Policy Points

Balancing the State Budget: Raise Revenues before Cutting Programs

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Summary

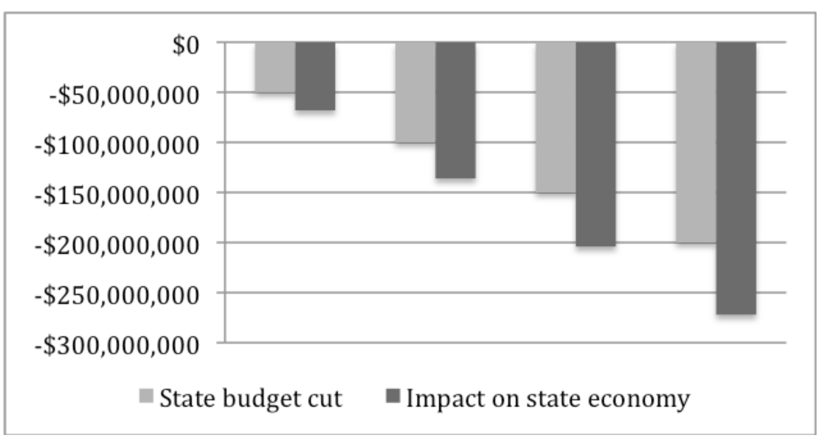
West Virginia recently joined 46 other states facing a budget shortfall for FY 2010. In order to balance next year's budget, policymakers must weigh the relative benefits and drawbacks of different options – maximizing existing funds, raising taxes and/or cutting spending. Because public spending is a strong economic stimulus during recessions, without which jobless rolls will grow, spending cuts should be considered only after all opportunities for raising revenues have been exhausted. This paper outlines six revenue options that, together, would bridge the state's budget gap without reducing public services.

Why Spending Cuts Should Be the Option of Last Resort

Governor Manchin has called for a 4.5 percent cut in his proposed budget due to declining revenue estimates for the coming fiscal year. This would mean nearly $200 million of reductions in public programs. The no-frills budget originally proposed by the Governor in February was only 1.87 percent above this year's budget.[i] There are no easy cuts to be made. Extracting $200 million from next year's spending is likely to impede economic recovery, trigger further job loss, and erode public services that support and protect the state's most vulnerable citizens.

- *Spending cuts would impede economic recovery.* "It takes money to make money" is the principle behind the federal economic recovery plan. A significant, temporary increase in public spending is needed to rapidly increase the demand for goods and services, which in turn fuels the economy, stabilizes businesses, and preserves jobs. Economists view state government spending as having a strong stimulus effect, generating $1.36 in economic activity for every dollar spent.[ii] (See Figure 1.) Applying this multiplier effect to reduced spending would mean that a $50 million state budget cut would translate into lost economic activity of $68 million. A $200 million cut would mean an overall loss of $272 million.

Figure 1: For each state dollar cut, economic activity drops $1.36



- *Spending cuts would trigger further job loss.* State spending supports large numbers of jobs in both the public and private sectors. Spending cuts would result in lay-offs not only of public employees, but also of workers in private sector companies that contract with the state to provide a wide range of goods and services. For example, a 2003 study by the WVU Bureau of Business and Economic Research found that a 10-percent reduction in Medicaid spending would result in the loss of 3,268 jobs statewide.[iii]
- *Spending cuts would erode public services that support and protect the state's most vulnerable citizens.* Reduced spending would jeopardize essential services, such as public health, law enforcement, and services for children, seniors and people with disabilities. Many of these programs have been operating with little or no increase in recent years and are unable to absorb further cuts without reducing services. Rising unemployment has boosted demand for safety net programs, since only 36 percent of jobless West Virginians receive unemployment insurance.[iv]

Revenue Strategies that Promote Recovery and Equity

Unlike the federal government, states must balance their budgets rather than operate with a deficit. Difficult decisions must be made. In the absence of ideal solutions, the preferred options should be those that do the least harm to the economy and to those most affected by the recession. This paper will examine six options for balancing West Virginia's FY 2010 state budget by enhancing revenues, rather than reducing spending. (See Table 1.) The options fall into these two categories:

- *Maximize existing funding.* Two of the options involve taking full advantage of funds that are already available to the state to use in the event of budget shortfalls. One is to use stimulus funds from the federal Recovery Act where appropriate to avert cuts in spending and services. The other is to use a modest portion of the state's Rainy Day Funds. Together, these options would generate $98.5 million, about half of the total amount needed to balance the budget.
- *Increase certain taxes.* Four of the options involve raising certain taxes, primarily on the businesses and individuals most able to pay them. They include delaying recently approved business tax cuts, reinstating the West Virginia estate tax, and increasing the personal income tax for the highest earners. A quarter of the projected revenues from the proposed tobacco tax increase are also included, with the majority reserved for expanding and improving health care for the uninsured.

Table 1: Revenue Enhancement Options for FY 2010

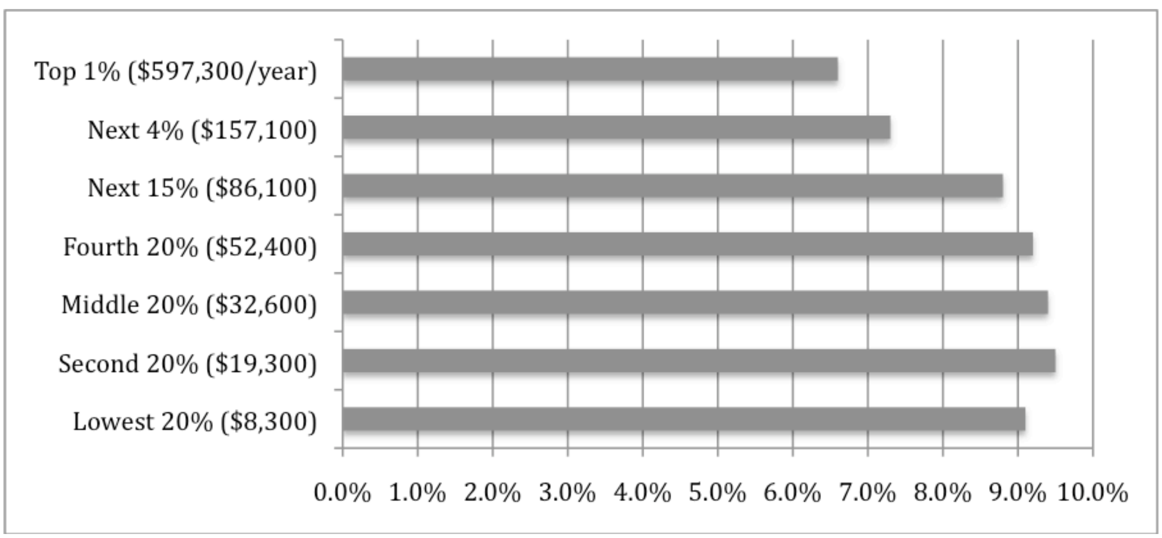
Revenue Option	Estimated Gain
A. Use federal Recovery Act funds allotted for state fiscal stabilization.	$48.5 million
B. Tap portion of state's Rainy Day Funds.	$50 million
C. Delay certain business tax cuts and credits.	$26 million
D. Reinstate West Virginia's estate tax.	$21 million
E. Increase personal income tax for highest earners.	$89 million
F. Apply 25 percent of proposed tobacco tax increase to general revenue.	$30 million
TOTAL FOR ALL OPTIONS	$264.5 million

Sound tax policy is key to addressing the state budget crisis. The current shortfall is not the result of overspending, but rather a drop in revenues. Cutting public spending is the wrong tool for the problem and would have a greater chilling effect on the economy than increasing taxes. According to two highly respected economists – Nobel Prize winner Joseph Stiglitz of Columbia University and Peter Orszag, director of the federal Office on Budget and Management:

> "Economic analysis suggests that tax increases would not in general be more harmful to the economy than spending reductions. Indeed, in the short run (which is the period of concern during a downturn), the adverse impact of a tax increase on the economy may, if anything, be smaller than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption."[v]

In addition, policy changes could help make the distribution of taxes more equitable across income levels. West Virginia's lower-income families contribute a larger portion of their incomes toward state and local taxes than do higher-income groups. (See Figure 2.) For example, families of three or four people living at the poverty level[vi] pay 9.5 percent of their incomes in state and local taxes, while families in the top 1 percent of income pay only 6.6 percent.[vii]

Figure 2: Lower-income families pay larger portion of income in state and local taxes



Source: Institute for Taxation and Economic Policy

Notes: Figure 2 reflects 2008 tax laws at 2006 income levels; income amount listed is midpoint in the range for that group.

No single revenue option will fill the budget gap, but a combination of these and perhaps other alternatives could balance the state budget without worsening the recession, furthering job loss, or reducing needed services. With nearly 60,000 West Virginians out of work, this is the time to expand – not slash – public investment in the economy.

Option A: Use federal Recovery Act funds allotted for state fiscal stabilization.

Estimated State Revenue Gain = $48.5 million

On February 17, President Obama signed into law the American Recovery and Reinvestment Act of 2009. The goals of the Recovery Act are to preserve and create jobs, promote economic recovery, invest in technology and infrastructure, and assist those most impacted by the recession.

The State of West Virginia is expected to receive more than $1.5 billion for a wide range of public programs designated by the Act.[viii] Federal funds for designated programs will be distributed to states via the state agencies that currently manage those programs. The law also increases certain benefits paid to individuals in the form of tax credits, food stamps, and unemployment insurance.

The State Fiscal Stabilization Fund included in the Recovery Act is aimed at helping state and local governments avert budget cuts in critical services. The Fund provides two block grants for states – one for education and another for government services to be used at the discretion of the governor, such as public safety and law enforcement, services for the elderly and people with disabilities, and child care. West Virginia is allotted $266.5 million under this provision of the Act. The education portion is $218 million, and the portion for other government services is $48.5 million. The funds are available immediately, and must be spent within two years of receipt of the grant.[ix] Applying the second block grant to programs funded by the General Revenue Fund would reduce the FY 2010 shortfall by one-fourth.

At least nine states are using Recovery Act funds to minimize spending cuts. Arizona, Colorado, Connecticut, Florida, Georgia, Maryland, Oregon, South Carolina, and Virginia have already proposed or enacted plans to use these funds to balance their state budgets in ways that reduce spending cuts. For example, Maryland Governor Martin O'Malley has proposed that $800 million of the state's Recovery Act funds be used to offset revenue shortfalls and avert budget cuts.[x]

Option B: Tap portion of state's Rainy Day Funds.

Estimated State Revenue Gain = $50 million

The state has two Revenue Shortfall Reserve Funds (Rainy Day Funds). The funds were established in state code (§11B-2-20) in 1994, with surplus funds from FY 1994, and in 2006, with the cash balance of the West Virginia Tobacco Settlement Trust Fund. At the end of each fiscal year, 50 percent of surplus general revenues, if any, are deposited into the fund.

The combined total of the state's two Rainy Day Funds was $455 million at the end of January 2009,[xi] up 1.5 percent from the end of December 2008. State officials strive to keep 10 percent of the General Revenue Fund in reserve, or roughly $400 million. Even within these parameters, the current balance would allow $50 million to be used to fund FY 2010 state expenditures.

Although Rainy Day Funds are considered in a state's credit rating, no minimum balance is required. According to Standard & Poor's:

> "No one level or type of reserve is considered optimal from Standard & Poor's perspective. Many different types of reserves have factored into an improved government credit profile. Some important considerations when establishing a reserve are:
>
> - The government's cash flow/operating requirements;
> - The historic volatility of revenues and expenditures through economic cycles;
> - Susceptibility to natural disaster events;
> - Will the fund be a legal requirement or an informal policy;
> - Are formal policies established outlining under what circumstances reserves can be drawn down; and
> - Will there be a mechanism to rebuild reserves once they are used.
>
> "It is important to keep in mind that use of budget stabilization reserves is not in and of itself a credit weakness. The reserves are clearly in place to be used. A balanced approach to using reserves is important in most cases, however, because full depletion of reserves in one year without any other budget adjustments creates a structural gap in the following year if economic trends continue to be weak."[xii]

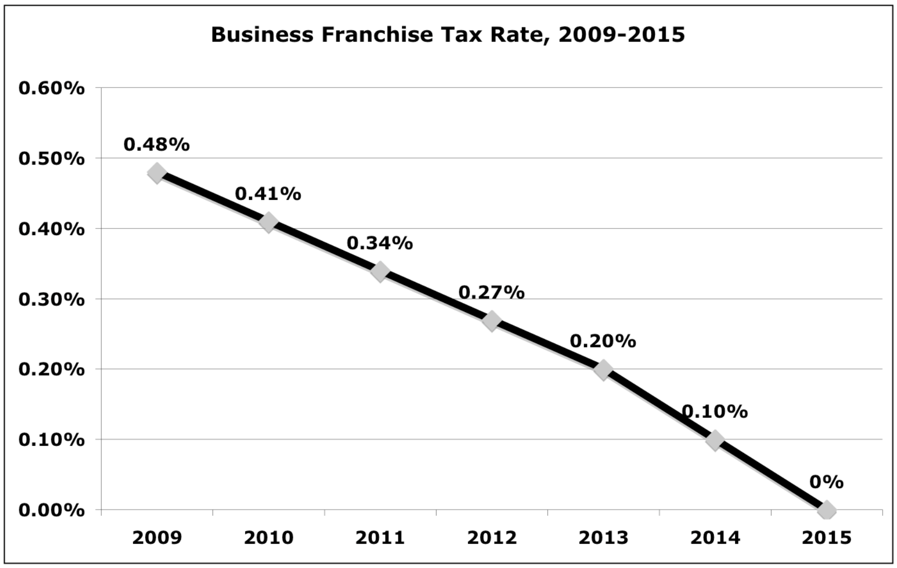
While it may be tempting for states to hunker down and hold on to their reserves, a wait-and-see approach may slow recovery efforts, further depress tax revenues and lengthen the recession. As of July 2008, West Virginia ranked fourth highest in the nation in its Rainy Day Fund balance as a percentage of annual spending.[xiii] Although the balance has decreased since that time, the state remains well situated to invest of portion of these reserves in the FY 2010 budget.

Option C: Delay business franchise tax cut, and suspend manufacturer's credit for inventory.

Estimated State Revenue Gain = $26 million

Last year, the Legislature voted to eliminate the Business Franchise Tax over the next six years (see Figure 3). This same legislation (SB 680) also created a state tax credit for manufacturers to offset their property taxes on inventories.

Figure 3



The business franchise tax rate is set to reduce from 0.48 percent to 0.41 percent in 2010. If the Legislature delayed this reduction for one year, it's estimated that the state would collect an additional $15 million in revenue.[xiv] The business franchise tax applies to the net equity of a business for the privilege of conducting business in West Virginia. It applies to partnerships, limited liability companies and most corporations. While there's some debate about who pays the business franchise tax, it is likely paid by out-of-state business owners and investors. Because West Virginia is a relatively small state, with the second lowest per capita income in the nation[xv], relatively affluent people who live outside West Virginia will most likely own the majority of stock in corporations benefiting from the tax reduction. Thus, the proposed freeze of the rate would generally not affect West Virginia residents, especially low- and moderate-income residents.

The West Virginia Manufacturing Property Tax Adjustment Act, which is a non-fundable tax credit that allows manufacturers to claim the local property tax paid on inventory against the business franchise tax and corporate net income tax liabilities, began in 2009. If the state implemented a suspension of the credit, the estimated revenue gain would be $11 million. A one-year suspension of the credit would not significantly hurt West Virginia's business climate for manufacturing. According to the West Virginia Tax Department, "the West Virginia state tax burden for the manufacturing sector is generally competitive with surrounding states because of the 50% tax break offered by the Manufacturing Investment Tax Credit."[xvi]

Option D: Reinstate West Virginia's estate tax.

Estimated State Revenue Gain = $21 million

West Virginia could restore millions of dollars in lost revenues by reinstating the state's estate tax at its 2001 level. At that time, people were taxed on money they inherited over and above $675,000, after deductions such as funeral expenses and charitable donations. In 2001, Congress passed legislation that gradually phases out the estate tax by 2010. (See Table 2.) The law effectively repealed by 2005 the state "pickup" taxes through which West Virginia shared in federal estate tax collections.

Table 2: Phase-out of Estate Tax under 2001 Tax Law

Year	Exemption Per Person
2001	$675,000
2002	$1 million
2003	$1 million
2004	$1.5 million
2005	$1.5 million
2006	$2 million
2007	$2 million
2008	$2 million
2009	$3.5 million
2010	Phase-out of estate tax is complete.
2011	Law sunsets; Congressional action expected.

Source: Center on Budget and Policy Priorities

Revenue from the state's estate tax was $21.1 million in 2000, prior to changes in the federal law. The state could prevent any more revenue loss by "decoupling" from the federal change. Approximately 14 states plus the District of Columbia have decoupled from the federal changes.[xvii] As of 2007, 23 states have some form of estate or inheritance tax.[xviii]

By not acting, West Virginia lawmakers are allowing a tax cut that benefits only millionaires who can pass on large fortunes to their children. In 2007, of the 27,676 West Virginians that died only 76 or 0.4 percent owned any federal estate tax.[xix] The Obama administration has proposed to keep intact the estate tax at 2009 parameters. However, his proposal would eliminate the state pick-up – meaning that if West Virginia did nothing it would completely lose its state estate tax.[xx]

This would be unfortunate because the state estate tax is one of the most progressive taxes, meaning that it applies only to those with large inherited fortunes. This is important because West Virginia's current tax forces low and middle-income people to pay more of their income in taxes than higher income residents. Reinstating the estate tax would not only improve tax fairness for working families, but would also help thwart the growing income inequality in West Virginia.[xxi]

Option E: Increase personal income tax for highest earners.

Estimated State Revenue Gain = $89 million

West Virginia has a graduated, marginal personal income tax (PIT) rate that begins at three percent and ends at 6.5 percent (See Table 3). Increasing the marginal tax rate by 0.5 percentage point for taxpayers with incomes between $200,000 and $250,000, by 1 percentage point for incomes between $250,000 and $300,000, and by 2 percentage points for incomes over $300,000 could increase revenue by an estimated $89 million from fewer than 10,000 taxpayers.[xxii] Currently, 15 states have higher PIT rates than West Virginia.[xxiii]

Table 3: West Virginia Personal Income Tax Schedule

(AGI) Income Bracket	Marginal Rate
0-$10,000	3%
$10,000-$25,000	4%
$25,000-$40,000	4.5%
$40,000-$60,000	6%
$60,000-$200,000	6.5%
$200,000-$250,000	***7.0%***
$250,000-$300,000	***7.5%***
$300,000 and over	***8.5%***

Source: West Virginia Tax Department

While some may claim that increasing West Virginia's PIT rate will hurt the state's economy, there's considerable evidence to the contrary. A recent study of states with PIT rates above 6.5 percent found that there was "no direct link" between income tax levels and private sector job creation.[xxiv] As a matter of fiscal policy, economists Joseph Stiglitz and Peter Orzag found that tax increases are preferable to spending cuts in state services. They wrote:

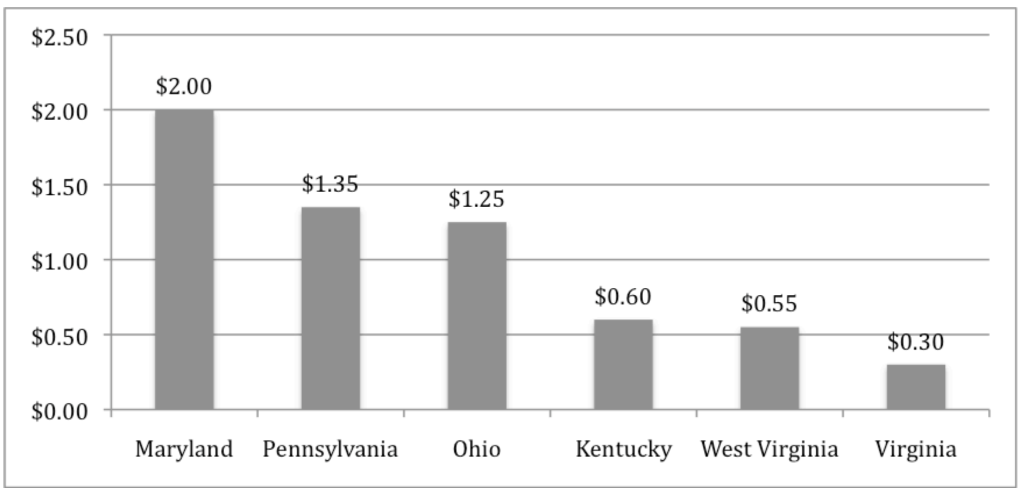
> "Tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run. In a weak economy, it is particularly important to minimize reductions in overall spending. And reductions in government spending on goods and services, or reductions in transfer 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."[xxv]

Option F: Apply 25 percent of proposed tobacco tax increase to general revenue.

Tobacco use is the leading cause of preventable death and disease in the nation and claims the lives of more than 3,800 West Virginians each year. The state has the highest smoking rates in the country among adults and pregnant women, but ranks in the bottom 20 percent in the size of its tobacco tax. Given that tobacco price increases lead to reduced use, the health and economy of West Virginia would be well-served by a tobacco tax increase.

Since 2003, West Virginia has had a state tax of 55 cents per pack of cigarettes and a 7-percent tax on smokeless tobacco products. In the last several years, most other states have aggressively increased tobacco taxes so that the national average is now $1.20 per pack. West Virginia's cigarette tax is second lowest in the region. (See Figure 4.)

Figure 4: State Cigarette Taxes per Pack, 2009



Source: Campaign for Tobacco-Free Kids

During the first year, the tobacco tax would generate $120 million, including $110 from cigarette and $10 million from smokeless tobacco. Like other consumption taxes, the tobacco tax imposes a disproportionate burden on people with lower incomes. To reduce this unfairness, the Center on Budget and Policy has recommended that most of the tobacco tax revenues should be dedicated Medicaid and other public programs that benefit lower-income individuals and their families.[xxvi] Since these public programs are supported in part by the General Revenue Fund, it would be reasonable to use a quarter of the projected tobacco tax revenues -- $30 million – to reduce the shortfall.

Endnotes

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