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SECURING OUR FUTURE DURING AN ECONOMIC DOWNTURN

by Nicholas Johnson, Garrett Martin and Kurt Wise

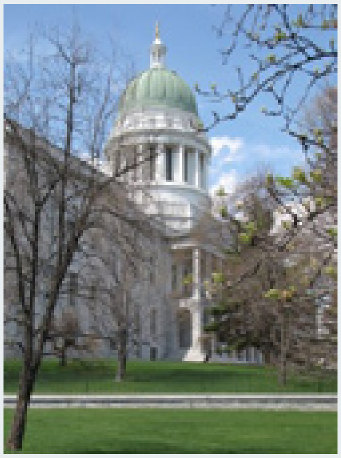
Maine currently faces a budget crisis – one created by economic decline at a global, national and state level. The challenge before state policymakers is how to address the current revenue shortfall without exacerbating the effects of this economic downturn. Part of that challenge is finding a way to address the crisis that is fair for all Maine people and puts us in the best position to bounce back when the economy inevitably turns the corner.

At present, the Governor's proposed solution focuses on spending cuts. While some cuts may be necessary, they should not be viewed as the only option. Other options include drawing on reserve or one-time funds, and introducing temporary tax increases. Indeed, in the early 1990s under the leadership of Governor McKernan, Maine demonstrated its capacity to withstand comparable shortfalls.[1] The solution then included austere cuts and selective – and time-limited – tax increases. A similar approach is required today.

The Extent of the Shortfall

Current projections show a General Fund revenue shortfall of $1.4 billion over the coming 2010-2011 budget cycle.[2] This represents approximately 21% of projected General Fund costs for the same 2-year period.[3] To put this figure in perspective, Maine's K-12 education accounts for 39 % of General Fund expenditures. Even were we to slash General Fund K-12 spending by half, we still would have a revenue shortfall. Under normal circumstances, the state's rainy day fund might be tapped to address shortfalls. Unfortunately, this fund will be depleted to plug holes in the 2009 budget. Clearly difficult choices lie ahead.

Maine is not alone in facing challenging economic times. In an effort to help jumpstart the national economy and create a platform for future growth, the federal government, with backing from Maine's congressional delegation, passed the American Recovery and Reinvestment Act (ARRA) of 2009. This legislation includes one-time



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assistance to states that can be used to close anticipated budget shortfalls.[4] In Maine's case, this amounts to approximately $550 million during the biennium leaving a gap of at least $850 million that must be addressed by state policymakers.[5]

A Shortfall Lessened by Years of Fiscal Restraint

At its core this shortfall is about a decline in state economic activity due to the global economic crisis. Two thousand Mainers are losing their jobs each month. Retail sales have fallen by 9 percent relative to 2008.[6] While our situation is not unique in comparison to other states, we have important choices to make both in how we define the problem and how we move forward.

The state budget is already lean. Since 2004, inflation adjusted state spending in Maine has declined even as underlying costs have continued to grow. During the last three budget cycles, legislators pared away tens of millions of dollars from the budget, impacting the full range of departments and state programs.

In real terms, Maine's total General Fund expenditures have fallen by $100 million over the last four years, a drop of roughly 3 percent.[7] Indeed, the Governor's original $6.1 billion budget proposal for the 2010-2011 biennium represented a further 1.5 percent decline from the previous biennial budget.[8] These drops have come at a time when health care costs continue to spiral out of control and when Maine's population has grown in numbers and in age. Thus, during a period when multiple factors were driving costs upward at a pace greater than inflation, Maine's policymakers demonstrated fiscal restraint. Ongoing fiscal restraint and rounds of cuts have left little fat in the budget.

The Case for Raising Revenues

While additional spending cuts may be unavoidable, Maine policymakers must be willing to consider increasing revenues through short-term tax increases. Cuts alone will serve only to deepen our state's economic woes, disproportionately impact low- and moderate-income households, and lengthen the period to full recovery. Fourteen states already have recognized these negative impacts and are raising taxes in response. Twenty more are weighing proposals to do the same.[9]

How Maine responds not only will affect our ability to weather the current crisis, but also our future competitiveness and growth relative to other states. In much the same way that corporations that continue to invest in research and development during recessionary periods outperform those companies that do not, states that continue to support demand for goods and services and invest in critical human and physical capital – educated and healthy people, efficient transportation and energy systems – are in the best position to leverage future private investment and sustain growth. Still, we recognize policymakers must weigh the political and economic arguments for increasing taxes during this difficult time.

The Political Arguments

Partisan political rhetoric has created an environment in which any discussion of government spending is marred by slogans and ideological entrenchment. This has created a disconnect between what we desire from our government – quality schools, access to health care, good roads, and safe neighborhoods – and our willingness to pay for these items through taxes.

The mere suggestion of tax increases, regardless of the circumstances, unleashes a maelstrom of opposition from special interest groups, and political supporters and opponents alike, creating a chilling effect on lawmakers. Still, our experience in the current economic crisis reminds us of the important role government plays in mediating between the public and private, the individual and the collective, and in ensuring that the fundamental pillars upon which future success rests are firmly in place. We must move beyond our knee-jerk reaction against raising taxes if we are to arrive at real solutions to the challenges before us.

The Economic Arguments

The typical economic argument against tax increases is that they undermine consumption and curtail investment. The theory goes that lower taxes foster greater consumption and investment which ultimately results in increased economic activity and public revenue. While the merits of this prescription when times are good are debatable, if implemented when times are bad it can be disastrous.[10] To understand why, let's look at how individuals respond to a recession.

When faced with economic uncertainty, individuals tend to reduce spending, increase savings when possible, and put off discretionary purchases. While this behavior makes sense at an individual level, when aggregated at local and national levels it reinforces the cycle of decline by reducing overall demand for goods and services. This is the very definition of recession. This response typically does not change until individuals perceive greater economic security in the form of steady employment, increased earnings, or asset appreciation.

Given individual retrenchment and its resulting impact on private business activity, how can we help jumpstart Maine's economy during a recession? The answer: by preserving state spending.

Private business activity is the core component of a vibrant economy, but government spending plays a significant role in sustaining economic activity and mitigating the effects of economic downturns on individuals and businesses. This is particularly true of spending by state and local governments, which is highly concentrated on goods and services produced and supplied locally. By contrast, private consumers and businesses tend to spend more of their dollars on goods and services provided by out of state vendors. As a result, public purchases are more likely to circulate throughout the state's economy, supporting purchases and jobs here at home and further boosting demand.

Unfortunately, government revenues are not immune to the general economic decline. In order to preserve state spending, policymakers either must tap into reserves or other one-time funds, or increase taxes. In the present crisis, Maine's reserve funds will be depleted to fill current year budget shortfalls. Federal stimulus funds can fill only part of the coming biennial gap. That leaves one option – to increase taxes.

Both spending cuts and tax increases remove dollars – and therefore demand – from the economy. However, according to a wide range of economists – among many others, Mark Zandi of Moody's.com; Nobel prize-winning economist and Columbia University Professor Joseph Stiglitz; and Peter Orszag, the former Director of the nonpartisan Congressional Budget Office and current Director of the White House Office of Management and Budget - cuts in government spending result in a larger relative decline in demand and therefore are more likely to exacerbate an economic downturn.[11]

Here's why: when state government cuts or cancels a program – for example, by reducing payments to a local nursing home, eliminating positions at a community college, or cutting staff at a corrections facility – every single dime of that cut is money that no longer enters the local and state economy. Each dollar in cuts results *directly* in one full dollar of demand exiting the marketplace.[12] By contrast, we know that individual demand is already being curtailed. Any further reduction in individual income due to tax increases does not translate into a one-for-one reduction in individual purchases as consumers can only reduce their spending by so much.

Thus, the economic arguments for raising taxes to maintain government spending during a recession are clear. Dollars placed in the hands of government will enter the economy in full and are more likely to be spent on *local* services than dollars that remain in the hands of individuals. It is this boost to demand that is of primary consequence for the state's long term economic and fiscal health. Recognizing this connection between government spending and long term economic health, last December more than 100 economists signed an open letter urging the Governor of New York to include tax increases as part of a balanced approach to closing that state's budget gap. Stiglitz followed suit with his own letter.[13] Many other states already have or soon will pursue this policy.

Finally, two additional points underscore the wisdom of seeking a balance between cuts and taxes. All Mainers will feel the impact of drastic budget cuts as we lose essential government services. The pain of these cuts will be borne disproportionately by those who rely most on government services of all kinds, including police, hospitals, libraries, and schools. Tax increases spread the pain more widely and can be targeted toward those people with greatest ability to pay. In sum, it is both economically efficient and fair to look to tax increases to preserve government spending during a recession.

What Options Exist for Increasing State Revenues?

State government draws revenue from a variety of taxes, fees, and other sources. The overwhelming majority of General Fund revenue – close to 85% - derives from just two sources, the individual income tax (51%) and the sales tax (32%). When considering where to look for additional revenues it is natural therefore to focus on these two sources.

As Stiglitz and Orszag make clear, the least harmful way to raise additional revenues is to draw those revenues from higher income households. The economic argument for this approach is that higher income households curtail their spending less than lower income households when faced with a tax increase. This minimizes the decline in private demand and thus - in concert with the public investments these additional tax dollars make possible - supports the state's return to full economic and fiscal health.

Currently, nine states are considering or have passed legislation that would place an additional tax on high income households, typically those with incomes over $250,000 or $500,000. In Maine, a 10 percent surcharge on income taxes paid by those with incomes over $250,000 would generate about $40 million a year, or some $80 million over the 2010-2011 biennium. Important to note, such a tax would not result in the loss of the full $80 million dollars from these taxpayers' pockets. Because state tax payments are deductible from federal income, somewhere between a fifth and a third of these *state* taxes would be offset by a lower *federal* tax liability.

The other major source of General Fund revenue, sales taxes, offers another means of closing the budget gap. Unlike the income tax, where increases easily can be targeted to affect only upper earners, sales taxes are levied on goods and services also purchased by low and moderate income Mainers. As such, raising sales taxes – while economically still preferable to curtailing government spending – has the potential to more significantly reduce private consumption.

There are a number of ways to partially mitigate these adverse effects. These include focusing sales tax increases on items and services used more heavily by higher income households, as well as on goods and services used more heavily by visitors from out of state. This second option is particularly desirable as it "exports" more of Maine's tax burden and thereby ensures that visitors to our state help share more of the cost of the services and resources they travel here to enjoy. The adverse effects associated with a less focused, *broad-based* sales tax increase, however, also can be mitigated. It is possible to use the state *income* tax (and other state systems) to provide a "refund" to low and moderate income Mainers in amounts roughly equivalent to the additional sales taxes they would pay. Strengthening the existing state EITC by making it refundable, and better integrating the property tax circuit breaker into the income tax system are two important ways to accomplish this result.

During the 1991 recession, Maine raised the sales tax from five cents on the dollar to six cents. Were we to adopt this approach today, sales taxes would generate roughly an additional $190 million annually, or some $380 million over the 2010-2011 biennium.[14] Even if $60 to $75 million of this additional revenue were returned to Mainers with household incomes under $60,000, this increase would close some $225 to $250 million of the biennial shortfall.

From 1992 to 1997, both the 10% surcharge placed on taxable income and the one-penny sales tax increase helped return Maine to economic and fiscal health. Maine's economy steadily improved, growing by 11% overall in real terms.[15] As a result, both tax increases "triggered off" when state finances finally stabilized, guaranteeing that emergency measures did not outlive the emergency they were designed to address. A "sunset" provision could be part of the solution today.

Conclusion

No one is happy about large budget shortfalls or the resulting need for either spending cuts or tax increases. Certainly, Maine would be far better off were the state, national, and global economies chugging along at two or three percent rates of annual growth. Maine people would not be facing layoffs and home foreclosures, Maine businesses would be enjoying brisk sales, and the Maine state budget would be in balance.

Given the seriousness of the national recession Maine is not immune from the pressures that have led to tax increases in many other states. If the proper steps are taken to close the budget gap, we can reduce the length and depth of this recession, and position Maine to bounce back more quickly when the economy finally turns the corner. Focusing exclusively on spending cuts and thereby neglecting key public investments in education, healthcare, and infrastructure is not the recipe for future success. A responsible approach to the current crisis requires a *balance* of cuts *and* tax increases.

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Endnotes

1. While the 2001-2002 recession created a sizable hole in the state budget, this gap was significantly smaller than the one we faced either in the early 1990s or today. The 2001-2002 budget gap was addressed principally through spending cuts, though revenue enhancements also were used.
2. Figures are drawn from the Revenue Forecasting Commission's "Summary of Preliminary Recommendations, May 2009 Forecast", pg 1; and OFPR's "Summary of 2010-2011 Biennial Budget, February 2009", pg 1. Calculations were performed by the Maine Center for Economic Policy.
3. Ibid. This percentage is based on OFPR's "Current Services" GF expenditures estimate.
4. Governor's website: http://www.maine.gov/tools/whatsnew/index.php?topic=transparency_news&id=69604&v=article
5. Maine's state government will directly handle some $1.2 billion in federal stimulus money. Many hundreds of millions in additional federal stimulus money will flow to Maine (including $645 million in tax relief), though much of this will not be controlled or disbursed by state government.
6. Maine State Planning Office, Retail Sales Report for February, 2009: http://www.maine.gov/spo/economics/economic/retailsales.htm
7. Using appropriate state cost inflation adjuster, BEA website (see Table 3.10.4): http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N
8. Revenue projections updated in May have opened a new, $445 M gap in the Gov.'s budget. Given the Gov.'s current allocations, about $200 M in federal stimulus remains to help fill this gap.
9. Nicholas et al, Center for Budget and Policy Priorities, forthcoming paper
10. In addition, these arguments tend to ignore the role of government spending in providing services and supporting broader economic activity.
11. Stiglitz and Orszag, "Spending Cuts vs. Tax Increases at the State Level": http://www.cbpp.org/cms/index.cfm?fa=view&id=1346
12. Higher relative multiplier effects for public spending additionally augments its stimulative value.
13. The text of the letter, dated December 13, 2008, is available at: http://www.fiscalpolicy.org/StiglitzLetter_TaxesVsCuts_March2008.pdf
14. Figures are drawn from the Revenue Forecasting Commission's "Summary of Preliminary Recommendations, May 2009 Forecast", pg 5
15. US Bureau of Economic Analysis: http://www.bea.gov/regional/gsp/default.cfm?series=SIC

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