make a fundamental mistake if we regard this as its only salient virtue. Simple, broad, and uniformly graduated is much more economically sound than taxes tied to benefits, those based on consumption, or even a "millionaire's tax" strapped onto an upside-down, regressive structure.

B. Borrow More Widely to Fund State Infrastructure Investments. Replace cash capital outlay with the issuance of new general obligation bonds. In recessions of much milder form and shorter duration than the current one, do not hesitate to use modest capabilities for short-term borrowing by which to fund ongoing government services and operations. In more severe downturns, such short-term borrowing can also be used to bridge small revenue gaps that remain unfilled by companion revenue increases. While many states have resorted to implicit short-term borrowing of this type—through fiscal policy actions often derided as "gimmicks"—it is far better to adopt the more explicit form sanctioned by many state codes and constitutions. Custom rather than law has persistently taken this tool from the hands of most of our nation's state legislators.

Any of this borrowing—short or long-term—will often draw unwarranted criticism from bond rating firms and from those who would use these firms and their judgments as a political tool. Such borrowing can and should be defended, however, as a legitimate and appropriate means by which to generate or maintain economic activity, state revenue, and economic stability—undertaken by governments with no realistic chance of default. Indeed, such goals are congruent with the professed benchmarks of the bond rating firms. Because it enhances economic performance, revenue generation, and economic stability, increased borrowing during a recession ought to boost, not diminish, a state's creditworthiness.

C. Use Rainy Day Funds in a Timely Manner. Deplete Rainy Day funds earlier rather than later. Total depletion should be timed as closely as possible to coincide with the estimated bottoming-out of recessionary revenue decline. Delay future additions to these funds until reaching a suitably low unemployment rate trigger and a suitably high revenue surplus threshold.

D. Build Trust Funds Wisely. If options A, B, and C leave small budget gaps unfilled, cut back modestly on contributions to retirement or other such funds normally operated under a conservative and unrealistic near-100 percent long-term funding basis. Unlike private businesses, which may vanish and leave pledged

benefits unmet, states have no practical reason to fret about thirty-year forecasts for partially unfunded liabilities. Temporary unfunded liabilities, that take funding even below the 80 percent level at which private plans are typically judged adequate, can be filled easily in a more active economy encouraged partly by the temporary diversion of these mostly idle funds.

2. Make Tax Increases and Tax Reform One and the Same

A. Enact Progressive Tax Changes. As noted in 1A above, recognize clearly the way in which progressive tax reform serves equity, adequacy, and economic vitality all at once.

B. Repeal Unworthy Tax Expenditures (tax deductions, exemptions or credits that drain revenue from state treasuries). Many tax expenditures are uniformly and almost perfectly regressive; their repeal—partial or whole—would create a uniformly and almost perfectly progressive change. The widespread allowance for itemized deductions on state personal income tax returns is a good example of this, accounting for many billions of lost revenue in many of the 41 states with broad-based income taxes. With this special deduction, California alone surrenders approximately $10.3 billion in annual revenue.

3. Encourage Federal-State Revenue Sharing

The federal government can more completely engage in economically appropriate policy during a recession—by increasing borrowing, running deficits, and financing the remaining portion of the federal budget on a much more progressive basis than states or localities. Because of this, states should ask for, expect, and applaud federal recessionary aid, in either temporary form (direct temporary assistance), a permanent but adjustable form (increased federal match rates triggered by an unemployment threshold), or permanent form (programs that automatically increase the flow of federal funds or loans for welfare, unemployment insurance, etc.). Note that increased federal aid does not have to imply increased federal control, especially if the aid is transmitted through already existing federal-state programs.

State lawmakers should also recognize that how they choose to structure the state's tax policy has the potential to increase unrestricted federal aid, without having to lobby a single federal official or revamp any complex grant-making process. When a state raises new revenue through income tax reform, for example, a portion of this new tax liability is refunded to many of its citizens on their federal tax returns, by way of an increased federal income tax deduction. Tantamount to a federal grant equal to 25-30 percent of the overall state tax increase, this is discarded every time a state chooses to raise fees or consumption taxes instead.

To Defend a More Progressive and Economically Sound Approach

1. Don't Equate Frugality or Efficiency with Budget Austerity

We should always champion frugal spending practices, should always insist on getting a "dollar's worth for a dollar spent," and "efficient" allocation of goods and services ought to be considered a role for which state governments are particularly well-suited. But a larger budget can reflect these priorities just as effectively as a smaller one, and with both economies of scale and substitution for fragmented, uncompetitive, or labor-stingy private procurement, it may often stand a better chance of delivering genuine economic efficiency. If tax increases and expanded budgets are the appropriate economic medicine for a sick economy, concerns for "efficiency" or "frugality" should not impede their implementation.

2. Call out the Short-sighted and the Mythmakers of the Anti-Tax Brigade

Recognize (and publicize) how opponents' "no-new taxes" pledges do not really mean no new taxes…usually they mean, instead, only no new income taxes—the kind that makes the most sense, in good times and bad. As income taxes are swept off the table, the truth is that less visible but significant increases in the following types of taxes often fill the gap: sales

and/or local property taxes (as state budget cuts lead to cuts at the local level); increased fees and fines; higher tuition at public colleges; roadway tolls; and higher mandatory "contributions" from public employees for retirement or health care benefits. Long-time Senate Finance Committee chairman Russell Long once derided this approach as "don't tax you, don't tax me, tax the man behind the tree." Letting it prevail doesn't result in lower taxes; only less equitable and economically sound ones.

Written by ***David Shreve***, Economist and member of the Virginia Organizing Project's Tax Reform Committee.

Reviewed by Economists ***Emily Kawano, Gerald Friedman, and Susan Mesner***.

United for a Fair Economy is a national, non-profit, non-partisan organization that helps people of all races, ethnicities and classes work to reduce economic inequality. UFE supports and helps build social movements for greater equality, as well as advocating for changes to the government rules and corporate practices that create and sustain inequality.

The **Tax Fairness Organizing Collaborative**, a project of UFE, is a network of statewide grassroots organizations in 24 states educating and organizing for progressive and adequate state tax policies.