CALIFORNIA BUDGET PROJECT

policy points

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BUDGET CUTS OR TAX INCREASES: WHICH ARE PREFERABLE DURING AN ECONOMIC DOWNTURN?

California faces a large budget gap, while at the same time, the state and national economies are struggling. California's unemployment rate is the highest it has been in 12 years and forecasts project it will climb even higher in coming months.[1] As the economy continues to worsen, California's budget gap continues to widen. Governor Schwarzenegger recently proposed a package of spending cuts and revenue increases to narrow the budget gap. The Governor's revenue-raising proposal largely relies on increases in the sales tax. While basic economics demonstrates that carefully chosen tax increases are preferable to spending cuts when the economy is weak, prominent economists argue that "tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits."[2] Nobel Prize-winning economist Joseph Stiglitz recently wrote that when the economy is weak: "Economic theory and evidence gives a clear and unambiguous answer: It is economically preferable to raise taxes on those with high incomes than to cut state expenditures."[3]

KEY FACTS

- **State spending reductions could further exacerbate the weak economy.**

Consumers buy less and businesses produce less when the economy is weak. Therefore, the key to promoting the state's economic growth in the short run is to encourage spending on goods and services.[4] Stiglitz writes: "In a recession, you want to raise (or not decrease) the level of total spending – by households, businesses and government – in the economy. That keeps people employed and buying things, and makes it more likely that businesses will want to invest to serve that consumer demand."[5] However, state spending reductions have the opposite effect: Each dollar less that the state spends generally reduces consumption by the same amount.[6] This dollar-for-dollar reduction in consumption tends to occur because state spending cuts disproportionately affect lower-income Californians, who typically spend all of their incomes. For example, every dollar of cash payments to low-income families that the state cuts would reduce the money that these families have to spend on rent, groceries, and other goods and services by an equal amount.

- **Personal income tax increases are a better option than spending cuts because they have a lesser impact on consumption.**

Personal income tax increases have less of an impact on consumption than state spending cuts because they affect higher-income Californians – who are more likely to save than to spend their incomes – to a greater extent. The more that tax increases are targeted to higher-income taxpayers, the less those increases will affect consumption. For instance, if high-income taxpayers spend, on average, 90 percent of their incomes and save 10 percent, then each dollar of a tax increase imposed on high-income taxpayers would reduce spending by 90 cents rather than by one dollar. For this reason, Stiglitz and Peter Orszag, currently the director of the Congressional Budget Office, conclude: "Tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run."[7]

- **Personal income tax increases are a better option than spending cuts because they have a lesser impact on local economies.**

According to Stiglitz:

> "Every dollar of state and local government spending enters the local economy right away, generating a greater economic impact. The impact is especially large when the money goes for salaries of teachers, policemen and firemen, doctors and nurses and others that provide vital services to our communities." In contrast, "raising taxes on high income households also will reduce spending, but by less than the amount of the tax increase since those with plenty of income typically spend only a fraction of their income – and some of what they spend is spent on luxury goods made abroad."[8]

Furthermore, lower-income families tend to spend more of their incomes locally than higher-income families.[9] For example, lower-income families spend a greater percentage of their incomes on housing – a local expenditure – than higher-income families.[10] Therefore, because state spending reductions would disproportionately affect lower-income Californians, they would have a greater impact on local economies than personal income tax increases, which would affect lower-income Californians to a lesser extent.

- **The economies of states that substantially increased taxes in recent years performed as well as or better than those of states that did not.**

States that enacted large tax increases between 2002 and 2004 – increasing state revenues by at least 5 percent – subsequently experienced stronger average growth in personal income than states that did not increase taxes at all.[11] Additionally, average job and wage growth was essentially the same for states that increased taxes the most during this period as it was for states that did not increase taxes. Moreover, states that raised taxes substantially are considerably less likely to face budget shortfalls this year than are states that did not.[12]

The Economies of States That Increased Taxes in the Early 2000s Performed as Well as or Better Than Those of States That Did Not

	Average for States That:	
Percent Change, 2004 to 2006	Increased Taxes Substantially	Did Not Increase Taxes
Median Wage	5.7%	5.9%
Number of Jobs	3.5%	3.4%
Personal Income	10.6%	9.7%

Note: States that increased taxes substantially are those that enacted tax increases between 2002 and 2004 that resulted in a cumulative increase in state revenues of at least 5 percent.
Source: Center on Budget and Policy Priorities

- **The economies of states that enacted large tax cuts in the late 1990s and early 2000s performed worse than those of other states.**

States that enacted large tax cuts between 1994 and 2001 – reducing revenue by at least 7 percent – subsequently experienced weaker growth in jobs and personal income and larger increases in the unemployment rate, on average, than other states.[13] Furthermore, the states that enacted large tax cuts faced larger budget shortfalls when their economies weakened.

- **Public services are critical to a healthy business climate.**

Research suggests that the quantity and quality of public services may play a more important role in business location decisions than state and local taxes.[14] This finding reflects the fact that state and local taxes tend to make up a very small share of business costs.[15] Moreover, public services can reduce the cost of doing business. For example, high-quality infrastructure can reduce transportation and shipping costs, and high-quality public education can reduce workforce training costs. Given this finding, it is not surprising that most of California's business executives favor increasing funding for the state's public schools.[16]

Alissa Anderson prepared this Policy Points. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

1 For an overview of key economic indicators, see California Budget Project, *Labor Day 2008 Little to Celebrate* (August 2008).

2 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), p. 2.

3 Joseph E. Stiglitz, letter to New York Governor David A. Paterson, New York Senate Majority Leader Joseph L. Bruno, and New York State Assembly Speaker Sheldon Silver (March 27, 2008), p. 1.

4 See Peter Orszag and Joseph E. Stiglitz, *Biting the Budget Bullet: Why Raising Taxes Is the Least Painful Way Out of the State's Fiscal Crisis* (Tax Policy Center: April 27, 2003).

5 Joseph E. Stiglitz, letter to New York Governor David A. Paterson, New York Senate Majority Leader Joseph L. Bruno, and New York State Assembly Speaker Sheldon Silver (March 27, 2008), p. 1.

6 See 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).

7 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), p. 2. According to Stiglitz and Orszag, "A much better approach [than spending cuts] would close more of the budget gap by levying an income-tax surcharge on higher-income families ... while leaving the current rate ... in place for others." See Peter Orszag and Joseph E. Stiglitz, *Biting the Budget Bullet: Why Raising Taxes Is the Least Painful Way out of the State's Fiscal Crisis* (Tax Policy Center: April 27, 2003), p. 3. An income-tax surcharge – an additional rate added on top of the existing rate structure – can raise a substantial amount of revenue with a relatively small increase in current tax rates. Moreover, state taxpayers would not bear the full cost of an income-tax surcharge because state income taxes reduce federal income taxes for taxpayers who itemize their deductions. Because most high-income taxpayers itemize, part of the cost of an income tax surcharge targeted to high-income taxpayers would be offset by reduced federal income taxes. See Elizabeth C. McNichol and Andrew C. Nicholas, *Using Income Taxes To Address State Budget Shortfalls* (Center on Budget and Policy Priorities: February 21, 2008).

8 Joseph E. Stiglitz, letter to New York Governor David A. Paterson, New York Senate Majority Leader Joseph L. Bruno, and New York State Assembly Speaker Sheldon Silver (March 27, 2008), pp. 1 and 2.

9 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), p. 2.

10 US Bureau of Labor Statistics, *Consumer Expenditures in 2005* (February 2007), Table 1.

11 Center on Budget and Policy Priorities. A total of 17 states enacted large tax increases between 2002 and 2004, resulting in cumulative revenue increases of between 5.1 percent and 15.7 percent. Six states did not enact any tax increases during this period.

12 Seven out of 17 states (41 percent) that enacted tax increases resulting in increased revenues of 5 percent or more faced budget shortfalls this year, compared to all six of the states that did not increase taxes at all.

[13] Nicholas Johnson and Brian Filipowich, *Tax Cuts and Continued Consequences: States That Cut Taxes the Most During the 1990s Still Lag Behind* (Center on Budget and Policy Priorities: December 19, 2006). Sixteen states enacted large tax cuts between 1994 and 2001 that reduced revenue by at least 7 percent. The change in the number of jobs and in personal income represents the average annual percent change between 2001 and 2006. The change in the unemployment rate represents the percentage point change between 2001 and 2006.

[14] "Hundreds of surveys have found that tax incentives play little role in investment decisions, [which is] particularly remarkable given that survey respondents may have a strong interest in exaggerating the importance of tax incentives they could receive." Moreover, "statistical and econometric studies are nearly unanimous in concluding that state and local tax incentives fail to attract a significant number of new businesses, create numerous jobs, or substantially enhance state economic performance." See Robert G. Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development* (Economic Policy Institute: March 2004), pp. 21 and 25.

[15] By one estimate, state and local taxes accounted for approximately 1 percent of the cost of doing business in 2000. See Robert G. Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development* (Economic Policy Institute: March 2004), p. 4.

[16] Greenberg Quinlan Rosner Research and California Foundation for Commerce & Education, *Selected Survey Results: Business Executives' Attitudes on California Education Conducted for the California Foundation for Commerce and Education* (March 2007), downloaded from http://www.calchamber.com/CC/News/Archive/2007/03122007PR.htm on March 6, 2008. This survey of a representative sample of more than 1,300 business executives was conducted in early 2007.