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Updated February 25, 2011

A BALANCED APPROACH TO CLOSING STATE DEFICITS

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As states head into their fourth year of fiscal crisis, most continue to face severe revenue shortfalls that require closing huge deficits.[1] As they prepare and consider budgets for the upcoming fiscal year, which begins July 1, 2011 in most states, the choices they make about how to close those deficits have serious implications both in the short and long term. States that rely solely or primarily on widespread budget cuts to close deficits are harming residents and businesses that need immediate assistance; they also are reducing demand in the economy and impeding their state's economic recovery.

Projections suggest that states collectively will need to close over $125 billion in deficits as they enact their fiscal year 2012 budgets. If states were to close the entire $125 billion in deficits with budget cuts, they would create a significant drag on the economy. While there might not be any perfect choices for closing deficits in an economic slump this deep and long, it is clear that a balanced approach — rather than one that relies heavily or exclusively on spending cuts — is useful in mitigating the damage.

There are options available to states outside of the often cited "either-or" framework of tax increases and spending cuts. And while tax increases and spending cuts are important components of a balanced approach, how they are structured is critical for both residents and the state economy. This report examines seven components of a balanced approach to dealing with state deficits. They are:

- **Efficiency** – focusing on the goals of expenditures and whether there are better ways to reach those goals;
- **Using all available resources** – employing reserves and rainy day funds responsibly and wisely;
- **Scrutinizing all spending**, not just what is appropriated through the budget – including programmatic expenditures made in the form of tax breaks;
- **Improved collections** – aggressively seeking taxes due that are not being paid;
- **Tax increases** – particularly those that have a more positive impact on the economy than spending cuts;

- **Prioritization** – making careful decisions based on goals and effectiveness when budgets must be cut; and
- **Paying close attention to future impact** while fixing today's problems.

States generally are required to balance their general fund, or operating, budgets. Prohibited from running a deficit, state policymakers' first impulse when confronting a revenue shortfall is usually to reduce spending. This is particularly true when a deficit develops in the middle of the fiscal year, which can occur because revenue slowdowns are more severe than anticipated, the demand for services in programs such as Medicaid exceeds estimates, or projected program savings do not materialize. Often in this circumstance, a governor or legislature will order an across-the-board cut in spending. Even in the normal course of budget preparation prior to a fiscal year, all or almost all agencies typically are required to submit budgets that are reduced by a specified percentage when shortfalls are expected.

> **"A balanced approach [to closing deficits] helps to assure that no one segment of residents and businesses in the state bears the brunt of recession-induced deficits."**

Strategies relying this heavily on spending cuts can be harmful. States may leave residents without services they need, as has happened already in this recession and its aftermath as a result of budget cuts in the past three years; the problem is poised to deepen substantially in the budgets currently under consideration. States are proposing deep cuts in K-12 education that would increase class sizes and eliminate athletic programs and are proposing to eliminate pre-kindergarten programs for at-risk children. States are proposing further increases in public college and university tuition and cuts in student aid — on top of such actions taken in previous years — making it harder for young people from moderate-income families to attend college. Some states are proposing to drop health insurance coverage for large numbers of vulnerable residents, and are reducing access to various types of health services. As states attempt to shift the cost of funding services to local governments,. businesses may find themselves without necessary services ranging from fire protection to access to courts. And budget cuts that result in layoffs or reduced salaries for public employees, or for employees in businesses and nonprofits that contract with governments, reduce economic demand in the state and as a result undermine state and national economic recovery.[2]

Far better is a balanced approach to closing deficits, one that relies on a variety of strategies. A balanced approach helps to assure that no one segment of residents and businesses in the state bears the brunt of recession-induced deficits. And it can minimize economic harm to the state and the country.

Promoting Efficiency – Doing Things Differently

There is value in times like these to ask whether a state's current goals can be met at a lower cost by changing the way those goals are pursued. Sometimes states operate programs or activities that were designed for a set of circumstances that existed in the past, for example, and those programs and methods are no longer the most efficient way to move forward.

Before giving examples, however, it is important to add a note of caution. Many people assert that there are huge savings to be gained because state governments are operated inefficiently. However, efficiency studies conducted in several states over the years show that very large savings are rare, if they exist at all.[3] When seriously measured, management of state functions turns out to be more efficient than popular opinion and political rhetoric might suggest. And it often is the case that a program eliminated in the name "efficiency" in the eyes of one person is an "essential program" to someone else. But even if savings from changing the way things are done are modest and targeted, they are likely to be worth considering in this economic and fiscal climate.

Corrections Spending

Spending on prisons and related areas is getting a lot of attention during this recession and its aftermath; a number of states have been looking for ways to reduce corrections budgets without compromising public safety. The business-as-usual way of reducing costs is through such operating changes as staff reductions or hiring freezes, eliminating programs for the prison population, decreasing health services, or closing facilities.

Different ways of approaching the problem — that would have both short- and long-term implications — could include changes that reduce recidivism, appropriately accelerating the release of some prisoners, and rethinking who needs to go to prison for how long.[4]

The number of people who return to prison because while on probation or parole they commit new offenses or violate rules is a significant driver of costs in most states. Several states are strengthening their ability to work at the community level with people who have been released from prison rather than reflexively return them to custody for minor infractions by upgrading reentry programs and community supervision. Some are using research and evidence to institute gradual responses to violations, eliminate supervision requirements for lower-risk people, and reward success. For example, Arizona, Nevada, and Washington allow supervision time to be reduced for those in full compliance with their requirements. States such as Colorado and Wisconsin are moving ahead to increase the ability of inmates to shorten their sentences through "good time." Other states are establishing commissions or task forces to reconsider mandatory sentencing policies, especially with regard to non-violent drug offenders who could benefit more from treatment than incarceration. New York had resentenced 1,700 nonviolent offenders through such reforms as of February 2010, and South Carolina expects to save $400 million over five years with a sentencing reform package passed in June 2010. While some of these policies require a degree of up-front funding, most are likely to result in budget savings in the near term.

Economic Development Expenditures

States spend significant amounts of money in the hopes of improving their "business climate" or attracting specific businesses to move from other states. The subsidies states provide may be in the form of direct expenditures, loan guarantees, or tax breaks to locate, build, or expand a facility. (Tax breaks in general will be discussed further below.)

Most of this spending is not disclosed and itemized in a way that ensures the public and even legislators are fully aware of how much is spent and what the state gets in return. Objective analysis of the costs and benefits of such spending — including whether they actually serve as incentives or not — is rarely produced or made available. Even if a state conducted an analysis when the subsidy was awarded, which might be several years in the past, the results might differ greatly if the costs and benefits were reevaluated today.

Enterprise Zones are an example of a strategy that was thought to be effective many years ago, but changes in design and circumstances over the years have sometimes yielded a very different result — with job creation or retention not necessarily occurring, a very high cost per job induced by the program, and incentive benefits sometimes exceeding the company's investment.[5]

"Research over the years has shown that economic development incentives rarely are the deciding factor in business location."

The incentives nearly every state gives to movie and television producers for shooting films and videos in the state are another example of a policy that may have seemed like a good idea when it started but no longer is effective for most states.[6] Today, more than 40 states offer some form of media production incentive, up from five in 2002. The subsidies totaled $1.5 billion in fiscal year 2010 and are very generous in some states; Louisiana handed out $139 million in fiscal year 2010, while Alaska and Michigan offered credits worth up to 44 and 42 cents on the dollar, respectively. These credits are refundable or transferrable, often paying companies far more than what their tax liability would be. And with so many states offering subsidies, states periodically have opted to increase how much they give to continue to lure production from other states. However, there is a lack of credible evidence showing that these incentives are a good investment for states. Research shows that alternative uses of the funds now devoted to these incentives could yield a better bang for the buck in terms of economic development. Arizona has eliminated its tax credit; Iowa, Kansas, and New Jersey have suspended their credits; some states have curbed their credits; and others are considering curbing or repealing theirs. Even in New Mexico, one of the first and most aggressive states to attempt to build a local film industry through subsidies, the governor has proposed to reduce the state's credit this year to its original level.[7]

The outcome of economic development subsidies is often shrouded in secrecy because businesses consider some of the information that is necessary to evaluate the efficacy of the incentives to be proprietary. A minority of states require disclosure of this information in a form that would facilitate evaluation. In most states, only the state government — and not outside researchers — can access the information needed to analyze whether incentives are a good investment, but few states undertake such analysis. For example, Texas produces a substantial amount of data about its subsidies, but does not identify the recipients. Unfortunately, it does not correlate the data in such a way as to yield a cost-benefit analysis.[8]

Research over the years has shown that economic development incentives rarely are the deciding factor in business location. Factors such as the availability of an educated workforce, access to transportation, and quality of life are usually found to be more important than specific incentives. But businesses will ask for location incentives if they think they can be achieved, and may "shop" among states for the best deal.[9] The key is for states (and localities) to understand what they are buying when they give such incentives, and evaluate the cost of such incentives against other uses of the funds that may be more effective in promoting economic activity.

States can do an audit of their economic development incentives. Ideally, an audit would be established as a regular part of state scrutiny of expenditures. If there is no regular mechanism, this would be a particularly good time to undertake such an audit. States can identify successful incentives — those that are creating jobs for a reasonable expenditure per job — and repeal or stop offering those that have outlived their usefulness or do not make economic sense today.

Moving forward, states can avoid creating open-ended incentives that are difficult to evaluate, particularly those that occur through the tax code. It is important for states to require guarantees of performance on new incentives. For example, states should include "clawback" provisions that halt incentives if employment targets are not met and require the recipients to return all or part of the money they received. All of these actions can save significant amounts of money while assuring that the state is getting value for its expenditures.[10]

Contracting

Over the years, states have chosen to provide various types of services through contracting with private sector individuals or companies (or sometimes with nonprofit organizations) instead of running those programs themselves or providing the services with public employees supported by state revenues. While states sometimes make these decisions after careful evaluation of the relative costs of public versus private provision of the service, other times they are driven by ideology or an unproven assumption that the private sector is a less expensive alternative.

Whatever the situation, it would be timely to reevaluate those decisions. If a state conducted a cost comparison sometime in the past, circumstances may have changed and re-analysis might yield a different result. If a state did not conduct an initial cost-benefit analysis, now could be a good time to do one. For example, a study in New York found that the state could save $375 million a year by having state employees, rather than outside consultants, perform a variety of professional services work, and another study showed that consultants charged 62 percent more than public employees for doing the same work (inclusive of employee benefits). In recognition of this problem, New York passed legislation during a November 2009 special session to facilitate the hiring of state employees to lessen the reliance on consultants.[11] In a different type of example, Texas in 2007 cancelled a large contract with a private entity to operate eligibility and benefit determination and other aspects of its food stamp, Medicaid, and TANF programs because of cost overruns and other problems with the contract.

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Council of State Governments Justice Center Justice Reinvestment Project http://www.justicereinvestment.org/

Pew Center on the States Public Safety Performance Project www.pewcenteronthestates.org/publicsafety

Good Jobs First has a substantial amount of information on economic development best practices on its Web site. See http://www.goodjobsfirst.org/accountable_development/key_reforms.cfm

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Using Reserves

Most states accumulate reserves, often called "Rainy Day Funds" during times of strong economic growth.[12] Given state balanced budget requirements, and the inevitable decline of revenue and the enhanced need for services during recessions, it makes sense for states to save during good times

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and then, in order to maintain necessary services, to spend that money during a downturn or its immediate aftermath when revenues remain weak.

Some states are reluctant to draw down their rainy day funds for fear that their bond ratings will be downgraded if they do so. But there is little basis for such concern. In fact, a University of Tennessee study of state bond ratings found that seven of the ten highest-rated states in 2007 had used at least one-third of their rainy day funds in 2002, and three of these AAA-rated states had used their *entire* fund.[13] And the rating agency Standard & Poor's offers the following guidance:

> It is important to keep in mind that use of budget stabilization reserves is not in and of itself a credit weakness. The reserves are clearly in place to be used. A balanced approach to using reserves is important in most cases, however, because full depletion of reserves in one year without any other budget adjustments creates a structural gap in the following year if economic trends continue to be weak.[14]

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Some states, however, do not have such reserves or they accumulate inadequate amounts during periods of economic growth. Arkansas, Colorado, Illinois, Kansas, and Montana do not maintain rainy day funds.[15] Moreover, at the beginning of fiscal year 2008, just before the recession hit, 21 other states had balances of less than 5 percent of a year's expenditures in their funds. Analysis of earlier recessions has shown that states need substantial reserves — in the neighborhood of 15 to 20 percent of annual expenditures — to help balance their budgets without overly relying on spending cuts or tax increases. And the 2001 recession and the current one have confirmed the need for substantial reserves at that level. Some states have inadequate reserves because the amount their rainy day funds can contain is limited by law; some 30 states cap their funds at 10 percent of spending or less and 13 states have capped theirs at 5 percent or less.

In addition, some states have barriers to using reserve funds during a downturn, such as requiring a "supermajority" vote of two-thirds of the legislature or that repayment of the funds must begin even before the economy improves.

All of these impediments lessen the potential effectiveness of rainy day funds as a way to mitigate the need for budget cuts and tax increases during recessions.

Use of reserves is one of the best strategies from the standpoint of the impact on a state's economy. Budget cuts reduce overall economic activity by removing demand because when public employees lose their jobs or income, or a contract with a private entity is cancelled, those people have less money to spend. Tax increases potentially have a similar effect, depending on how they are structured. (See discussion below.) But the draw-down of reserves *adds* demand to the state economy by injecting into it money that essentially was sitting in a "savings account."

The bottom line is that having adequate rainy day funds and other reserves — and using them when the fiscal weather gets rough — is a key component of a balanced approach to meeting public needs.

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Curbing Tax Expenditures

Each year states give up billions of dollars of revenue in the form of tax credits, deductions, and exemptions spent through the tax code as opposed to through the regular appropriations process. These "tax expenditures" range from poverty-reducing tax credits, to middle-class benefits, to corporate subsidies. Just as with direct spending on schools, health care, or road construction found in the budget, tax expenditures are a tool states can use to accomplish policy goals.

But there is an important difference. For budget appropriations, states typically require extensive documentation of how much direct spending they do each year, and the process entails evaluation of each item. Tax expenditures usually receive far less scrutiny. For the most part, policymakers do not regularly examine tax expenditures, nor do states document their effectiveness the same way they do for on-budget expenditures.

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Tax expenditures have a tendency to grow even while general fund budgets are being constrained during a recession. A recent study by the Iowa Department of Revenue projected that business tax credits would grow 350 percent between 2006 and 2011 in the state, while general fund revenues remain stagnant. After soliciting recommendations from a review panel, Iowa passed a law in 2010 that places limitations on certain business-related credits, creates a tax expenditure review committee, and requires the committee to closely evaluate each tax expenditure's costs and benefits at least once every five years.[16] This falls short of the review panel's recommendation to institute a five-year expiration for all tax credits unless specifically reenacted, but is nonetheless a significant improvement in transparency and accountability.

Several states do not even prepare reports on the amounts they spend on tax expenditures; they are Alabama, Alaska, Indiana, Nevada, New Mexico, South Dakota, and Wyoming. These states have no way to obtain the information needed to control this type of spending. Most other states prepare reports, but they vary in completeness and rarely include evaluations of whether the tax expenditures have been effective in meeting the purposes for which they were enacted.

Establishing a process to evaluate tax expenditures would be timely, whether it is a periodic regular review or a special panel. Tax breaks that were put into the code years ago may have lasted well beyond their purpose and be needlessly costing a state money. Other tax breaks may have greatly exceeded their estimated cost and are no longer affordable. For example, policymakers in Oregon were told before enactment that a business energy tax credit for renewable energy would cost \$4.1 million for 2009-2011. The cost is now projected to be \$185 million for that period, rising to \$290 million in the subsequent biennium.[17]

Another example is the widespread use of tax subsidies for companies that produce movies in a state, which is discussed above.

These and other business tax expenditures deserve particularly careful scrutiny. A recent report by the Federal Reserve Bank of Boston points out that some of the desired activities would have occurred without the credits. It also finds that credits rarely "pay for themselves" through generating additional economic activity. Thus it is important for states "to understand the benefits [they] are gaining for the revenues they are giving up."[18]

Some tax expenditures for individuals may also be problematic. A number of states offer special tax breaks to residents over 65 years of age or to residents receiving pensions, regardless of whether those residents are wealthy, middle class, or poor. As the population ages, these tax breaks are becoming increasingly more expensive; states could evaluate whether the elderly would be better served if the tax breaks were better targeted at seniors who need them and the saved revenues used to provide services to older residents.

States that do not tally up their tax expenditures and issue regular reports certainly should do so. Nearly every state could do a better job of evaluating tax expenditures against their original goals and determining whether or not they are cost effective. For example, Oregon law requires the preparer of the state's tax expenditure report to "determine whether each tax expenditure is the most fiscally effective means of achieving each purpose of the tax expenditure" and whether each "has successfully achieved the purpose for which the tax expenditure was enacted and currently serves, including an analysis of the persons that are benefited by the expenditure" — a requirement that goes much farther than those in other states. Nevertheless, virtually every tax expenditure in Oregon is noted in its report as having "achieved its purpose," with no further explanation.

Ideally, tax expenditures should be considered in the same manner as the general fund budget— all spending subject to similar scrutiny and to similar reductions in times of deficit — as part of a balanced approach to closing budget gaps.

Decoupling from Federal Tax Breaks

A special category of tax expenditures is comprised of tax breaks the federal government puts into the federal tax code that flow through to state tax codes and result in state revenue losses. This occurs because many states use the federal tax code as a starting point for state calculations and because most states use federal definitions of income and expenses in calculating taxes.

States can take action to separate themselves from the impact of these federal tax changes. This is a longstanding issue, and states have taken a variety of approaches to the problem — some usually accepting the federal changes that affect their own codes, some decoupling from most or some recent federal changes, and some enacting rules that prevent federal changes from taking effect unless specifically adopted by the state.

Among the federal tax changes from which some states have decoupled and other states still can are the following. (Note that additional information on all of these provisions may be found in the reports in the "Resources" section below.)

- The "domestic production deduction, " a corporate tax break (Section 199 of the federal code) that allows companies to claim a deduction based on profits from a wide range of activities including not only manufacturing but film making, food production, and utilities. Some 23 states could still benefit from disallowing this deduction for state tax purposes.[19]

- The "net operating loss carryback" deduction allows businesses to use current losses to offset past profits and receive refunds of prior-year taxes paid — at exactly the time that current-year tax collections are falling. Nineteen states still allow these carrybacks either through conformity to the federal provisions or through state-specific provisions. Carryback is particularly problematic at the state level and states could eliminate it.[20]

- Bonus depreciation provisions that allow businesses to deduct from their income in 2011the entire cost of newly purchased equipment in the year of purchase, and 50 percent of the cost in subsequent years, rather than deducting the cost of the equipment more slowly over its useful life.[21]

Whether or not these tax changes make sense at the federal level, they are for the most part inappropriate for states. Some, like the domestic production deduction and bonus depreciation provide a state tax break to multi-state companies regardless of whether the activity giving rise to the deduction took place in the state. Others, such as net operating loss carryback, reduce state revenue just at the time it is most needed during a recession and its aftermath. This is not such a problem for the federal government that arguably should be running deficits during a time of economic weakness, but is a huge obstacle for states that have to balance their budgets.

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Improved Collections

It makes sense for states facing deficits to try to do a better job of collecting taxes that already are due. Some states make the attempt by conducting amnesty periods that encourage taxpayers to pay delinquent taxes. Other strategies also are possible.

Remote Sales

The failure of those who sell products through catalogues or on the Internet to collect and remit state and local sales taxes is a major problem. This inability to collect all sales taxes that are legally due costs states billions of dollars each year in lost revenue. In 2008, New York State enacted an innovative law that helps address this problem, and Rhode Island and North Carolina enacted similar laws in 2009. As a result, some companies are now remitting sales taxes on purchases made by residents to some of these states (although Amazon is suing New York — so far unsuccessfully — to overturn the law).

The laws rely on the relationships that many such out-of-state retailers have with independent in-state websites known as "affiliates" to promote sales. Affiliates, which often are private businesses or nonprofits, place links on their websites to the retailer's site and receive a commission when someone follows the link and purchases from the retailer. The states that enacted these laws determined that this relationship with affiliates satisfies the requirement set down by the U.S. Supreme Court that states can require sales tax collections only from retailers with in-state property, employees, or independent sales representatives. Other states, including Arizona, California, Connecticut, Hawaii, Illinois, New Mexico, and Vermont, are considering a law — often called an "Amazon Law" even though its coverage is far broader than one company — similar to those in New York, North Carolina, and Rhode Island.[22]

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Another strategy is to try to step up efforts to collect taxes from in-state consumers on their remote purchases. Sales taxes are legally due on sales to state residents over the Internet even if the seller does not collect and remit them to the state. In all 45 states with a sales tax, the purchaser is liable to pay a "use tax" on remote or out-of-state purchases — which is the amount of the sales tax that would be due on the sale — directly to the state. Very few individual taxpayers are aware of use tax liability, however, and fewer actually pay use tax to states. It is possible for states to make residents more aware of this obligation through publicity campaigns and to facilitate payments by incorporating the use tax instructions and forms into state income taxes. In 2010, for example, Colorado enacted a law to require internet sellers that don't collect the state's use tax to inform their customers with each purchase that the tax nonetheless must be paid directly to the state and to annually send a form listing total annual purchases to both the customer and the state; however, a federal judge recently temporarily enjoined enforcement of the law. Oklahoma also amended its law in 2010 to require internet sellers to tell their customers with each purchase that use tax is likely due.

Vermont has tried some different approaches to increasing self-remittance of use taxes, such as urging paid preparers to inform clients about the use tax and ask them if they have liability. It also uses other methods to push payment — which has resulted in significantly more compliance than is typical (although still in the range of 5 percent to 8 percent of liability). The state provides tables that allow taxpayers to estimate their use tax liability without keeping all of their receipts from remote purchases. It also has expanded the state's use tax to cover digital downloads of movies, music, books, and ringtones.[23]

Sales Tax Collection Discounts

More than half the states with sales taxes allow retailers to retain a small portion of the sales tax they collect. These so-called "vendor discounts" largely stem from an era before computerization, when it took retailers considerable time and effort to calculate and remit sales taxes. Moreover, many states allow the same percentage discounts for all types of businesses, which advantages larger stores since "big box" retailers are likely to spend the same or less effort to collect and remit taxes on the total of its daily sales than a "mom and pop" store would require. Because of the volume of their sales, the big box store receives a much larger payment from the state for each day's submission in states that use a flat percentage discount.

There are two major issues regarding vendor discounts. First, the fact that some 20 states with sales taxes do not provide vendor discounts suggests that such discounts are not a necessary part of sales tax administration today. Second, some 13 other states have some form of limitation on how big a vendor discount can be taken each month, quarter, or year. This prevents very large retailers from unduly benefitting from a discount.

All states that continue to give vendor discounts could consider eliminating them. The discounts have little policy justification. For example, businesses aren't reimbursed for the cost of withholding social security or income tax from their employees' wages or for the cost of preparing and filing W2 forms, even though the workers are ultimately responsible for those taxes in the same way consumers are ultimately responsible for the sales tax. Governors or legislatures in Pennsylvania, Maryland, Utah, and Virginia have recently proposed eliminating these discounts as a component of balancing their budgets. Colorado has temporarily suspended its vendor discount.[24]

At a minimum, states that currently give unlimited vendor discounts could consider placing caps on them.

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Increasing Revenue

There is no shortage of voices making the claim that raising taxes is the worst strategy during a recession or when the economy remains weak. But this conventional wisdom has little basis in fact.

When revenues are insufficient and a state has to balance its budget in a recession or before the economy recovers, the choices states make often involve some kind of budget cut and some kind of tax increase (if reserves are not available). The anti-tax argument does not take into account the reality that cuts in spending are problematic policies during an economic downturn because they can make the downturn deeper in the state. That is because when states cut spending, they lay off employees, cancel contracts with vendors, eliminate or lower payments to businesses and nonprofit organizations that provide direct services, and cut benefit payments to individuals. In all of these circumstances, the result is that companies and organizations that would have received government payments have less money to spend on salaries and supplies, and individuals who would have received salaries or benefits have less money for consumption. This directly removes demand from the economy.

Tax increases can also remove demand from the state economy, but potentially to a lesser degree. For example, if the taxes fall on higher-income households, some of the additional tax payments will come from funds that otherwise would be held in savings, or from money that might be spent outside of the state. In neither case would those alternative uses of funds benefit the state's economy in the short term.

A number of economists have made this point, including Peter Orszag who was recently director of the federal Office of Management and Budget and Nobel Prize winner Joseph Stiglitz. They note:

> "…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 during the short run."[25]

By "short run," they mean during a recession or the aftermath when fiscal conditions remain weak.

There also is evidence that raising taxes in a recession does not harm a state's economy in the longer run. The recession of 2001 hit some states harder than others. As a result, some raised taxes while others did not. The tax-raising states were no faster or slower to recover from the recession than those that did not raise taxes. In fact, states that raised taxes rebounded as swiftly from the recession as states that did not, even though they were typically climbing out of a deeper hole. Moreover, states that had enacted significant tax increases (more than 1 percent of revenues) in the 2002-04 period saw growth rates in personal income, employment, and the median wage from 2004 to 2007 that closely matched national averages.[26]

"There is no shortage of voices making the claim that raising taxes is the worst strategy during a recession. But this conventional wisdom has little basis in fact."

So far in this economic downturn, several states have at least in part followed the advice of many economists and added a high-income bracket to their income tax or have raised the rate on their top bracket, either permanently or temporarily. These states are Connecticut, Delaware, Hawaii, Maryland, New Jersey, New York, North Carolina, Oregon, and Wisconsin.

There are also a number of other ways it could make sense for some states to raise revenues. Similar to the discussion of "decoupling" above, there are states in which federal estate tax changes resulted in the loss of the state estate taxes that were tied to the federal law. Nevertheless, about two-fifths of the states continue to collect either an estate or inheritance tax — either because they decoupled by remaining tied to the federal policy prior to the changes or because they maintain an independent estate or inheritance tax. In total, the states are collecting over $4.5 billion a year from these taxes. The remainder of the states could follow suit.[27]

Another strategy is expanding the list of services that are covered by sales tax. And still another is enacting "combined reporting" for corporations, a method of taxation that prevents businesses from transferring their profits on paper to states in which there is no corporate tax or a lower corporate tax. Both are discussed in more detail in the section below on looking to the future. These are in addition to the actions many states are taking to raise the rates on cigarette or alcohol taxes or increase their sales tax rates.

All told, some 12 states have raised overall revenues by more than 5 percent as a component of balancing their budgets from 2008 to 2010. They are Arizona, California, Delaware, Florida, Hawaii, Indiana, Massachusetts, Nevada, New Hampshire, New York, North Carolina, and Oregon. Already in 2011, Illinois has raised substantial revenue through new tax measures. Some of the tax increases have been temporary, some permanent. Either strategy may be appropriate in a recession, depending on the type of tax change and the circumstances in the state. In any case, increasing taxes is a critical component of a balanced approach to closing budget deficits.

"Recent polls …suggest that voters favor increasing taxes to preserve important services as part of the budget solution instead of relying only on spending cuts."

In addition to tax increases being an advisable element of a balanced approach from the point of view of preserving jobs and helping the state economy, there is evidence that voters are willing to support such actions as preferable to losing state services they consider important. On January 26, 2010 voters in Oregon chose to retain tax increases on higher-income residents and corporations that the legislature had passed in 2009. The revenue from these tax increases was already incorporated into Oregon's biennial budget, and it was clear that major service cuts would have been required had the measures not been upheld.[28] The vote was approximately 54 percent to 46 percent in favor of maintaining the tax increases. Recent polls from some other states, including Kansas and Utah, also suggest that voters favor increasing taxes to preserve important services as part of the budget solution instead of relying only on spending cuts. An October 2010 poll in Arizona, California, Florida, Illinois, and New York by the Pew Center on the States and the Public Policy Institute of California finds that people "are willing to increase their own taxes to pay for the things they consieder most important, particularly K-12 education and health and human services."[29]

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Budget Cuts – Setting Priorities

Every expenditure in a state budget is not necessarily equally important or equally effective in meeting the goals of the state. Some states have formal procedures for determining the relative "value" and effectiveness of various budget expenditures in meeting specified goals. States that have such procedures can be guided by them when in a situation where they feel they must reduce spending; these states can cut spending that they have judged is least effective in reaching agreed upon goals.

Washington State, for example, has one of the more comprehensive methods for ranking expenditures called Priorities of Government. Prior to every biennial budget, government and citizen representatives choose 10 areas of expected statewide results, such as student achievement, postsecondary learning, health care, security of vulnerable children and adults, and economic vitality, to prioritize. A committee then considers indicators of success in each area, and uses available research and experience to determine activities that are likely to lead to success. Based on this process, the activities and programs relating to each of the 10 goals are ranked in four categories: high-priority activities, low-priority activities, activities to fund only if additional money is available and ineffective activities that should not be funded. Within the "low priority" and "additional funds" categories, activities are ranked by effectiveness.[30]

Such a process is not easy to accomplish, nor is it a panacea. Criticisms can be made with respect to the specific research and measures that are relied upon for ranking, and as to whether research and data is robust enough to allow the numerical rank ordering of activities. And in the case of the Washington process, one could ask why it applies only to on-budget expenditures and not to those made through the tax code (as discussed above). Nevertheless, having information of the type produced by the Washington Priorities of Government process, which at least tries to distinguish the relative effectiveness of programs, is arguably far better than "flying blind" when budget cuts are necessary. And it definitely is better than making across-the-board cuts that risk highly detrimental effects because they make no distinctions among priorities, needs, or effectiveness.

Determining priorities can help lessen the adverse impacts on residents and businesses in the state. While it does not necessarily lessen the negative economic impact from cuts in spending, when used in a balanced combination with other strategies outlined in this report, effective prioritizing is a reasonable component of restoring budget balance.

Of course, not every state would want to go through such a comprehensive process every year or two as a normal part of creating and enacting a budget. In the current circumstances of ongoing budget deficits, however, states could use such a process to guide budget choices that inevitably will have to be made. Since state fiscal distress is expected to last at least two more years in most states, it would be timely to undertake some form of analysis of state priorities and the effectiveness of programs to address those priorities as part of a balanced approach to closing deficits.

Considering the Future

While it indisputably is the economy that right now is dragging down state revenues and causing deficits, there also are factors in state budget and tax systems that will continue to be problematic even after the economy recovers.

The failure to scrutinize and prioritize budgets and tax expenditures can lead to inefficiency that threatens long-term fiscal health. This is a good time for states to put systems in place that facilitate both budget prioritization and the side-by-side evaluation of expenditures that are reflected on-budget and those that take place through the tax code.

States that do not have firm mechanisms in place for replenishing their rainy day funds should consider establishing such procedures now. As the economy recovers, there will be pent up demand to restore services and expenditures that were cut during the recession and its aftermath. For example, some states have increased school class sizes, cut back on art, music, or language instruction, or eliminated pre-school programs. Others have reduced the reimbursements medical professionals receive under the Medicaid program. Still more have cut mental health services or programs for the elderly. And more cuts are already on the way in 2011-2012. All of these programs may be viewed as worth restoring. States will have to balance the need for program restoration with the need to accumulate a prudent level of new reserves in anticipation of the next downturn. This is a good time to consider and perhaps codify a way to strike that balance. For example, a state may require a deposit into its rainy day fund in any year when the economy is healthy — when personal income growth reaches a specified level.

In addition, tax systems in many states are in need of modernization to better reflect the 21st century economy. As policymakers contemplate strategies to close the current cyclical deficits, they have the opportunity to choose paths that also would strengthen the longer-term fiscal stability of the state.

Sales tax policy is one such area. As noted above, states need to find solutions for collecting sales taxes on purchases residents make over the Internet. But the problems in the sales tax are more fundamental than that. Many states' sales taxes still primarily are levied on tangible goods, though the American economy has changed to where services – many of them not subject to sales tax and some that did not exist when sales taxes were first enacted – make up an increasing proportion of household consumption. This issue has been widely analyzed and discussed over the past two decades, and some states have incrementally extended their sales taxes to cover more services. Still, according to the Federation of Tax Administrators, a majority of states apply their sales tax to fewer than one-third of 168 potentially-taxable services. Five of the 45 states with sales taxes impose them on fewer than 20 services.

"Tax systems in many states are in need of modernization to better reflect the 21st century economy."

Expanding sales taxes to cover more services is one of the more important elements of modernization a state can undertake; it can raise revenue immediately to help balance budgets now. In the longer run it can reduce the volatility of sales taxes, improve fairness, and prevent sales tax revenues from eroding over time as the service sector grows.

Several areas of business and corporate taxation also are in need of updating. One is the treatment of Subchapter S-Corporations (S-Corps) and Limited Liability Corporations(LLCs), which are forms of businesses that have greatly proliferated in recent years. They are not taxed under corporate tax laws. Instead, they pass their profits through to the owners who in most cases pay individual income tax on the money; the owners might or might not live in the state in which the business is located. According to the Internal Revenue Service, in 2003 there were 3.3 million S-Corps and 1.3 million LLCs operating in the United States, many of which were large, profitable businesses. Some 31 states already have significant taxes and fees that apply directly to these businesses in recognition of the fact that they enjoy a wide variety of services and protections in the states in which they are located; 19 other states only apply low, nominal taxes or fees to S-Corps and LLCs. There is an opportunity for modernization that could improve both revenue and the fairness of business treatment into the future.

In still another area of corporate taxation, requiring large, multi-state corporations to use the accounting method "combined reporting" is the only way to fully protect against these companies using the tax sheltering strategy of transferring profits to subsidiaries and affiliates in states that assess little or no corporate income taxes. While there long have been some opportunities for corporations to transfer profits in this way, the problem has grown in recent years as more profits are made from intangibles such as intellectual property and as companies use ever more sophisticated accounting strategies.

A majority of states with corporate income taxes have adopted combined reporting, including seven— Massachusetts, Michigan, New York, Texas, Vermont, West Virginia, and Wisconsin, as well as the District of Columbia — since 2004. Combined reporting has also recently received serious consideration in Iowa, Maryland, New Mexico and North Carolina. In states without combined reporting, corporate tax avoidance is likely to increase in the future, undermining revenue collections and adding to the frustration of in-state businesses that feel they are being treated unfairly.

In addition to these three specific areas, a number of other budget and tax strategies discussed above also have implications for the long-term fiscal health of states.

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Conclusion

When states face a deficit, an across-the-board reduction in spending is often the first response that comes to the minds of policymakers. But as this report shows, states in fact have a far wider range of policy choices they can employ to close deficits and maintain important services — the need for which grows even as revenues falter. Many of these budget-balancing policies do far less damage than budget cuts do to state economies. Some have the added advantage of strengthening the long-term fiscal situation of the state — beyond the immediate need to achieve a balanced budget this year or next.

The key is to construct a balanced approach to state budget balancing, instead of overly relying on spending cuts. The enormity of deficits in many states suggests that no one strategy can be sufficient on its own to fully close deficits. By using a balanced approach, states can minimize harm to the individuals, families, and businesses that depend on state services, and can also avoid further damaging economies already made fragile by the pressures of a recession.

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