At Issue:

Do budget shortfalls mean states must raise taxes?

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It's the cruel irony of a recession: Struggling families need crucial services more than ever, but states have much less money to pay for those services. Wisely, most states are taking a balanced approach in their response to this conundrum, putting tax increases in the mix rather than attempting the impossible by closing their large budget shortfalls only with cuts in spending.

Make no mistake: All 30 of the states that have raised taxes since January have also reduced spending sharply. But in the face of plummeting revenues — down an unprecedented 12 percent since last year — a cuts-only approach would not only decimate vital services like health care and education but also further damage the economy, making the recession even worse.

That's because, as more than 100 economists advised in a letter to policy makers during New York state's budget debate, "Almost every dollar that states and localities spend on aid for the needy, salaries of public employees and other vital services enters the local economy immediately. So if states cut their spending in these areas, overall demand suffers at a time when demand is already too low and support services are most needed."

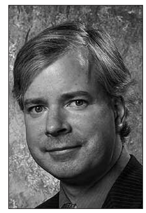
Tax increases take less money out of the economy and reduce demand less than spending cuts, because some of the additional taxes collected come from money that would have been saved rather than spent. This is particularly true of tax increases on households with high incomes and greater savings.

Budget cuts and tax increases are simply not an "either-or" choice in difficult times. Indeed, in the last two recessions as well as the current one, most states raised taxes to help balance their budgets — states in every part of the country, some governed by Democrats and others by Republicans.

It didn't make them less competitive. Data show that the states that raised taxes enjoyed the same post-recession economic growth as those that didn't.

Balancing budgets through measures like eliminating medical treatment for kids and putting college out of the reach of talented moderate-income students is no way to build a prosperous future. States can avoid the worst of these cuts by including tax increases, preferably focused on those best able to pay, in their budget-balancing plans.

When the economy recovers, the states in the best shape will be those that didn't act like a farmer eating his seed corn.



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Media stories are highlighting the supposedly draconian cuts that state and local governments are making to their budgets. And it is true that state policy makers need to make tough choices to balance their budgets during recessions. But for the states overall, the data do not reveal draconian cuts, just a lull in spending growth after years of substantial increases.

According to the Bureau of Economic Analysis (BEA), total state and local spending surged 30 percent in the five-year period 2003 to 2008. Data for the first half of calendar 2009 show that spending has leveled off since the first half of 2008. Spending in 2009 will probably end up being about the same as it was in 2008. On the revenue side, a drop in state and local tax receipts of 6.5 percent so far in 2009 has been made up by an increase in federal grants of 18 percent.

Now compare this flat government spending to the drop in private-sector economic activity during this recession. Private-sector wages are down 5 percent in the first half of 2009 compared to the same period last year, while U.S. business investment is down a stunning 25 percent, according to BEA data.

Families and businesses are tightening their belts and restructuring their finances, and there is no reason why governments shouldn't be doing the same. Just as recessions weed out the least successful businesses in the economy, policy makers should use the recession as an opportunity to weed out their least successful programs.

Looking ahead, state and local revenues will likely be stagnant for some time, and so additional restraint will be needed. One place to look for savings is in the compensation packages of the nation's 16 million state and local workers. Half of all state and local spending — $1.1 trillion out of $2.2 trillion in 2008 — goes toward employee wages and benefits.

Thus, policy makers should look at trimming government labor forces, freezing worker wages until the economy recovers and restructuring the generous benefit packages that many state and local workers receive.

Some policy makers are trying to balance their budgets by increasing taxes, but that will cause long-term problems for budgets by suppressing economic activity. Instead, by focusing on restructuring programs and worker-compensation packages, policy makers will make their own jobs easier down the road by creating lasting budget savings.