

State and Local Finances: Where We're Going

by Tracy Gordon

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Try a little party game in which you ask your friends and neighbors where their tax dollars come from and where they go. Most will probably know their federal tax bite. They may also be able to tick off major federal spending programs like Social Security, Medicare, and national defense. It is likely that few, however, will mention the nation's 50 states and nearly 90,000 counties, cities, towns, school districts, and other local agencies.

That omission is unfortunate because states and localities do much of the heavy lifting in our federalist system. Although the federal government raises more revenue, states and localities undertake more spending on domestic goods and services (that is, spending net of intergovernmental grants and national defense). They outspent the federal government in nine of the last 10 fiscal years and in most years since World War II (Figure 1, next page).¹ The exception was 2009, when federal expenditures spiked in response to the Great Recession.

As most Americans are probably aware, 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 compared with a year

¹U.S. Office of Management and Budget, "Historical Tables, Budget of the United States Government, Fiscal Year 2011" (Washington: U.S. Government Printing Office, 2010), available at <http://www.whitehouse.gov/omb/budget/Historicals>.

earlier.² 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 through fiscal 2011.³ In most states, lawmakers were called back to the bargaining table shortly after enacting a budget to find more revenue or spending cuts.⁴ At the local level, revenue has been more stable but are starting to dip as state aid cuts take effect and property taxes increasingly reflect market values (Figure 2, p. 341).⁵

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 the 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.

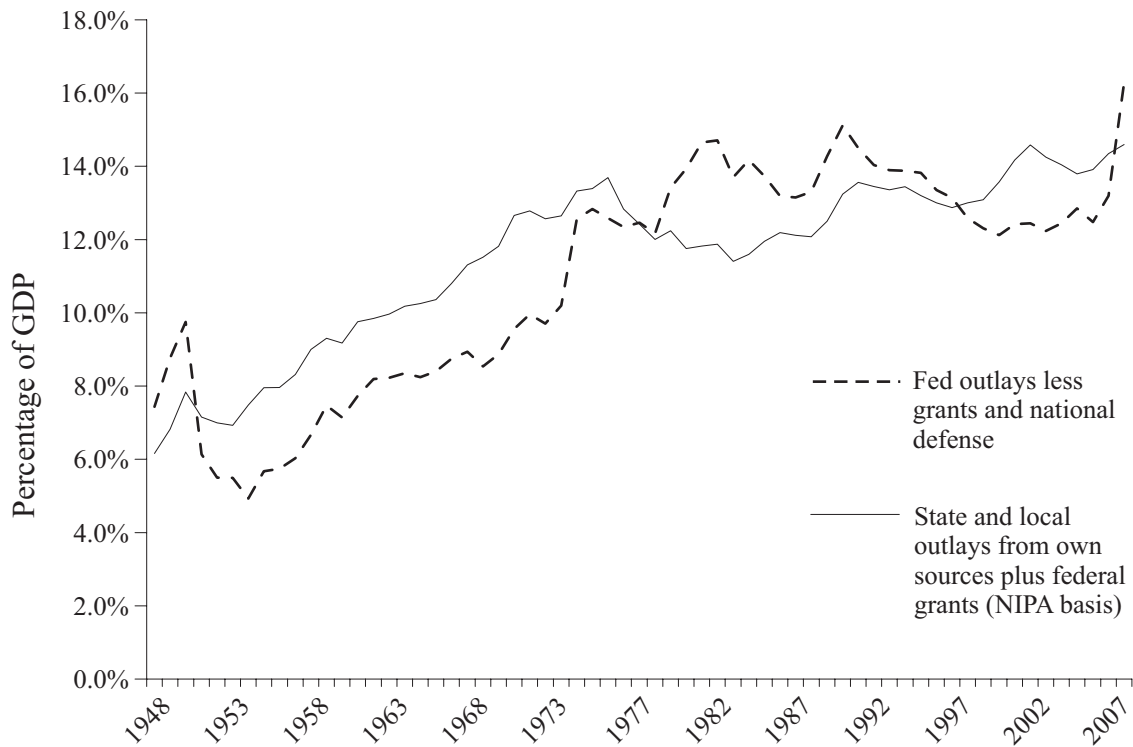
²Donald Boyd and Lucy Dadayan, "State Tax Revenues Rebound Further, Growing for Third Straight Quarter" (Albany: Rockefeller Institute of Government, 2010), available at http://www.rockinst.org/pdf/government_finance/state_revenue_report/2010-11-30-State_Revenue_Flash.pdf.

³Elizabeth McNichol, Phil Oliff, and Nicholas Johnson, "States Continue to Feel Recession's Impact" (Washington: Center for Budget and Policy Priorities, 2010), available at <http://www.cbpp.org/files/9-8-08sfp.pdf>.

⁴National Governors Association and the National Association of State Budget Officers, "The Fiscal Survey of States" (Washington: Fall 2010), available at <http://www.nasbo.org/LinkClick.aspx?fileticket=C6q1M3kxaEY%3d&tabid=38>.

⁵Christopher Hoene and Michael A. Pagano, "City Fiscal Conditions in 2010" (Washington: National League of Cities, 2010), available at http://www.nlc.org/ASSETS/AE26793318A645C795C9CD11DAB3B39B/RB_CityFiscalConditions2010.pdf. See also U.S. Congressional Budget Office "Fiscal Stress Faced by Local Governments," *Economic and Budget Issue Brief* (Washington: U.S. Government Printing Office, 2010), available at http://www.cbo.gov/ftpdocs/120xx/doc12005/12-09-Municipalities_Brief.pdf.

Figure 1.
Federal Versus State and Local Spending



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

States and localities must therefore increase taxes or cut spending to balance their books. Those actions can harm vulnerable populations and short-circuit a national economic recovery. States and localities are the nation's largest employer — responsible for one out of seven jobs — and in most years they contribute a third percentage point in real annual GDP growth. In 2009, however, their contribution was negative.⁶ 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 coming.⁷

Concerned about those spillover effects, federal policymakers often provide aid for state and local governments. Examples include the Antirecession Fiscal Assistance program, the Local Public Works program, and the Comprehensive Employment and Training Act 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.⁸

The American Recovery and Reinvestment Act of 2009 (ARRA) went much further, directing more than \$280 billion to states and localities, including roughly \$135 billion in flexible funds. Under ARRA, federal grants are estimated to have reached a

⁶U.S. Bureau of Economic Analysis. "National Income and Product Accounts" (Washington: U.S. Government Printing Office, 2010), available at <http://www.bea.gov/national/nipaweb/SelectTable.asp>.

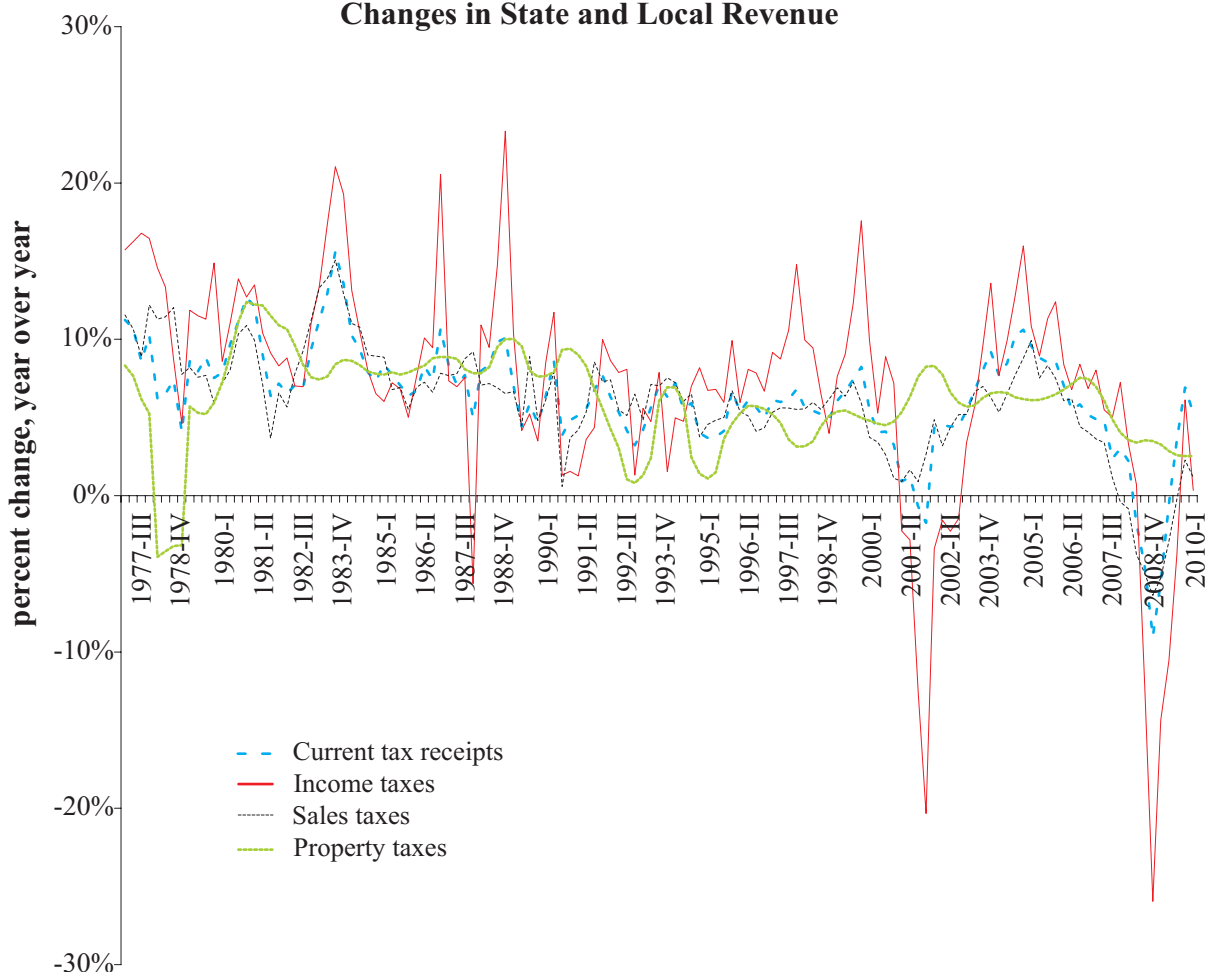
⁷U.S. Bureau of Labor Statistics, "Employment, Hours, and Earnings from the Current Employment Statistics" (Washington: U.S. Government Printing Office, 2010), available at <http://www.bls.gov/ces/home.htm#tables>; Christopher W. Hoene and Jacqueline J. Byers, "Local Governments Cutting Jobs and Services" (Washington: National League of Cities and National Association of Counties, 2010), available

at http://www.nlc.org/ASSETS/06F2CD78F5FB4A7DA1B84DA4A92008A8/LJAreport_FINAL.pdf.

⁸Richard H. Mattoon, "Should the Federal Government Bail Out the States? Lessons From Past Recessions," *Chicago Fed Letter* 265 (Chicago: Federal Reserve Bank of Chicago, 2010), available at http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2009/cflaugust2009_265.pdf.

(Footnote continued in next column.)

Figure 2.
Changes in State and Local Revenue



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

historic peak in nominal terms and as a share of GDP.⁹ Nevertheless, ARRA covered at most 40 percent of state budget shortfalls; and most payments will expire next year, while revenue is not expected to recover for another two to three years because of standard lags in rehiring and reinvestment.

The longer term is even more troubling. Sovereign debt crises abroad and a few high-profile municipal bankruptcies at home have some observers worried about a tsunami of state and local de-

faults.¹⁰ Although those worries may be overstated, difficult challenges loom.¹¹ In particular, states and

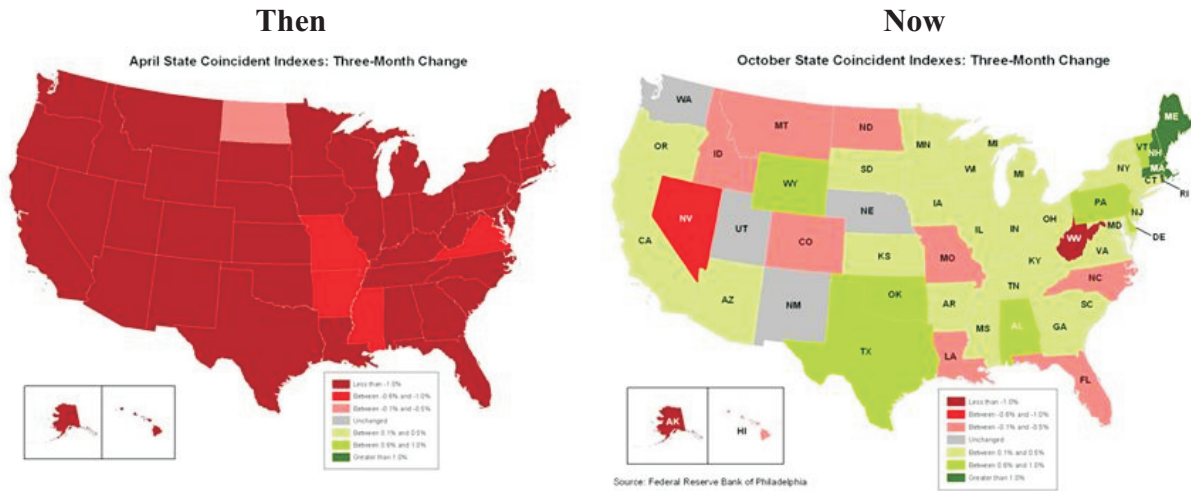
¹⁰See, e.g., David Wessel, "Local Debts Defy Easy Solution," *The Wall Street Journal*, Sept. 23, 2010, available at <http://online.wsj.com/article/SB10001424052748704814204575507842266619222.html>; Michael Cooper and Mary Williams Walsh, "Mounting Debts by States Stoke Fears of Crisis," *The New York Times*, Dec. 4, 2010, available at http://www.nytimes.com/2010/12/05/us/politics/05states.html?_r=1&pagewanted=1.

¹¹As noted below, local government defaults (missed debt service payments) and bankruptcies are rare. Only 16 states

⁹U.S. Office of Management and Budget (2010).

(Footnote continued on next page.)

Figure 3.
Philadelphia Federal Reserve Bank's State Coincident Index



Source: Federal Reserve Bank of Philadelphia (2010).

localities face unfunded pension and retiree health-care obligations of up to \$4 trillion depending on modeling assumptions.¹² The U.S. Government Accountability Office has estimated that rising health-care costs and aging populations — the same pres-

ures busting the federal budget — will lead to operating shortfalls on the order of 5 to 6 percent of GDP by 2060.¹³

Say that you were still at that party and, unbelievably, your friends and neighbors were still listening. Is there any room for optimism?

Maybe. First, as has been widely reported, revenue collections are picking up. State and local tax receipts were up 5 percent in the third quarter of 2010, compared with the same time last year.¹⁴ To be sure, much of that increase is the result of \$24 billion in legislated — and often temporary — tax rate increases.¹⁵ Without those 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 those actions, state tax revenue remains significantly below their pre-recession peak.¹⁶ Nevertheless, we have now seen three consecutive quarters of revenue increases as compared with previous

authorize local governments to declare bankruptcy, although 10 provide limited access. Unlike personal or corporate filings, the threshold for a municipality to declare bankruptcy is insolvency, or inability to pay debts. Also, judges cannot order a municipality to liquidate, so there are often holdout problems as in Vallejo, Calif., where bankruptcy proceedings have continued since May 2008. *See, e.g.*, Milken Institute and the Ewing Marion Kauffman Foundation, *Ensuring State and Municipal Solvency* (New York and Santa Monica, Calif.: Milken Institute and the Ewing Marion Kauffman Foundation, 2010), available at <http://www.kauffman.org/uploaded/files/ensuring-state-and-municipal-solvency.pdf>.

¹²Pew Center on the States, “The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform” (Washington: Pew Charitable Trusts, 2010), available at http://downloads.pewcenteronthestates.org/The_Trillion_Dollar_Gap_final.pdf; Robert Novy-Marx and Joshua Rauh, “Policy Options for State Pension Systems and Their Impact on Plan Liabilities,” *NBER Working Paper* #16453, October 2010, Cambridge, Mass.: National Bureau of Economic Research, available at <http://www.nber.org/papers/w16453>; Robert Novy-Marx and Joshua Rauh, “The Crisis in Local Government Pensions in the United States,” working paper, Oct. 13, 2010, available at <http://www.kellogg.northwestern.edu/faculty/rauh/research/NMRLocal20101011.pdf>.

¹³U.S. Government Accountability Office, “State and Local Governments’ Fiscal Outlook,” GAO-10-358 (Washington: U.S. Government Printing Office, 2010), available at <http://www.gao.gov/new.items/d10358.pdf>.

¹⁴U.S. Bureau of Economic Analysis (2010).

¹⁵NASBO and NGA (2010).

¹⁶Boyd and Dadayan, *supra* note 2.

years, 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 non-farm payroll employment, average hours worked in manufacturing, the unemployment rate, and real wage and salary disbursements). For the three-month period ending in October, 34 states saw an improvement, while 12 saw reductions and four (Nebraska, New Mexico, Utah, and Washington) saw no change.¹⁷ Again, the latest news compares favorably with February through April 2009, when the three-month index was consistently in decline for all 50 states (Figure 3).

Unfortunately, some states started farther behind. To take one example, most states experienced their pre-recession revenue peak in fiscal 2008. For Michigan, the peak year was 2000.¹⁸

Put another way, states differ in their underlying fundamentals, or fiscal capacity. One way to see that is by applying national average state and local tax rates to the economic conditions in each state, as under the Representative Revenue System. In a 2002 study, Yesim Yilmaz and coauthors performed this exercise and found that the average U.S. state had a revenue capacity of \$4,659.¹⁹ The top five states were Connecticut, Delaware, Massachusetts, Alaska, and New Jersey, while 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 in the news lately. Illinois recently reported the largest midyear

state budget shortfall in the nation at \$13 billion, or 47 percent of its general fund.²⁰ California was dubbed the "Lindsay Lohan of States" after its non-partisan Legislative Analyst's Office projected \$20 billion-plus shortfalls through fiscal 2016.²¹ 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.²²

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.

However, a look at those states' revenue capacities reveals a more complicated picture (Table 1, next page). All those states except Ohio had above-average revenue capacity as of 2002, but 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 revenue 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).²³

²⁰National Conference of State Legislatures, "State Budget Update," Denver, National Conference of State Legislatures, November 2010, available at <http://www.ncsl.org/?TabId=21829>.

²¹NCSL (2010); Allysia Finley, "California: The Lindsay Lohan of States," *The Wall Street Journal*, Nov. 2, 2010. Available at <http://online.wsj.com/article/SB10001424052748703506904575592612400443370.html>.

²²Betty Liu and Martin Z. Braun, "Whitney Says U.S. States May Need Federal Bailout," Bloomberg, Sept. 30, 2010, available at <http://www.bloomberg.com/news/2010-09-30/whitney-says-states-may-need-federal-bailout-in-next-12-months.html>.

²³Matthew N. Murray, "The Search for Revenues to Fill the Illinois Fiscal Gap," Presentation to the Chicago Federal Reserve Bank, June 2010, available at http://www.chicagofed.org/digital_assets/others/events/2010/charting_illinois_fiscal_future/murray.pdf. (Illinois lawmakers voted on January 12, 2010, to increase individual income tax rates from 3 percent to 5 percent and corporate rates from 4.8 percent 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.)

¹⁷Federal Reserve Bank of Philadelphia (2010), "State Coincident Indicators" (Philadelphia: Federal Reserve Bank of Philadelphia, 2010), available at <http://www.philadelphiafed.org/research-and-data/regional-economy/indexes/coincident/>.

¹⁸Eric Scorsone and David Zin, "The Michigan Economy and State Revenue: A 10-Year History" (1999-2009) (Lansing: Senate Fiscal Agency, 2010), available at <http://www.senate.michigan.gov/sfa/Publications/Issues/StateRevenueTenYears/StateRevenueTenYears.pdf>.

¹⁹Yilmaz, Yesim, Sonya Hoo, Matthew Nagowski, Kim Rueben, and Robert Tannenwald, "Fiscal Disparities Across States, FY 2002" (Washington: Urban Institute and the New England Public Policy Center at the Federal Reserve Bank of Boston), available at <http://www.urban.org/url.cfm?ID=311403>.

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).

No discussion of state finances would be complete without mentioning political gridlock. California is notorious for budgets that arrive late and are balanced on a wing and a prayer.²⁴ Illinois and New York also missed their budget deadlines this year because of 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.²⁵ At the national level, large majorities say that they will resist *any* actions to balance state budgets, including spending cuts, tax increases, and a federal bailout.²⁶

What about recent talk of a U.S. state and local debt crisis? Comparisons with Greece, Ireland, and Spain have escalated in recent weeks amid mutual fund sell-offs and rising yields for of municipal bonds and credit default swaps.²⁷ There is some

disagreement about whether those trends reflect a heightened awareness of state and local fiscal troubles or just adjustments in the municipal bond market. In particular, with the end of the Build America Bonds (BABs) program on December 31, 2010, states and localities may be upping the supply of new issues, thereby depressing prices and raising yields.²⁸

Alternatively, municipal 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, and tender option bond pricing — that have until recently made long-term debt more palatable to short-term buyers. Although new products may be

 bondbuyer.com/issues/119_486-1021008-1.html; Josh Barro, “Evaluating States’ Credit With Bond Yields,” *Issue Brief 6* (New York: Manhattan Institute, 2010), available at http://www.manhattan-institute.org/html/ib_06.htm.

²⁸The BABs 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. That feature allows the federal government to provide a deeper and more targeted subsidy to state and local governments. The tax exemption 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: U.S. Government Printing Office, 2010), available at <http://www.cbo.gov/ftpdocs/106xx/doc10667/10-26-TaxPreferredBonds.pdf>. See also Diana B. Henriques, “Revised Fed Data Raises Doubt on Foreign Appetite for Build America Bonds,” *The New York Times*, Dec. 9, 2010, available at <http://www.nytimes.com/2010/12/10/business/economy/10muni.html?scp=1&sq=revise%20fed%20data%20raises%20doubts&st=cse>.

²⁴Tracy Gordon, “The Year of Magical Thinking,” *Tax Vox: The Tax Policy Center Blog* (Washington: Urban Institute and Brookings Institution Tax Policy Center, 2010), at http://taxvox.taxpolicycenter.org/blog/_archives/2010/10/12/4653983.html.

²⁵Pew Center on the States and Public Policy Institute of California, “Facing Facts: Public Attitudes and Fiscal Realities in Five Stressed States” (District of Columbia and San Francisco: Pew Charitable Trusts and PPIC, 2010), available at <http://www.ppic.org/main/publication.asp?i=951>.

²⁶Pew Research Center for the People & the Press, “Public Rejects Variety of Options for Fixing State Budgets” (Washington: Pew Research Center, 2010), available at <http://people-press.org/report/628/>.

²⁷Dan Seymour, “Muni Mutual Funds Keep on Bleeding,” *Bond Buyer*, Dec. 13, 2010, available at <http://www.bondbuyer.com>.

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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).

emerging, some analysts suggest that muni yields are returning to higher pre-credit-bubble levels.²⁹

U.S. state and local debt levels are modest compared with those of sovereign nations in trouble — for example, 16 percent of GDP in 2009 compared with Greece’s 127 percent.

Also, it is important to recall some differences between U.S. states and localities and the eurozone. U.S. state and local debt levels are modest compared with those of sovereign nations in trouble — for example, 16 percent of GDP in 2009 compared with

Greece’s 127 percent.³⁰ Moreover, states and localities issue debt to build physical assets like bridges and airports, not to finance day-to-day operations. Short-term borrowing generally constitutes no more than 2 percent of muni debt outstanding.³¹ As a result, states and localities are less vulnerable to so-called rollover risk when short-term notes come due but further borrowing is prohibitively expensive.³²

³⁰Those comparisons do not account for state and local taxpayers’ share of total debt. *See, e.g.*, U.S. Congressional Budget Office, “Economic Impacts of Waiting to Resolve the Long-Term Budget Imbalance” (Washington: U.S. Government Printing Office, 2010).

³¹U.S. Census Bureau, *2008 Annual Surveys of State and Local Government Finances* (Washington: U.S. Government Printing Office, 2010), available at <http://www.census.gov/govs/estimate/>.

³²That 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. Mike Spector and Michael

²⁹Dan Seymour, “BABs: The Last Pillar Standing,” *Bond Buyer*, Nov. 29, 2010, available at http://www.bondbuyer.com/issues/119_476/build_america_bonds-1020407-1.html.

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U.S. states and localities have other strengths as well. In addition to explicit debt and implicit pension and other liabilities noted above, states and localities have assets (Table 2, previous page). 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.³³ Although not all those assets are liquid, similar to untapped revenue capacity, some might be leveraged through sale-leaseback and other one-time arrangements.³⁴

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 rare and usually limited to special purpose entities, like water districts.³⁵

Corckery, "Illinois Seeks Wall Street Cash," *The Wall Street Journal*, Dec. 11, 2010, available at <http://online.wsj.com/article/SB10001424052748703727804576011644076639916.html>.

³³Board of Governors of the Federal Reserve System, "Flow of Funds Accounts of the United States," Table L.105, Dec. 9, 2010, available at <http://www.federalreserve.gov/releases/z1/current/>.

³⁴Of course, sale and lease-back arrangements can involve many issues. See, e.g., Michael Cohen, "Sale Leaseback of State Office Buildings" (Sacramento: California Legislative Analyst's Office, 2010), available at http://www.lao.ca.gov/reports/2010/infr/sale_leaseback/sale_leaseback_110910.pdf.

³⁵U.S. Congressional Budget Office (2010).

So what is to be done? Recent dust-ups over extensions of unemployment insurance and enhanced federal Medicaid matching funds for states suggest further help from Washington will not be coming.

However, states and local governments are not sitting idly by. Most states have set up tax reform or performance review commissions to look for efficiency improvements.³⁶ Many states are identifying cost savings through prison reform, school district consolidation, and public employee compensation restructuring, among other areas.³⁷ The federal government has also gotten into the act, providing incentives for local policy innovation (for example, Race to the Top education funds).

To be sure, state and local governments face difficult days and even years. However, as we've heard a lot lately, crises also create opportunities. States and localities may find new ways to raise revenue and provide services that are valued by taxpayers — or to drop the ones that aren't. Living up to Justice Louis Brandeis's vision of the state and local sector as a "laboratory of democracy" may be one way for those often-overlooked governments to stand up and be noticed. ☆

³⁶National Association of State Budget Officers, "Recommendations from State Restructuring Commissions and Agencies" (Washington: 2010), available at <http://www.nasbo.org/LinkClick.aspx?fileticket=7nTvXpAIrnY%3d&tabid=138>.

³⁷Lauren Stewart, "State Government Redesign Efforts 2009 and 2010" (Washington: National Governors' Association, 2010), available at <http://www.nga.org/Files/pdf/1010STATEGOVTREREDESIGN.PDF>.