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STRENGTHENING STATE FISCAL POLICIES FOR A STRONGER ECONOMY

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Strengthening state economies and creating jobs – now and into the future – will require sensible, forward-looking state fiscal policies. States need to invest adequately in education, health care, transportation and workforce development. To do that, they need to generate sufficient revenue, and they need to do so in an equitable and transparent manner.

This paper is a guide to fiscal policies that can create jobs now and prime states for long-term economic prosperity. Each section contains links to Center on Budget and Policy Priorities analyses that describe these best practices in more detail. As the rest of this paper describes, in this year's legislative sessions policymakers should:

- Restore state revenues quickly and target investments to get the economy back on track;
- Avoid ineffective strategies and gimmicks that weaken the state's economy;
- Protect state services and investments that create jobs over the long term to ensure a sustained recovery; and
- Strengthen opportunities for families and children to contribute to the economy by avoiding cutbacks in their purchasing power while also making sure they have the supports they need into the future.

Protect State Priorities to Boost the Economy, Now and in the Future

The financial crisis and resulting recession brought record-breaking declines in state revenues; the primary response to the hole blown in state budgets was deep cuts in education, health, human services, and other areas. Cuts of this magnitude are job killers. They directly eliminate jobs in both the private and public sectors, and indirectly cost additional jobs by reducing consumer buying power. In these ways, excessively large spending cuts make recessions deeper and longer than they would be otherwise.

See: *State Budget Cuts in the New Fiscal Year Are Unnecessarily Harmful: Cuts Are Hitting Hard at Education, Health Care, and State Economies*

Here's how the economic damage from spending cuts happens: when lawmakers cut services they end contracts with private sector businesses and reduce spending on private sector goods, leading to layoffs or lower wages among private sector workers. When lawmakers cut services they also lay off teachers, firefighters, police officers, and other public sector workers (over 650,000 state and local government workers have lost their jobs since the recession hit the states). In turn, private AND public sector workers who are laid off, or who see their pay reduced, buy less and further reduce economic activity.

Deep cuts to state services also erode the foundations of a strong economy, in both the short and long term. Spending on education, transportation, and public safety has been shown to stimulate economic growth in the short run and is among the most important determinants of economic growth and job quality in the long run.[1] Research also shows that expanding and improving upon these investments through well-targeted tax increases (in other words, finding new money to pay for better services) stimulates income and job growth.[2]

By limiting additional spending cuts this year and beginning to restore past cuts, states can help boost the nation's economic recovery and restore their investments in the future. States can also scrutinize their spending to emphasize priorities, pursue revenue increases, improve their revenue systems for the longer term, and attract more federal funds – all steps that will improve their economic performance and create jobs.

See: *States Continue to Feel Recession's Impact*

A Balanced Approach to Closing State Deficits

- **Invest in the state's priorities**. Many states need to rebuild public systems that are fundamental to job growth and a strong economy. This means reversing some of the most harmful spending cuts made over the past four years in key areas like education and health and sustaining or expanding investments that will help to get the economy back on track. For example, research clearly shows that investments in specific types of education and training can produce a lot of bang-for-the-buck. Preschool not only improves children's academic performance, but also increases the quality of a state's workforce and the quality of jobs. Likewise, investments in customized job training that assists people with basic skills according to the needs of local employers has been shown to produce substantial payoff.[3]

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1 Bartik, Timothy, "State Economic Development Policies: What Works?," Presented at the 19th Annual State Fiscal Policy Conference, Center on Budget and Policy Priorities, Washington, DC, November 30, 2011, http://research.upjohn.org/presentations/27/; Fisher, Peter S., 2011, "Corporate Taxes and State Economic Growth," Iowa Fiscal Partnership, http://www.iowafiscal.org/2011docs/110209-IFP-corptaxes.pdf; Lynch, Robert G., "Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development," Economic Policy Institute, http://epi.3cdn.net/f82246f98a3e3421fd_o4m6iiklp.pdf.

2 Robert G., "Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development," Economic Policy Institute, http://epi.3cdn.net/f82246f98a3e3421fd_o4m6iiklp.pdf.

3 Bartik, Timothy, "State Economic Development Policies: What Works?," Presented at the 19th Annual State Fiscal Policy Conference, Center on Budget and Policy Priorities, Washington, DC, November 30, 2011, http://research.upjohn.org/presentations/27/.

- **Make careful decisions on spending.** States can free up funds for priorities by reviewing the goals of other areas of spending and whether there are better ways to reach those goals. While the savings from finding efficiencies are usually modest, some areas of state spending hold particular promise. A number of states, for example, have pursued corrections reforms that save money without compromising public safety. States can also improve how well they monitor and evaluate economic development subsidies and eliminate subsidies that are ineffective. And states can evaluate their contracting practices; some states have saved money by lessening their reliance on consultants.

  See: *Improving Budget Analysis of State of State Criminal Justice Reforms: A Strategy for Better Outcomes and Saving Money*

- **Scrutinize ALL forms of spending**, not just what is appropriated through the budget – including programmatic expenditures made in the form of tax breaks. 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. For the most part, policymakers do not regularly examine these "tax expenditures" to determine whether they are effective the way they do for on-budget expenditures.

  See: *Promoting State Budget Accountability Through Tax Expenditure Reporting*

- **Pursue focused tax increases**. Tax increases on individuals and businesses at the top of the income spectrum, who are unlikely to spend less as a result, are preferable to spending cuts in an economic downturn. This is especially true when the cuts in question threaten to undermine the underpinnings of a sound economy – a high-quality education system, access to college, and modern transportation networks, for example.

  Rather than continue to damage these fundamental economic building blocks, state policymakers can raise taxes on high-income households and profitable corporations through the state income tax. Many states could also do so by reinstating taxes on inherited wealth. While some claim that these kinds of tax increases will drive large numbers of affluent people to other states, this claim is false.

  See: *Budget Cuts or Tax Increases at the State Level: Which Is Preferable When the Economy Is Weak?*

  Raising State Income Taxes on High-Income Taxpayers

  State Taxes On Inherited Wealth Remain Common: 21 States Levy An Estate or Inheritance Tax

  Tax Flight Is a Myth: Higher State Taxes Bring More Revenue, Not More Migration

- **Improve tax collections**. It makes sense for states facing shortfalls to try to do a better job of collecting taxes that already are due rather than cutting services. For example, the failure of those who sell products through catalogues or on the Internet to collect and remit state and local sales taxes costs states billions of dollars each year. Similarly, many states forego revenues by failing to ensure that online travel companies like Expedia, Orbitz, and Priceline collect and remit the appropriate amount of tax on hotel room bookings. And by requiring corporate parent companies and their subsidiaries to add their profits together, "combined reporting" states can nullify a variety of tax-avoidance strategies employed by large multistate corporations.

  See: *New York's "Amazon Law": An Important Tool for Collecting Taxes Owed on Internet Purchases*

State and Local Governments Should Close Online Hotel Tax Loophole and Collect Taxes Owed

A Majority of States Have Now Adopted a Key Corporate Tax Reform — "Combined Reporting"

- **Modernize state revenue systems.** 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 and economic footing of the state. For instance, many states primarily levy sales taxes on tangible goods, even though services – many of which, like cable TV, did not exist when sales taxes were first enacted – make up an increasing proportion of household consumption and the American economy. State lawmakers can fix the erosion of their sales tax systems, improving their long-term ability to invest in the state's priorities, by expanding the sales tax base to include more services.

  See: *Expanding Sales Taxation of Services: Options and Issues*

- **Leverage Federal Dollars through Health Reform**. State economies get a boost when new income flows into the state. So, state policymakers should look for opportunities to attract more federal dollars. One way to do that now is by expanding state Medicaid coverage to more low-income adults. Under the federal health reform law, the federal government will pay for part of an expansion now and, in 2014, will cover the full costs.[4] For states currently using their own funds to provide health coverage to people ineligible for Medicaid, this option is particularly attractive, since it allows states to use federal money to cover part of the state's existing costs. That will allow the state to shift its own funds to other priorities that save jobs and help build a strong future economy.

  See: *No Need to Wait Until 2014: States Can Cover Low-Income Adults in Medicaid Now*

Avoid Ineffective Strategies and Gimmicks That Set Economies Back

A number of states have cut taxes for corporations or high-income people based on the misconception that these cuts would spur economic growth. In the coming legislative session, more tax-cutting proposals are being made. They would eliminate or sharply curtail state income taxes, or in other ways severely depress the capacity of states to fund their future needs and remain flexible in the face of changing circumstances. These proposals not only would fail to produce the positive economic results that supporters promise, but also would make it increasingly difficult to pursue the policy options that *do* create jobs over the short- and long-run.

- **Steer clear of corporate tax cuts**. State lawmakers should avoid enacting costly corporate tax breaks that do little, if anything, to spur economic growth. Corporate and other tax breaks are, at best, a zero-sum game because they require a dollar-for-dollar cut in other areas of spending and are no guarantee of job creation. State film tax credits are a good example. Film companies receive generous tax benefits in many states for creating largely temporary and part-time jobs that they might have created anyway. These credits don't pay for themselves, and because of

[4] The federal government will cover the full costs of expansion in 2014, 2015, and 2016. After that federal support will phase down slightly, but even in 2020 and later years will cover 90 percent of the costs.

state balanced budget requirements, people who rely on other forms of state spending take the hit.

See: *Cutting State Corporate Income Taxes Is Unlikely to Create Many Jobs*

The Zero-Sum Game: States Cannot Stimulate Their Economies by Cutting Taxes

State Film Subsidies: Not Much Bang For Too Many Bucks

- **Avoid harsh spending limits**. Strict, arbitrary formulas to limit revenues and spending, like Colorado's TABOR, are gimmicks that can sound appealing to the public but hamstring policymakers' ability to adapt to changing needs and voter demands. TABOR has been rejected in every other state where it has been considered because it does more than limit state spending. It requires massive reductions in vital services that residents want and need— education, health care, public safety, transportation, environmental protection, and others — and that lay the foundations for a strong economy.

  See: *A Formula for Decline: Lessons from Colorado for States Considering TABOR*

- **Reject supermajority restrictions**. Supermajority or voter approval restrictions for raising revenue make it harder for states to protect their priority investments during recessions, which costs jobs and weakens economic recovery. These restrictions typically even reduce a state's ability to repeal costly and wasteful tax loopholes. They can also damage a state's bond rating and can lead to legislative gridlock: Because a small minority of legislators can block a tax measure, they can hold it hostage to narrow concerns, making it harder for lawmakers to enact policies that serve the state's broader interests.

  See: *A "Super" Bad Idea: Requiring a Two-thirds Legislative Supermajority to Raise Taxes Protects Special Interest Tax Breaks and Gives Budget Veto Power to a Small Minority of Legislators*

- **Protect income taxes**. Some lawmakers have proposed eliminating income and business taxes altogether and substituting them with higher, broader sales taxes. Inaccurately dubbed the "Fair Tax," this policy would threaten a state's ability to maintain many of the services necessary for a strong economy and would sharply increase the other taxes that low- and middle-income households pay. Other state proposals to eliminate income taxes for individuals and businesses without replacing those revenues would result in drastic reductions in the services that residents need and use every day, and that businesses and the economy rely on, like schools, transportation, and public safety.

  See: *"FairTax" Proposals to Replace State Income and Business Taxes With Expanded Sales Tax Would Create Serious Problems*

Use Strong Fiscal Management to Protect Investments in the Future

Strong fiscal management can help states to better gauge what will be needed to sustain the investments most critical to economic growth and prosperity. This means putting in place mechanisms that will help state policy leaders make prudent and forward-looking spending decisions that allow the state to meet residents' needs and build for the future.

- **Strengthen "rainy day" funds**. Reserve funds designed to help states meet people's needs during recessions – also known as "rainy day funds" – are a crucial part of prudent fiscal management. In hard times, lawmakers can tap these funds to sustain state demand for private sector goods and labor while protecting state investments that are key to future economic growth. Some states, though, either lack such funds or place arbitrary or onerous restrictions on their use, rendering them largely useless. To prepare more effectively for future recessions, these states should enact or improve their rainy day funds.

  See: *Why and How States Should Strengthen Their Rainy Day Funds: Recession Highlighted Importance of Funds and Need for Improvements*

- **Institute a PAYGO system**. As the economy recovers, more states will be tempted to cut taxes in ways that damage their ability to protect fundamental state investments over the long term. States also may be tempted to enact new programs that are not sustainable without significant new revenue. States can protect themselves against these possibilities by adopting a *"pay-as-you-go" (PAYGO)* system. A state PAYGO system would require that the governor and the legislature fully offset over a 5-year period the cost of proposed and enacted increases in spending or reductions in revenues with spending cuts or revenue increases. PAYGO would help policymakers and the public understand the consequences of budget decisions and tax cuts so they can properly weigh the long-term impact of competing proposals.

  See: *PAYGO: Improving State Budget Discipline While Retaining Flexibility*

Protect the Purchasing Power of Struggling Families and Children and Strengthen Their Opportunities for the Future

The recession continues to take a major toll on families. Unemployment remains high and two of every five unemployed persons have been out of work for half a year or more. Poverty is on the rise as a result. The loss of purchasing power by families – particularly poor and middle-class families who are most likely to spend money locally -- is part of why state economies are slow to rebound.

Child poverty is particularly costly to states and the nation in the long run, too. Not only does it cause children in poor families to perform less well in school than their better-off counterparts, but it also can diminish their earnings as adults.[5] Foregone earnings and other side effects of child poverty create a substantial drag on the economy over the long run.[6]

Given the negative and far-reaching economic consequences of poverty, state lawmakers should redouble their efforts to keep struggling families from falling into the ranks of the poor and avoid cutting supports that ease hardship. Such efforts can help protect families and children, make work pay, and buoy consumer demand – all steps that are good for the economy.

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[5] Duncan, Greg J. and Katherine Magnuson, "The Long Reach of Early Childhood Poverty," Pathways, Winter 2011, http://www.stanford.edu/group/scspi/_media/pdf/pathways/winter_2011/PathwaysWinter11_Duncan.pdf. Job loss during the recession has exacerbated poverty and hardship for children, which means even greater future costs to individuals, families and state economies.

[6] Holzer, Harry, Diane Whitmore Schatzenbach, Greg J. Duncan, and Jens Ludwig, 2007, "The Economic Costs of Poverty in the United States; Subsequent Effects of Children Growing Up Poor," Center for American Progress, http://www.americanprogress.org/issues/2007/01/pdf/poverty_report.pdf.

- **Protect and expand state EITCs**. Fifteen states tax income below the poverty line for a two-parent family of four. State Earned Income Tax Credits (EITCs), other low-income tax credits, and "no-tax floors" can help low-earning families keep more of what they earn or shield them from the unintended consequences of broad-based tax increases or improvements, like expanding the sales tax base to services.

  State EITCs play a particularly important role in the current economic climate, as many families have seen their wages or hours cut back or have lost a wage earner due to the recession. State EITCs in conjunction with the federal credit are considered the most effective tool for combating child poverty and provide low-earning families with the "bootstrap" they need to move up the economic ladder by making work pay. The credit also allows low-wage working families to keep more of what they earn, which they tend to spend in their communities, giving local businesses a boost. Lawmakers should look to expand these credits as the economy improves.

  See: *The Impact of State Income Taxes on Low-Income Families in 2010*

  A Hand Up: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2011

- **Properly fund Unemployment Insurance systems**. As the unemployment insurance (UI) system in this country is designed, states are supposed to raise enough revenue during good times to pay for the benefits jobless people need during recessions. By supporting the income of jobless people when the economy is weak, UI helps sustain consumer demand, reducing the severity of recessions. Prior to the recent recession, though, many states kept UI taxes artificially low, leaving their trust funds underfunded. In many states the share of wages that are taxable fell to extremely low levels. As the economic recovery gains traction, these states should raise the share of wages that are taxed, to prepare better for future recessions.

  See: *Rebuilding the Unemployment Insurance System: A Deficit-Neutral Plan That Limits Tax Increases and Maintains Benefits*

- **Protect supports for the neediest**. Families turn to welfare when they lose a job, are facing a crisis such as fleeing an abusive situation, or need to care for a sick child. Many also face serious mental or physical health problems. State lawmakers should maintain support for cash assistance as well as other supports like child care and transportation subsidies provided through Temporary Assistance to Needy Families (with both federal and state dollars) that help these families meet basic needs and stay in the workforce as they transition off of assistance.

  See: *Many States Cutting TANF Benefits Harshly Despite High Unemployment and Unprecedented Need*