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MEMORANDUM

January 16, 2009

To: Milton Glick, President

From: Elliott Parker, Professor of Economics

RE: The Economic Principles of State Budget Cuts

Recent articles in the *Reno Gazette Journal* about the budget cuts have focused on how the state's general fund expenditures can be cut to match projected revenues, or how tax revenues might be increased. The Governor's speech last night makes it clear that he thinks spending cuts are much better for the economy than tax increases, and he is willing to destroy the university in the process.

But what are the economic effects? Is it best to cut expenditures to balance the budget, raise taxes, or borrow from future revenues? Pardon me for being the professor, but I feel the need for an economics lecture coming on. Government expenditures and the taxes that fund them have macroeconomic, microeconomic, and distributional effects. In understanding the economic effects of balancing the government budget, it is important to separate out these three areas.

The Macroeconomic Issues:

Government budgets affect the overall level of spending in the economy. Spending cuts reduce the income of both government workers and the firms which sell goods to the state, and so they also reduce the amount of potential spending in the economy. Higher taxes also reduce the disposable income of firms and households, and so reduce how much they can spend in turn. Both of these have so-called "multiplier" effects, because the first round of reduced spending reduces the income of those who would have sold them goods, and so in turn leads to successive rounds of further spending cuts. In a small state a high percentage of the spending leaks out, as spending cuts or tax increases reduce the amount residents spend on goods from elsewhere.

Economists on both sides of the political spectrum agree that the multiplier effect for a cut in government spending is larger, in the macroeconomic sense, than the effect for an increase in taxes. If we assume that what was being produced for or by the government was worth producing in the first place, then society loses this benefit in addition to the reduction in disposable income it causes, and the effect this has on spending in turn.

For a small state, a spending cut reduces state income by the cut plus a small in-state spending effect, while the effect of a tax increase on state income is close to zero.

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In a severe downturn, governments might want to consider cutting taxes and increasing spending, rather than doing the opposite. Even the Hoover administration presided over a net increase in government expenditures and a reduction in tax revenues during the Great Depression, but most of this was a natural outcome and not the result of intentional policy. As Gross Domestic Product fell by 43 percent from 1929 to 1932, expenditures by federal, state, and local governments rose a little overall due to an increase in social benefits to the unemployed, while tax revenues declined as the economy collapsed. As a share of GDP, however, total tax revenues actually rose by a third. The Revenue Act of 1932 reflected President Hoover's primary concern with returning to a balanced budget, and it raised tax rates significantly even as the economy continued to slide.

While our federal government has apparently learned its lesson in this regard, state governments are usually bound by balanced-budget rules that lead them to become, in the recent phrase of Paul Krugman, a Nobel-prize winning economist, fifty Herbert Hoovers. It is worth noting, too, that all state and local governments together produce more public goods than the federal government, by far. Cutbacks by states may thus overwhelm the efforts of the federal government to stave off a deeper recession.

In the past, some macroeconomists took a mechanistic view of this process, but that view has long since been discarded by the economics profession. Multipliers depend on many things, for example. People who remain employed but anticipate a recession are more likely to save any tax rebate, and not spend it, while people who are saved from losing their jobs are less likely to be forced to severely cut back their consumption. What may help the economy avoid a steeper decline may not be so effective at leading to faster growth when the economy has recovered. More borrowing by the government can increase the costs of borrowing for the private sector, and government spending can crowd out private spending. It may also cause foreign savings to flow into our markets, creating a trade deficit as it crowds out our exports. To paraphrase a letter written to the editor of a local newspaper, our government borrowed money last year by running deficits financed by China to give most of us a tax rebate, which we then spent on imports from China, and we were somehow surprised that it did not stimulate our economy very much.

The Great Depression was caused by many things, of course, and not just the Hoover Administration's budget. There was a bubble and financial collapse, of course, but there was also a Federal Reserve system that actively made it all much worse by letting the money supply drop by a third. There was a two-thirds decline in our exports and imports due to protectionism, and a gold standard that forced other countries to reduce their own money supplies too. It was not until World War II, when government expenditures increased by staggering amounts, that the economy fully recovered.

Of course, once the economy recovers then balanced budgets become important again. If the government finds it is more politically popular to keep taxes low and spending high, then it may run up an unsustainable public debt, both explicit and implicit, putting the future in jeopardy. States, in general, can't do this as easily as the federal government

can. Thus, it is incumbent on states to set aside adequate “rainy day” funds when times are good, and find better ways to run temporary deficits when times are bad.

In sum, the macroeconomic principle is that trying to cut expenditures and raise taxes during a severe economic downturn is a bad idea. It is natural for expenditures to rise during recessions, and tax collections to fall, and this should be allowed to happen in the short-run, and even encouraged. If you have to choose, it is better to raise taxes than to cut expenditures, but it is best to do neither.

The Microeconomic Issues:

Free and private markets work very well under some conditions, but those conditions – perfect information, perfect competition, and complete markets in which sellers pay all the production costs and buyers receive all the benefits – are not always met. Governments may be able to address some of these market failures. In particular, government can provide or subsidize public goods, which are called that because they are things that benefit society but that can’t or won’t be provided by the private sector in adequate amounts. Police and fire protection, a justice system, national defense, financial regulation, highways, pollution control, sanitation, public health, and education are all good examples of public goods.

The taxes that pay for these public goods can distort incentives, however, because if we raise the cost of doing something, people will do less of it. Of course, there are times we want people to do less of something, which is why so-called “sin” taxes are popular, but in most cases economists think higher tax rates are inefficient.

There are also other potential inefficiencies in government intervention that may sometimes lead to making things worse. Governments, like private firms, are made up of human beings, and they share the same pitfalls. All organizations require good management so that the actions of individuals are made consistent with the interests of society. When state agencies lack information or proper incentive, when they lack competition, especially in light of government’s potential for coercive power, or when their political leaders make spending decisions based on what is good for their own re-election and fund-raising prospects, then governments may not make things better.

We must realize that every public good we fund has an opportunity cost, and we must balance these costs and benefits against each other; we must decide what to do and how to do it as if it were our own money we were spending, and we need to decide what needs doing by how it benefits the citizens of the state. Because the state usually produces goods that the private sector does not, and monopolies tend to become inefficient whether they are public or private, it is important that we manage what the state does, to push all government agencies to act as if we actually faced competition. In areas where competitive private markets are likely to work well, the state should step back and let them do so.

We should also realize that taxes are less likely to distort incentives when rates are relatively low and collected from a wide range of activities, so that the relative prices of different goods are unaffected. And when taxes cannot be applied equally, we should consider that taxes will have a higher ratio of revenue to inefficiency when we tax goods where demand and/or supply is inelastic, which means that buyers or sellers are not very sensitive to price.

There is a tradeoff between the social benefits of providing public goods and their social costs. But it is important to understand that whether or not government should fund any particular activity, an economic downturn does not change the tradeoff. If education is worth funding when the economy is doing well, a recession does not make it less worth funding. If a particular tax was inefficient in 2005, then it probably remains so in 2009 and beyond.

Those who advocate a smaller government should do so when the economy is strong, and not use a recession as an excuse. Those who advocate spending cuts over tax increases during a recession are therefore doing so for microeconomic, not macroeconomic reasons. Their argument is that smaller government is always better, and the recession just makes it easier to force the issue.

The Distributional Issues:

Relative to the above micro and macro effects, the distributional effects are much harder to define in economic terms. Taxing one person to provide benefits to another raises issues of fairness and justice that are very subjective, and government taxation is by its very nature coercive. Should government provide a social safety net for those who become unemployed, or should they be expected to have saved for this themselves? Should government help those who have become homeless, or might this be rewarding those who have made poor choices? Should higher education become more available to those who have lost their jobs and seek retraining, or should universities be required to take cuts – even disproportionate ones – out of a sense of “comparable” sacrifice? Should taxpayers who might be struggling with their own efforts to stay financially afloat have to pay higher taxes? Should public employees be required to take pay and benefit cuts even as they watch their home’s resale value drop far below its mortgage, and their 401Ks turn into 201Ks (to paraphrase a friend of mine)? In economic theory, we distinguish between efficiency and equity, and we have lots to say about the former but not much about the latter, except to leave it to the realm of politics and public opinion.

When people argue over the government budget, sometimes they are arguing about micro issues, about whether smaller government is better or whether the market’s failure to provide public goods is outweighed by the government’s failure to get the incentives right. More often, however, they are arguing over what each thinks is fair. There is a story of an economist who witnesses two women yelling at each other from their front yards. “They will never come to an agreement,” the economist tells his companion, “because they are arguing from different premises.”