

# GOVERNING

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### RAISING TAXES IN A RECESSION

*"Cutting the salary of a teacher, firefighter or police officer; cancelling a contract with a local vendor; reducing reimbursement rates for nonprofits; -- that's money they cannot spend locally. And typically, you're reducing the amount of services at a time when the need is not declining - in many cases it's rising" (Johnson, Nicolas)*

As states went through the pain of balancing their budgets for this fiscal year, 48 of them faced a total of \$166 billion in revenue shortfalls. It was hard enough finding cuts in spending and increases in taxes and fees to narrow and finally close those gaps; within weeks, the budget holes opened wide again. As Nicholas Johnson, director of the State Fiscal Project at the Center for Budget and Policy Priorities, points out, federal stimulus funds helped--but still only filled in 30 to 40 percent of state budget shortfalls. The remaining 60 to 70 percent, he notes, is still a very large number.

In [a recent paper](#) he wrote with Andrew Nicholas and Steven Pennington for CBPP, "Tax Measures Help Balance State Budgets: a Common and Reasonable Response to Shortfalls," he reported that since January 1, 30 states had raised taxes and seven more were considering doing so. The hole-filling question I put to Johnson--and one he raised in the paper--is whether tax hikes make sense in a recession. It's a question I'll also pose, in a later edition of this newsletter, to an expert from the Tax Foundation, which favors spending cuts over tax increases to balance budgets.



Nicholas Johnson

I talked to Johnson a few days ago. Here are the highlights of the interview:

#### **Is it good policy for states to raise taxes in a recession?**

It can be, particularly if it is the way for states to avert severe spending cuts. Raising taxes can moderate state spending cuts so they are not so severe.

#### **Why not close the gap with cuts, however painful those might be?**

The worst thing in a recession is to make deep cuts in education, health care, public safety or other state services that take dollars directly out of local economies. In a recession, you don't want to reduce aggregate demand, and that's what spending cuts do. Tax increases can also reduce aggregate demand, but not if they are levied on higher-income families or profitable corporations that have retained earnings. The money to pay those tax increases doesn't come as directly out of aggregate consumption.

#### **What do you mean by that?**

If you cut the salary of a teacher, firefighter or police officer, if you cancel a contract with a local vendor, if you cut reimbursement rates for nonprofits--that's money they then cannot spend locally. And, typically, you're reducing the amount of services that are provided at a time when the need for those services is not declining and in many cases is rising. So cuts alone can be worse for the local economy than a more broad-based mix of spending cuts and tax increases. If you have to close a budget hole of a certain size, what you want is a combination of some cuts and some tax increases.

Historically, the answer in most states has been some of both. But when a recession comes, the first thing states do is draw down reserve funds or do other measures to avoid having to make big cuts. Second, they try to trim spending. Those are things that can be done quickly. Then they get around to raising revenue--if it's a severe recession, and this is one.

## Is this the worst downturn for states?

In terms of the depth of the recession itself, I'm not a macro-economist. I have heard other economists describe this as the worst since the Great Depression. In terms of impact on state budgets, it certainly could be as bad as the recession in the early 1980s. But the data makes it hard to compare how bad things are. Do you take federal assistance into account? One thing ameliorating the situation at the state level today is additional stimulus money from the federal government.

## You seem to suggest in your paper that states that raise taxes do better in the long run--post-recession, that is.

It's hard to draw clear conclusions because lots of other factors are going on. In at least some cases, there is reason to think that raising taxes doesn't sink you or how you perform economically. There's no clear evidence that a tax increase undermines your recovery.

The point we were trying to make with the paper is not that raising taxes is a guaranteed path to economic growth but rather to dispute the contrary notion that raising taxes will harm economic growth. What happens depends on a lot of different factors, including the quality of public services--you need an adequate tax base to pay for adequate services.

## Isn't that the case Governor Deval Patrick made a few weeks ago when Massachusetts raised its sales tax--for the first time in a generation and at a time when many residents are under severe economic stress?



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Massachusetts made deep cuts in services. It's really hard to see how they could go still deeper. The tax increase will help them bridge the gap. Years down the road, they may be able to scale it back or rethink it when the economy is back fully functioning. No one knows how long that will be.

New York put together a package of revenue raises, but states like California and Arizona have had a more difficult time doing that. California needs a supermajority to raise taxes (or a vote of the people). It even needs a supermajority to pass a budget. Arizona needs a supermajority to raise taxes--or a vote of people. Either state could go to a ballot, but that's iffy. So supermajorities are a recipe for gridlock. It's hard enough to get even a majority to agree on anything.

## What taxes have states been targeting?

Everything is on the table. A number of states have done an increase in income taxes on higher-income people. There have been a number of sales-tax rate increases or a broadening of the base to tax more services. Business tax increases are out there. One thing states are interested in is taxing the online economy relative to the mainstream economy. There are states looking at that, but most of what they are talking about would be a relatively modest revenue raiser.

There have been a number of proposals to tax soda. The governors in New York and in Massachusetts proposed those. There are policy justifications for that, but it's hard to go after selective consumer goods when people are feeling pinched. It's an idea that will come back, but right now it's a little bit of a hard sell.

**What state or states have done a particularly good job in putting together tax packages?** I haven't done a full assessment. But what Delaware did a few weeks ago looks reasonable: It increased the top income-tax rate, made some business-tax changes and increased its gross receipt taxes--those are like a sales tax. No one measure is going to solve large budget problems. That's why a lot of states are doing packages of measures--something on sales, income, business and excise taxes--as well as budget cuts. That's going to be the solution in most states.