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State Budget Cuts Could Put the Economy Back into Recession

The economic news at first appeared to be very encouraging. Government estimates found that the U.S. economy was picking up a little speed in the fourth quarter of 2010 — experiencing 3.2% annual GDP growth. Then, in late February of 2011, that rate was significantly revised downward to 2.8%. The culprit — state and local governments had cut spending by 2.4%.

State and local government budget cuts have acted as a big wet blanket thrown over an economy trying to bounce back from a devastating recession. Between February 2009 and February 2011, 417,000 jobs were shed by state and local governments, according to the Bureau of Labor Statistics. Such public sector job loss only exacerbates the country's economic badge of shame — 14 million people looking for work with an additional 9.5 million forced into part-time jobs. Not only is the public sector cutting jobs, but contracts with vendors are being cancelled, payments are being reduced to businesses and nonprofits that provide public services, and benefit payments to individuals are being cut. All of these actions stifle economic growth. Further, the positive effects of the federal stimulus program (the Congressional Budget Office estimated it had saved or created almost 3.5 million jobs) have been wiped out by state and local government budget cuts. With no additional federal help on the horizon and state budget cuts accelerating, the situation looks grim, and opens the possibility of the country falling back into a deeper recession.

It makes perfect economic sense to maintain rather than cut current public services. Consider the example of a teacher who was hired in 2008 at a salary of $35,000. That teacher paid state income taxes on her earnings, paid state sales taxes on items she bought with those earnings, and, if she owned a home, paid property taxes. She also spent much of her income in the community, and this spending supported numerous private sector jobs. Now consider that she has lost her job in 2011 due to state education aid being cut. The government not only loses the tax revenue from this teacher but also has to provide unemployment payments and possibly other forms of government assistance. Most importantly for the economy, the teacher is no longer spending that paycheck in the community resulting in losses to private sector businesses. Two Harvard economists have recently estimated there is one private sector job lost for every $25,000 in state budget cuts.[1] Additionally they concluded that every $10 in budget cuts reduces state personal income by $17.

Not only do public sector budget cuts have an immediate negative impact on the economy but these cuts will cause substantial long-term harm to the country. Reducing education funding will ultimately give rise to higher crime rates, higher health care costs, and more people collecting welfare. Additionally, the country's human capital will be eroded, compromising our workforce's ability to adapt to sophisticated technologies and compete in international markets.

States are constitutionally required to balance their budgets. If budget cuts are so harmful, is there a sensible alternative for complying with balance budget requirements? The only alternative of any significance is to raise taxes, although this too may act as a retardant for economic recovery because it might lead to some reduced consumer spending. Yet, the analysis shows that for a typical state revenue raised by increasing taxes, especially at the top of the income scale and invested in public services like education, the net effect on jobs and personal income is positive.

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[1] "The effects of state budget cuts on employment and income," Jeffrey Clemens and Stephen Miran, Draft paper May 10, 2010.

State Budget Cuts Could Put the Economy Back into Recession (cont.)

During 2009 budget deliberations in New York over how to close a growing budget gap, Governor Paterson and the legislature received a letter from 120 economists in the state that said "raising taxes during a downturn — particularly taxes that affect only higher-income families — is generally better for a state's economy, and better for its citizens, than sharp budget cuts." This letter echoed the conclusions of a paper by two noted economists — Columbia University professor and Nobel Prize winner Joseph Stiglitz and former director of the U.S. Office of Management and Budget Peter Orszag — examining the last recession of 2001. After examining the data, they concluded that spending cuts were more harmful to a state's economy than tax increases.[2]

The reason is simple. When the novice teacher making $35,000 a year is laid-off, her spending takes an immediate direct hit, as do the businesses she once patronized. The very wealthy, on the other hand, are able to save a substantial portion of their earnings so that for each $1 increase in taxes, their spending will be reduced by much less than a $1. Raising taxes does reduce spending but by less than budget cuts of a comparable size.

Austerity measures will only inhibit economic recovery. These "cut and burn" policies not only reduce the number of jobs and the overall amount of spending, but lead to the loss of the public goods the state and local governments provided in the first place, much of which — like education — are crucial to our long-term recovery and well-being.

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[2] Peter Orszag and Joseph Stiglitz, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other during a Recession?" Center on Budget and Policy Priorities, revised November 6, 2008, http://www.cbpp.org/archiveSite/10-30-01sfp.pdf.