States Still Feel Recession's Effects Two Years After Downturn's End

By Jason Saving

The U.S. economy entered a financial-market-driven recession in December 2007 from which it has yet to fully recover. The boom of the mid-2000s has been replaced with a stubborn national reality of high unemployment and sluggish output growth, with no clear indication when economic activity will return to more normal levels.

Yet the states have, in many ways, borne the brunt of the recession. Demand for public services increased at the very moment tax revenue—especially from property taxes—declined. As late as this October, a full two years after the recession ended, states from Florida to California to New York warned of new shortfalls that must be addressed through spending cuts and tax increases. In Texas, lawmakers completed work on cuts totaling at least $15 billion for the upcoming two-year budget cycle.

As the nation's economic woes continued, the federal budget deficit climbed, posing potential limits on aid Washington could provide. The deficit soared to $1.4 trillion in 2009 and is expected to remain above $1 trillion annually until 2013. At least one major ratings agency downgraded the country's top-tier credit rating, warning as part of its unprecedented action that officials must do more over the short term to stabilize and improve the deficit picture. Other ratings firms have similarly cautioned that their assessments of U.S. creditworthiness could be cut if fiscal imbalances aren't addressed.

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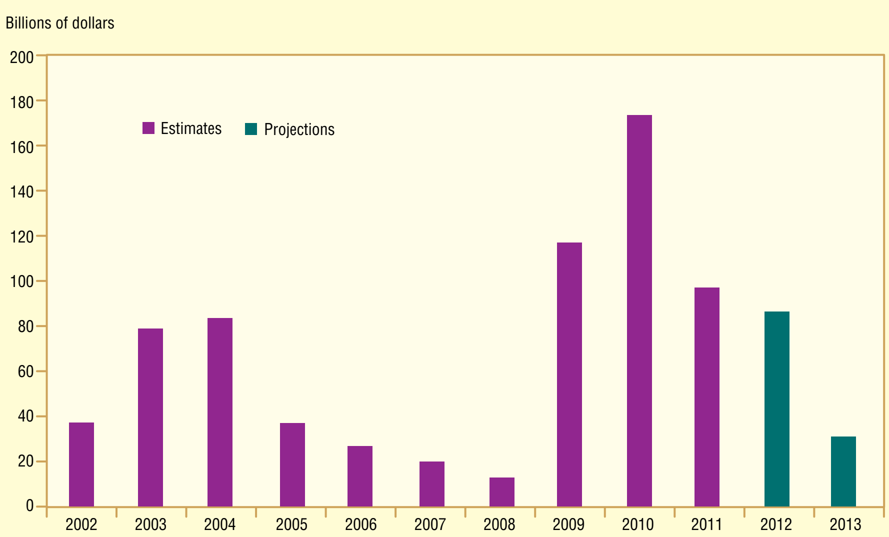
How Have States Done?

Following the 2001 recession, state budget outlooks improved. After posting collective budget gaps of about $80 billion in 2003 and 2004, fiscal retrenchment coupled with above-average economic growth virtually eliminated shortfalls by mid-decade. Even in the first full year of the most recent recession, 2008, it appeared states might weather the national economic storm relatively unscathed.

Unfortunately, the nation ultimately is the sum of its parts and cannot fall into a serious recession without it affecting most states and their finances. On the revenue side, job losses and wage cuts reduced individual income and consumption, crimping state revenue. And at the very moment revenue fell, residents beset by poor economic conditions increased their demand for an array of state-provided social services ranging from Medicaid to job training, driving up expenditures beyond projections. The result: a dramatic widening of state fiscal gaps.

The depth of the recent recession is vividly illustrated by ballooning state deficits in 2009–11, which produced an unprecedented three consecutive years of more than $90 billion shortfalls (*Chart 1*). In 2010 alone, 43 states confronted a cumulative $174.7 billion budget hole—the largest ever recorded. And while those deficits narrowed somewhat in 2011, they are not

Chart 1
State Shortfalls Reach Record $174 Billion in 2010



SOURCE: National Conference of State Legislatures.

expected to return to prerecession levels for at least two years amid the relatively weak economic recovery.

With balanced budgets required in 49 of the 50 states by law or state constitution, jurisdictions coming up short must cut services (or raise taxes) to bring spending plans into balance. To be sure, budgetary tricks—for example, strengthening near-term economic assumptions or making favorable assumptions about social-service caseloads—can sometimes soften the blow. These devices can only go so far, ensuring that some sacrifices will be required.[1]

But were those measures limited to unnecessary and little-used programs, or did states reduce funding to key budget areas, such as health and education?

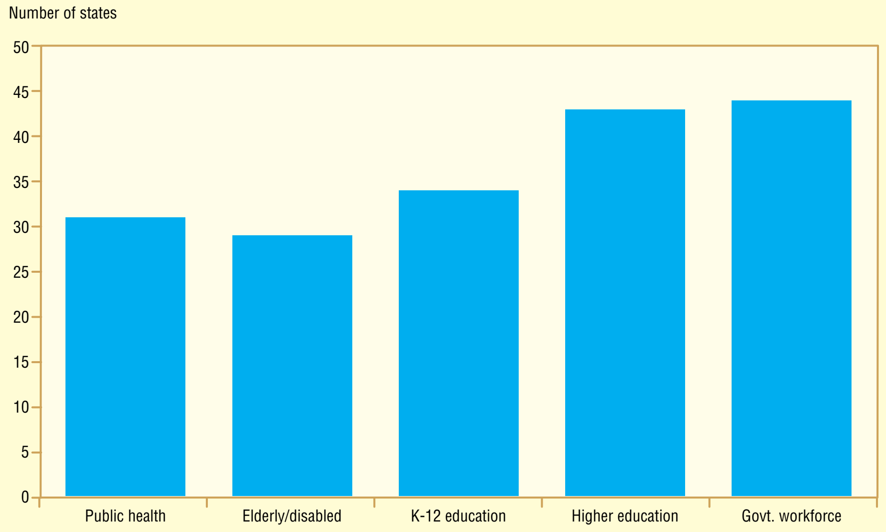
In 2010 (the last year for which data are available), 43 states reduced funding for higher education, according to the National Association of State Budget Officers (*Chart 2*). This coincided with a period when out-of-work individuals increasingly turned to colleges for occupational retooling. Some states also enacted policy changes to reduce support for higher education over the longer term, continuing a trend seen over the past few decades.

A slightly less common target was K-12 education, which 34 states cut in fiscal 2010 (October 2009 to September 2010). The reductions coincided with debate over whether class sizes had become too large and student test scores too low. Since a majority of most states' outlays go to education and health, substantial budget cuts cannot—from a purely mathematical perspective—occur without affecting either item. Typically, such reductions are at least partially restored in later years as the economy improves. The 2007–09 recession's aftereffects have lingered longer than many expected, perhaps delaying by several years the reinstatement of funding.

Public health programs were pared in 31 states; support for the elderly and disabled was trimmed in 29. These cuts revealed a paradox. States, while well-positioned to help individuals when most citizens (and the tax base) are healthy, struggle to offer their standard menu of benefits when widespread and pervasive economic shocks increase the number of people needing assistance.

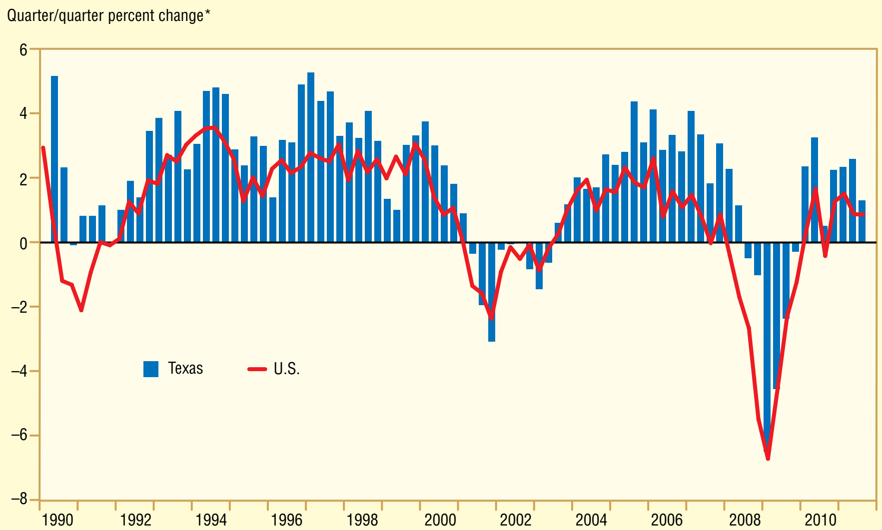
The difficulty could be mitigated by giving states more leeway to incur deficits. But, as has become evident at the federal level, deficit spending can create problems of its own, at least over the medium to long term.

Chart 2
Most States Cut Health, Education, Other Areas in 2010



SOURCE: National Association of State Budget Officers.

Chart 3
Texas Exceeds Nation in Job Growth



* Seasonally adjusted annualized rate.

SOURCES: Bureau of Labor Statistics; Texas Workforce Commission; Federal Reserve Bank of Dallas.

What About Texas?

As a majority of state economies entered recession in late 2007, Texas continued growing (*Chart 3*). And as most state economies emerged from recession in 2009–11, Texas outperformed the remainder of the country in employment growth by a full percentage point—about equal to Texas' historical advantage over the past few decades.

Texas' favorable performance stems from a number of factors, including its oil and gas industry, a low cost of living, favorable demography, restrictive home-lending laws, an attractive business climate and a housing sector that held up better than it did elsewhere. These items do not and cannot guarantee growth here will exceed that of the nation—Texas trailed the U.S. in 10 of the 86 quarters depicted in Chart 3, for

How Dependent Is Texas on Federal Funding?

Texas has significantly trailed the national average in federal spending per capita since the late 1980s and has been somewhat below the national average in federal spending per tax dollar paid to Washington. This means the Texas economy isn't as dependent on federal spending as the typical state and receives less for its contributions.

In 2005—the latest year for which complete data are available—Texas received roughly $6,500 per person in federal outlays, compared with a national average of $7,600. The Texas figure is 86 percent of the national average and places the state 42nd out of 50 in per capita federal funding.

Another way to address the conceptual question of Texas' dependency on federal funding is to examine federal aid to state governments themselves, a narrower but somewhat less volatile measure of federal support for a region. Here the answer is similar: Texas received $1,179 per person, compared with the national average of $1,460, putting it in 43rd place.

This makes Texas somewhat of an outlier in its "neighborhood." New Mexico routinely receives larger per capita federal outlays than any other state, for example—about 50 percent more than Texas. Louisiana is also somewhat above the national average, receiving about 15 percent more than its much larger neighbor.

What about stimulus funding? Might it be that Texas has received an influx of funding whose sudden withdrawal would cause hardship relative to other states?

It turns out that official government data on stimulus funding by states are broadly consistent with other outlay data. To date, Texas has been awarded $674 per person in stimulus-related contracts, grants and loans from the federal government. While this puts Texas in second place among the states in total dollars received, Texas ranks 48th on a per capita basis, behind only Florida (whose governance resembles Texas' in many respects) and New Jersey. The bottom line: Texas is not disproportionately dependent on stimulus monies.

One final issue concerns the possibility of a downgrade to Texas' credit rating if the nation's creditworthiness were reduced. Texas is currently one of 15 states to boast a top-tier rating from Moody's, for example. Five of those 15 were recently placed on a downgrade watch and would face a likely cut if there were a technical default by the U.S. But Texas was not one of the five, in part because it is less dependent on federal funding. So while the possibility of a state downgrade cannot be ruled out, there are few indications it will happen in the near term.

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example. But they do suggest that, other things being equal, Texas economic activity should be at least slightly stronger than the national average.

Despite this relatively favorable environment, Texas entered the 2012–13 budgeting biennium with a shortfall of between $15 billion and $27 billion, depending on the spending baseline chosen.[2] This gap represents about 10 percent of state spending and 1 percent of economic activity over the two-year cycle. In light of the $3 billion to $4 billion in debt accumulated by the federal government daily, roughly $20 billion over two years may not seem especially significant. But it is a large amount in a state that offers little assistance to the poor and prides itself on a business-friendly (read: small and efficient) tax and regulatory regime. (*See accompanying box.*)

The Legislature passed and the governor signed a $172.3 billion budget for fiscal 2012–13—about $10 billion below the previous two-year budget and $15 billion less than actual 2010–11 expenditures. Each spending category depicted in Chart 2 was cut, with an especially large proportion borne by health services. A variety of elements prevented even larger reductions. These included increased revenue from a recovering state economy, a larger-than-expected withdrawal from the state's rainy-day fund and just under $5 billion in "nontax revenue enhancements" such as higher license and registration fees.

Downgrading Debt?

As if state budget cuts were not enough, questions about excessive state government indebtedness have arisen. Following S&P's downgrade of U.S. borrowings, ratings firms said debt-ridden states might themselves be lowered in the near future—as Nevada and New Jersey were earlier this year and California was in 2010. Texas, however, has not been cited as a

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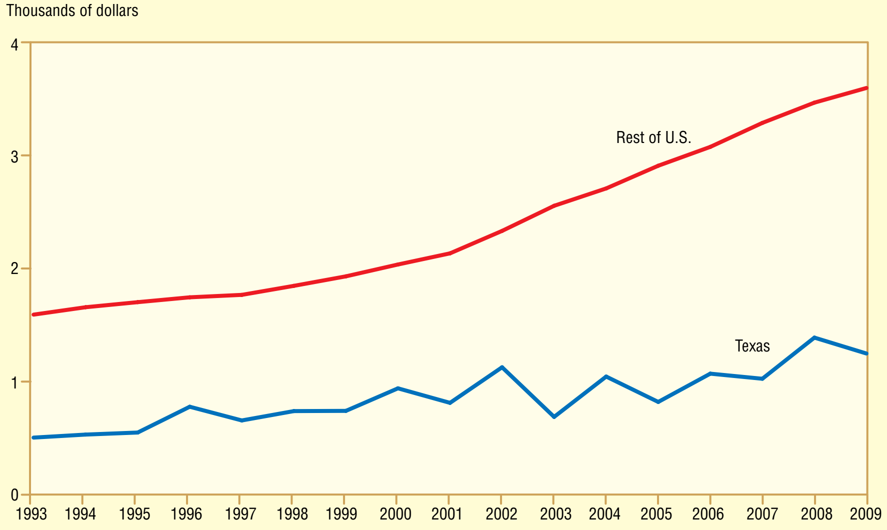
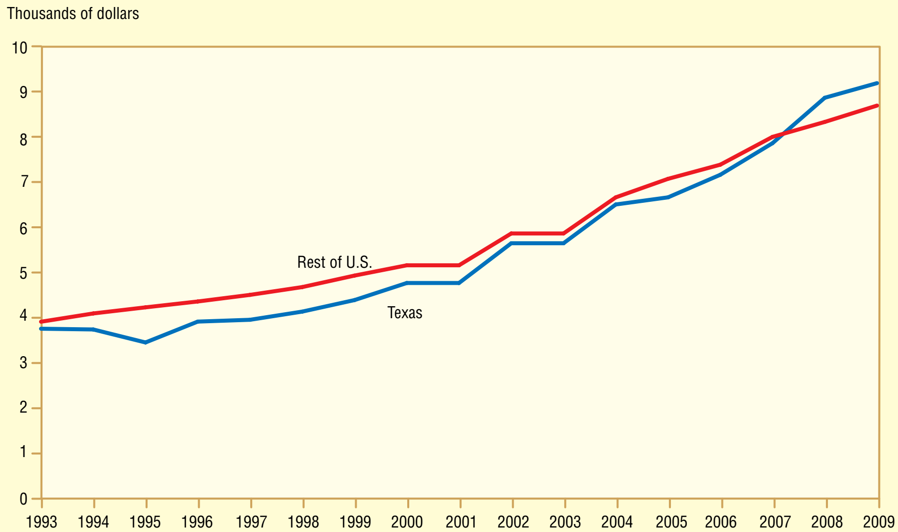
Chart 4
Texas Trails Rest of Nation in State Per Capita Debt



SOURCES: Bureau of the Census; U.S. Treasury.

Chart 5
Texas Mirrors Rest of Nation in State and Local Per Capita Debt



SOURCES: Bureau of the Census; U.S. Treasury.

downgrade candidate. How do its debt levels compare with those in other parts of the country?

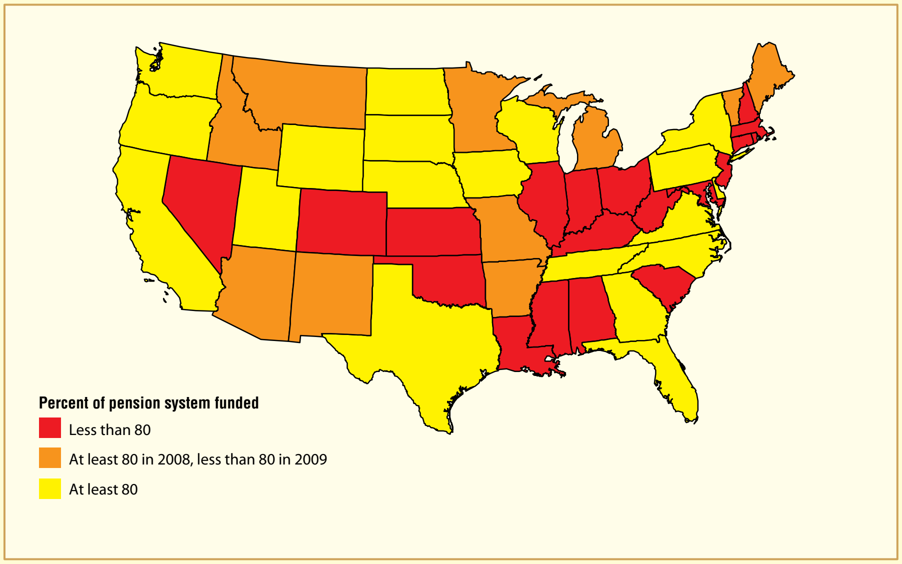
Such a comparison would generally use per capita state debt. Over the past two decades, per capita state debt shows Texas at about one-third the debt level of the rest of the nation (*Chart 4*). In 1993, for example, Texas incurred per capita state debt of $478 versus $1,576 for the remainder of the nation. In 2009, the last year for which data are available, the comparison was $1,228 versus $3,599.

However, Texas has historically enabled localities—cities, counties and school districts—to undertake functions that elsewhere might be done (or at least paid for) by the state. This suggests that a more valid comparison would need to include local as well as state debt.

In terms of state and local per capita debt, Texas essentially tracked the rest of

Chart 6

Texas Pension Funding Exceeds Recommended 80 Percent in 2009



SOURCE: Pew Center on the States.

the nation over the past two decades, with a slight uptick over the past several years (*Chart 5*). This suggests that looking at state government data alone may provide a misleading impression of the extent to which Texas is a small-government state. Rather, Charts 4 and 5 illustrate what economists sometimes call "fiscal federalism"—the delegation of responsibilities to the smallest government unit able to carry them out. (Florida is also notable in this regard.)

Such a structure is neither inherently desirable nor inherently undesirable on economic grounds alone. On one hand, delegating tasks to localities can help government better tailor the services it provides to the needs of individual communities and may improve efficiency by making civil servants more accountable to their constituents. On the other hand, it can exacerbate income inequality by impeding revenue-sharing across jurisdictions and perhaps reduce economies of scale that larger jurisdictions may produce. There is some economic evidence that empowering localities can boost state economic growth, though both state and local debt patterns must be considered when this is done.

States have an additional key liability not captured by debt-issuance figures: the degree to which their pension programs are underfunded. Any time a jurisdiction makes pension promises to its workers without adequately setting aside revenue streams to pay for them, future taxpayer liabilities are created, even though these promises do not immediately increase measured state debt. Media reports have revealed states with large and under-recognized fiscal gaps in their pension systems. That liability will eventually swamp the rest of their debt and require very large fiscal adjustments. Might this be true for Texas?

Chart 6 illustrates the extent to which the continental states have adequately funded their pension systems. Nineteen states, including Texas, were at least 80 percent funded in both 2008 and 2009, a benchmark for sustainable pension systems. In those states, relatively modest fiscal adjustments should be enough to maintain solvency over the medium to long run. Nineteen other states fell below the 80 percent threshold in both years, sometimes by a significant margin. In those states, considerable adjustments may eventually be necessary, whether they come in the form of reduced benefits or higher tax revenues, or both. The remaining 10 states fall between these two extremes.

Texas doesn't appear to be an outlier when it comes to government debt and unfunded pension liabilities.

Meeting Service Needs

State finances have eroded considerably over the last few years, leading to cutbacks across wide swathes of program areas nationwide. Texas joined this group in the 2012–13 budget cycle, addressing a $15 billion to $27 billion shortfall almost exclusively through expenditure reductions.

Across the country, state debt issuance has risen in recent years. Texas has followed suit, though its overall borrowing levels and unfunded pension liabilities lie well within national norms.

Provided the nation does not fall back into recession, state shortfalls are expected to gradually recede toward more usual levels by about 2013. But sizable fiscal challenges will remain in the areas of infrastructure, education and health as states struggle to catch up in the aftermath of the recession and slow recovery. Across the nation, including Texas, those issues can be addressed when economic headwinds diminish.

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Notes

[1] This article will look primarily at state expenditures. For more information on the revenue side of the equation, see "Poor State Finances Deepen Recessionary Hole," Federal Reserve Bank of Dallas *Southwest Economy,* Fourth Quarter 2010.

[2] When matching previous spending levels, unadjusted for inflation and population growth, the figure is $15 billion. Addressing these factors and compensating for certain previous spending cuts raises the figure to roughly $27 billion.