STATE AND LOCAL GOVERNMENT FINANCES: WHERE WE'VE BEEN, WHERE WE'RE GOING, AND HOW TO GET THERE

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State and local governments have been much in the news lately, and not in a good way. Sovereign debt crises abroad and looming pension obligations at home have some observers wondering about an impending default crisis on par with the home mortgage meltdown.[1] Investors have been selling off municipal bonds in droves, driving up yields for already cash-strapped borrowers.

What's going on here? Are U.S. states the next Greece? Not quite. To be sure, states and localities were hit hard in the Great Recession and they face significant ongoing challenges. Nevertheless, although there is significant variation among states and regions, there are also positive developments on the horizon and valuable policy lessons learned from the recent crisis.

First, recent events have confirmed the importance of the nation's 50 states and nearly 90,000 counties, cities, towns, school districts, and other local agencies in our federalist system. Over the past decade, states and localities spent 14 percent of GDP on domestic goods and services (that is, spending net of intergovernmental grants and national defense) compared to the federal government's 13 percent (figure 1; U.S. Office of Management and Budget, 2010).

The exception was fiscal year 2009, when federal expenditures spiked in response to the Great Recession. The recession also put state and local governments through a fiscal wringer. States in particular suffered historic revenue declines – with taxes plummeting 17 percent in the second quarter of 2009 relative to a year earlier (Boyd and Dadayan, 2010). At the same time, spending pressures mounted for Medicaid and other public assistance programs.

The result was record state budget gaps, estimated at up to $430 billion or nearly 30 percent of General Fund budgets through fiscal 2011 (McNichol et al., 2010). In most states, lawmakers were called back to the bargaining table shortly after enacting a budget to find more revenues or spending cuts (National Governors Association (NGA) and the National Association of State Budget Officers (NASBO), 2010). At the local level, revenues have been more stable but are starting to dip as state aid cuts take effect and property taxes increasingly reflect market values (figure 2; Hoene and Pagano, 2010).[2]

Commentators frequently note that all states except Vermont are constitutionally or statutorily required to balance their budgets. Some requirements are looser than others, requiring the governor to propose or legislature to enact a balanced budget rather than preventing a state from carrying over a deficit year to year. However, bond markets also tend to limit funds for deficit-related borrowing.

States and localities must therefore raise taxes or cut spending to balance their books. These actions can harm vulnerable populations and short circuit a national economic recovery. States and localities employ one out of seven workers and in most years they contribute one third percentage point in real annual GDP growth. In 2009, however, their contribution was negative (U.S. Bureau of Economic Analysis, 2010). Since the start of the recession, local governments have cut 241,000 jobs and surveys suggest as many as 481,000 more cuts may be forthcoming (U.S. Bureau of Labor Statistics, 2010; Hoene and Byers, 2010).

Concerned about these spillover effects, federal policymakers often provide aid for state and local governments. Examples include the Antirecession Fiscal Assistance (ARFA), Local Public Works (LPW), and Comprehensive Employment and Training Act (CETA) of the early 1970s. More recently, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) provided $10 billion in state fiscal relief through a temporary increase in federal Medicaid matching rates (Mattoon, 2009).

The American Recovery and Reinvestment Act of 2009 (ARRA) went much further, directing more than $280 billion to states and localities

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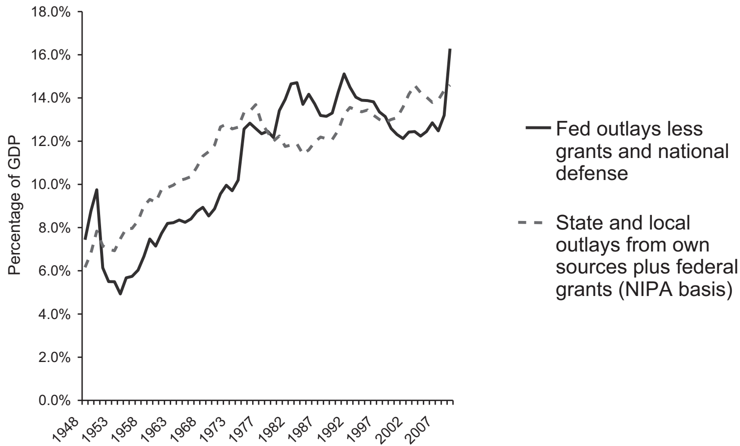
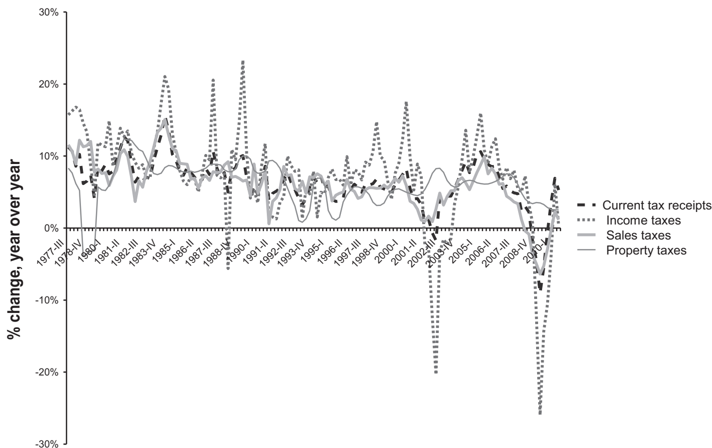
Figure 1: **Federal vs. State and Local Spending**



Source: U.S. Office of Management and Budget (2010).

Figure 2: **Changes in State and Local Revenues**



Source: U.S. Bureau of Economic Analysis (2010).

including roughly $135 billion in flexible funds. Under ARRA, federal grants are estimated to have reached a historic peak in nominal terms and as a share of GDP (U.S. Office of Management and Budget, 2010). Nevertheless, ARRA covered at most 40 percent of state budget shortfalls and most payments will expire this year. Revenues, on the other hand, are not expected to recover for another two to three years due to lags in rehiring and reinvestment.

The longer term is even more troubling. States and localities face unfunded pension and retiree health care obligations of up to $4 trillion depending on modeling assumptions (Pew Center on the States, 2010; Novy-Marx and Rauh, 2010a, 2010b). The U.S. Government Accountability Office (2010) has estimated that rising health costs and aging populations – the same pressures busting the federal budget – will lead to operating shortfalls on the order of 5 to 6 percent of GDP by 2060.

Is there any silver lining in all of this grim news? Maybe.

First, revenue collections are picking up. State and local tax receipts were up 5 percent in the third quarter of 2010 compared to the same time last year (U.S. Bureau of Economic Analysis, 2010). To be sure, much of this increase is due to $24 billion in legislated – and often temporary – tax rate increases (NASBO and NGA, 2010). Without these changes – in states like California, New York, North Carolina, and Massachusetts – nominal tax receipts would have declined slightly in the second quarter of 2010. Even with these actions, state tax revenues remain significantly below their pre-recession peak (Boyd and Dadayan, 2010). Nevertheless, we have now seen three consecutive quarters of revenue increases on a year-over-year basis, a welcome change from five consecutive quarters of negative growth in 2008 and 2009.

Second, just as the average national temperature is not terribly informative, neither are average state fiscal conditions. Some states are emerging from the Great Recession faster than others as illustrated by the Philadelphia Federal Reserve Bank's State Coincident Index (a composite of labor market measures including nonfarm payroll employment, average hours worked in manufacturing, the unemployment rate, and real wage and salary disbursements). For the three month period ending in October (an update will be available December 21), 34 states saw an improvement, whereas 12 saw reductions and 4 (Nebraska, New Mexico, Utah, and Washington) saw no change (Federal Reserve Bank of Philadelphia, 2010). Again, the latest news compares favorably to February through April 2009, when the three month index was consistently in decline for all fifty states (figure 3).

Unfortunately, some states also started farther behind. To take one example, most states experienced their pre-recession revenue peak in fiscal 2008. For Michigan, the peak year was 2000 (Scorsone and Zin, 2010).

Put another way, states differ in their underlying fundamentals, or fiscal capacity. One way to see this is by applying national average state and local tax rates to the economic conditions in each state, as under the Representative Revenue System (RRS). In a 2002 study, Yilmaz and co-authors performed this exercise and found that the average U.S. state had a revenue capacity of $4,659 (Yilmaz et al., 2006). The top five states were Connecticut, Delaware, Massachusetts, Alaska, and New Jersey, whereas the bottom five were Mississippi, West Virginia, Arkansas, Alabama, and Oklahoma. Results were qualitatively similar in 2005, although they may have changed more recently.

Consider two states that have been much in the news lately. Illinois recently reported the largest mid-year state budget shortfall in the nation at $13 billion, or 47 percent of its General Fund (National Conference of State Legislatures (NCSL), 2010). California was dubbed the "Lindsay Lohan of States" after its nonpartisan Legislative Analyst's Office projected $20 billion-plus shortfalls through fiscal 2016 (NCSL, 2010; Finley, 2010). The two are tied for the lowest credit rating of any state and they topped bank analyst Meredith Whitney's list of states in fiscal trouble, with California in first place and Illinois tied for second with New Jersey, Illinois, and Ohio (Liu and Braun, 2010).

A look at these states' revenue capacities reveals a more complicated picture (table 1). All of these states except Ohio had above average revenue capacity as of 2002, however only California and New Jersey demonstrated above average revenue effort (actual collections). The gap between revenue capacity and effort means that if Illinois levied taxes and fees at nationally representative rates, it would have raised an additional $3.8 billion, or 7 percent of total revenues in 2002. More recent analyses also suggest that Illinois, like many states, has untapped revenue potential in income and retail sales taxes (especially in broadening the base to include services; Murray, 2010).[3]

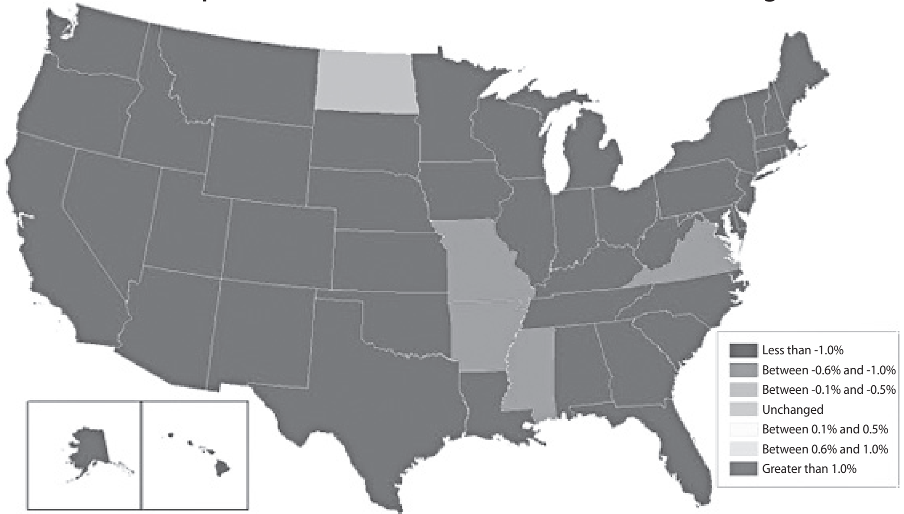
No discussion of state finances would be complete without mentioning political gridlock. California is notorious for budgets that arrive late and balanced on a wing and a prayer (Gordon, 2010). Illinois and New York also missed their budget deadlines this year due to partisan wrangling.

In California, a recent initiative lowered the vote threshold for new state budgets and may improve timeliness. However, legislators will still have to contend with recalcitrant voters. Residents of California and other "fiscally challenged" states including Arizona, Florida, Illinois, and New York are united in the belief that their state is headed in the "wrong direction" (Pew Center on the States and Public Policy Institute of California, 2010). At the national level, large majorities say that they will resist any actions to balance state budgets, including spending cuts, tax hikes, and a federal bailout (Pew Research Center for the People & the Press, 2010).

Figure 3: **Philadelphia Federal Reserve Bank's State Coincident Index**

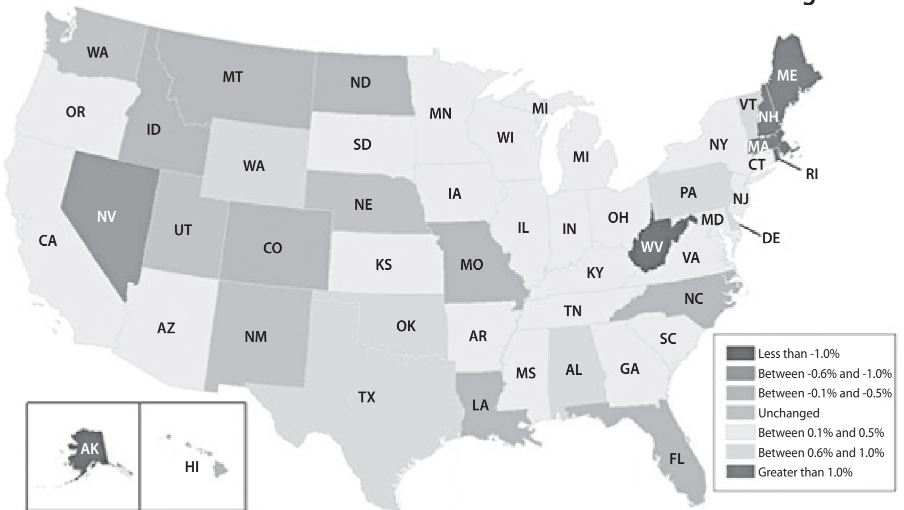
Then

April State Coincident Indexes: Three-Month Change



Now

October State Coincident Indexes: Three-Month Change



Source: Federal Reserve Bank of Philadelphia (2010).

Table 1
Representative Revenue System Rankings

State	*Total Per Capita Revenue Capacity*	*Revenue Capacity Index*	*Rank*	*Total Per Capita Revenue*	*Revenue Effort Index*	*Rank*	*Revenue Capacity*	*Revenue Collections*
United States	$4,659	100		$4,659	100		$1,338,934,152,400	$1,338,934,152,400
California	$5,075	109	11	$5,174	102	20	177,567,458,953	$181,030,999,000
Illinois	$4,844	104	15	$4,540	94	37	60,959,931,031	$57,131,319,000
New Jersey	$5,657	121	3	$5,554	98	29	48,517,350,500	$47,641,389,000
Ohio	$4,369	94	27	$4,584	105	13	49,848,202,209	$52,305,744,000

Source: Yilmaz et al. (2006).

What about recent talk of a U.S. municipal debt crisis? Comparisons to Greece, Ireland, and Spain have escalated recently amid record mutual fund sell offs and rising bond yields (Seymour, 2010a; Barro, 2010). There is some disagreement about whether these trends reflect a heightened awareness of state and local fiscal troubles or larger adjustments in the municipal bond market including an end to the Build American Bond (BAB) program, the Fed's announcement that it would buy back Treasuries, and extensions of the 2001 and 2003 federal income tax cuts.[4]

Alternatively, muni bond investors may be expressing uncertainty about a future without not only BABs but also other financial instruments – variable rate demand obligations, auction rate securities, tender option bond pricing – that have until recently made long term debt more palatable to short term buyers. Although new products may be emerging, some analysts suggest that muni yields are returning to higher pre-credit-bubble levels (Seymour, 2010b).

Also, there are several differences between U.S. states and localities and the Eurozone. U.S. state and local debt levels are modest compared to those of troubled European sovereigns – e.g., 16 percent of GDP in 2009 compared to Greece's 127 percent.[5] Moreover, states and localities issue debt to build physical assets like bridges and airports, not to finance day-to-day operations. As a result, states and localities are less vulnerable to so-called "roll-over risk."[6] Unlike mortgage debt, muni bonds are predominantly held by domestic individuals and institutions.

U.S. states and localities have other strengths as well. For one thing, in addition to explicit debt and implicit pension and other liabilities noted above, states and localities have assets (table 2). As of the third quarter of 2010, they held $2.62 trillion (18 percent of GDP) in financial assets apart from employee retirement funds and another $8.3 trillion in nonfinancial assets such as buildings (Board of Governors of the Federal Reserve System, 2010). Although not all of these assets are liquid, similar to untapped revenue capacity, some might be leveraged through sale-leaseback and other, albeit one-time, arrangements.[7]

Finally, states and localities have staying power. Unlike corporations, they have the power to tax, although of course taxpayers may flee if they don't feel they are getting their money's worth and if there's someplace more attractive or less financially burdened to go. As sovereign entities, states cannot legally declare bankruptcy. Municipal defaults and bankruptcies are exceedingly rare and usually limited to special purpose entities, like water districts (U.S. Congressional Budget Office, 2010).

So what is to be done? Dust ups over unemployment insurance extensions and enhanced federal Medicaid funds suggest that substantially more aid from Washington will not be forthcoming.

However, states and local governments are not sitting idly by. Governors in states such as New York, California, and Illinois are making tough tax and spending decisions.[8] They are asking the federal government for leeway in maintenance of effort requirements.[9] Many states have set up tax reform or performance review commissions that have already identified savings in prisons, school district consolidation, and public employee compensation restructuring (Stewart, 2010).

To be sure, state and local governments face difficult days and even years ahead. However, as we've also heard a lot lately, crises create

Table 2
State and Local Government Assets and Liabilities (excluding employee retirement funds), 2010:III

	(Billion $s)	*(% of GDP)*
Total financial assets	**2,672**	**18%**
Checkable deposits and currency	82	1%
Total time and savings deposits	268	2%
Money market mutual fund shares	88	1%
Federal funds and security repurchase agreements	174	1%
Credit market instruments	1,352	9%
Commercial paper	53	0%
Treasury securities, including SLGS	509	3%
Agency- and GSE-backed securities	440	3%
Municipal securities and loans	6	0%
Corporate and foreign bonds	157	1%
Total mortgages	187	1%
Corporate equities	112	1%
Mutual fund shares	32	0%
Trade receivables	178	1%
Taxes receivable	296	2%
Unidentified miscellaneous assets	91	1%
Total liabilities	**3,063**	**21%**
Credit market instruments	2,402	16%
Municipal securities and loans	2,388	16%
Short-term municipal securities and loans	129	1%
Long-term municipal securities and loans	2,259	15%
U.S. government loans	14	0%
Trade payables	661	4%

Source: Board of Governors of the Federal Reserve System (2010).

opportunities. States and localities may find new ways to raise revenues and provide services that are valued by taxpayers – or to drop the ones that aren't. Living up to Justice Louis Brandeis' vision of a "laboratory of democracy" may be one way for often overlooked state and local governments to stand up and be noticed.

Notes

[1] For example see: Wessel, David. Local Debts Defy Easy Solution. *Wall Street Journal*, September 23, 2010; Cooper, Michael and Mary Williams Walsh. Mounting Debts by States Stoke Fears of Crisis. *New York Times,* December 4, 2010.

[2] See also U.S. Congressional Budget Office. Fiscal Stress Faced by Local Governments. *Economic and Budget Issue Brief*, December 2010.

[3] Illinois lawmakers voted on January 12, 2011, to increase individual income tax rates from 3 to 5 percent and corporate rates from 4.8 to 7 percent. The increases are expected to raise roughly $7 billion annually for the next four years before being rolled back to 3.75 and 5.25 percent, respectively.

[4] The Build America Bond program was created under ARRA. Unlike traditional tax-exempt municipal bonds, BAB payments to investors are taxable, but the federal government subsidizes 35 percent of the issuer's borrowing costs. This feature allows the federal government to provide a deeper and more targeted subsidy to state and local governments. It also can make state and local debt more attractive to foreign investors. U.S. Congressional Budget Office and Joint Committee on Taxation. Subsidizing Infrastructure Investment with Tax-Preferred Bonds. Washington, DC: October 2009. See also Henriques, Diana B. Revised Fed Data Raises Doubt on Foreign Appetite for Build America Bonds. *New York Times* December 9, 2010.

[5] These comparisons do not account for state and local taxpayers' share of total debt, e.g., U.S. Congressional Budget Office. Economic Impacts of Waiting to Resolve the Long-Term Budget Imbalance. Washington, DC: December 2010.

[6] This is not to say that states don't experience cash crunches. California famously paid vendors with IOUs in 2009 and Illinois is currently seeking investors to help cover $4.5 billion in overdue bills. Spector, Mike and Michael Corckery. Illinois Seeks Wall Street Cash. *Wall Street Journal*, December 11, 2010.

[7] Sale and lease back arrangements can be complicated and have been criticized for merely delaying the day of reckoning. See, e.g., Cohen, Michael. Sale Leaseback of State Office Buildings. Sacramento: California Legislative Analyst's Office, November 9, 2010.

[8] See., e.g., Dougherty, Conor and Amy Merrick. Governors Chop Spending: Politicians in Both Parties Aim to Balance State Budgets Through Cuts, Not Taxes. *Wall Street Journal,* February 7, 2010.

[9] See, e.g., National Governor's Association. Letter to Majority Leader Reid, Senator McConnell, Speaker Boehner, and Representative Pelosi. Washington, DC: January 24, 2011. Available at: http://www.nga.org/portal/site/nga/menuitem.cb6e7818b34088d18a278110501010a0/?vgnextoid=b990c07128cad210VgnVCM1000005e00100aRCRD

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