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Economic Stimulus:

What Can National And State Governments Do To Save And Create Jobs Quickly?

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THE ECONOMIC THEORY OF HOW STIMULUS WORKS

As unemployment remains high and policymakers at all levels of government recognize the need for policies that encourage economic growth, it is important to examine how economic stimulus policies work and which levels of government have the strongest capacity to create jobs and stimulate the economy quickly.

The standard prescription for government action in a recession is to stimulate the economy by increasing spending and reducing taxes. In the short term, both of these strategies put money in people's pockets, to spend on goods and services. This higher spending should induce employers to hire more workers. As new hires begin to spend, companies produce more products to replenish inventories, and that leads to more hiring and a positive cycle of steadily increasing economic activity. As the private sector grows stronger and demand continues to grow because more and more people are working, eventually job growth accelerates to a level that allows the government to end the stimulus policies. This is the strategy used by the federal government in the stimulus law, the American Recovery and Reinvestment Act (ARRA). When that law was enacted in February of 2009 the nation was losing over 700,000 jobs a month. [1] The rate of job loss declined significantly by April,[2] and now, during the second quarter of 2010, official estimates indicate that ARRA is increasing the number of people employed by 1.4 million to 3.4 million.[3]

While the economy began to turn around with ARRA's enactment, unemployment remains far too high for the economy to be considered strong. The immediate question is what actions, by which levels of government, could most effectively increase economic activity and create jobs.

CAN STATES STIMULATE THE ECONOMY SIGNIFICANTLY & QUICKLY?

The basic model of economic stimulus accepted by economists depends upon a government's being able to run deficits in periods of economic recession. Both direct spending and tax cuts create additional demand in the economy and have a stimulative effect. Both spending cuts and tax increases reduce demand and weaken the economy in the short run. On the margins, there may be some sets of tax and spending policies that could be modestly stimulative. These possibilities are discussed below. But fundamentally the requirement at the state level to produce balanced budgets -- which means paying for tax cuts with tax increases or spending cuts, and paying for spending increases with other

[1] US Bureau of Labor Statistics.
[2] US Bureau of Labor Statistics.
[3] Congressional Budget Office, "Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from January 2010 Through March 2010," May 2010, Table 1, page 2. http://www.cbo.gov/ftpdocs/115xx/doc11525/05-25-ARRA.pdf

spending cuts or tax increases -- means that states cannot undertake classic stimulus strategies. There are some exceptions: if states have built reserves that they can use during a recession, then they can spend modestly more than they take in for a few years. Similarly if the federal government provides emergency aid to states during a recession, as the federal government did with the ARRA, then states can stimulate their economies by spending more than they take in. But aside from these two specific cases, it is hard for state governments to undertake standard economic stimulus policies. States can make investments to improve long-term productivity so that they can outperform other states at each phase of an economic cycle, but there is very little they can do to affect economic cycles.

WHAT COULD THE FEDERAL GOVERNMENT DO RIGHT NOW?

Across the country state governments face an estimated $144 billion in budget gaps in FY 2011.[4] If those gaps are closed only with state spending cuts and tax increases it will likely cost the economy up to 900,000 jobs.[5] Because of the balanced-budget requirements that states face, federal relief is one of the only ways they can address budget gaps without implementing tax and spending policies that harm the economy. Estimates of the impact of ARRA on jobs and the economy have found aid to state governments to be one of the most effective strategies the federal government can pursue.[6]

Recognizing the effectiveness of state fiscal relief for job creation and retention -- and the long-term economic and human damage of deep state budget cuts to education, health care, and other basic public services -- the US House and Senate each voted earlier this year to extend the largest portion of state fiscal relief in ARRA for an additional six months (the aid is in the form of increased federal reimbursements for Medicaid spending, known as FMAP). Massachusetts and 29 other states have used that expected revenue in their budgets to avoid additional tax increases or spending cuts.[7] While that extension has passed each house of Congress in separate bills, it has yet to be included in a single piece of legislation that has been approved by the both the House and Senate -- and there is significant concern that it may not be. If Congress fails to approve the six-month FMAP extension, Massachusetts would be forced to cut its budget, raise taxes, or deplete reserves that will be needed next year by a total of $600 million to $700 million.[8] Nationally states would lose over $20 billion -- which would force spending cuts and tax increases that would weaken our economy and reduce employment at a very precarious point in our economic recovery.

The Congress is also considering legislation that would stimulate the economy by providing $23 billion in additional revenue to states for education. This proposal is estimated to create or save 313,471 jobs and would have the additional benefit of adding to the nation's long-term economic strength by improving the education and skills of the students who are our workforce of the future. [9]

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[4] Center on Budget & Policy Priorities, "Premature End of Federal Assistance to States Threatens Education Reforms and Jobs Loss of Education Jobs Stands at 105,000 and Rising; Recovery Act Saved 350,000 Jobs But Will Soon Expire," May 25, 2010. http://www.cbpp.org/cms/index.cfm?fa=view&id=3158.

[5] Center on Budget & Policy Priorities, "Additional Federal Fiscal Relief Needed to Help States Address Recession's Impact, Center on Budget and Policy Priorities," March 1, 2010. http://www.cbpp.org/cms/index.cfm?fa=view&id=2988

[6] Congressional Budget Office, "Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from January 2010 Through March 2010," May 2010. http://www.cbo.gov/ftpdocs/115xx/doc11525/05-25-ARRA.pdf

[7] Center on Budget & Policy Priorities, "Failing to Extend Fiscal Relief to states Will Create New Budget Gaps, forcing Cuts and Job Loss in At Least 34 States," June 8, 2010. http://www.cbpp.org/cms/index.cfm?fa=view&id=3207

[8] See revenue discussions in *MassBudget* Budget Monitors, e.g., http://massbudget.org/doc/727/1213

[9] Council of Economic Advisors estimate, May 2010. http://edlabor.house.gov/documents/111/pdf/publications/WhiteHouse-EducationJobsbyState-20100526.pdf

WHAT CAN STATES DO WITHIN CONSTRAINTS THEY FACE?

While a state has far less capacity than the federal government to stimulate the economy in the short run (because it must balance spending and taxes), are there particular strategies within those constraints that are most effective? States can adopt policies that put money into the hands of people who will be most likely to spend it. This principle was explained in detail in a paper by Nobel Prize winning economist Joseph Stiglitz of Columbia University, and Peter Orszag, now the Director of the Office of Management and Budget:

> "Basic economic theory suggests that direct spending reductions will generate more adverse consequences for the economy in the short run than either a tax increase or a transfer program reduction. The reason is that some of any tax increase or transfer payment reduction would reduce saving rather than consumption, lessening its impact on the economy in the short run, whereas the full amount of government spending on goods and services would directly reduce consumption ….
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> "*For states interested in the impact only on their own economy rather than the national economy, the arguments made above are even stronger*. In particular, the government spending that would be reduced if direct spending programs are cut is often concentrated among local businesses…. By contrast, the spending by individuals and businesses that would be affected by tax increases often is less concentrated among local producers — since part of the decline in purchases that would occur if taxes were raised would be a decline in the purchase of goods produced out of state."[10]

The same principle enunciated above holds, no matter what form a state tax cut might take. While at the federal level taxes can be cut for individuals and businesses without offsetting spending cuts (because the federal government can deficit spend), at the state level tax cuts need to be paid for with spending cuts or tax increases elsewhere. A recent report from the Center on Budget and Policy Priorities explains: "Because of this dynamic that occurs under a balanced-budget requirement, a state cannot stimulate its economy during a fiscal crisis by cutting taxes."[11]

While cutting overall levels of taxation will not stimulate a state economy when those tax cuts have to be paid for with spending reductions, it is theoretically possible that corporate tax cuts or credits could have a stimulative effect if they can meet two criteria:

1. They are fully paid for with offsetting tax policy changes that do not reduce consumption more than the proposed policy would increase it. Because, as Stiglitz and Orzag note, "higher-income families tend to have lower propensities to consume than lower-income families," increasing taxes on the former to finance particularly effective tax (or direct spending) initiatives could have an overall stimulative effect on a state economy.
2. They are extremely well targeted to encourage new job creation and do not lead to significant tax rewards for an activity that would have occurred regardless of the tax incentive. To meet this criteria a tax credit would give each business just enough of a financial incentive to hire new workers, but no windfalls— tax credits for hiring that the firm would have done anyway. In practice, such an efficiently targeted tax incentive is impossible to construct.[12]

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[10] Center on Budget & Policy Priorities, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?," November 6, 2001. http://www.cbpp.org/cms/index.cfm?fa=view&id=1346

[11] Center on Budget & Policy Priorities, "The Zero-Sum Game: States Cannot Stimulate Their Economies by Cutting Taxes," March 2, 2010. http://www.cbpp.org/cms/index.cfm?fa=view&id=3100

[12] Ibid.

There have recently been a number of proposals for specific tax policy changes in Massachusetts, often put forward as efforts to create jobs or otherwise stimulate the economy. In general these proposals have failed to meet the first criteria for effective stimulus in a context where the budget is required to be balanced: they have not come with any strategy to pay for them in a manner that doesn't do more harm to the economy than the benefit they may offer.

As Stiglitz and Orszag explain, to raise revenue with the least negative impact on consumption, states should raise taxes on higher-income households. In many states, tax increases can be targeted at those with the lowest propensity to consume – higher-income taxpayers—by the creation of new tax brackets or higher rates on higher-income taxpayers, which a number of states have done to address fiscal challenges brought on by the national recession.[13]

In Massachusetts the state constitution prohibits higher tax rates for higher-income taxpayers. The state Constitution allows, however, for the state to tax different "classes" of property at different rates. Thus the state could raise revenue to pay for economic stimulus strategies by raising the tax rates on those types of income that are received primarily by higher-income taxpayers: capital gains and dividend income. One of the proposals that have been put forth as a strategy for stimulating the economy is to create differential capital gains tax rates to reward and encourage long-term investments in Massachusetts companies. While such a policy raises constitutional issues (discussed below), if preferential capital gains rates for in-state investments are constitutional, such a policy could be achieved by raising capital gains tax rates on investments other than in Massachusetts companies and thus creating a tax incentive to invest in Massachusetts firms. Such a policy would also generate revenue that could be used for stimulative tax or spending policies.

SPECIFIC PROPOSALS: THE CHALLENGE OF NOT PAYING COMPANIES TO DO WHAT THEY WOULD DO ANYWAY

"As a businessman I never made an investment decision based on the tax code…. If you give money away I will take it, but good business people don't do things because of inducements."

-Former Treasury Sec. Paul O'Neil, January 18, 2001

The balanced-budget constraint applies to several specific ideas that have been offered recently to reduce taxes in Massachusetts: the costs of those tax breaks would have to be paid for and the budget cuts or tax increases needed to pay for them would harm the economy more than the tax breaks would help. In addition to this general problem, many recent proposals suffer from an additional problem: they are not, and probably cannot be, targeted effectively on encouraging job creation and instead would give costly tax benefits to a significant number of companies for doing things that they would do anyway.

Reduce The Capital Gains Tax Rate On Investments In Massachusetts Start-Up Companies Held For Three Years.

This change in tax law would provide tax breaks for profits from investments in Massachusetts start-ups lasting at least three years. Besides providing a tax break for any investments that might be induced by this incentive, the policy would also provide significant tax breaks for similar investments

[13] Center on Budget & Policy Priorities, "State Tax Changes in Response to the Recession," March 8, 2010. http://www.cbpp.org/cms/index.cfm?fa=view&id=3108

that would have been made even without the tax break. To determine whether this would be a cost-effective policy would require identifying evidence of the jobs or other positive economic activity induced by the tax break and weighing that against the tax break's cost. These costs include both the tax breaks going to individuals whose investment choices were actually altered by the incentive and tax breaks conferred on investors for doing what they would have done anyway.

In addition to the lack of evidence supporting the cost effectiveness of this proposal, it suffers from the further concern that it may conflict with the state Constitution's requirement of uniform tax rates on each class of property[14] and the prohibition of the federal Constitution's commerce clause against state tax policies that discriminate against other states.[15] If, however, such preferential tax treatment of in-state investments were constitutional, it would be most likely to have an overall positive effect on the economy if it were financed in a manner consistent with the principle laid out by Stiglitz and Orszag. For example, if the Commonwealth were to pay for this tax incentive by raising taxes on capital gains generated by other investments, the resulting bias might increase the flow of capital into Massachusetts start-up companies. Since capital gains taxes are paid mostly by very high- income taxpayers, no matter where the capital is located, no change in the distribution of the tax burden by income class would result. Maintaining the tax burden at the high end of the income scale would be important because, as Stiglitz and Orszag explain, "Since higher-income families tend to have lower propensities to consume than lower-income families, the least damaging approach in the short run involves tax increases concentrated on higher-income families."

CREATE NEW OPPORTUNITIES FOR MULTI-NATIONAL COMPANIES TO REDUCE THEIR MASSACHUSETTS TAXES BY SHIFTING THEIR PROFITS INTO SUBSIDIARIES IN OTHER COUNTRIES.

Two years ago the state enacted a landmark tax reform law to reduce corporate tax avoidance by making it harder for companies to shift income to subsidiaries in no-tax jurisdictions, or jurisdictions that don't tax particular types of income, as a means of reducing their taxes in Massachusetts. In the wake of those reforms, some multi-national companies have advocated for tax law changes that would allow them to reduce their Massachusetts taxes by shifting profits to affiliates in other nations.[16] Specifically, these changes would allow companies to pay royalties or interest to foreign affiliates and then deduct those royalty or interest payments from their taxable Massachusetts income. Creating subsidiaries in jurisdictions with low or no taxes on royalty and interest payments and then shifting income to those subsidiaries in the form of royalty or interest payments from other subsidiaries is a common tax avoidance strategy used by multi-state and multinational companies.[17] While such proposals have been defended on the grounds that certain treaties regulate taxes on income subject to those treaties, those treaties generally regulate federal taxation and not state taxes, unless states choose to be affected. [Technical edit made June 11, 2010].

These proposed changes would likely have a negative effect on the state economy as there would be a significant revenue cost to the Commonwealth that would have to be paid for with spending cuts or other tax increases.

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[14] See Salhanick v. Commissioner of Revenue. 391 Mass. 658 (1984).

[15] This prohibition has been enforced by the Supreme Court in decisions such as Fulton Corp. v. Faulkner, 516 U.S. 325 (1996), where the court struck down a feature of North Carolina's tax on intangible property which reduced the tax on ownership of corporate stock to the extent that the corporation did business in NC. The Court reasoned that by reducing the tax on ownership of companies engaging in in-state business, the tax impermissibly discriminated in favor of in-state corporate activity. This issue is examined in greater detail in Peter D. Enrich "Saving the States from Themselves," 110 Harv. L. Rev. 377 (1996).

[16] *MassBudget*, "Facts At A Glance: Corporate Tax Update II," November 17, 2009. http://massbudget.org/doc/707.

[17] Center on Budget & Policy Priorities, "State Corporate Tax Shelters and the Need for Combined Reporting," October 26, 2007. http://www.cbpp.org/files/10-26-07sfp.pdf

AWARD TAX CREDITS TO COMPANIES THAT ADD JOBS

There has been a proposal to award firms a $2,500 tax credit if they add an employee and maintain the worker on their payroll for at least a year. As with the proposals discussed above, this tax credit suffers from a basic flaw: most of the money would be used to pay companies to do things that they would do anyway. A recent study found that there will likely be 44,000 jobs that would be created in Massachusetts without this tax credit that would, nonetheless, be eligible for the tax credit.[18] If the state provides a $2,500 credit for each of those 44,000 jobs that would have been created anyway, that would cost the state $110 million in windfall tax credits. The tax credit proposal, however, includes a cap of $50 million. The credits would be awarded on a first-come first-served basis. Thus, employers who may be creating jobs in response to the new tax credit will essentially be racing against employers who would have created jobs anyway to claim credits. At the time they are considering creating a job in response to the tax credit, businesses' owners may have no way of knowing if they will actually receive the credit as they won't know if the full $50 million in credits will have been allocated before they become eligible. This uncertainty would reduce the likelihood that the credit would induce significant job creation.

CONCLUSION

Because of balanced-budget requirements, states cannot engage in the same type of economic stimulus policies that the national government can pursue. Because states generally experience both revenue declines and increases in demand for safety net protections during a recession -- and are required to balance their budgets -- they face extremely difficult choices. There is no easy answer to the challenges states face. But some policies are more productive than others.

The best policy may not be a politically exciting one. To build both short-term and longer- term economic strength, state governments can focus on the basics: maintaining high-quality infrastructure, investing in education and worker training to improve the productivity of the workforce; providing local communities with the resources they need to remain safe and well-functioning places where businesses will want to locate and people will want to live; and providing work supports, like child care, to enable lower-income parents to work and support their families.

Besides making the investments in education and infrastructure that can make our people and economy more productive, state government can encourage long-term economic growth by coordinating state economic development efforts to make it as easy as possible for businesses considering locating or expanding in the state to navigate state government. Recent proposals to consolidate and better coordinate quasi-public agencies could be important steps towards achieving those goals.

The danger to avoid is reckless gambles on unproven new tax breaks or new appropriations that don't relate to the core public purposes of government. Such expenditures generally must be paid for with cuts to core public services which harm the state's economy in both the short and long run.

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[18] PERI, "Generating Jobs through State Employer Tax Credits: Is There a Better Way?" Jeff Thompson & Heidi Garrett-Peltier. March 2010. Page 5. http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_201-250/WP219.pdf

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