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http://www.brookings.edu/papers/2011/0105_state_budgets.aspx

States' Budget Woes Go Deep Below the Surface

New Brookings report shows seeds of deficit troubles were planted years ago, and problems may be larger than they appear

Washington, D.C. — As state governors and lawmakers begin work on their daunting budget challenges in the aftermath of the Great Recession, new research from the Brookings Institution's Mountain West project and the Morrison Institute for Public Policy at Arizona State University shows this situation actually has been building for several years, and may be worse than it first appears.

The new paper by the two research organizations, *Structurally Unbalanced: Cyclical and Structural Deficits in California and the Intermountain West*, looks at four states—Arizona, California, Colorado, and Nevada—and shows how these problems may go far beyond shorter-term revenue declines associated with the economic slowdown. Solving states' budget challenges may be more difficult than is generally thought as they can involve massive, entrenched imbalances that will not disappear with economic recovery.

These four states have been among the hardest-hit by the Recession, and several are contending with deep, chronic imbalances that should serve as a caution to other states.

“The budgetary condition of many states is, if anything, worse than is recognized,” said Mark Muro, a senior fellow and the policy director of the Metropolitan Policy Program at Brookings. “The gravity of states' short-term and especially longer-term deficits underscores that this is a time when state policymakers must break their bad habits and turn to more responsible budget planning practices that looks in a balanced way at the long-term fit of revenues to spending.”

Matthew Murray, the report's lead author and a professor of economics at the University of Tennessee notes, “The ongoing deficit problems confronting these states have compelled the states to resort to an unattractive mix of tax increases, spending cuts and one-time fixes to bring budgets into alignment.

“These actions have created significant hardship for residents and have diverted the attention of policymakers from the critical need of providing quality services and an environment conducive to long-term economic development,” he said.

To repair the current difficulties brought on by past mistakes, the paper offers several policy recommendations, including:

- **Commit to a balanced approach.** Massive budget gaps cannot be responsibly closed by only cutting spending. Budgetary balance and revenue diversification are crucial. In addition to balance and diversification, broad bases and tax system responsiveness should be mantras of fiscal system repair. Tax policies that increase the base and elasticity of state tax systems reduce the need for discretionary and unpopular rate increases. But this revenue cannot be used to fund programs that prove to be unsustainable during periods of economic and fiscal distress.
- **Maintain adequate rainy day funds.** Most of the Mountain states exhausted their rainy day funds well before relieving their acute fiscal stress. As the economy gets back on its feet, state governments need to not just replenish, but increase their rainy day funds so that they can better weather protracted economic downturns in the future. A properly established rainy day fund designed to smooth cyclical revenue and expenditure flows would also help expose the scope of any underlying structural deficit.
- **Increase local flexibility and control.** States have a history of passing measures that constrain local governments’ ability to raise revenues and respond to changing fiscal circumstances. Those local governments need greater control over revenue generation and public service. These policies may include local access to a variety of general tax instruments (sales, property, and income), increased state aid, and fewer tax and spending limitations.
- **Improve budget processes and information sharing.** Good policy decisions rest on good information and common-sense processes for delivering that information to the people who need it. Decision-makers need to have good data clearly presented about real and projected conditions, the range of policy options, and their consequences. In order to reach a sustainable fiscal trajectory, states should move to report budgets in a transparent manner. Budget guides for the public and legislators should explain in clear language historical budget patterns, current budget policy issues, and the long-term pressures on public finances.

The paper also highlights a bright spot—the State of Utah. Utah has been able to avoid massive budget problems and maintain a balance through good information and sound processes. Utah was relatively less invested in the housing boom that led to the recent real estate crash and associated budget disasters of the Great Recession.

But another influence on the state's enviable condition has been its strong embrace of quality budget information and sound budget processes. The state is managing its long-term pension liability well and carries relatively little debt. In sum, routine, evidence- and process-driven review has enabled one Mountain West state to catch an incipient structural deficit early and act intentionally to rectify it before it becomes entrenched.

"Utah's avoidance of trouble confirms that a long-term vision and sound processes can promote budgetary balance over time," Murray said, while Muro notes that "improved policymaking going forward will be essential if states are to avoid prolonging the current crisis or falling into new ones."

"Budget balance shouldn't be the only goal of states but it's a crucial prerequisite for the sustained delivery of the essential human capital, infrastructure, and innovation investments that are critical to helping states build the next economy in their metropolitan areas," Muro said. "Without sound, balanced fiscal management states will struggle to build a stable platform for economic development and shared prosperity."

About Morrison Institute for Public Policy

Morrison Institute for Public Policy is a leader in examining critical Arizona and regional issues, and is a catalyst for public dialogue. An Arizona State University resource, Morrison Institute uses nonpartisan research and communication outreach to help improve the state's quality of life. Visit www.MorrisonInstitute.asu.edu.

About Brookings Mountain West

Established in 2009 as a partnership between the Brookings Institution and the University of Nevada, Las Vegas (UNLV), Brookings Mountain West (BMW) seeks to bring high-quality independent and influential public policy research to the critical issues facing the dynamic metropolitan areas of the Mountain West region. In this, the new initiative builds upon the work of Brookings' Metropolitan Policy Program, which focuses on helping metropolitan areas like Las Vegas grow in robust, inclusive, and sustainable ways through attention to the fundamental drivers of prosperity such as innovation, infrastructure, human capital, and quality of place, as well as regional governance. Along those lines, BMW, along with partners throughout the Mountain West, takes a deep interest in such areas as infrastructure improvement, economic growth, demographic change, environmental impact, alternative energy, and real estate investment.

As the Mountain West emerges as a new American Heartland, it will play an increasingly significant role in shaping national policy discussions. BMW provides a forum for this dialogue and offers knowledge-based policy solutions to help improve the quality of life in the West. Learn more at <http://brookingsmtnwest.unlv.edu/>

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About the Metropolitan Policy Program at Brookings

Created in 1996, the Metropolitan Policy Program (MPP) provides decision makers with cutting edge research and policy ideas for improving the health and prosperity of metropolitan areas including their component cities, suburbs, and rural areas. To learn more visit:

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