Iowa Fiscal Partnership

BACKGROUNDER

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Between a Rock and a Not-As-Hard Place

State Budgeting Options to Avoid Prolonging or Deepening a Recession

In December, Governor Chet Culver called for Iowa lawmakers to construct the 2010 budget in a way that minimizes any potential to prolong or deepen the recession in Iowa.

Effectively, this means that spending and taxation decisions should be assessed for their immediate impact upon the economy as well as for their overall public purpose and longer-term benefit to the state. Depending on how it is structured, each action taken to address the budget shortfall will have a particular consequence for the state economy.

Since states are constitutionally barred from deficit spending, they must address any budget deficits by some form of "belt tightening" — by cutting spending or increasing revenues. Too often, however, such "belt tightening" only looks at the expenditure side of the state budget. While increasing taxes during a recession can have negative effects on the economy, cutting expenditures also can have negative effects. The question around any expenditure or tax is its relative impact on the economy.

Economists generally agree that what is needed to stimulate the economy in times of recession is increasing demand for goods and services, which means supporting consumer spending, particularly on mainstay products and services. Economists also agree that keeping people employed or getting them back to work is essential for an economic recovery.

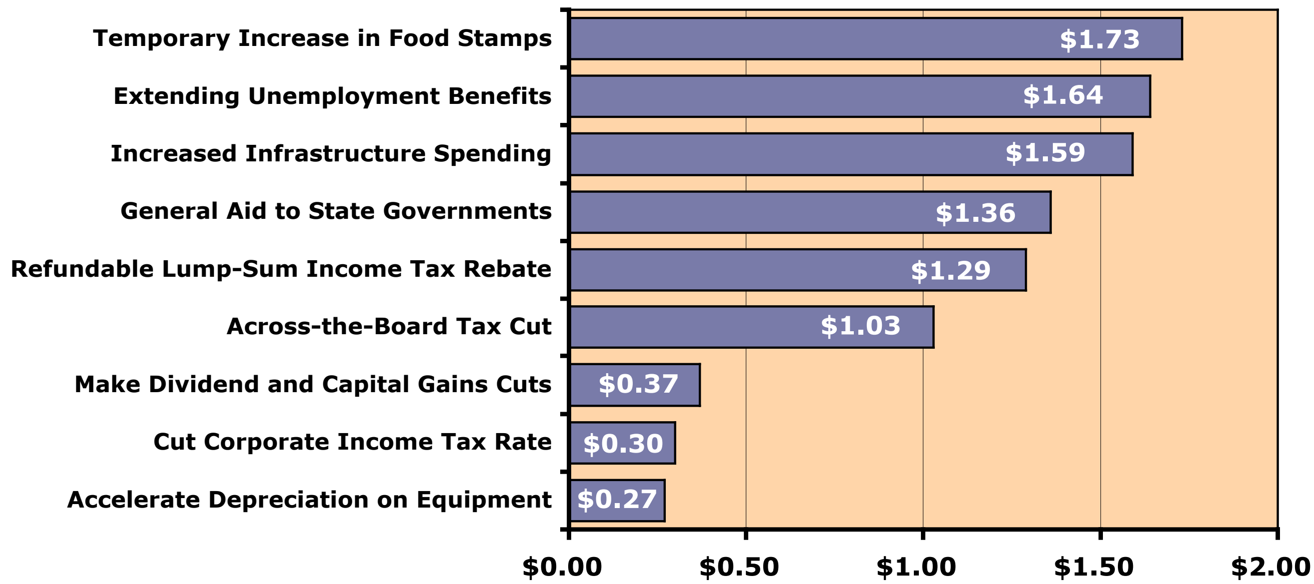
Economist Mark Zandi, the chief economist and co-founder of Moody's Economy.com and an adviser to John McCain's presidential campaign, has estimated the relative impacts of different actions the federal government might take to increase economic activity and stimulate the economy. Moody's Economy.com provides economic research and consulting services to businesses, governments and other institutions. Zandi's figures are frequently referenced by economists and policymakers.

Zandi's estimates of the extent to which different federal budgetary actions would stimulate the economy are shown below:

The Iowa Policy Project
20 E. Market Street
Iowa City, IA 52245
(319) 338-0773 • www.iowapolicyproject.org

CHILD & FAMILY POLICY CENTER
1021 Fleming Building • 218 Sixth Ave.
Des Moines, IA 50309
(515) 280-9027 • www.cfpciowa.org

Figure 1. Relative Economic Impact of Different Federal Actions
Change in Gross Domestic Product (GDP) for Each Dollar Invested



Source: Mark Zandi, founder and chief economist at Moody's Economy.com, written testimony before the House Committee on Small Business hearing on "Economic Stimulus For Small Business: A Look Back and Assessing Need For Additional Relief," Thursday, July 24, 2008.

The current emphasis at the federal level on enacting a major economic recovery package that involves substantial new government spending is based upon this economics and is broadly supported by a wide range of respected economists.

This is because tax cuts that benefit upper-income families don't necessarily result in additional spending; these families may just save more money than they would have otherwise. A 2008 analysis by the Congressional Budget Office on federal stimulus options made this point just over a year ago:

> If the additional income put into consumers' wallets through stimulative policies is saved rather than spent, it will generate little extra demand and bring few resources into production. [. . .] The bigger the chunk of that additional income that consumers are willing to spend instead of save, the more stimulus there will be from a particular tax reduction or increase in government transfer payments. [. . .] Lower income households are more likely to be credit constrained and more likely to be among those with the highest propensity to spend. Therefore, policies aimed at lower income households tend to have greater stimulative effects.[1]

Applying this Analysis to Iowa's Budget Choices

As stated earlier, while the federal government can deficit spend in times of recession, states cannot. While many states have created "rainy day" funds to enable them to maintain spending in times of recession, most of these are not sufficient to address the entire deficit they face today.

[1] Congressional Budget Office. "Options for Responding to Short-Term Economic Weakness. January 2008.

In very simple terms, at least 45 states, including Iowa, now face major budget shortfalls and must make decisions to either reduce spending or increase revenues (through taxes and fees) or decide to do some combination of the two. In making these decisions, states should strive to minimize the impact of their actions on prolonging or deepening the recession.

The type of analysis conducted by Zandi on federal economic stimuli can be employed in looking at state budgeting choices, although the goal at the state level in belt tightening obviously is in minimizing adverse impacts rather than maximizing positive ones. In addition, additional factors specific to state spending and taxation need to be taken into account.

First, some state spending, such as Medicaid, is matched by the federal government. In Iowa, each dollar spent on Medicaid is matched by approximately two federal dollars, tripling its impact on the economy, or its "multiplier effect." Every dollar cut in state Medicaid spending pulls three dollars out of the Iowa economy. At the same time, a dollar increase in state Medicaid spending puts three dollars into the state economy.

Second, some tax increases — such as a temporary surcharge on income taxes for high-income individuals or corporations — would have a lessened net effect because individuals and corporations can deduct their state income taxes on their federal tax return. For an individual in the 35 percent federal tax bracket, a dollar increase in state income taxes results in 35 cents less in federal taxes, so the impact is lessened.

Third, some of any spending cuts or tax increases may not stay within Iowa borders but goes out of state. For instance, some share of infrastructure investment, such as building roads, goes to purchase materials outside the state, and some of the workforce may also be from outside the state. Similarly, some people and corporations who pay taxes in Iowa live or have their major corporate offices outside the state. Therefore, only a portion of most spending or taxing will have an impact on the local or state economy. In general, however, spending that is directed toward lower-income households is likely to stay within the state economy longer and have a higher overall impact.

In short, while state economic impacts will be somewhat different, and often lower, than the ones Zandi produced at the national level, the general ranking is likely to be quite similar, with the exception of expenditures such as Medicaid that draw down additional funding from outside the state.

To illustrate these different economic impacts, two possible Iowa actions to address the fiscal crisis are described below.

First, in order to balance the budget by cutting spending, Iowa lawmakers might reduce state appropriations to the child-care subsidy program, which currently helps low-income families pay a share of their child-care costs. Reducing subsidies would make it more difficult for low-income workers to continue to be employed. It would mean that low-income families would have to spend more of their limited income on child care rather than on other basic needs or turn to cheaper and less desirable alternatives for providing child care. Reducing subsidies would also reduce the income of a child-care center or family day-care home that itself employs lower-wage workers and contributes to the economy. Because child-care subsidies go to families with low incomes to pay for local services, research from Cornell University indicates that the economic multiplier effect of child-care subsidies is very high, with returns to the local economy of at least $1.60 for every dollar spent.[2] In short, cutting the child-care subsidy program reduces local spending and employment and therefore contributes substantially to prolonging and deepening the recession.

Second, Iowa lawmakers might choose to address the fiscal crisis by limiting special Iowa tax treatment of long-term capital gains for the sale of a business to the first $100,000 of such gains, with any amount above that taxed at the same rate as other capital gains and employment income. This particular provision would annually affect approximately 600 Iowans whose profit from the sales of their businesses exceeds $250 million and would generate $20 million in annual state revenues. Because these Iowans can deduct their state taxes on their federal return, the total impact of this policy change would be less, amounting to about $14 million. More significantly, however, individuals with this wealth are not likely to immediately have spent a great share of the $14 million they would have otherwise received. They are more likely to save that money. If they do spend it, they are likely to spend it on discretionary and luxury goods and services, some of which would be outside the state or even the country. Such a tax change contributes much less (if at all) to deepening and prolonging a recession than the child-care subsidy cut example.

If Iowa is to minimize the possibility of budgeting decisions prolonging or deepening the recession, it must examine tax expenditures and credits every bit as much as direct appropriations in determining where to make changes. As the examples above show, some state actions will have much more severe impacts on the economy than others.

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[2] Warner, M & Liu, Z. (2006). The Importance of Child Care in Economic Development: A Comparative Analysis of Regional Economic Linkage. Economic Development Quarterly Vol. 20, No. 1. pp 97-103.

Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint fiscal policy initiative of two nonprofit, nonpartisan Iowa-based organizations, the Child & Family Policy Center in Des Moines and the Iowa Policy Project in Iowa City. IFP reports are available at www.iowafiscal.org.

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