State and Local Budgets and the Great Recession

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KEY FINDINGS

- In the first three years of the recession, state and local own-source receipts (i.e., excluding federal grants) were down by a total of $71 billion, a deeper and more sustained drop in revenues than in the three previous economic downturns. Although the sharp uptick in federal grants initially offset the loss, this compensatory effect will weaken as federal relief payments come to an end.
- As revenues decline, spending pressures have increased due to climbing enrollments for Medicaid, Unemployment Insurance, and higher education. The result is large gaps between projected revenues and expenditures in nearly every state.
- To close these gaps, states and localities must settle on a mix of raising revenues, cutting spending, or drawing down reserves. Although states have often relied on raising revenues in past recessions, many states are now trimming local payrolls. Between August 2008 and December 2011, state payrolls declined by 2.5 percent and local payrolls by 3.3 percent.

Moreso than in past economic downturns, much of the debate and discussion in the current downturn has focused on state and local budgets, in part because state and local governments have been such a prominent casualty of the downturn. The main problem: Revenues plunged in the recession. States in particular saw revenues decline dramatically. Although taxes have been rebounding of late, growth has been uneven across states and has slowed in recent months. Moreover, local property taxes have dipped recently, consistent with a two to three year lag between home prices and property tax rolls. These reductions coincide with state cutbacks in local aid, further squeezing local budgets. Meanwhile, service demands have continued or escalated.

It goes without saying that the discussion of such matters is highly politicized. For example, in the summer of 2012, presidential candidate Mitt Romney said, "[The president] wants another stimulus, he wants to hire more government workers. He says we need more firemen, more policemen, more teachers. Did he not get the message of Wisconsin? .... It's time for us to cut back on government and help the American people." When the Obama campaign then responded, "Mitt Romney shockingly promised to cut jobs for firefighters, police, and teachers," Mitt Romney immediately fired back, "Of course, teachers and firemen and policemen are hired at the local level and also by states. The federal government doesn't pay for teachers, firefighters, or policemen. So obviously, that's completely absurd. He's got a new idea, though, and that is to have another stimulus and to have the federal government send money to try and bail out cities and states" (see http://takingnote.blogs.nytimes.com/2012/06/12/we-dont-need-no-teachers/).

This exchange is in itself unrevealing, indeed it's just a matter of stock politics, and we rehearse it here simply to emphasize that state and local spending is a key issue in the current downturn. It follows that a dispassionate rehearsal of the facts is very much in order. The purpose of this overview is to explain what happened to state and local governments in the Great Recession, how they responded, and what may be in store for them over the near term.

These are critical issues, and not only because politicians increasingly care about them. They are also critical because state and local governments are workhorses of the U.S. federalist system. They undertake most direct public spending on goods and services (including their expenditures from federal funds), and they bear primary responsibility for goods and services—such as education, social services, and infrastructure—that directly affect the economy and our quality of life.

We accordingly begin with a primer on state and local government finance. We thereafter take on three simple, albeit key, questions:

How much have state and local revenues declined during the downturn? In economic downturns, state and local revenues will typically decline, but the size of that decline depends on a host of variables, such as the extent of federal grants, and therefore can be quite variable. We will ask whether the current downturn lives up to its “Great Recession” billing when it comes to revenue decline at the state and local level.

To what extent have pressures for state and local spending intensified? The hallmark of all downturns is that, just as revenues decline, many types of spending demands intensify, particularly those involving public welfare. We will ask whether we’ve experienced a Great Recession not just in terms of revenues but also in terms of spending pressures.

How have states and local governments responded? When there’s an operating deficit, states and localities can respond by raising revenues, cutting spending, or drawing down reserves to close the gap. We will ask which of these three possible responses has been most frequently adopted.

We then conclude by briefly speculating on how states and localities will respond to ongoing economic pressures. Because the state and local levels have become the front line of the Great Recession, much rides on how they react and adapt.

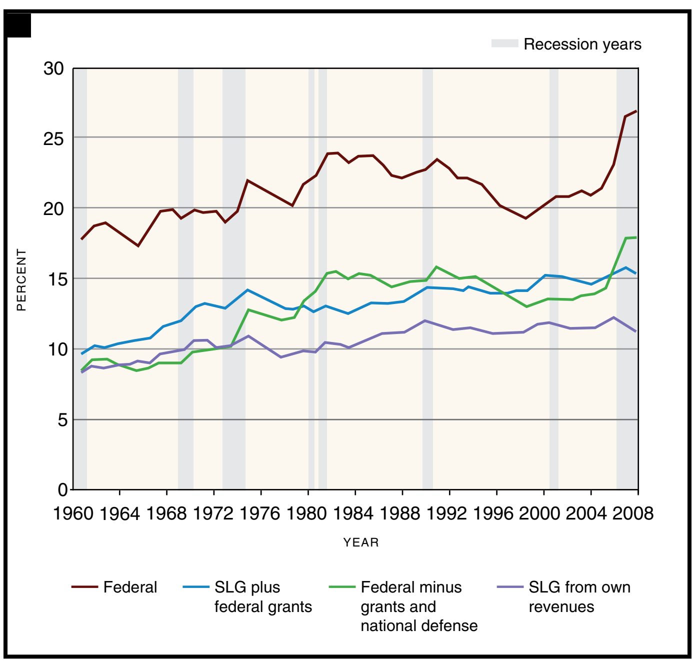
A Primer on State and Local Government Finance

We begin, however, with the primer. The simple question upon which we’ll first focus is that of the size of state and local governments. Is the United States indeed highly decentralized in its spending? We should care about this because it tells us to what extent declines in spending at the state and local level will have meaningful economic effects.

To better understand the role of state and local government, we therefore turn to figure 1, which shows spending by level of government as a share of gross domestic product (GDP). We see that, in 2010, federal spending represented about 27 percent of GDP, whereas states and localities represented a rather smaller 11 percent. This might at first blush lead one to conclude that the role of state and local government has been overemphasized by some commentators.

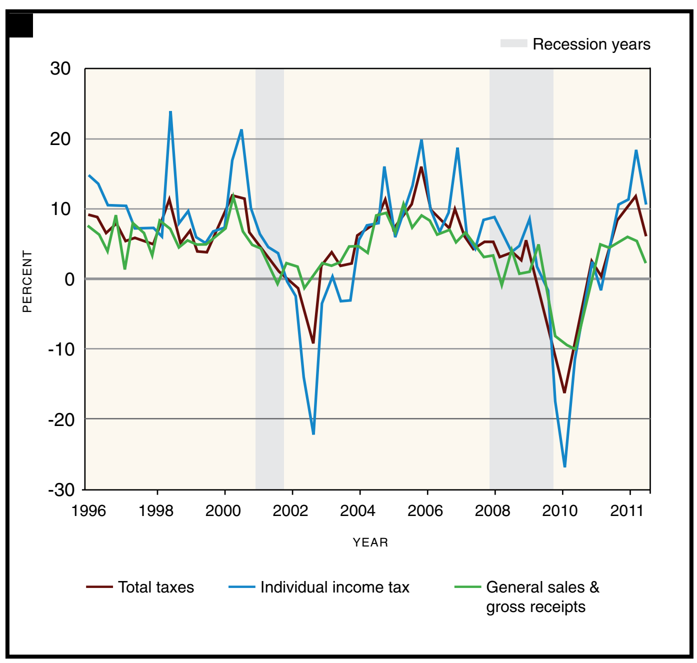
There are two reasons why that shouldn’t be the take-home point. First, note that the federal level is unusually high because of the recession, indeed since 1960 the historical average has been about 20 percent rather than the current 27 percent. The spending level at the state and local level has, by contrast, increased rather less from its historical average of approximately 10 percent of GDP. Second, if we exclude fed-

FIGURE 1. Government Expenditures by Level



Source: National Income and Product Accounts, 2011.

FIGURE 2. Percentage Change in State Taxes Year over Year



Source: U.S. Census Bureau, Quarterly Tax Survey, 2011.

eral spending on national defense and allocate federal grants to the level of government where they are ultimately spent—states and localities—the average federal share drops to just under 13 percent and the average state and local share rises to just above 13 percent of GDP. As figure 1 shows, there are also several years in which states and localities outspent the federal government by this measure.

The importance of state and local governments isn't surprising when one takes the long view. States historically preceded the federal government and the Tenth Amendment to the U.S. Constitution explicitly reserves to them any powers not granted to the federal government. For most of American history, states and localities were dominant and the federal government was limited to national defense, foreign relations, courts, and the postal service.

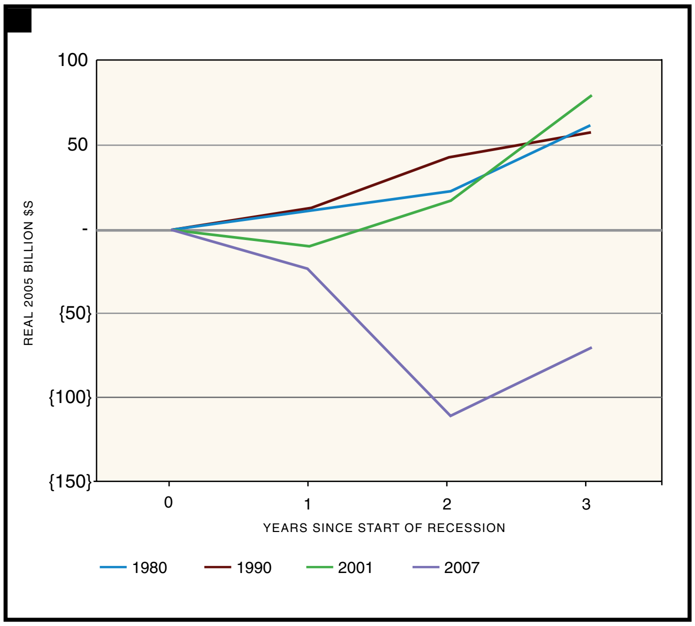
This relationship switched in the Great Depression, as the federal government expanded into broad social insurance programs, and during World War II, as it built up the military. Even then, however, the federal government continued to rely on states and localities for implementation, especially in public works and social safety net programs. This implementation role grew with the introduction of Great Society programs in the 1960s, especially the joint federal-state Medicaid program in 1965. These social safety net responsibilities continue today and are reflected in state and local spending patterns. State and local governments concentrate their activities in education, public welfare, and health and hospitals, which accounted for roughly two thirds of all state and local spending in fiscal year 2009.

A Sharp Decline in Revenues?

It's clear, then, that state and local governments constitute an important part of our public sector. We turn now to the question of how states and localities fund their expenditures and whether those revenue sources fell off substantially with the Great Recession. The key distinction to be made in understanding state and local funding sources is that between (a) federal grants, and (b) "own-source receipts," which include sales taxes, individual income taxes, corporate income taxes, and other various sources.

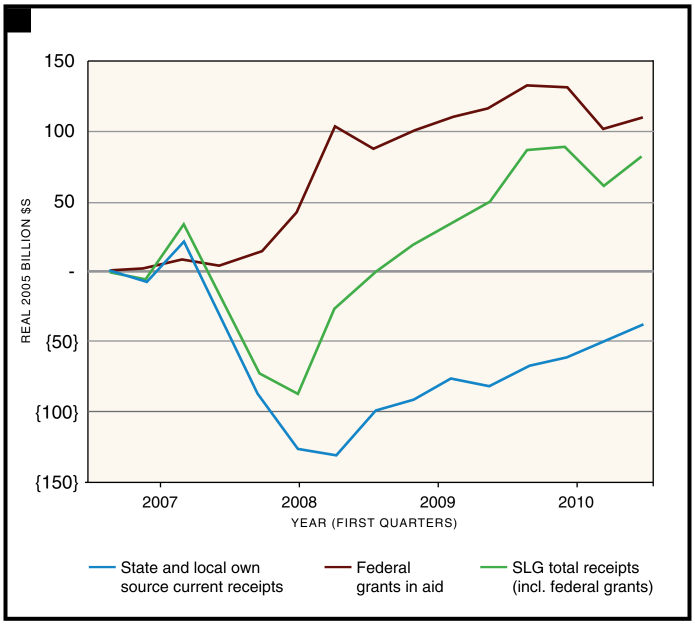
Let's consider own-source receipts first and, in particular, tax receipts. As shown in figure 2, state taxes rose at the beginning of the recession, but they began falling in the fourth quarter of 2008. Sales taxes were the first to fall, but income taxes ultimately fell harder and faster. At their low point in the second quarter of calendar year 2009, state taxes were 17 percent below their level one year earlier and personal income taxes were 27 percent lower.

FIGURE 3. Cumulative Change in State and Local Government Own Source Receipts



Source: U.S. Bureau of Economic Analysis, 2011.

FIGURE 4. Cumulative Change in State and Local Finances



Source: National Income and Product Accounts, 2011.

More recently, state tax revenues have been rebounding. Taxes rose by 6 percent in the third quarter of 2011 compared to one year earlier. Growth was particularly strong in individual income taxes (11 percent). However, recent state reports suggest that this growth may be moderating.

To put these trends in perspective, state and local own-source receipts (excluding federal grants) declined by $111 billion in real terms from the last quarter of 2007 to the second quarter of 2009. As shown in figure 3, this drop is deeper and more sustained than in previous downturns, including a pair of back-to-back recessions in the early 1980s. Even three years into the recession, state and local own-source receipts were still down by $71 billion, relative to 2007.

Have federal grants served to offset these state and local revenue losses? We see in figure 4 that federal transfers did help offset some of the drop in state receipts. However, they declined after the scheduled end of stimulus payments.

The overall conclusion, at least as regards state and local own-source receipts, is therefore that the Great Recession has lived up to its billing. The sharp decline in own-source receipts is indeed unusual relative to the experience of previous downturns.

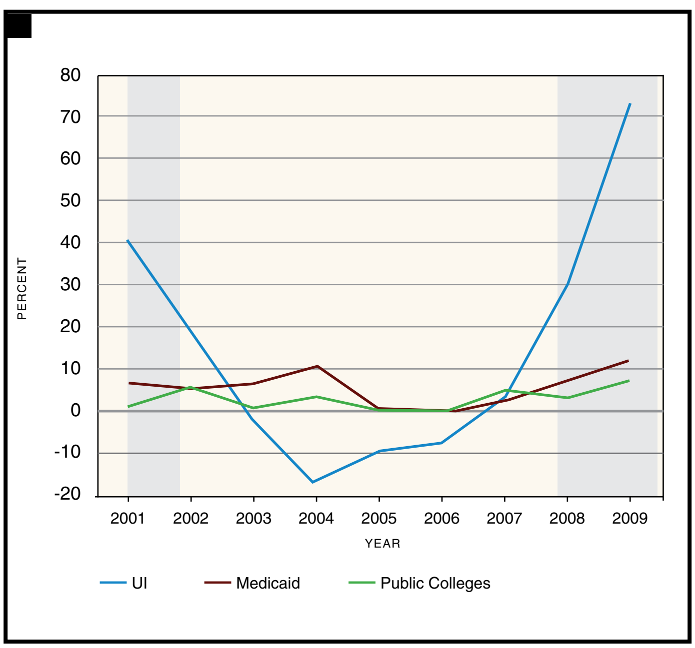
To What Extent Have Spending Pressures Escalated?

We care about the level of state and local spending during a recession for two reasons. It's not simply that spending by states and localities can serve as a counterweight to declines in other sectors of the economy. In addition, the demand for some types of spending, such as public welfare, will typically increase in a recession; and we of course prefer, all else equal, that states and localities have the capacity to meet that demand.

We therefore consider next whether we're experiencing a Great Recession not just in terms of revenues but also in terms of spending pressures. The simple answer: As figure 5 shows, spending pressures have indeed continued or escalated. In particular, enrollments climbed for Medicaid, Unemployment Insurance, and higher education.

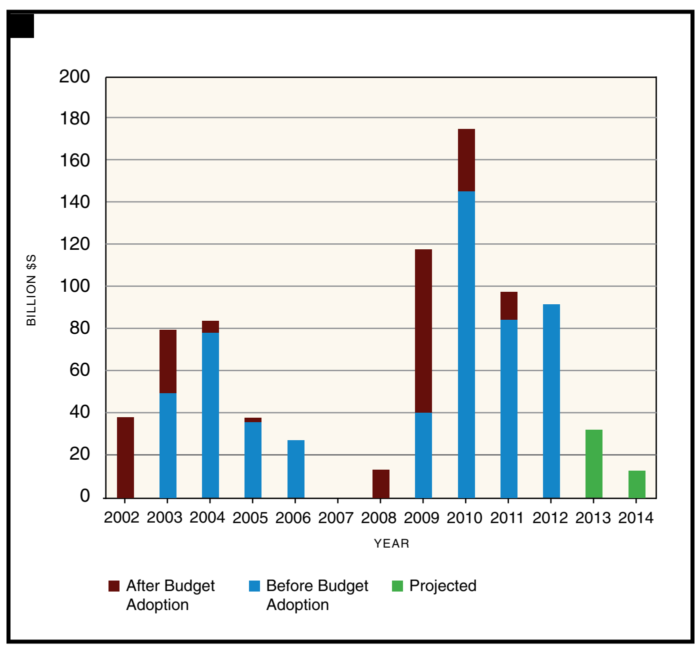
As a result, gaps between projected revenues and expenditures opened in nearly every state, including a record number of states (43) that confronted gaps in the middle of a budget year, necessitating further actions beyond those already taken (see figure 6). Since the start of the recession, states have faced nearly $500 billion in estimated cumulative shortfalls, a number that can be calculated by summing the estimated shortfalls in figure 6 for the years 2009 to 2012.

FIGURE 5. Year over Year Percentage Change in Caseloads for Selected State Programs



Sources: U.S. Department of Labor, Employment and Training Administration; U.S. Census Bureau Current Population Reports, Health Insurance Coverage in the United States; U.S. Census Bureau, Current Population Survey.

FIGURE 6. State Budget Gaps



Source: National Conference of State Legislatures, 2011.

How Did States Respond?

The evidence of figures 5 and 6 makes it clear that states faced considerable financial pressures in the Great Recession. How have they responded to that pressure?

Although it is frequently asserted that all states except Vermont are constitutionally or statutorily bound to balance their budgets, the reality is more nuanced. Many state balanced budget rules are prospective in nature, meaning that governors must submit or legislatures must enact a balanced budget. More restrictive rules (as exist in 38 states) prohibit carrying a deficit year to year. In any event, capital markets generally limit access to borrowing to cover an operating deficit. By implication, states and localities must raise revenues, cut spending, or draw down reserves to close a budget gap.

We might well imagine that, when a recession is conjoined with strong political pressure to avoid tax increases, the opportunities (and incentives) to raise revenue are limited. This supposition would appear to be correct. In the recent recession, states relied less on revenue increases compared to previous downturns. Although tax and fee increases in fiscal year 2010 were the highest on record ($23.9 billion), this was in nominal terms and not as a percentage of prior year collections (figure 7).

In all, 40 states enacted tax or fee hikes between fiscal years 2009 and 2011. The largest increases occurred in California and New York (accounting for about half of the total over this period). Some states (Ohio, Indiana, North Dakota, Missouri, Alabama, Wisconsin, Louisiana, and Michigan) also cut taxes.

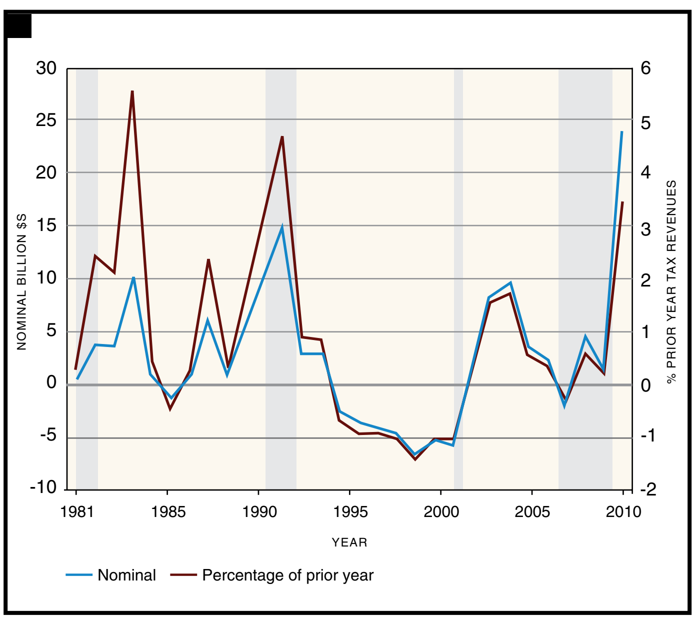
Many states cut spending. Cuts fell predominantly in education, health, and social services. According to the Center on Budget and Policy Priorities, 34 states reduced expenditures on K-12 education during the recession, 43 cut colleges and universities, 31 health care, and 29 services to the elderly and disabled between fiscal years 2009 and 2011. Another 44 states reduced employee compensation.

These cuts are evident in declining state and local payrolls. Overall, state payrolls declined 2.5 percent (132,000 jobs) and local payrolls 3.3 percent (524,000 jobs) between August 2008 and December 2011. Job losses have been concentrated in the local sector and in states outside of education. The duration of state and local job losses deviates from past recessions—continuing more than 4 years since the start of the 2007 recession (see figure 8).

What's Next?

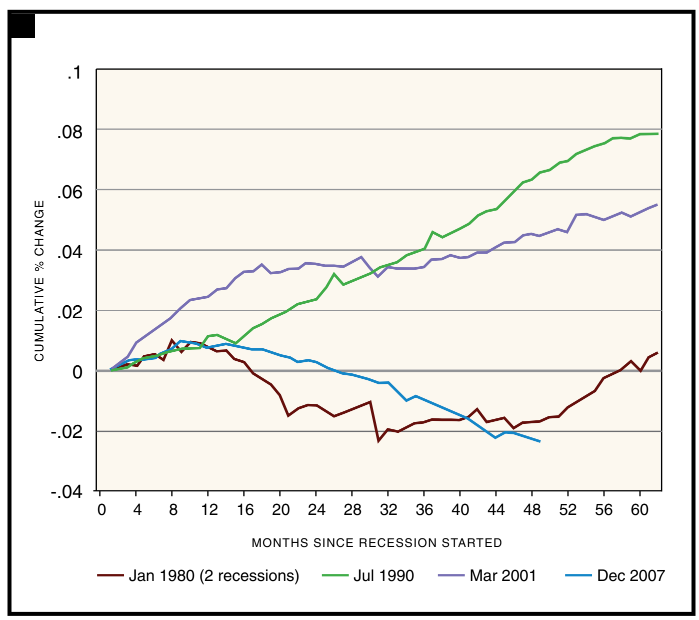
As figure 1 showed, state and local spending constitute a healthy percentage of our GDP, especially when federal

FIGURE 7. Enacted State Tax Change



Sources: National Association of State Budget Officers and Bureau of the Census, 2011

FIGURE 8. State and Local Job Losses



Source: Bureau of Labor Statistics, 2011 grants are counted as part of that spending. It follows that the U.S. economy depends in good measure on the states and localities.

This simple fact makes it important to consider how states and localities are faring in the Great Recession and its aftermath. We've asked whether state and local revenues declined much in the downturn, whether pressures for state and local spending intensified substantially, and whether states resorted to cuts or revenue-raising in dealing with operating deficits.

The answers to these questions all point to an economic downturn that is posing unprecedented challenges at the state and local level. The own-sources revenue decline has been substantial and indeed deeper and more sustained than in previous downturns. Moreover, just as own-source revenues declined, there's been an increase in many types of spending demands, particularly those involving Unemployment Insurance, Medicaid, and public college. Although states have in the past reacted to recessionary challenges by raising revenues, they've especially relied in the present recession on spending cuts, with the result being substantial and unprecedented state and local job losses.

The speed with which states emerge from their budget crises will depend on the speed of their economic recoveries. In general, some states have weathered the recession more easily than others, typically due to rich natural resources endowments and diverse regional economies. Others have taken aggressive steps to close their budget gaps and to address long term structural imbalances. In the longer run, many states and localities will have to contend with underfunded pension and retiree health care plans, whose liabilities have been variously estimated at $1 to $3 trillion.

In the current budget crisis, many states and localities are re-examining service delivery, renegotiating labor agreements, and engaging citizens in conversations about budget tradeoffs. These steps may be fruitful over the longer term. Showing a tighter connection between revenues raised and services provided may also prove a valuable lesson from this recession for all levels of government.

ADDITIONAL RESOURCES

Gordon, Tracy. 2012. *What States Can, and Can't, Teach the Federal Government about Budgets*. Washington, DC: The Brookings Institution. Available at: http://www.brookings.edu/research/papers/2012/03/states-budgets-gordon

Oliff, Phil, Chris Mai, and Vincent Palacios. 2012. *States Continue to Feel Recession's Impact*. Washington, DC: Center on Budget and Policy Priorities. Available at: http://www.cbpp.org/cms/index.cfm?fa=view&id=711

Pew Center on the States. 2012. *The Widening Gap Update*. Washington, DC: Pew Center on the States. Available at: http://www.pewstates.org/research/reports/the-widening-gap-update-85899398241

U.S. Bureau of the Census. *Annual Survey of State and Local Government Finances*. Washington, DC: 2011.

U.S. Government Accountability Office. *State and Local Governments' Fiscal Outlook*. Washington D.C.: April 2012. Available at: http://www.gao.gov/products/GAO-12-523SP

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To further explore the data presented here and to produce customized graphs on recession trends, go to www.recessiontrends.org