STATE RECESSION ECONOMICS 101:

WHY A STATE BUDGET THAT SLASHES SPENDING WILL MEAN MORE JOBLESSNESS THROUGHOUT PENNSYLVANIA

In June of this year, the nation lost another 467,000 jobs and the national unemployment rate edged up to 9.5%. Even before June's disappointing employment report, as of May 2009, one-third of Pennsylvania counties (22 in total), most of them in rural areas, already had unemployment rates of 9.5 percent or higher (http://www.paworkstats.state.pa.us/). (For unemployment changes since 2008 go to http://www.keystoneresearch.org/unemploymap.html.)

The disappointing June jobs numbers underscore the importance of the revenue and spending decisions that lawmakers are now considering to resolve the 2009-10 budget stalemate.

Through May (the latest month for which state-level figures are available), Pennsylvania's unemployment rate has been lower than the national rate by roughly one percentage point-- 8.2% in May versus 9.4% nationally. One percent translates into roughly 60,000 Pennsylvania jobs-- only a third of the 182,000 jobs lost in Pennsylvania in the current recession but still a lot of jobs.

In the budget debate, if Pennsylvania leans too heavily towards deep spending cuts, the state's unemployment rate is likely to climb back towards the national rate, with negative consequences for tens of thousands of workers and hundreds of thousands of family members.

In the context of a deepening recession, lawmakers need to consider alternatives to deep spending cuts for resolving the state's budget stalemate--alternatives that preserve jobs. Fortunately, economists provide some straightforward guidance for state lawmakers seeking to preserve employment in Pennsylvania.

STATE SPENDING CUTS REDUCE EMPLOYMENT BY MORE THAN EQUAL TAX INCREASES

It is well known to economists--including Nobel Prize-winning economist Joseph Stiglitz--that sharp spending reductions may generate the most adverse economic consequences for states in a recession. By contrast, tax increases, especially on higher-income households, are the least damaging way to close state fiscal deficits in a recession and to provide for long-term economic growth. (For details, see http://www.fiscalpolicy.org/10-30-01sfp.pdf.)

The basic economic reasons are straightforward for maintaining state spending through revenue increases that fall on higher earners:

1. Both tax increases and spending cuts reduce total (or "aggregate") demand in the economy, lowering employment and profits. **But a dollar in state budget cuts reduces aggregate demand--slows down the economy--by a full dollar** because state government injects into the economy every dollar it raises in taxes. (In the language of economists, the state government's "propensity to consume" its additional tax revenue is 1.)

2. **By contrast, a dollar in tax increases reduces aggregate demand by less than a dollar**--because consumers, especially upper-income consumers, do not spend every dollar of income, a portion is saved. A tax increase will therefore come partly out of savings rather than entirely out of household consumption and as a result reduce aggregate demand by less than an equivalent amount of government spending cuts in the short run.

3. **Federal deductibility of state income taxes further enhances the positive impact on aggregate demand of spending maintained through a state income tax increase that falls on higher-income taxpayers.** Because state income taxes are subtracted from federal taxable income, taxpayers who itemize deductions can receive as much as a 35 cent reduction in federal taxes for each dollar increase in state income taxes. This further reduces the impact of a state personal income tax increase on consumption spending. Or to put it another way, it means that short-term tax increase to maintain spending will have an even larger advantage in terms of preserving jobs than spending reductions as argued in No. 2 above.

4. **State spending financed through bonds--in effect, through future state revenues--can further stimulate the state economy in the short run.** The reason is again straightforward. In this case, the reduction in consumer spending for each $1 increase in bond-financed state spending is below 40 cents because only a small fraction of the bond payments are made this year. With reasonable assumptions, each dollar of bond-financed spending can increase aggregate demand this year by 85 or 90 cents. The expansionary impact of bond-financed investment in a slow economy is one reason that the state's water and sewer infrastructure and $650 million Alternative Energy Investment Fund are so well timed. Given the expansionary impact of bond-financed investment, and given renewed evidence that this will be a deep, prolonged recession, the state could be looking closely at additional bond-financed investments.

IMPLICATIONS FOR THE STATE BUDGET DEBATE

The basic economic principles summarized above underscores that Governor Ed Rendell's proposal to balance the state's budget in part through an increase in the state's personal income tax is on target and that the alternative course of significant cuts in state spending would reduce employment by more. As noted above, Pennsylvania unemployment remains about a percentage point lower than the national rate--an advantage that translates into 60,000 jobs. The wrong budget agreement would jeopardize that Pennsylvania advantage.

States with graduated income taxes are better able to target tax increases to higher income individuals. Pennsylvania could target its income tax increase to higher-income earners through a differentially higher tax on investment income (such as dividends, capital gains, and net profits). This can be done in Pennsylvania without a constitutional change because each component of investment income is a separate "class" of income and may be subject to a different tax rate under the state's constitutional uniformity clause.

Taxing investment income at higher rates makes particular sense at this moment because of private-sector pessimism about future demand. This pessimism means that a lot investment income is especially likely to stay on the sideline in today's economy. As a consequence, taxing this income at modestly higher rates (e.g., at rates between the current income tax rate and the top income tax rate of our neighboring states--5.5%) would enable the state to maintain spending levels and sustain the state's economy while having minimal impact on private sector demand.