The Long Road to State Fiscal Recovery

Donald Boyd

The recent recession has been recognized as the worst in memory, and its effects are still being felt. Less well understood is the fact that this recession has been far worse for state governments than the drop in gross domestic product (GDP) would suggest. While state government finances have stopped falling off a cliff, they are closer to the bottom of that cliff than the top. Tax receipts have not returned to their pre-recession levels, and new revenue demands may overwhelm any interim improvements in collections. Even if states can avoid these challenges, it will be a long, slow road to fiscal recovery, with several large risks along the way.

State and local governments play a major role in the economy and in our daily lives. They finance more than 90 percent of K-12 education and deliver virtually all of it. Public colleges and universities educate three-quarters of students enrolled in degree-granting institutions. State and local governments oversee, design, and build more than 90 percent of the nation's public infrastructure. They finance much of the nation's social safety net and implement much of it as well. In fact, state and local governments spend more on direct implementation of domestic policy than does the federal government.

The services financed and delivered by state and local governments tend to have stable and generally rising demand. When a recession hits, there is no reduction in the numbers of children in school or elderly people in nursing homes—two of the most important spending areas for state and local governments—or in the numbers of fires or crimes. For programs such as Medicaid and higher education, for example, demand for the kinds of services that state and local governments provide typically rises during recessions. Unless and until states can fix their revenue structures or develop adequate reserves, public policy will continue to gyrate with every turn in the economy.

Decline in State Tax Collections

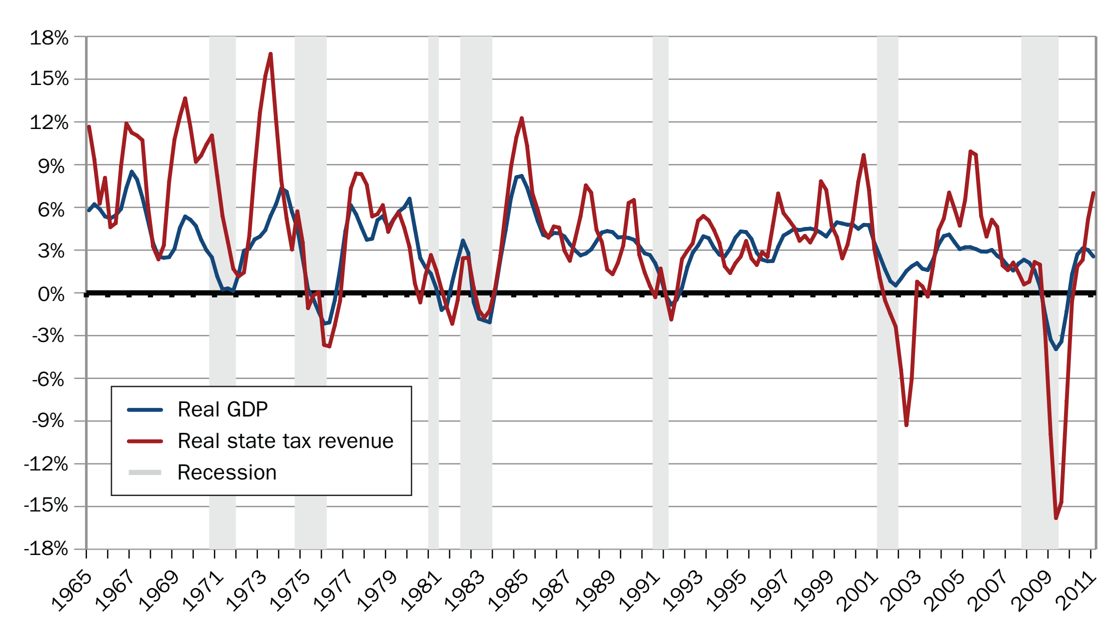
The Great Recession that started in December 2007 was the deepest and longest recession since the Great Depression of the 1930s. The unemployment rate rose to 10.1 percent and has remained stubbornly high, falling only to 9.1 percent after two years of recovery. State tax collections plummeted, falling for five consecutive quarters beginning in the fourth quarter of 2008 and continuing through 2009. Tax revenue fell by a dizzying 16.8 percent in the second quarter of 2009, and over the next several years it declined further and more sharply than it had in any other recession since World War II (figure 1).

The recent drop in GDP has been significant in comparison to past recessions, but the declines in taxable consumption and personal income, two components that typically constitute the tax bases of state and local government, have been far worse. Taxable consumption fell by about 11 percent, while GDP fell by about 5 percent. Taxable components of personal income also fell much more sharply than the overall economy and still languish more than 5 percent below the pre-recession peak, reflecting the jobless recovery.

Even though this has been the worst post-war recession by traditional economic measures, these measures do not tell the whole story. Capital gains, an important component of state tax bases, are not included in personal income as measured in the nation's economic accounts. These gains have increased in importance and are a major cause of increased volatility in state finances. Capital gains fell by more than 55 percent, driving down tax collections in the final quarter of the 2009 fiscal year, when tax returns reflecting the 2008 stock market collapse were filed.

FIGURE 1

Percent Changes in State Tax Revenue and GDP, 1965–2011



Source: Prepared by the author using data from the U.S. Census Bureau and U.S. Bureau of Economic Analysis.

The net result of these and other forces was huge declines in state income, sales, and corporate taxes. Figure 2 shows that annual income taxes fell by more than 15 percent in inflation-adjusted terms, sales taxes fell by more than 10 percent, and corporate income taxes fell by more than 25 percent. Property taxes, which are crucial to local governments but generally not a significant revenue source for states, remained quite stable through much of the period, although they are beginning to weaken and in some parts of the country have fallen significantly.

A Slow Recovery

The recession ended in June 2009 and the economy has been recovering slowly. State tax collections grew in each quarter of calendar year 2010, and the character of that growth has improved over time. In the first two quarters of 2010, increased tax rates more than offset declines caused by the weak underlying economy, but in the last two quarters tax revenue growth was driven primarily by the improving economy. By the fourth quarter, tax revenue grew by 7.8 percent, but even without tax rate increases it would have grown by 7.0 percent. Tax revenue in the January–March 2011 quarter grew 9.3 percent compared to the previous year, and 21 states had double-digit growth. Preliminary data for the April–June quarter show tax revenue up 11.4 percent.

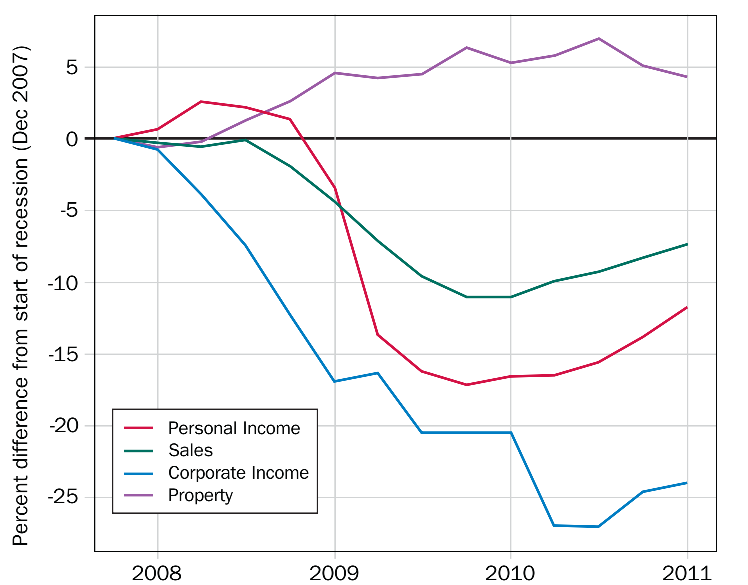
Inflation-adjusted state tax revenue for the nation as a whole in the latest four quarters (ending in the first quarter of calendar year 2011) was 7.7 percent below the peak attained in 2007. The heady growth in the first two quarters of 2011 probably cannot be sustained because much of it appears to have been driven by stock market gains in tax year 2010, boosting income tax returns in the second quarter. Those gains almost certainly will not be repeated in 2011.

In addition, turmoil in European debt markets and the recent Standard & Poor's downgrade of U.S. long-term debt have contributed to fears of a double-dip recession. There are indications that economic growth will be slower than most states have assumed in their current budgets. States are closer to the bottom of the cliff than the top, and are at risk of falling back down. Meanwhile, there are some signs that local government tax revenue also is beginning to weaken.

While tax revenues are now growing in most states compared to the last year's low collection rates, they have not reached the levels prior to the recession. After adjusting for inflation, tax revenues for the latest four quarters are below the calendar year 2007 level in 43 states, and revenues

FIGURE 2

Varying Trends in Personal Income, Sales, Corporate Income, and Property Taxes During and After the Recession



Source: Prepared by the author using data from the U.S. Census Bureau and U.S. Bureau of Economic Analysis.

are 10 percent or more below that level in 20 of those states. Among the seven states showing a positive shift in revenue collection, only Oregon (8.9 percent), Delaware (13 percent), and North Dakota (62.9 percent) are at levels above 2 percent.

State and Local Government Responses

States hit by falling revenue also face rising entitlement costs driven in large part by Medicaid enrollment, which typically increases after unemployed workers exhaust health insurance benefits. According to the National Association of State Budget Officers (2011, ix), Medicaid enrollment rose by 8.1 percent in fiscal year 2010, and by an estimated 5.4 percent in fiscal year 2011; states project a further increase of 3.8 percent in fiscal year 2012. These and other types of required expenditures cause further stress in the day-to-day operations of state and local governments.

It is difficult to measure the impact of spending cuts on state and local programs, but changes in state and local government employment can be tracked. Although private sector employment fell sharply from the beginning of the recession, state and local government employment continued to rise modestly for about a year and a half. Shortly before private sector employment reached its nadir, state and local government employment began to decline, and states and localities have been cutting employment aggressively. Local government employment is now about 3 percent below its peak, and state government employment is about 2 percent below its peak.

Education employment in most states is related primarily to higher education—community colleges, four-year colleges, and universities—although some is related to the administrative bureaucracy for elementary and secondary education, and in some states it includes part of the K-12 workforce. State government education employment has continued to rise significantly throughout the recession and recovery, reflecting in part the increased demand for higher education that usually comes with recessions (figure 3). When jobs are hard to find, many people choose to build skills and knowledge by entering an education program or extending their time in school (Betts and McFarland 1995).

Meanwhile, state governments have been cutting noneducation employment at an accelerating pace, so that it is now down almost 5 percent from its mid-2008 peak, nearly comparable to the current, slightly recovered condition for private sector employment. In each of the nine previous recessions, state government noneducation employment either did not decline at all or it declined by much less, as was the case in the 2001 recession.

Figure 4 shows the same employment data for local governments, which are being hit increasingly hard by slowing property taxes and cuts in state aid. Education employment is now down about 3.5 percent from its late-2008 peak, and the noneducation sector is down about the same percentage from its peak. There are no signs that these cuts are slowing, and little reason to believe they will abate in the near term.

Continuing Fiscal Pressures

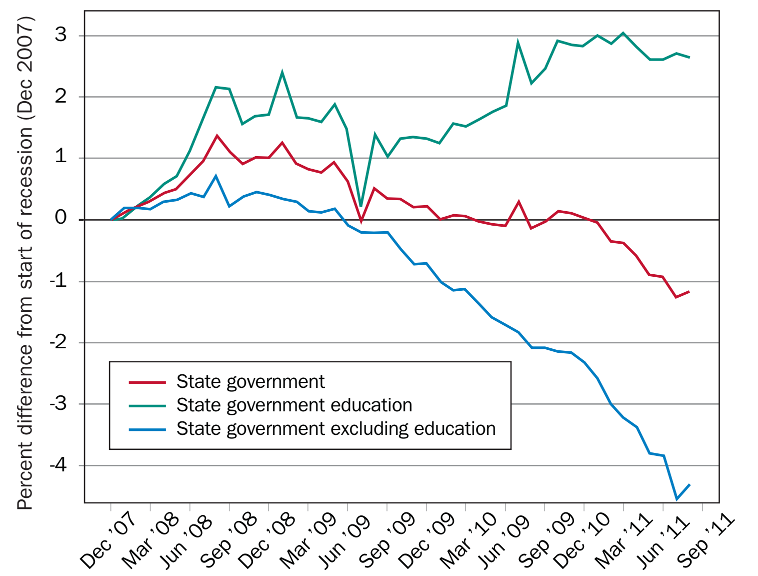
The recent improvement in state tax revenue is welcome, but many challenges remain. States still face fiscal trouble for four main reasons. First, total revenue remains well below its peak. Second, the recession has had lagged fiscal effects, driving up the demand for many government services, especially Medicaid, other safety net programs, and higher education. The recession also has created other pressures and problems for states by depleting unemployment insurance trust funds, which may lead to higher unemployment insurances taxes in order to repay federal loans.

Third, state cyclical adjustments are not yet complete because they must contend with losses in both federal stimulus aid of more than $50 billion in fiscal year 2011–12 and the fact that temporary revenue measures put in place in response to the recession will expire soon. Fourth, even after this cycle is fully stabilized, states will have to contend with large increases in pension contributions and payments for retiree health care—a pressure that is likely to build for years to come for several reasons, including: increasing numbers of retirements by an aging workforce; the likelihood that health care costs will continue to rise more quickly than the overall rate of economic growth (Keehan et al. 2011); and, in the case of some pension systems and most retiree health plans, years of chronic underfunding.

States finance these services with unstable revenue sources, and tax revenue has become much less dependable over the last two decades, reflecting in large part the increasing role of volatile capital gains taxes. Unless and until states broaden their tax bases to make their revenue structures less volatile, or develop adequate reserves, public policy will continue to gyrate with every turn in the economy.

FIGURE 3

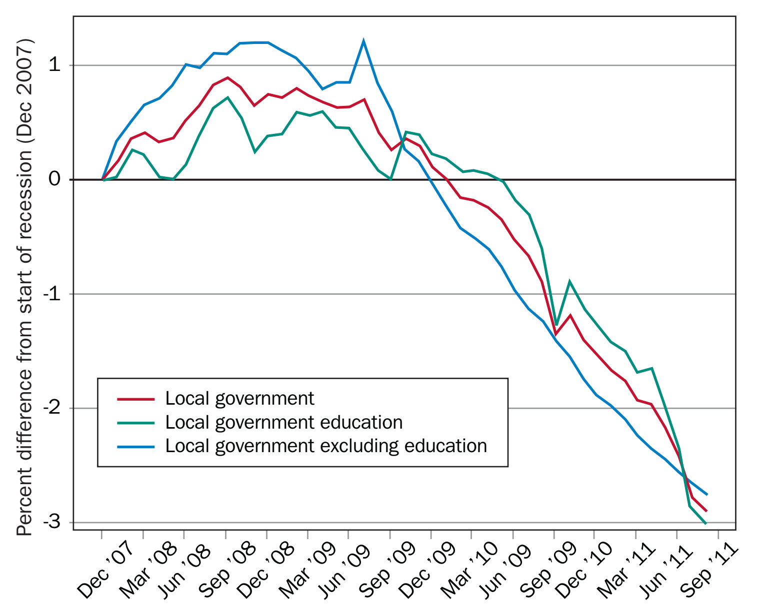
State Government Employment Trends During and After the Recession



Source: Prepared by the author using data from the U.S. Bureau of Labor Statistics.

FIGURE 4

Local Government Employment Trends During and After the Recession



Source: Prepared by the author using data from the U.S. Bureau of Labor Statistics.

ABOUT THE AUTHOR

DONALD BOYD *is the executive director of the national Task Force on the State Budget Crisis, co-chaired by former Federal Reserve Board chairman Paul Volcker and former New York lieutenant governor Richard Ravitch. Boyd is currently on leave from his responsibilities as senior fellow at the Rockefeller Institute of Government, where he conducts research on state and local government fiscal issues. Contact: donboyd5@gmail.com*

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