

Poor State Finances Deepen Recessionary Hole

By Jason Saving

States are in the midst of perhaps the most challenging fiscal environment of the postwar era.

In the summer of 2009, California paid vendors with registered warrants rather than cash. The warrants, a kind of IOU, were used as lawmakers struggled to close a gap between expenditures and revenues approaching 25 percent of the California budget—a nearly unprecedented shortfall. As the situation deteriorated further in 2010, the governor ordered the wages of more than 150,000 state workers temporarily reduced to the statutory federal minimum of \$7.25 per hour and directed the employees to take three unpaid furlough days each month until California's underlying budget problems could be addressed.

Given a rapidly deteriorating national economic environment, it is perhaps inevitable that some states would be especially squeezed—and the particulars of this recession were especially unkind to California. Its geography and zoning laws made it vulnerable to real estate downturns, and some of its leading sectors, such as semiconductors and the Hollywood entertainment industry, are highly tied to world demand. California also has a unique legislative structure in which a two-thirds majority is necessary to make fiscal adjustments that many other states could accomplish by simple majority. A recession that combines a real estate bust *and* a collapse in world demand *and* significant budgetary adjustments would almost inevitably hit California hard.

But practically every state is suffering during this recession, many with quite different characteristics. All 50 states requested and received funds from aid programs such as 2009's American Recovery and Reinvestment Act to weather these extraordinary economic times. And almost every state has undertaken spending cuts or tax increases or both over the past two years, ostensibly tied to the recession from which the nation is only now beginning to emerge.

To examine the fiscal health of states, it's helpful to look at their health immediately before the recession—how many ran

in the red and why those shortfalls emerged during good economic times. Looking at the extent to which these figures worsened over the past three years—as the nation struggled through the longest downturn of the postwar era—provides perspective on the depth of the problems. Additionally, why do budget pressures become especially pronounced during recessions and what, if anything, can be done to mitigate them? Finally, there is the case of one state that only now confronts a large shortfall, Texas, and why it came to the party so much later than its peers.

Where States Stood

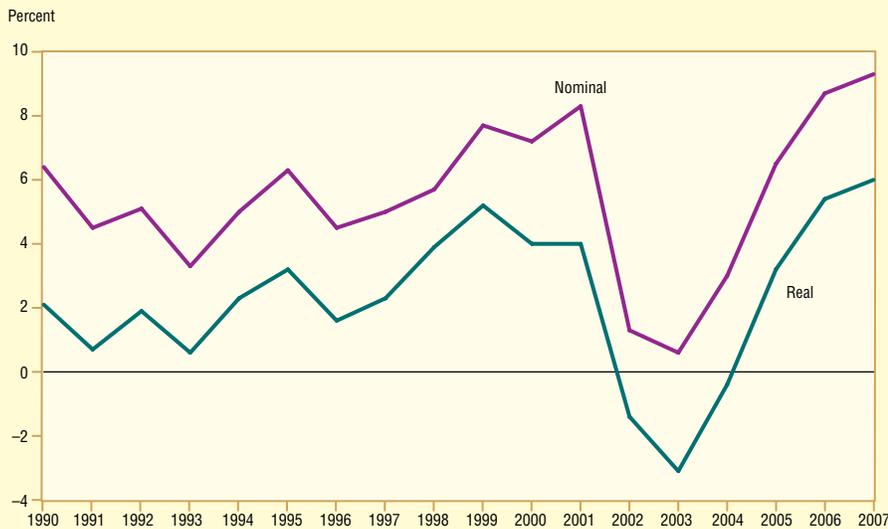
At the onset of the 2007–09 recession, 13 states wrestled with budget gaps totaling at least \$23 billion. Another 11 states faced revenue shortfalls and/or expenditure overruns leaving them vulnerable to deficits, especially if economic growth slowed.

Standard economic theory suggests that states should run surpluses during expansions. Extra revenue can be set aside into rainy-day funds to help weather recessions that inevitably follow expansions. How is it that almost half the nation's 50 states experienced fiscal pressures even before the recession?

In 2007, states ramped up spending at a 9.3 percent annual rate (6 percent in real terms)—the strongest such growth in two decades (*Chart 1*). Among states boosting spending at above-average rates were Massachusetts and New York in the northeast, Florida and South Carolina in the southeast, Arizona and New Mexico in the southwest and California in the west—all would be particularly hard-hit in the crisis that followed (*see map*).

A second cause is a greater reliance on borrowing. Between 1993 and 2001, overall state debt grew 5 percent annually, varying only slightly from year to year in response to business cycle considerations. As the 2002–03 recession struck, increased

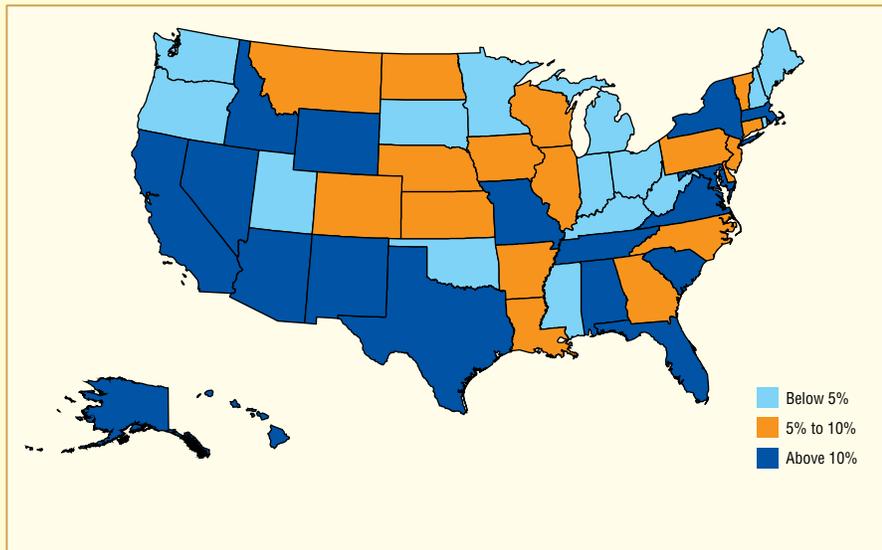
Chart 1
State Budgets Expand During Housing Boom
 (Budget changes by fiscal year)



SOURCE: "The Fiscal Survey of States," December 2007, National Association of State Budget Officers.

In 2007, states ramped up spending at a 9.3 percent annual rate—the strongest such growth in two decades.

State Expenditure Growth, Fiscal Year 2007



SOURCE: "The Fiscal Survey of States," December 2007, National Association of State Budget Officers.

demand for state services along with lower-than-expected revenue drove overall state debt above the trend line (*Chart 2*). When that downturn ended, however, state debt levels did not return to trend—as both economic theory and previous experience would predict. Instead, policymakers continued borrowing at the elevated pace they had embarked upon during the recession,

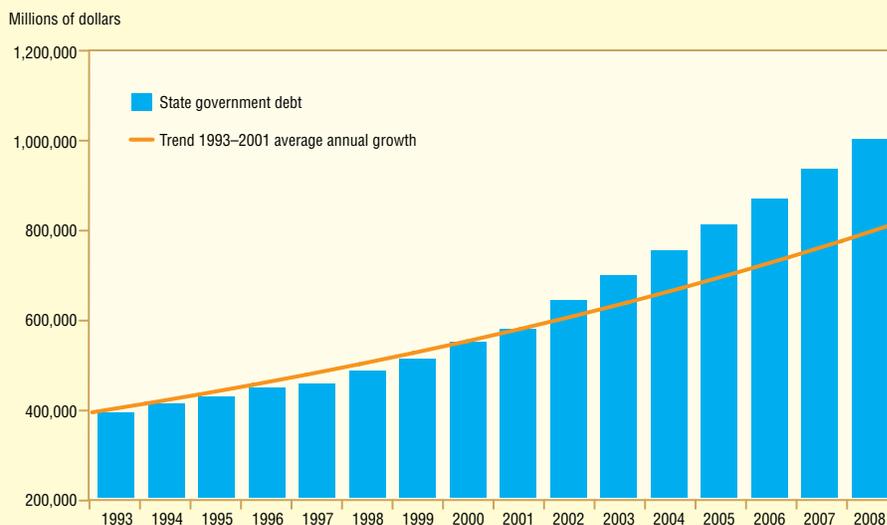
spending at historically high rates while also offering small but significant tax cuts. This left states poorly positioned for the financial crisis that soon arrived.

National Recession Strikes

In fiscal 2010, 48 states wrestled with a total shortfall of \$129 billion—five times the gap they faced three years before. Re-

Texas stands out as a state that faced only modest fiscal pressure over the past two years but now confronts more significant headwinds.

Chart 2
State Government Debt Grows Above Trend in 2000s
 (Debt outstanding by fiscal year)



SOURCE: Census Bureau.

markably, this number is after \$63 billion in additional federal funding, such as stimulus aid, arrived. Without that money, the deficit would have ballooned to \$192 billion.

The latest figure, along with smaller gaps in 2008 and 2009, led local lawmakers to make painful choices. In those years, 43 states reduced funding for education, including 32 that pared kindergarten–12th grade education funding.¹ Thirty-one states reduced public health and welfare outlays by raising eligibility requirements, curtailing dental coverage or mental health benefits or reducing physician reimbursement rates. And 29 states pared support for the elderly and disabled, often scaling back mental health and in-home nursing care, while also sometimes instituting across-the-board benefit cuts.

These painful choices are reflected in overall levels of state spending, which fell in 2010 for 40 of the nation’s 50 states. Several large states with serious shortfalls, including New York and California, reduced spending by less than the national average and still confront difficulties. Others, such as Florida and Nevada, cut spending more dramatically during fiscal 2010.

The arbiter of U.S. recessions, the National Bureau of Economic Research’s Business Cycle Dating Committee, declared that the recent downturn ended in June 2009. With the recovery under way, one might expect improved forecasts for 2011 and 2012. That isn’t the case. Aggregate

state shortfalls exceeding \$100 billion are expected for each of the two years, with sizable spending cuts likely as states further retrench from the rapid expenditure growth of the prerecession years. Additionally, at least 30 states increased taxes during fiscal 2009 and 29 did so during this fiscal year, the 12-month period that for most states ended June 30.

This suggests widespread fiscal imbalances across virtually every part of the country during the 2007–09 recession and its aftermath.

Becoming More Recession-Proof?

While it’s impossible for a state to be completely recession-proof, economic theory suggests some revenue sources are more resilient than others during downturns. Consumption remains much more stable than income during recessions, for example, because individuals tend to smooth their consumption over time even when experiencing dramatic swings in income, such as following job loss.

Aggregated state revenue figures from fiscal 2009, the most recent year for which complete data are available, show sales tax revenue dropped 6.2 percent during the 12 months. But state income tax revenue fell by almost twice that amount, 11.2 percent, and state corporate income tax revenue declined even more, 16.9 percent. And to the extent those income tax fluctuations are driven by

individuals and corporations seeking out lower-cost states, the recession's fiscal impact could linger for some time in areas where net outmigration is occurring.

This doesn't necessarily mean there should be less emphasis on income taxes. States relying on those levies tend to experience revenue booms in good economic times as income growth outpaces consumption—the flipside of enduring greater suffering during busts. Additionally, income-tax-reliant states can maintain greater progressiveness in their tax systems, ensuring that upper-income individuals, with the greatest resources, contribute a disproportionate share of revenue. Also, sales tax regimes run the risk of losing revenue as commerce shifts toward untaxed out-of-state Internet sales. While economists and policymakers have devised sales-tax-like “consumption-tax” plans that overcome these objections, such proposals are controversial too, leading some states to conclude that cyclical revenue sources such as the income tax should remain a significant funding source.

On the expenditure side, some have proposed that state spending be pegged to a constant share of that state's economy, automatically contracting during recessions and rising during expansions. This approach fails to recognize that demand for government services goes the other way—

citizens hit by bad economic times increasingly turn to the government for help. This is also true for education and even prisons, as poor job markets induce individuals to return to school or, in some cases, turn to crime. Even short-run reductions in nutrition and learning, and short-run increases in crime, can have long-run consequences.

Thus, there are no easy answers to fiscal volatility. Of course, states could better cope with recessions by making larger deposits into “rainy day” funds during good economic times, as some policymakers have suggested. But this, too, involves sacrifice because these deposits cannot simply appear out of the ether and must be funded by spending less or taxing more. The bottom line: Barring radical changes in state revenue and expenditure systems, one can expect states' fiscal health to deteriorate during future recessions just as it has in past downturns.

What About Texas?

Texas stands out as a state that faced only modest fiscal pressure over the past two years but now confronts more significant headwinds. It entered recession months later than the nation (*Chart 3*) and created more jobs during 2008 than all the rest of the country, bolstering revenue at a time when much of the country struggled. But the lingering aftereffects of recession

have ramped up demand for health services through the Medicaid program and other social welfare expenditures. The needs are particularly acute in Texas, which has the greatest proportion of uninsured individuals in the nation. Coupled with a revamped franchise tax bringing in \$3 billion per year less than expected from business, a big drop in energy prices and the expiration of roughly \$12 billion in stimulus monies, the state now faces a shortfall for the next biennium estimated at up to \$21 billion—or 11.5 percent of its \$180 billion budget.

Other states will face similar pressures, even if the national economy gradually regains its footing next year. Of course, large fiscal shortfalls in Texas and other states are not surprising in an era of trillion-dollar federal deficits. The difference is that every state (with the exception of Vermont) is constitutionally required to fill its shortfall—and make painful choices in so doing.

Postwar Era Challenges

States are in the midst of perhaps the most challenging fiscal environment of the postwar era. Spending and revenue patterns broke away from trend in the years leading up to the recession, leaving states relatively poorly positioned to overcome the slowdown. And while they have made adjustments to deal with \$100 billion-plus gaps in each of the past two years, further action will be needed in 2011 and 2012. Some states that have skirted the edges of shortfall, thus far, may still face significant fiscal pressure.

Saving is a senior research economist and advisor in the Research Department at the Federal Reserve Bank of Dallas.

Note

¹ “The Fiscal Survey of States,” various years, published by the National Governors Association and the National Association of State Budget Officers.

