NAVIGATING State and Local Finances

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Past trends will not foretell the future, but charting how state and local finances weathered the 2001 recession suggests viable ways to navigate going forward. Lacking the deficit finance ability of the federal government, states and localities must set a spending course based on anticipated taxes and revenues. An unexpected crisis—like the stock bubble burst at the beginning of this century and the subsequent economic slowdown—that throws budgets into fiscal chaos requires such unpopular bailouts as tax increases or cuts in services and welfare. Did that happen?

Participants at a Lincoln Institute–sponsored conference in March 2007 gathered at the Urban Institute in Washington, DC, to discuss the recession and share findings on how states and localities determined various actions and policies to address its impacts. This conference, titled "State and Local Finances after the Storm: Is Smooth Sailing Ahead?", was also hosted by the Urban Institute–Brookings Institution Tax Policy Center, and by the Kellogg School of Management and the Institute for Policy Research, both at Northwestern University.

A prior conference in April 2003 focused on what we do and do not know about state fiscal crises. Although the economy takes a downturn about once a decade, policy makers continue to be caught unprepared. The recession of 2001 was further exacerbated by tax reductions enacted by state governments in the boom period of the late 1990s and by spending accelerations.

The personal and corporate income taxes and the sales tax all yielded lower revenues in 2002 than in the previous year, according to research presented at that 2003 conference. At this year's conference, we learned that the corporate income tax rebounded as a share of state tax receipts starting in 2003, but that the effective tax rate on corporate profits has slipped even further.

Presentations also noted that substantial rainy day funds in some states may have staved off broad-based tax increases and protected social services for low-income families. Cities don't have rainy day funds, however.

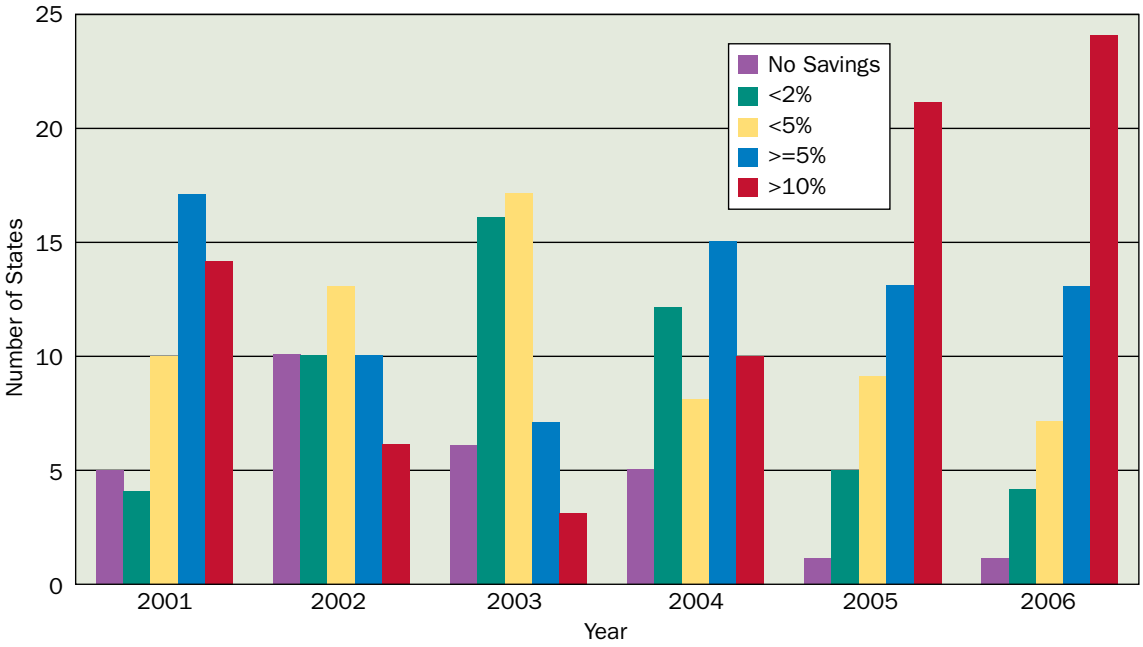
Many cities found that the resilience of property taxes proved to be the great equalizer as states and localities faced large declines between available revenues from other sources and the resources needed to maintain services. Yet, as a case study of Minnesota showed, no two cities respond to fiscal crises in exactly the same way. For example, more than 38 percent of Minnesota's cities relied more on increased service charges than on property taxes (Anderson 2007).

Cutting funds to K-12 education is perhaps the most unpopular way to reconcile local budgets during a recession. However, new numbers presented at the 2007 conference showed that while state and local education spending trended slightly upward in 2002, it dipped briefly in 2003 and 2004. Many localities' direct education spending has recovered; states, however, have not returned to pre-recession education spending levels.

What are the budget busters going forward? Medicaid recently became the largest spending category for states, and it is one of the most rapidly growing areas of state and local budgets. Recent court-mandated school finance reforms and local tax limitation efforts have been shifting the onus of education spending from localities to the states. Both of these trends are expected to continue as the baby boom generation ages.

State pension fund activity, both growth and decline, is also affecting the long-term fiscal health of many states. Overlooked unless it is headline news—such as underfunding of pension funds in

FIGURE 1
State General Fund and Rainy Day Fund Savings as a Percent of Expenditures



Source: Adapted from Figure 5 in Maag and Merriman (2007)

Illinois or New Jersey's diversion of billions of dollars from its pension fund for state and local workers into other government purposes—pension funding could have a huge impact on state finances.

Responses to the 2001 Recession

"To many people the recession of 2001 probably seems like ancient history. But we need to understand it because what happened in the first few years of this decade was, by some measures, the worst fiscal crisis in at least 50 years," said Nick Johnson of the Center on Budget and Policy Priorities in Washington, DC, and a moderator at the 2007 conference. He noted that states did make some expenditure cuts with scaled-back health benefits, declines in Medicaid enrollment eligibility, and cuts or freezes in childcare assistance.

But according to David Merriman of the University of Illinois at Chicago, states entered the 2001 recession better prepared than they had been for downturns in recent decades (see figure 1). Using 2001–2006 data from the National Association of State Budget Officers, Merriman and Elaine Maag of the Urban Institute showed that state tax revenues grew only two-thirds as fast as gross domestic product (GDP) in those five years—remarkable since state revenues grew almost 25 percent faster than GDP in the two-and-a-half decades prior to that recession.

Still, state savings in general funds or rainy day funds propped up spending and deterred draconian tax increases or budget cuts. Simulations suggested that, if states did not have savings at the recession's start, per capita spending would have fallen about 21 percent by 2004, rather than the observed 5 percent drop. States also appear to be replenishing their savings rapidly, thus preparing for future fiscal crises.

Those looking at state corporate income tax reform to shore up budgets against future economic dips may be disappointed. The corporate tax is surprising small, according to William Fox of the Center for Budget and Economic Research at the University of Tennessee, amounting to only about 10 percent of state and local business taxes. Although perceptions of corporate tax abuse may be wildly overstated, Fox, with coauthors LeAnn Luna and Matthew Murray, argued that corporate taxes should have rebounded dramatically with the recent growth in profits, but they have not. The ability to carry losses forward may explain part of the lag, as would increasingly effective business tax planning.

Fox suggested that participants look to Ohio, where gross receipts taxation offers a viable alter-

State and Local Bonds Weather the Storm

Three major credit rating agencies, Moody's, Standard and Poor's, and Fitch Ratings, evaluate the creditworthiness of states and localities before they issue municipal bonds. Ratings provide an independent assessment of credit quality, thus facilitating state and local government market access to borrow for capital projects. Ratings are continuously upgraded and downgraded as economic and fiscal circumstances and governmental behavior change the credit outlook.

According to Melanie Shaker and Laura Porter of Fitch Ratings, local governments can be more vulnerable than states to economic shocks due to their more limited tax base. Any large loss of taxpayers, increased expenditures (including for out-of-work taxpayers), changes in industrial concentration, or drops in housing construction can impede financial performance, force increased debt issuance, and, possibly, lower bond ratings.

Cleveland's recent experience with high mortgage foreclosure rates, for instance, required a rating discussion when the city issued bonds in 2007; Detroit was downgraded to 'BBB' based on its financial and economic woes. Future challenges for localities, said Shaker, will be their ability to withstand fluctuations in the housing market and sustain financial integrity despite fiscal pressures such as rising health care and pension costs.

Varied tax structures and regional economies led to very different changes in state ratings during the 2001 recession. Impacts were generally more severe in such higher-income states as California, Massachusetts, and New York, which had benefited the most from capital gains and stock option runs-ups, according to Porter. Of the eight states with rating downgrades in the recession, only California and Oregon have been upgraded since then, and neither is back up to its pre-recession rating. These states also reflect the impact of voter initiatives that limit financial flexibility.

With upturns in the last few years, state government finances appear strong enough to weather a recent deceleration in the pace of growth, particularly to the sales tax. Issues to watch, Porter said, include rising health care and transportation program costs, property tax relief demands, and a softening housing market.

native to corporate income taxation. Gross receipts taxes have several obvious problems, such as the repeated taxation of goods as they are resold during the production process and the introduction of incentives to firms to vertically integrate to avoid the tax. However, this type of taxation has some advantages.

The Ohio Commercial Activity Tax (CAT) replaces franchise and personal property taxes with a lower rate on gross receipts. The tax is levied on all businesses that have an economic presence in the state. The application to all businesses promotes the perception of fairness, and its relatively simple application in Ohio helps control administrative and compliance costs.

After the 2001 recession many states adopted tax amnesty programs that provided a short-run boost to state revenues at little direct cost to the states. Most amnesties forgive penalties and interest charges. Their repeated use, however, may prove to be self-defeating if taxpayers start to cheat with the reasonable expectation of being offered an amnesty in the future.

Pushing Down the Problem

The federal government transfers about one-fourth of its revenues to the states, which in turn disburse

important operating funds to cities and counties. State governments play a major role in funding local governments—including counties, municipalities, and school districts—for education, transportation, public health, and social services. When tough economic times depress revenues at the top, jurisdictions at the bottom bear the burden. Many cities saw a decline in revenues after the 2001 recession, according to Christopher Hoene of the National League of Cities. Some local governments raised public service fees to make up the shortfall, and others responded to reduced state fiscal assistance by increasing property taxes—their major revenue source.

Despite rhetoric on the importance of public education, 29 states—enrolling two-thirds of the nation's public school students—reduced education aid per capita between fiscal years 2002 and 2004, according to Richard Dye of Lake Forest College in Illinois. These data, presented in a paper coauthored with Andrew Reschovsky of the University of Wisconsin-Madison, "understate the fiscal pressures placed on local school districts," Dye said. New accountability standards imposed by the 2001 No Child Left Behind law only compounded the pressure to maintain public education in light of state aid cuts and rising costs.

How did school districts cope in the wake of state aid curtailment? Dye and Reschovsky reported that increases in local school district property tax revenues between fiscal years 2002 and 2004 largely offset decreases in state aid, providing strong evidence of the strength and resiliency of the property tax. Of the 22 states with decreases in state aid, 19 increased property tax collections, and eight of these—Alabama, Arkansas, California, Georgia, Kansas, Massachusetts, South Carolina, and Utah—increased property tax collections by more than 5 percent. These eight states also had the largest cuts in inflation-adjusted per capita state aid. These revenue increases might be the result of actions taken by local governments or, as noted by Hoene, the result of rising property values leading to higher property taxes.

James Alm and his coauthors Robert Buschman and David Sjoquist of Georgia State University, also studied the negative impacts of the 2001 recession on K-12 education spending, mainly at the state government level. They looked at both education spending trends and the variables behind the trends, and they found that the legal and institutional restrictions on states and localities appeared to have little consistent impact on revenues in the post-recession period.

However, they also found that the fiscal structures of state and local governments, as well as regional differences, are important explanatory factors in these trends. The increase in local spending in the Northeast was substantially larger than in other regions, for example. As for "tastes," states with more educated citizens, all else being equal, are less likely to reduce education spending, Alm said, while states with higher home ownership rates were found to be more likely to reduce spending.

Nathan Anderson of the University of Illinois at Chicago offered a case study of Minnesota to illustrate the importance of examining responses at the local level. While the aggregate data for Minnesota suggest that cities responded to aid cuts primarily by raising property taxes, individual-level data reveal that more than one-quarter of Minnesota cities actually lowered property taxes. About 38 percent of the cities replaced more of their lost aid with service charges than with property taxes. He emphasized the "local heterogeneity" of cities, especially since many similar cities received very different aid cuts and responded very differently in terms of whether or not to raise property taxes and by how much to raise them. Again, these increases in property taxes might be due to rising property values.

Anderson also discussed responses to what he referred to as broken promises by the Minnesota

state government to its local governments. State aid is promised one year in advance so that cities can set their property tax rates. In 2003, the exact nature of the aid cuts was not revealed until city policies had already been set. Once cities realized that they had been misled, in some cases it was too late to raise property taxes, forcing those cities to either dip into alternative funds or to cut services.

Likely Budget Busters Going Forward

Many of the policy choices that states and localities make this year—or have already made—will influence the major issues of health, pensions, and education for years to come. "We're often setting ourselves up for failure," said Eugene Steuerle of the Urban Institute, "since many policies are pre-set before the relative importance of different types of pressures and needs of society can be known."

This is particularly evident with the Medicaid program, which has grown dramatically since its inception in 1965 (see table 1). Now providing health benefits to about one-sixth of the national population, Medicaid has become the biggest expenditure item for state governments and is a major element in the system of federal transfers to the states.

To illustrate the growth in Medicaid, James Marton and David Wildasin of the Institute for Federalism and Intergovernmental Relations at the Martin School of Public Policy of the University of Kentucky compared the health program spending to welfare spending. In 1967 both aid programs were approximately equal in amount. By 1988 Medicaid spending was nearly three times as large as cash welfare spending. By 2003 Medicaid was nearly nine times as large as what is now called Temporary Assistance for Needy Families. The 1996 landmark welfare reform law, which made welfare temporary, continues to have a spillover effect on Medicaid. Demographics pose another important factor going forward, since the elderly requiring long-term care are a very large share of current Medicaid spending.

Considering the health care pressures stemming from an aging population, and a growing number of uninsured workers, Marton discussed the potential for Medicaid reform. State experiments may be the key to any national reform effort, he said, as evidenced by the number of states receiving waivers from federal law to launch innovative new systems. This continues the "laboratory of the states," since the granting of welfare reform waivers in the early 1990s served as a model for the 1996 reform. Any major Medicaid reforms, Marton predicted, are likely to involve some change in the intergovernmental fiscal and regulatory relations that now underpin the program.

Changing demographics is another major factor when examining the road ahead on education spending. "We're aging and the number of school-age children is growing," said Kim Rueben of the Urban Institute. These changes indicate a greater need for education spending, which may lack political support since older residents are often less inclined to vote for education funding increases than are younger voters and those with children.

The large role of education spending in state budgets is partly due to lawsuits that cropped up in the 1970s and 1980s as questions of equity and adequacy were raised across different states, resulting in requirements that education expenditures be equalized across school districts. This change meant moving reliance for school funding from the property tax to state sources. The growing number of special needs students, such as those with disabilities and limited English skills, also increases the cost of education. Some estimates put the cost of educating a special needs student at 50 percent more than the cost of educating an average student.

State pension systems are also quietly raising concerns, but not necessarily alarm. "Turbulence is a matter of comfort, not safety," said J. Fred Giertz of the University of Illinois at Urbana-Champaign in a paper with Leslie Papke of Michigan State University. "Underfunding has become a fact of life," he said. As evidenced in Illinois and New Jersey, state governments do not always invest pensions in a way that guarantees security for retiring workers. This was not always the case. High investment returns in the late 1990s allowed some states to reduce or eliminate their annual contributions to pension funds, just as some companies reduced their contributions to their fully funded pension funds. State and local public pensions are predominately of the defined benefit form—that is, employee and employer contributions, plus the investment returns, are intended to cover the cost of benefit payments.

In summary, the conference highlighted that throughout the 2001 recession the sustained strength of the property tax and the presence of rainy day funds largely protected state and local governments from the need to cut spending drastically or to raise tax rates. What does this tell us about potential fiscal pressures on the horizon? Ensuring sufficient revenues going forward, as well as having the flexibility to revamp fiscal structures, will be important for state and local governments, especially due to growing future spending need.

TABLE 1
Share of Total State Expenditures by Function (%)

	1985	1990	1995	2000	2005
K-12 Education	22.2	22.8	21.0	22.3	21.8
Higher Education	11.1	12.2	10.4	11.4	10.6
Cash Assistance Welfare	6.1	5.0	4.0	2.6	2.0
Medicaid	11.0	12.5	19.8	19.5	22.9
Corrections	2.2	3.4	3.6	3.9	3.5
Transportation	10.7	9.9	9.1	9.1	8.6
All Other	36.7	34.2	32.1	31.8	30.8

Source: Adapted from Table 1 in Murray, Rueben, and Rosenberg (2007) using data from the National Association of State Budget Officers, Washington, DC.

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