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HEADLINE: Biting the Budget Bullet: Why Raising Taxes is the Least Painful Way Out of the State's Fiscal Crisis

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LIKE MASSACHUSETTS, STATE governments across the nation are facing budget deficits of historic proportions. Next year, they will face combined projected shortfalls of between $70 billion and $85 billion-or about 15 percent of all the money they spend out of their general funds. In response, they are cutting back on vital services, curtailing school hours, and restricting access to Medicaid, as well as raising tuition at public universities and increasing taxes. Kentucky is releasing non-violent prisoners early to reduce costs. Missouri has even resorted to unscrewing every third light bulb in state buildings to save on electricity.

The states are in a difficult position. Unlike the federal government, they typically aren't allowed to run large ongoing deficits. Once they exhaust the various loopholes in their balanced-budget rules and spend down their rainy-day funds, the only two real choices are cutting spending or raising taxes. Neither is very attractive in a sluggish economy.
A look at the larger economic picture shows why. When the economy is weak, as it is today, firms suffer from excess capacity: They could produce more goods and services if consumers were only willing to buy them. (For example, only about 75 percent of the nation's industrial capacity was in use in March, well below the average figure for the past three decades.) In such situations, the key to short-term growth is to boost demand for goods and services.

But tax increases and spending cuts do exactly the opposite: They reduce demand for goods and services. State governments are thus forced to embrace Herbert Hoover economics: attempting to balance budgets in a lethargic economy despite the short-term economic harm imposed. With no good choices, policy makers must employ the cruel calculus of the lesser evil.

Massachusetts faces a $3 billion budget shortfall for fiscal 2004, on a total budget of some $22.5 billion this year. Governor Romney's proposed budget, released in February, represents a poor way of meeting the fiscal challenge. Instead of reversing recent cuts in the state income tax and increasing taxes on high-income families-the least harmful option-the governor calls for broad spending cuts. The House Ways and Means budget, released on Wednesday, calls for even deeper cuts.

To understand the folly of such an approach, it is important to dispel five myths about the Massachusetts economy.

Myth Number 1: Tax increases impose more harm on the economy than do other budget-balancing measures.

Despite proclamations by some politicians to the contrary, tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run. In a weak economy, it is particularly important to minimize reductions in overall spending. And reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, would result in relatively large declines in total expenditures in the state. But tax increases on higher-income families tend to reduce saving, not spending, since such families save a large portion of their income.

Furthermore, consider a little recent history: The increases in federal taxes on upper-income Americans in 1993, which were used to close the yawning budget gap at that time, preceded the strongest boom the US economy has had in more than a generation. There is no evidence that these tax increases harmed the economy-and considerable evidence that the deficit reduction that they helped finance was beneficial.

Myth Number 2: The current deficit reflects runaway spending.

The current fiscal imbalance was not caused by an explosion of spending. In fact, Massachusetts ranks 45th in the United States in the share of its personal income devoted to state and local spending. Between 1991 and 2002, inflation-adjusted spending rose by just 2.3 percent per year, compared to income growth of 2.6 percent per year. As a result, state spending fell from 9.4 percent of income in 1991 to 9.1 percent in 2002.

Myth Number 3: Spending increased in wasteful areas.

The spending increases that did occur in the 1990s were concentrated in three priority areas that are seldom considered wasteful: K-12 education, health care, and corrections. These three areas accounted for 99 percent of the spending increase between 1991 and 2002.

Myth Number 4: The state government is bloated.

The Massachusetts government is not swollen by excessive inefficiency or waste. State and local governments in Massachusetts employ 516 workers per 10,000 people; only eight states have fewer public employees per capita. Wages and benefits for public employees in Massachusetts amount to 5.7 percent of personal income in the state; only three states spend a lower share of income.

Myth Number 5: Taxes are relatively high.

Prior to the 1980s, Massachusetts deserved its reputation as a high-tax state. But following the aggressive tax cuts of the 1980s and '90s, taxes are now relatively low. According to a report from the House Task Force on Local, State, and Federal Revenues, the state has adopted 45 substantial tax cuts since 1990, adding up to an annual revenue decrease of more than $3 billion, even after taking account of more recent revenue increases. State and local revenue amounted to 13.9 percent of income in 2000, compared to a figure of 15.5 percent for state and local governments across the nation as a whole. Only a handful of states have lower revenue shares than Massachusetts.

Yet Governor Romney's budget does not propose any tax increases for higher-income families. Instead, it relies heavily on spending reductions-of roughly $1 billion-to reach balance. These include cuts in grants for early literacy programs, full-day kindergarten, and class-size reduction efforts, along with substantial reductions in higher-education funding and in unrestricted local aid. Most of the cuts translate directly into lower incomes or fewer jobs for teachers, health professionals, first responders, and others. As their incomes are reduced, so is their spending-which only hurts the economy as a whole.

A much better approach would close more of the budget gap by levying an income-tax surcharge on higher-income families-say, those making more than $100,000 a year-while leaving the current rate of 5.3 percent in place for others. But since such surcharges are forbidden under the state constitution, policy makers could instead reverse some of the recent tax decreases. The House Task Force on Local, State, and Federal Revenues estimates that the relatively modest step of returning to an income tax rate of 5.6 percent, its level in 2001, would raise $475 million. Going back to the 1999 rate of 5.95 percent would raise $1 billion a year. Either approach would allow the governor to forgo a substantial share of the spending reductions contained in his budget.

To be sure, higher-income families would bear a large share of any such tax increases. But such families benefited disproportionately from the tax cuts during the 1990s, even as their incomes were increasing at a particularly rapid pace. According to the Institute on Taxation and Economic Policy, the top 1 percent of taxpayers in the state received half of the total tax cut provided between 1989 and 2002. The top 20 percent received almost all of the aggregate tax cut. It seems reasonable to ask such higher-income families to play a significant role in addressing the current budget shortfall in the state, especially since the earlier tax cuts are one of the causes of the immediate budget problem.

Given how heavily the Bush administration's proposed tax cuts are slanted toward these families, they would still end up with substantially more money in their pockets, even with a modest increase in state taxes. What's more, state taxes are deductible under federal income-tax law, which means that some of the state tax increase would be offset by federal tax breaks.

Policy makers could also consider more fundamental budget changes-including abolishing the limits on the size of the state's rainy-day fund, reforming the state corporate-income tax in order to fully tax income that escapes taxation in other states, and raising tuition at public universities while increasing financial aid to lower-income students (as Governor Romney has proposed). Longer-term Medicaid reform would also help ease pressures on state budgets.

But these structural solutions still won't solve the immediate problem. If the federal government won't provide substantial fiscal relief-and there's little reason to think it will-Governor Romney should revise his budget plan to minimize the short-term economic damage. And while it may be difficult for politicians to face, an increase in the personal-income tax rate is the least damaging option available.

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