By James Heintz

# THE GRIM STATE OF THE STATES

## *The Fiscal Crisis Facing State and Local Governments*

THE COLLATERAL DAMAGE OF THE GLOBAL FINANCIAL CRISIS IS EXTENSIVE—RECORD JOB losses, falling incomes, and increasing uncertainty that paralyzes workers, consumers, and investors alike. State and local governments have joined the list of casualties. They are facing the worst budget crisis in decades and the situation will likely get worse before it gets better. If not enough is done, the fiscal crunch will have far-reaching implications for the severity of the crisis and the well-being of the American people.

A sample of the current budget situation from the 50 states shows that the fiscal crisis has spread nationwide. At the time of this writing, Arizona is projecting a $1.6 billion shortfall at the state level for the 2009 fiscal year, and this is expected to expand to $3 billion for fiscal year 2010.[1] Georgia State University has recently forecast that Georgia's revenues will drop by 6 percent in fiscal year 2009, opening up a $2.5 billion gap.[2] Minnesota must accommodate a $426 million deficit in the current fiscal year which is projected to grow to $4.8 billion in 2010-2011.[3] New York is anticipating a $1.6 billion current-year shortfall and this is expected to climb to an unprecedented $13.8 billion gap in the 2009-2010 fiscal year.[4] The list of states facing severe financial problems goes on and on. According to the Center on Budget and Policy Priorities, a Washington, D.C.-based research institute, as of January 2009 at least 46 states have reported facing budget shortfalls for the current and/or the next fiscal year, totaling an estimated $99 billion.[5]

These are just the initial estimates of the impact that the economic crisis will have on state revenues and budgets. The severity of the budget crisis ultimately depends on how long and how deep the downturn becomes and the degree of ongoing state support that the federal government ultimately provides over the next several years. Depending on the trajectory of the crisis, the Center on Budget and Policy Priorities forecasts that the combined state-level budget shortfalls may add up to over $350 billion by 2011. Keep in mind that these estimates do not reflect the problems that local and municipal governments are facing—which are equally severe

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and widespread. Despite the current uncertainty about just how bad the economic crisis will turn out to be, most state and local governments find themselves suddenly coping with the worst financial outlook in over half a century.

This is the second major fiscal disaster with which state and local governments have struggled in the past seven to eight years. The earlier crunch began around 2001 and followed the bursting of the dot-com stock market bubble, the corporate accounting scandals (epitomized by the Enron debacle), and the September 11th terrorist attacks. At the height of the crisis, state-level budget shortfalls amounted to an estimated $80 billion—smaller than the gap which states face in the current fiscal year.[6] The critical difference is that the current shortfall represents just the beginning of a more extensive meltdown. The gap will widen significantly before the economy turns around.

The rapidly unfolding fiscal crisis raises a number of critical questions. What is the likely impact of the crisis? Why are state and local governments so vulnerable to economic downturns? And, perhaps most importantly, what can be done to deal with this potentially catastrophic situation?

## IMPACT OF THE FISCAL CRISIS

All of the states, with the exception of Vermont, have some form of balanced budget requirement which prevents them from engaging in long-term borrowing to make up for an unexpected decline in revenue. The precise nature of these provisions differs from state to state. In some cases, the requirement is spelled out in the state constitution, in others it is a result of laws that have been passed, and in still others it has been the outcome of judicial decisions regarding the interpretation of state constitutions.[7] Apart from these legal barriers, states do not have the appropriate mechanisms in place to manage deficit financing. Unlike the federal government, when states take on debt, they often need legislative or public approval first. Therefore, states are not set up to routinely issue and manage debt to finance ongoing operational expenditures. It is important to note that balanced budget requirements generally apply to the operating budget only. Capital spending on public investments is frequently financed through borrowing.

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Trying to offset the lost revenues by raising state and local taxes during a major economic downturn may not be an attractive policy option. As I discuss later in the article, state and local governments rely on three taxes for most of their revenues: sales taxes, personal income taxes, and property taxes. Depending on how the increases are implemented, raising these taxes during a downturn can worsen pressures on families who are already feeling a squeeze. States could raise corporate income taxes to offset some of the revenue losses. However, given the current situation in each of the states, raising corporate taxes in the short run will not be enough to solve the immediate revenue crisis. There are three reasons for this: corporate taxes currently represent a relatively small share of total state revenues; reported taxable income of corporations will be substantially lower during the downturn (that is, the potential tax base will be dramatically reduced); and the lack of a long-term coordinated approach to corporate taxation among the states means that corporations often are able to evade a large share of the tax increases in any given state.

Given the balanced budget requirement and the limited scope for recouping revenues through tax increases during the crisis, a substantial decline in state revenues triggers cuts in spending. The expenditure reductions may not correspond one-for-one to the decline in revenues for a variety of reasons. Many states have set up "rainy day funds" which provide some scope to prop up spending during recessions, but these funds are insufficient to weather the current economic storm. State and local governments often finance capital investments in infrastructure through borrowing—specifically, by issuing state and municipal bonds—although the turmoil in financial markets makes securing credit difficult. States can also borrow short-term to manage their cash flows, but such bridge financing is only a temporary measure. In short, even with these strategies at their disposal, states, municipalities, and towns will not be able to accommodate the expected revenue shortfalls without large-scale reductions in expenditures. The size of the gap is just too big to avoid slashing spending if no new sources of funds are made available.

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To understand where the cuts will hit hardest, we only have to look at how state and local governments use the revenues they raise. Almost 40 percent of current expenditures—that is, spending which excludes capital investment in infrastructure—goes toward public education.[8] This includes public schools, vocational schools, community colleges, and state universities. Public education has already emerged as a major casualty of the current fiscal crisis.[9] Numerous states—including, but not restricted to, Iowa, Florida, Massachusetts, Rhode Island, and Kentucky—have announced hiring freezes and other emergency budget reductions at public universities as part of the first round of cuts for the current fiscal year. State universities and colleges will raise tuition and fees to offset the state spending cuts, making higher education less accessible. Public elementary and secondary schools do not have the option to raise fees and must absorb the cuts directly. New York State expects to reduce school aid by 3.3 percent for the 2009-2010 fiscal year, placing additional pressures on local school districts which will almost certainly erode the quality of education in the state through larger class sizes, heavier teaching loads, and a lack of resources to maintain quality teaching staff.[10]

Public welfare services account for an additional 20 percent of current state and local spending. These programs will come under pressure precisely at the time when they will be most needed, due to rising unemployment and falling standards of living. The need for programs such as Medicaid will rise as people get dropped from the insurance rolls. State and local government plays a crucial role in providing health care and maintaining public hospitals. Demand for health services has been increasing rapidly in recent years, but states will not be able to keep up. Already many states are implementing cuts that will reduce access to health care for low-income children and their families. [11] The impact of the budget crisis on social services is not restricted to health care. States are also planning to cut other social programs, including child care and foster care services, support for the elderly, supplemental income programs, and services for the disabled.[12]

Large-scale spending cuts mean that public sector jobs are at risk. At the present juncture at least 34 states are taking steps to reduce the size of their workforces, mostly through hiring freezes and layoffs.[13] In December 2008, Arnold Schwarzenegger, the governor of California, issued an executive order in response to a projected $42 billion budget deficit which imposed a statewide hiring freeze, ordered public agencies to reduce their payrolls by 10 percent, and required state employees to take off two days a month without pay.[14] States often respond to budget pressures by delaying pay raises or reducing public sector salaries. State governments may also demand concessions from public sector unions or effectively suspend public sector collective bargaining to deal with the budget problems. For example, Connecticut Governor Jodi Rell recently called for $295 million in union concessions to address the state's budget gap.[15] As the fiscal crisis intensifies, many public sector workers will face increasing job insecurity.

State and local governments are also primarily responsible for providing and maintaining the nation's infrastructure. Over 90 percent of all non-defense public assets are owned and maintained by state and local governments.[16] These assets include roads, bridges, water systems, waste management facilities, schools, hospitals, some utilities, and public transit systems. Although the federal government helps to finance public infrastructure projects through grants to states and municipalities, the fiscal crisis will mean that much-needed maintenance, investments, and repairs will not occur unless the federal government scales up its support significantly.

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In short, state and local governments are on the frontline when it comes to providing critical public goods and services. Moreover, the goods and services provided are essential for the long-run performance of the U.S. economy: basic and higher education, core infrastructure, and maintaining a healthy population and workforce. Ironically, the economic meltdown has triggered a fiscal crisis at the state and local level which will make a recovery that much more difficult. The consequences are not limited to the duration of the recession, but will be felt for years to come.

## WHAT'S BEHIND THE FISCAL CRISIS?

Rapidly declining tax revenues are responsible for the current budget crunch. What is surprising is how quickly the crisis in the financial sector spilled over to the public sector and started to affect government budgets. The connection is indirect. Even states with reasonably large financial sectors (e.g., New York with Wall Street) only get a small portion of their tax revenues from corporate taxes. In 2006, taxes on corporate profits accounted for just around 6.7 percent of state tax revenues. (Several decades ago, corporate taxes accounted for a larger share—for example, 9.7 percent in 1980.)[17] The decline of major financial corporations would have affected revenues to some extent, but it cannot fully explain the drop in revenues, particularly in those states where the financial sector is relatively less important.

Table 1 summarizes the major sources of tax revenues for state and local governments. On average, states get over 80 percent of their tax revenues from two sources: sales taxes and personal income taxes. The precise mixture varies from state to state. For example, not all states have general sales taxes or taxes on earned income—in these cases the burden of raising revenues falls on other forms of taxation. Both sales taxes and income taxes are sensitive to economic fluctuations. When individuals and businesses feel less secure about the economic future, they buy less, cutting into sales tax revenues. Likewise, as unemployment rises and household income falls, income tax revenues

**Table 1. Share of total tax revenues for state and local governments, U.S. average, 2006.**

| | State Governments | Local Governments | State and Local Governments |
|---|---|---|---|
| **Sales Taxes** | 46.8% | 16.3% | 34.5% |
| **Personal Income Taxes** | 34.6% | 4.7% | 22.5% |
| **Property Taxes** | 1.7% | 71.7% | 30.0% |
| **Corporate Income Taxes** | 6.7% | 1.1% | 4.4% |
| **Other Taxes** | 10.2% | 6.1% | 8.6% |
| **TOTAL** | 100.0% | 100.0% | 100.0% |

*Source: U.S. Census Bureau*

decline. The collapse of stock market and housing prices also reduces unearned income—for example, the capital gains realized when assets are sold at a higher price. The drop in capital gains taxes—often collected as part of personal income taxes—has been particularly pronounced in the current crisis. Even though corporate profit taxes account for a relatively small share of total tax revenues on average, they will also decline when the economy sours. Nationwide reductions in these key sources of revenue are fueling the fiscal crisis.[18]

Local governments are also under pressure, although through somewhat different channels. States, when they come under financial pressure, often reduce aid to local governments and municipalities. This does not resolve the fiscal squeeze, it just passes the burden on. For example, the governor of Minnesota, Tim Pawlenty, announced in December 2008 that he would address the $426 million deficit for the current fiscal year by cutting state aid to cities and counties, among other reductions.[19] The situation in Minnesota is not unique. Other states pursue similar strategies, creating a direct link between shortfalls at the state level and budget pressures at the local level.

Many local governments also receive funds from sales taxes. Therefore, the decline in sales taxes, where they exist, will affect both state and local governments. However, the single most important source of tax revenue for local and municipal governments is property taxation. On average, property taxes account for about 72 percent of all tax revenues raised by local governments. The current economic downturn has particular implications for property taxes because of the nationwide housing crisis and what it may mean for local governments in the future.

In the short run, the housing crisis primarily affects local government revenues through the non-payment of taxes in communities where foreclosure rates are high. This would affect the ability to collect taxes that are currently owed, but it would not undermine the tax base itself. However, housing prices have fallen significantly since the beginning of the subprime mortgage fiasco, and they are likely to remain low in the immediate future. The fall in housing prices creates a mismatch between the current market value of houses and the assessed value used to calculate property taxes. With mounting economic pressures, homeowners will likely demand that the authorities reassess their property to reflect the current reality. Such reassessments would affect the size of the tax base and could further reduce the resources available to local governments in the long run.

Since the major sources of revenues are highly sensitive to prevailing economic conditions and since revenue shortfalls trigger spending cuts, state and local government spending can be said to be "procyclical." That is, government spending rises and falls with the health of the economy. When the economy falters, it pulls down state and local governments with it. This implies that state and local governments actually contribute to the economic downturn—by cutting spending, reducing benefits to low-income families, and trimming their workforces. We often think of government as a countervailing force, helping to correct imbalances when the private economy begins to slide. However, state and local governments cannot play that role—their hands are effectively tied by the structure of taxes and the rules governing fiscal management.

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The tendency of state and local governments to reduce taxes during good times makes the problem more severe. Elected officials find it politically expedient to promise to cut taxes and "give back" to the taxpayers. However, this makes the revenue shortfalls during recessions far worse. Simply reversing the tax cuts when a fiscal crisis emerges does not represent a sensible approach to financial management. Tax cuts create a structural problem that makes it difficult to maintain sufficient revenues over time to finance state budgets. This problem can be resolved by eliminating politically motivated tax cuts and maintaining adequate tax rates during both good and bad times. The practice of reducing taxes when state and local economies are performing well presents a way of borrowing against the future. In this case the "debt" is paid back through cuts to public goods and services when the economic situation deteriorates. The practice is perverse in the sense that state and local government spending should increase during a recession to offset the harmful effects of the slump. Instead, just the opposite happens—taxes are reduced during upturns and spending is cut during downturns.

A recent study from the Georgia Budget and Policy Institute illustrates the impact of earlier tax cuts in the case of that state's current fiscal crisis.[20] According to the report:

> *The weakening of the tax base has occurred over the past 10 years as Georgia eliminated the sales tax on food, increased income tax breaks for senior citizens, increased personal income tax deductions and exemptions, implemented various personal income tax credits, passed numerous special interest and business sales tax exemptions, and implemented numerous corporate income tax credits.*

The study estimates that if these tax reductions had not taken place, annual revenues would be $1.5 billion higher. That is, the projected shortfall for fiscal year 2009 would have been $1 billion instead of $2.5 billion—representing a 60 percent reduction in the size of the cuts which Georgia will face next year.

## WHAT CAN BE DONE?

State and local governments, acting alone, have few immediate options to deal with the current crisis. Their revenues are tied to the fate of the economy, they have little scope to generate significant revenues in the short run by raising tax rates during the downturn, the precautionary measures they may have undertaken have proved to be insufficient, and they have legal mandates to balance their operating budgets. However, as we have discussed, the consequences of the fiscal squeeze will be disastrous if nothing is done. Therefore, we must look beyond the state and local levels for a short-run solution to the fiscal crisis. In the long run, state and local governments must consider institutional reforms to better manage their finances.

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The most obvious short-run solution is to increase intergovernmental transfers from the federal government to state and local governments. The federal government will not be immune to the general decline in tax revenues caused by the economic crisis. However, unlike state and local governments, its ability to borrow in order to inject money into a faltering economy represents a formidable policy instrument. Put another way, the federal government can implement a large-scale fiscal stimulus—an option unavailable to states, given how budgets are currently managed.

The American Recovery and Reinvestment Act, signed into law in February 2009, does exactly this. The fiscal stimulus program will provide states with additional financial resources in order to help address the threat of spending cuts. For example, the stimulus package includes $87 billion in aid to states to help meet Medicaid payments. The Recovery Act also includes about $48 billion to finance a State Fiscal Stabilization Fund program, which will help counter cuts to education.

The overall impact of the final package on the state budget crisis is complicated, since many of the grants to the states are linked to specific areas of spending—such as targeted infrastructure projects. In other words, a portion of the federal funds going to the states supports the administration of new spending programs detailed in the stimulus legislation. These funds do not always support existing state programs and priorities. This underscores a tension within the economic recovery program: the larger the share of money transferred to states to stimulate the economy through federally mandated programs, the smaller the share of money that will be available to protect state and local spending on education, health, and critical social services. This trade-off can be addressed by either increasing the size of the stimulus package or reducing the amount of federal money dedicated to tax cuts. Based on current projections, the fiscal stimulus package falls short of what will actually be needed. According to the Center on Budget and Policy Priorities, the state budget support contained in the Recovery Act will cover less than one-half of the forecasted shortfalls through the end of 2011.[22]

One danger, in the longer term, of a federally financed solution to the state fiscal crisis is that it could reinforce short-sighted fiscal management at the state and local levels. For example, governments that cut taxes irresponsibly and compromised the effectiveness of their "rainy day" reserve funds would effectively be bailed out. One solution to this problem would be to make increases in federal aid to states conditional on a comprehensive review of long-term fiscal management policies and practices at the state level. A number of structural issues are at stake. Tax cuts have worsened the ability of states to cope with fluctuations in their revenue bases. Rainy day funds have proven to be inadequate to deal with the crisis. States have increasingly relied on highly volatile sources of revenue, such as capital gains tax revenues which are often linked to speculative activities, to fund ongoing operations. Essential public services should not be so closely tied to the ebbs and flows of the national economy. A better system is needed.

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In addition, state and local governments generally rely on a narrow revenue base to finance their activities—sales taxes, personal income taxes, and property taxes. The burden of supporting state and local governments generally falls on individuals and their families. The lack of a coordinated approach to corporate taxes has eroded the size of this important source of revenue, since companies can play states off one another and various loopholes allow corporations to evade taxes, for example by reporting their profits in another state. If states were to cooperate in order to harmonize the approach to corporate taxation and close the existing loopholes, this potentially important source of revenue could be revitalized and some diversity in state revenue sources restored.

The magnitude of the fiscal squeeze currently gripping state and local governments is unprecedented, that much is certain. In the short run, a federal rescue effort is essential to prevent catastrophic spending cuts that would only make the recession worse. In many respects, state and local governments are ideally suited to be the agents responsible for implementing a national economic recovery plan. They are already charged with delivering public goods and services and this role should be expanded with federal support.

However, the recurring budget crunches of the past several years suggest that something is fundamentally wrong with the system for managing state and local finances. Long-run changes are needed, not just short-run federal bailouts. For example, tax policies should be designed so that revenues match expenditures over several years. Short-sighted incentives to cut state and local taxes must be eliminated. A long-run deficiency in tax revenues implies that tax rates have been reduced by too much. Rainy day funds must be expanded to be able to counter an unexpected decline in revenues. The use of these funds should be restricted to addressing revenue shortfalls due to poor economic performance. They should not be used to finance budget gaps opened up by deliberate decisions to reduce taxes. Highly volatile sources of revenues, such as unearned capital gains, could be dedicated to building up rainy day funds during good times and states would not depend on these uncertain sources of revenues to finance their core operating budgets. Finally, coordination among the states would increase the relative contribution of corporate income taxes and thereby make the tax base broader and more equitable.

## Notes

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15. "Rell budget calls for $295 million in concessions," *The Hartford Courant*, February 10, 2009.

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18. Donald J. Boyd and Lucy Dadayan, State Revenue Flash Report, Rockefeller Institute of Government, State University of New York at Albany, November 6, 2008.

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21. See id. at p. 3.

22. Nicholas Johnson, Elizabeth C. McNichol, and Iris J. Lav, "Funding for states in senate economic stimulus package would close less than half of projected state deficits," Center on Budget and Policy Priorities, February 20, 2009.