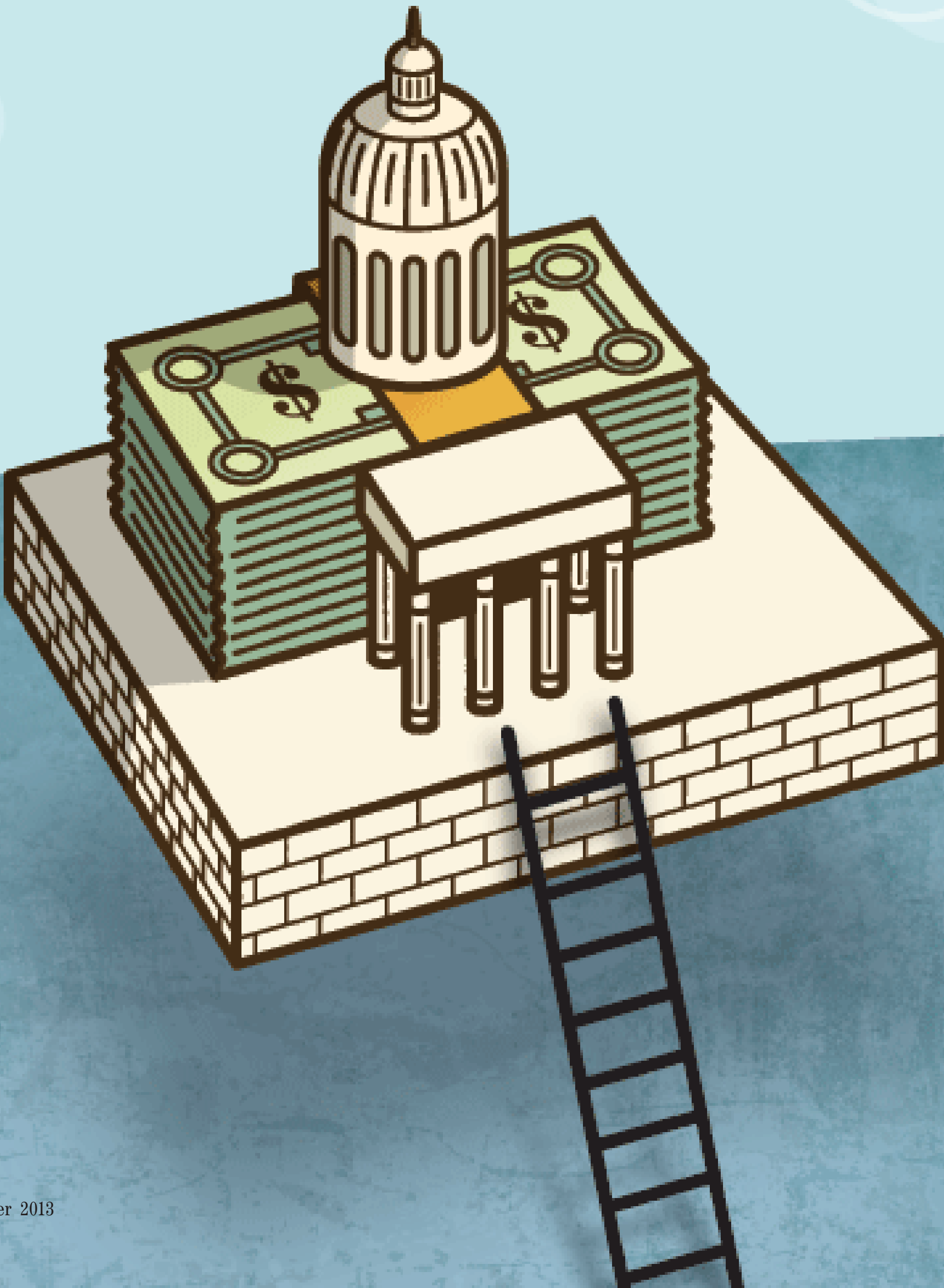
Climbing Out of the Trough: State and Local Government Budgets Regain Some Traction



After several years of battered budgets—first from the deep recession and slow recovery, and more recently from federal deficit reduction efforts—states are at a crossroads of sorts. Some states, like Florida, will begin to reverse cuts made during the recession. Others are considering tax cuts in an effort to boost economic growth.

In Tallahassee, Florida, Governor Rick Scott put his signature on a $74.1 billion budget. The state's 2013 budget, which includes a more than $1 billion increase in spending on public schools and the first across-the-board raise for state workers in seven years, is perhaps a sign that state finances are turning the corner. For the first time since 2008, the Florida legislature has extra tax revenues to spend—a sharp departure from recent years, when the state faced billions of dollars in budget shortfalls.

On the other hand, Louisiana's governor proposed a program popularly called a "tax swap," whereby state income and corporate taxes are eliminated while sales taxes are raised. Although it appears that the governor's proposal has been shelved for now, it highlights ongoing efforts to balance taxes and spending as state and local revenues strengthen. (See the sidebar for a more in-depth look into these two different approaches.)

Whichever path states choose—whether it's reversing cuts, as Florida is doing, or cutting taxes—the spending and taxing decisions of state and local governments will have a significant impact on the economy and the services most people rely on daily.

While news of the fiscal cliff, sequester, and mounting federal deficit may garner more headlines, state and local finances arguably hit closer to home for most people. State and local governments together spend more on directly consumed public goods and services (excluding grants and national defense) than the federal government does, said Tracy Gordon, a fellow at the Brookings Institution. The economic impact of that spending is significant—state and local governments account for approximately $1.8 trillion, or about 12 percent of U.S. gross domestic product, she added.

However, these positive contributions to the economy have weakened in recent years, especially since the recession. State and local governments, their budgets severely reduced, have dragged down growth during the recovery. This drag stands in stark contrast to previous recessions, said Benjamin Harris and Yuri Shadunsky in their research paper "State and Local Governments in Economic Recoveries: This Recovery Is Different." On average, state and local government consumption and gross investment would increase 6 percent in the three years following a recession, the authors found. But in the most recent recovery, consumption and investment by state and local governments *declined* 4 percent.

Recession dealt a blow to state finances

The damage caused by the Great Recession varies across state and local governments. Generally speaking, however, states were the first to feel the impact as unemployment rose and consumers kept a tighter hold on their pocketbooks. State revenues depend heavily on sales and income taxes, which began their descent in late 2008 and fell for five consecutive quarters, according to the U.S. Census Bureau. At their lowest point, in the second quarter of 2009, state revenues were 17 percent below year-earlier levels. Meanwhile, personal income taxes were down 27 percent during the same period, noted the Brookings Institution's Gordon. In the Southeast, state and local governments were on slightly better footing to withstand the recession.

Cities Get Creative

The financial crisis and Great Recession were especially hard on those cities that were financially strapped even before the downturn. Having exhausted most or all of the traditional ways to bolster their finances, some of these struggling cities are considering more unconventional means—asset sales and privatization, for example.

Detroit, Michigan, is one of those cities. Once the thriving hub of the U.S. automotive industry, the Motor City today is on the brink of bankruptcy. Kevyn Orr, the emergency manager appointed to fix Detroit's finances, is considering a creative source of revenue—literally creative. He has requested an appraisal of the city's art collection in case the city has to file for bankruptcy.

The *Detroit Free Press* in May reported that Orr had requested a valuation of the Detroit Institute of Art's (DIA's) renowned collection, which includes works by Vincent Van Gogh and Henri Matisse, to name just two. By some estimates, the most treasured pieces could sell for $50 million to $100 million apiece. With more than $15 billion in long-term debt, one thing is relatively certain: the city will have to take drastic action, like selling its unusual assets, to fix its finances.

Detroit's relationship with the DIA is unique. The city owns the building and art collection, while a nonprofit handles the day-to-day operations. Although many pieces were donated, some by families with surnames like Dodge and Ford, the city also purchased famous works during its automotive heyday. The collection is among the best in the nation, the crowning jewel for the beleaguered city. It is no surprise that reports that the artwork could be sold to pay off creditors are causing a stir.

No plans to sell the art had been announced at the time of this writing, but legislators and concerned citizens have been scrambling to build legal protections around the collection. For instance, Senate Majority Leader Randy Richardville introduced a bill that would prohibit Michigan museums from selling artwork for reasons other than to purchase new pieces or to maintain the existing collection.

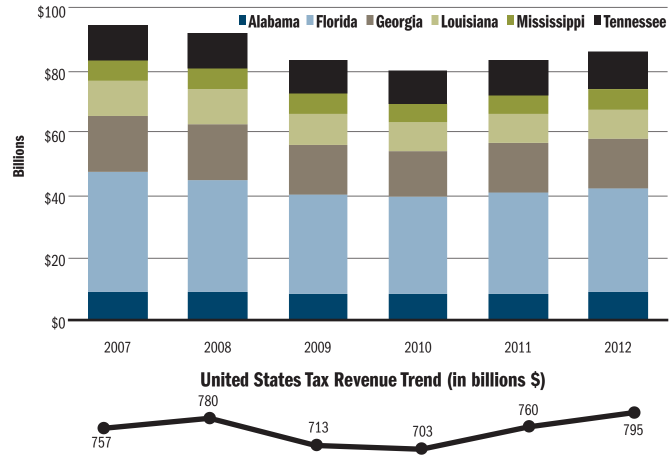
The fact that such a controversial sale is even under consideration reflects the difficult circumstances facing Detroit and other cash-strapped cities. Any plan to sell the art would almost certainly raise complex and contentious legal issues. Other assets could also end up on the auction block, according to the *Detroit Free Press*. Orr is reportedly taking stock of *all* municipal assets, including artifacts from the Detroit Historical Museum, public parks, and properties. The city is not the first to consider selling the family silver to ease financial woes. Baltimore, Maryland, and Newark, New Jersey, both sold historic buildings in recent years to help fill budget gaps. ∎

However, the region still suffered mightily from the downturn. During the period 2007 through 2009, total revenues in the southeastern states were down 11.8 percent from year-earlier levels (see chart 1).

At the same time that revenues were declining precipitously, demand for government programs was growing, driven largely by the weak economy. Federal stimulus funds, including $145 billion in general fiscal relief ($90 billion of which was enhanced federal Medicaid payments), helped blunt the recession's impact on state and local government finances. However, it wasn't enough to ameliorate the vise-like pressures of rising expenditures and declining revenues. States scrambled to close large budget gaps, which at their worst totaled close to $170 billion nationally in 2010.

In general, state and local governments had three options for dealing with budget gaps: raise revenues, cut spending, or draw down reserves. The most common response was to cut spending, Gordon said. That was certainly the case in the Southeast, where states tend to favor spending cuts over tax increases, explained Atlanta Fed research economist and

Chart 1
State Government Tax Revenues



Source: U.S. Census Bureau

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assistant policy adviser Chris Cunningham. A few other factors also helped put the region on firmer footing when the recession hit. In addition to a general willingness to cut spending quickly, southeastern states benefited from leaner public sector workforces and larger rainy day funds, he added. However, the willingness among southeastern states to slash spending "has also imposed greater stress on local governments that rely on state funds," Cunningham noted.

Local governments hit, too, but with a lag

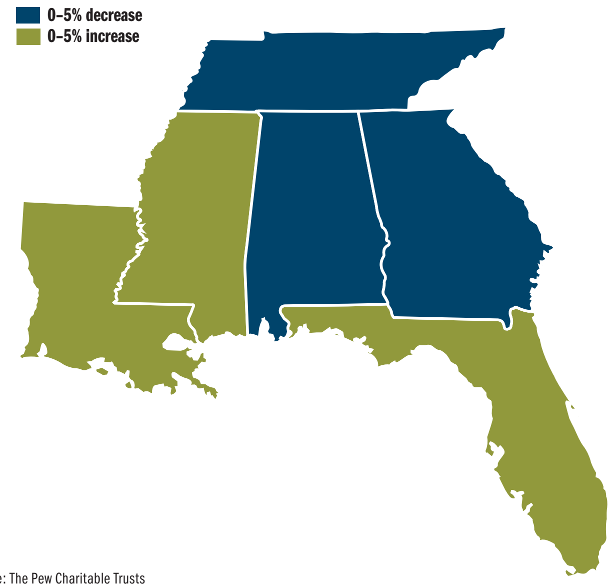
Local government finances also suffered in the recession and its aftermath, but only after a lag. Property taxes, which account for about 30 percent of local revenues, did not immediately respond to declining property values. Instead, they continued to grow during the recession and did not register a decline until the 2011 and 2012 fiscal years, said Lucy Dadayan, a senior policy analyst at the Rockefeller Institute of Government. Unfortunately, 2013 is not looking much better for property taxes than the last two years. Local governments will likely continue to see declining property tax collections and as a result "could face substantial fiscal challenges," she noted.

In past downturns, property taxes remained relatively stable. But like so many aspects of the Great Recession, this time was different. Falling property taxes were accompanied by a decline in state aid, which together account for more than half of local revenues (see chart 2). From 2009 to 2010, local governments in several southeastern states—including Alabama, Georgia, and Tennessee—saw their state funding shrink, according to an analysis of U.S. Census data by the Pew Center on the States. The one-two punch of declining property tax revenues and state aid, which has not occurred since the early 1980s, stressed local finances even further.

Governments shed jobs in wake of declining revenues

Perhaps the most visible indication of the pressures facing state and local finances has been the dramatic loss of public-sector jobs. After peaking in August 2008, state and local government employment shrank steadily. By the end of 2012, state employment nationally had shed 174,000 jobs and local government payrolls were down 552,000, according to the U.S.

Chart 2
Changes in State Aid to Localities, 2009 to 2010



Source: The Pew Charitable Trusts

Bureau of Labor Statistics. Today, more than five years after the recession began, the public sector continues to bleed jobs. Indeed, "it is this persistence of state and local job cuts that makes the Great Recession quite distinctive compared to past recessions," wrote Gordon in a 2012 Brookings Institution report. In comparison, state and local governments *added* jobs in the previous two recessions.

The trend is much the same in the Southeast, where recent job figures highlight the recession's lingering effects on state and local governments. Across the region, state and local payrolls remain significantly below peak levels (see chart 3). From August 2008 to December 2012, the Southeast lost roughly 46,600 state jobs and more than 98,000 local jobs.

Some improvements, but challenges on the horizon

Much like the broader economic recovery, improvements in tax revenues have been slow to materialize. The good news, though, is that state and local government finances are improving, albeit more slowly than in past recoveries. In 2012, tax revenues finally surpassed their prerecession peak and, by the end of the year, had increased for 12 consecutive quarters. Tax revenues rose 5.2 percent in the fourth quarter, driven in part by a 10.8 percent growth in personal income tax revenues.

However, Rockefeller Institute senior policy analyst Dadayan warned that the gain likely reflects taxpayer efforts to avoid the fiscal cliff. To avoid paying higher taxes on capital gains and other types of income, some taxpayers may have shifted income into the 2012 calendar year, she explained. "People are paying

Recovery Mode: Balancing Taxes and Spending

As the economy continues to recover slowly from the Great Recession, state governments are facing tough decisions on taxes and spending. Among them: do they restore some services cut during the lean years, or do they lower taxes?

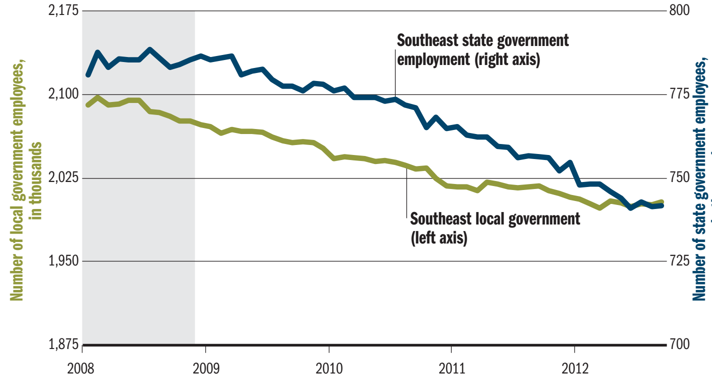
The way forward for state governments is as varied as their circumstances. Take Florida, for instance. The state, projecting its first budget surplus in years, passed a record $74 billion budget in May. Up 6 percent from the previous year, the budget includes $1 billion in new education spending, across-the-board raises for state employees, and increases in several financial aid programs for college students. Georgia, too, boosted its spending for the next fiscal year, although the $838 million increase mostly covers population-driven costs, the governor's office said in a press release.

At the other end of the spectrum, Louisiana Governor Bobby Jindal in early 2013 proposed eliminating the state's personal income and corporate taxes and replacing them with higher sales taxes. This "tax swap" is an effort to make the state more competitive against nearby low-tax states Texas and Florida. The governor was eventually forced to shelve the plan, however. Opponents of the plan claimed the swap would disproportionately affect low-income families and voiced concern about the political feasibility of raising the sales tax. Jindal instead asked state legislators to phase out the income tax over several years.

Although the tax swap plan may not become reality, it illustrates a key trend taking shape as revenues strengthen and governments seek to boost economic growth. Similar tax-cutting and swapping measures were under consideration in North Carolina and Virginia, according to the *Washington Post*'s Wonkblog. And in the past couple of years, legislators in Georgia, Kansas, and Oklahoma have debated proposals to eliminate state income taxes. Meanwhile, in North Dakota—a state flush with oil revenues—voters in 2012 considered and ultimately rejected a ballot measure to eliminate state property taxes.

Whatever the outcome, one thing is relatively certain. Governments at all levels will be faced with hard choices for some time to come when trying to balance taxes and spending. ∎

Chart 3
Government Employment



Note: Data are through March 2013. The gray bar indicates recession.
Source: U.S. Bureau of Labor Statistics

taxes on those gains at the state level, which is great," said the Brookings Institution's Gordon. "But it also means those gains will not be available in the future." In addition, "there's just a lot of uncertainty at the state and local level about whether we're really coming out of the downturn, whether these revenue gains are going to be sustained, and what's coming up in terms of federal policies that affect state and local governments, like changes to the Medicaid program or the tax code," she added. As a result, governments have been cautious about committing to new spending. But, as Florida's recent budget indicates, some states are starting to meet some of the pent-up demand accumulated during the recession by proposing modest spending increases.

In addition to the weak economic recovery and federal budget concerns, state and local governments face a host of longer-term issues, many of which Federal Reserve Chairman Ben Bernanke identified in a 2011 speech and which remain today. These issues include rising health-care-related costs, underfunded pensions, and increasing reliance on economically sensitive revenue sources. There is no one way for state and local governments to approach these and other pressing issues, but as Chairman Bernanke noted, "meeting them will be essential to ensuring that our resilient and dynamic economy delivers rising living standards…to our nation as a whole." ∎

This article was written by Lela Somoza, a staff writer for EconSouth.