Are the U.S. states impairing the recovery?

The U.S. economy is healing and one of the reasons for this improved situation is no doubt the recovery efforts made by the federal government. However, it appears as though these efforts resulted in less-than-anticipated outcomes since they were partially offset by the restrictive measures enacted by the states to balance their budgets. While the impact of federal stimulus programs is set to peak in 2010, the majority of public expenditures will increase at a more modest pace.

It is increasingly clear that the U.S. economy is recovering from the financial and economic crisis. We could even assume before any official announcement is made that the “Great Recession,” as it will probably become known, ended in the summer of 2009 after a year and a half of contraction.

Many signs, while not quite widespread, point to an improving situation. Even the job market is picking up steam with private employment posting sharp net growth in March. Just one year ago, at the end of winter 2009, the situation appeared and was much worse, with the stock market and confidence indexes hitting their lowest levels.

EFFORTS AT THE FEDERAL LEVEL

What rekindled some optimism were the efforts made by the U.S. federal government to inject growth back into the economy. The impact of the first round of the Obama administration’s stimulus plan was felt in the spring of 2009 just when measures to stabilize the financial markets were also starting to bear fruit. We can therefore assume that federal economic policy was the catalyst for the economic recovery.

According to the Congressional Budget Office (CBO), the recovery plan—a total of US$787B over 10 years—has had both direct and indirect impacts (via the multiplier) on real GDP growth in the U.S. In 2009 overall, this plan contributed at a minimum to a change of one percent in the real GDP\(^1\) (graph 1). These calculations take into account the net effect of the Obama administration’s recovery plan, therefore representing the difference between the current situation and a hypothetical situation where no recovery plan would have been adopted. This estimate allows us to assess the soundness of the policy choices made in Washington.

\[GRAPH 1 – The federal government’s recovery plan made a genuine contribution to real GDP growth\]

\(\text{In % points} \quad \text{The recovery plan’s estimated and expected quarterly contribution} \quad \text{In % points}\)

\[\begin{array}{cccccc}
\text{Q1 2009} & \text{Q2 2009} & \text{Q3 2009} & \text{Q4 2009} & \text{Q1 2010} & \text{Q2 2010} & \text{Q3 2010} & \text{Q4 2010} \\
\text{Estimate} & \text{CBO’s forecasts} & \text{Estimate} & \text{CBO’s forecasts} \\
\text{Lower estimate} & \text{Higher estimate} & \text{Lower estimate} & \text{Higher estimate} \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
1 & 1 & 1 & 1 & 1 & 1 & 1 & 1 \\
2 & 2 & 2 & 2 & 2 & 2 & 2 & 2 \\
3 & 3 & 3 & 3 & 3 & 3 & 3 & 3 \\
4 & 4 & 4 & 4 & 4 & 4 & 4 & 4 \\
5 & 5 & 5 & 5 & 5 & 5 & 5 & 5 \\
\end{array}\]

\(\text{Sources: Congressional Budget Office and Desjardins, Economic Studies}\)

\(\footnote{This contribution represents the minimum net effect estimated by the CBO. This minimum is calculated using relatively modest multipliers. Using higher multipliers, CBO estimates peg the maximum effect at two percentage points. As a precautionary measure, we prefer to focus on less ambitious data.}\)
Yet when we take a look at the U.S. national accounts, we can see that government spending has not increased in any significant way. For 2009 overall, public spending expressed in real terms rose by only 1.8%. This figure is far from a level that reflects the government’s major economic stimulus. A few factors explain this situation:

First of all, in the national accounts and when calculating the real GDP based on spending, i.e. consumption and economic agents’ investments, only direct expenses made by the public authorities are taken into account. Transfer payments are put aside to avoid being counted twice since those who receive these payments can, in turn, spend the amounts received. As such, an increase in unemployment insurance will not be considered as a public expense but as additional household income, and maybe even consumption.

Second, and this is what we find most interesting, the federal government is not the only government in the United States. There are of course 50 states and the District of Columbia (Washington, D.C.). Add to this territories such as Puerto Rico. We also have to take the counties and municipalities into account. In total, there are about 90,000 governments in the United States, and all of these organizations make up the U.S. public administration.

**NO DEFICIT**

Whereas the federal government doubled its efforts to kick-start the economy—while inflating its debt—the financial crisis forced states and local authorities to tighten their belts.

Why didn’t the states and local governments seek to adopt measures to jump start the economy when the recession prompted the federal government to increase its spending and cut certain taxes? The answer is quite simple: the majority of states are not allowed to have a deficit.

In fact, Vermont is the only state that is legally allowed to run deficits. The other states are required either by law or the Constitution to balance their current spending vs. their revenues. If individual states are allowed to borrow, they can only do so to fund capital projects. They can, however, accumulate revenues through surpluses during the good years to compensate for deficits incurred during leaner years. However, with the tough years multiplying and the scope of the damage left by this recession, many of these stabilization or proverbial “rainy day funds” have quickly melted away.

This obligation to balance budgets may seem like a good idea during multiple-year stretches of economic growth and when recession episodes are mild and few and far between. However, the “Great Recession” was severe and relatively long. From a national standpoint, this was the toughest recession since the period immediately following the Second World War, in terms of either GDP contraction or job losses (graph 2).

Since the main source of this recession was the bursting of the real estate bubble, the economic crisis had a major impact at the local level. State and local revenues are largely generated based on property values from taxes but also from capital gains. While existing home values fell by 33% between 2006 and 2009 according to the S&P/Case-Shiller index, the decline was even steeper in some regions, with prices plunging near 50% in California, Nevada, Florida and Michigan (graph 3). It is not surprising that these same states are struggling right now with the toughest budget difficulties.

So the states have had to deal with a sharp drop in revenues. To this already difficult situation, we have to add certain expenses that ended up being inflated due to the recession. For example, each state oversees its own unemployment insurance program, and the increased jobless numbers led to a considerable spike in the costs of these programs.
A run-up in expenses and plummeting revenues is the perfect recipe for a major deficit. And since the states cannot run a deficit, each state must make up for these shortfalls, in other words, the estimated gaps in the budget before the end of the budget year. There aren’t that many ways to offset these expected deficits besides increasing revenues and reducing spending. And while these solutions may be necessary, they are not really suitable when a recession strikes.

HUGE SHORTFALLS

According to the Center on Budget and Policy Priorities (CBPP), state revenues generated by taxes suffered a shortfall of US$87B between October 2008 and September 2009. This drop in tax inflows is the most severe on record, eclipsing even the problematic situation that took place in the early years of this decade.

During fiscal year 2008, revenues fell short of projections in 20 states. The source of this weakness clearly stems from the breadth of this recession, which gradually started to take hold in the United States in early 2008. Taxes on corporate revenues were the first to be affected while, at the same time, tax growth from individual incomes and sales taxes started to slow down.

The situation deteriorated sharply in 2009, when 41 states had to deal with weaker than expected tax inflows. In fact, the first three quarters of 2009 can be considered the worst in 50 years. This time, however, almost all the independent revenue streams simply disappeared. Compared to 2008, sales taxes in 2009 declined by 4.7%, income taxes tumbled 8.2% and corporate revenues plummeted by 16.1%.

For 2010, the situation is still very difficult even though some stabilization is starting to take hold. The uptick in retail sales and the job market recovery are keeping this glimmer of hope alive. However, the recovery is still quite uneven for the states, with about 31 states estimating that their tax receipts will still fall short of budget projections.

In terms of spending, mandatory social expenditures put upward pressure on budgets. These social programs are often financed by both the state and the federal government. The increase in the jobless rate and the sharp deterioration in households’ financial positions pushed some of these costs higher. For example, Medicaid, which finances health care for very low-income individuals, represents about 20% of all state spending. Increased demand saw the amounts allocated to this program shoot up by 7.8%. In general, between 2008 and 2009, state expenditures for social transfers increased by approximately US$20B.

The unexpected increase in expenses and the dramatic drop in revenues left a glaring gap in most state budgets. Some states were able to benefit from surpluses accumulated during previous years. The total amount of available funds reached a peak of US$69B in 2006, or about 11.5% of general annual expenses. This cushion then lost a few feathers, reaching US$59.1B in 2008 and US$32.0B in 2009 (graph 4). While in 2008 only 14 states held less than 5% of their general expenses in reserves, 33 states will be facing this situation in 2010 (of which 11 hold less than 1.0%).

Major budget shortfalls, too big to be filled by rainy day funds, have therefore accumulated in the past few years. According to the CBPP, the shortfall in 2009 was US$110B. For 2010, the estimate is US$196B. State governments have had to put fairly stringent measures in place to quickly compensate for these deficit projections.

RESTRICTIVE BUDGETARY MEASURES

Increased taxation

While grappling with a difficult financial situation, the states have tried to find ways to make up for the steep decline in cyclical revenues by raising some taxes and charging user fees for certain services. As such, 33 states developed specific measures to increase their revenues in 2008 and 2009. According to the CBPP, a total of US$31.7B per year has been accumulated through these measures. During this period however, some states cut their tax burden by a modest US$2.1B. The net effect of these tax policy changes is therefore US$29.7B.
What measures were taken? Few avenues were left unchartered in fact. Several states introduced legislation to raise income taxes by increasing taxation rates on one or several income levels while others (or the same states) opted as well to broaden the tax base by eliminating some previously eligible deductions or tax credits. And sales taxes were certainly not spared: many states raised sales taxes either on all goods and services or on certain items only. Sales and excise taxes on tobacco and alcohol were also targets of choice to generate additional revenues. Companies are also struggling with higher income tax rates. However, several states elected instead to reduce business income taxes to help support companies during the recession; the net effect was more subdued as a result. Lastly, new user fees for certain services, mostly vehicle registration, were also in the states’ arsenal. Graph 5 shows the proportion of additional income generated by each type of measure taken in the U.S. states overall.

It must be noted however, that some of these measures are temporary. For example, unless legislation is amended, the increase in California income taxes is slated to wind down at the end of 2010 while the 1% increase in sales tax is in effect only until June 30, 2011.

Cutting expenses

While these tax increases are eroding business and household incomes, they cannot on their own make up for the widespread decline in overall income due to the recession. In fact, these tax increases offset only about 36% of the estimated drop in tax inflows. Other measures are therefore required to fill the budget shortfalls. State governments have no option other than reducing their expenses.

Cuts to state spending are without a doubt the most visible austerity measure currently taking place in the 50 U.S. capitals. Only 3 states proceeded to cut budget spending in 2007, with 13 following suit in 2008. By fiscal 2009, 43 out of 50 states had cut their spending. According to NASBO (National Association of State Budget Officers), total expenditures were cut by US$31.3B (graph 6). A total of US$55.7B in expenditures is scheduled to be cut in fiscal 2010.

It is understood that some categories of state spending are very difficult to cut. For example, mandatory spending on Medicaid, social assistance and education, while partially financed by the states (often the source of income to fund specific programs), are also supported by the federal government, which dictates the conditions for receiving financing. The programs that are slated to be cut fall more often than not under the heading of “general expenditures”, which in 2008 represented about 46% of total state spending. In 2009, this ratio reached 41.7%, and it will surely shrink again in 2010. The potential for additional cuts in discretionary programs are therefore disappearing fairly quickly. But since some social programs are also financed by the overall income collected by the states, they are not completely exempt from the austerity measures put forth.

Several services provided by the states have been reduced or, in fewer cases, completely eliminated. Twenty-nine states have cut spending on public health care, and 29 states (not necessarily the same) have cut spending on primary and secondary education. Thirty-nine states have cut post-secondary spending (California has raised university tuition by 32% while cutting the number of admissions). Twenty-four states have cut spending related to the elderly and the handicapped.

Public service is also paying the price: 42 states have also eliminated jobs within their own ranks, i.e. at the state level. One of the most popular measures, especially in California,
was to impose unpaid furloughs. Graph 7 shows the drop in the number of workers employed by the state and municipalities.

Note that, thanks to low interest rates and a relatively reasonable level of debt (see box on page 6), debt service expenditures remained fairly stable.

WASHINGTON TO THE RESCUE!
The restrictive measures would have been even more severe if the federal government had not come to the rescue of states and municipalities. In fact, many measures in the recovery plan adopted in the winter of 2009 by the Obama administration were introduced just for the states. Since this plan was initially rolled out until the end of Q1 2010, the federal government has spent a total of US$373.4B (the total cost of the recovery plan was supposed to be US$787B over 10 years). Of this amount, US$75.5B, or 20%, has already been transferred to the states (graph 8). Other measures to help individuals have also lifted the states’ burden, like extending jobless claims, enabling workers who lost their jobs to purchase health insurance, providing additional funding for food stamp programs and temporary assistance for families in need. NASBO estimates that by the end of the 2010 budget year, the federal government will have transferred US$150B to the states.

Without this support, the state governments would have had to slash their programs or impose much higher tax increases. As it stands, of the US$110B shortfall for 2009 for the states as a whole, US$39B was replenished from the federal government’s coffers. For the US$196B gap estimated for 2010, Washington’s support should be US$133B. However, we expect this level of support to be less in 2011 and 2012 when substantial shortfalls will continue to widen according to the CBPP, or US$180B (minus US$36B in support from the federal government), and US$119B (with very little support from Washington, or US$1B) (graph 9).

The federal government is also making it easier for the states to finance themselves. While the states are hesitant to increase debt servicing, they have nevertheless reduced their investments that are not subject to budget balancing rules. The federal government has set up the **Build America Bonds** program, which offers less expensive financing on the bond market. This program allows the federal government to offer states direct subsidies that are equal to 35% of loan interest costs. By March 2010, US$150B of **Build America Bonds** had already been issued, or about 20% of the total issuances made by states and municipalities.

A NEGATIVE IMPACT ON ECONOMIC GROWTH
Yet while the federal government is trying to kick-start the U.S. economy with its recovery plan, the states are monopolizing a good portion of these efforts. At best, these transfers prevent the economic situation from deteriorating further by limiting the pressure put on state budgets.

However, the reduced expenses and higher taxes introduced by most states are affecting the economy much differently than what the federal government is trying to do. To date, the...
recovery plan has thus far relieved the tax burden on businesses and individuals by up to US$141.6B. We had seen earlier that the states increased their fees and charges to up to US$32B in 2008 and 2009. To this we must add the projected tax increases for 2010 which equal US$23.9B according to NASBO. These restrictive measures still managed to offset, without completely eliminating, a fair amount of the tax relief set forth by Washington.

Besides tax cuts and support for the states, the federal government expected to increase spending in its recovery plan, either as transfers to individuals or as direct expenditures, especially on infrastructures. Here as well, the austerity measures imposed by the states are in direct conflict with the federal government’s efforts.

Based on the national accounts (which do not take transfer payments into account), the federal government’s real expenditures, including investments, rose by 8.9% between mid-2008 and the winter of 2010. Real state and municipal expenditures declined by 1.6%. The issue here is that real state and municipal expenditures have a weighting that is

Not a debt-related problem

The budget problems experienced by state governments are not directly related to debt or debt servicing that is simply too expensive. In fact, the states and municipalities currently have modest debt levels, with outstanding market debt of US$2,362.4B in 2009, or just over 16% of GDP or 1.2 times the total annual revenues of states and municipalities (graphs 5 and 6). For comparative purposes, the U.S. government’s debt is 4.2 times its annual revenues. These ratios are also not as high as what we sometimes see in Canada. It bears noting that for most U.S. states and municipalities, the only new debts that are actually allowed are those related to infrastructure investments.

These debt levels do not however provide investors with much protection when the issue is state budget shortfalls. This crisis is such that a state can easily find itself running short of the liquidities needed to respect its commitments to its suppliers, employees and creditors. This was the case in the summer of 2009 when California had to institute urgent measures, including issuing vouchers to some suppliers. The New York State Comptroller recently announced that the state of New York could soon run into a cash shortage. These cases highlight a contradiction: the inability to run current deficits is in itself a risk to the value of debt securities.

Another problem is the underfunding of certain pension plans for state and municipal employees. The financial crisis eroded a large portion of the fund capital, and the governments will have to make up for these losses over the long term. Some estimates peg the shortfall at somewhere between US$2,000B to US$3,000B. Offsetting such an extensive gap is clearly a huge challenge, on top of the current budget woes.

Several states have had to deal with a deteriorating credit rating. While it is true that no state has defaulted on its debt since the Great Depression in the 1930s, a few municipalities have had to declare bankruptcy, even this time around.
1.5 times higher than federal expenditures. In fact, if we exclude defence, which eats up the majority of federal funds, state and municipal expenditures are twice as high as Washington’s spending. Taking this weighting into account, we note that declining expenses at the state and municipal levels greatly minimize the net contribution of government spending to real GDP growth (graph 10). This can also be seen in terms of labour. Other than the temporary effects tied to the upcoming 10-year census, jobs in the public sector have been generally declining since mid-2008 (graph 11).

At the same time, the federal government has to deal with its stratospheric debt that could very well spark concerns among local and foreign investors. As is it, measures that were part of the recovery plan should start to subside somewhat, especially as of 2011. Unless legislative amendments are made, the current aid being extended to the states will eventually run dry.

These factors and the reaction of economic agents to the withdrawal of federal stimuli and ongoing state austerity measures will have great consequences on the American economy’s future growth. The private sector will have to ramp up demand if we want to prevent a pullback in the growth of goods and services output.

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UNCERTAINTY IS A FACTOR IN THESE SCENARIOS
The negative contribution to economic growth due to the actions of states and municipalities absorbs and offsets a portion of the federal government’s efforts. However, much like the years that followed the recession in 2001, the expected budget shortfalls in state governments will extend beyond this year even if the recession probably ended sometime in mid-2009. Although the tax inflows showed some signs of improvement in the past few months (graph 12), it will take a while before we get back on top. In addition, some austerity measures were meant to be temporary and further actions may still be required. The gap created by the underfunding of state and municipal employee pension plans may have to be made up for as well in the years ahead. It may take a while to get this house back in order.
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