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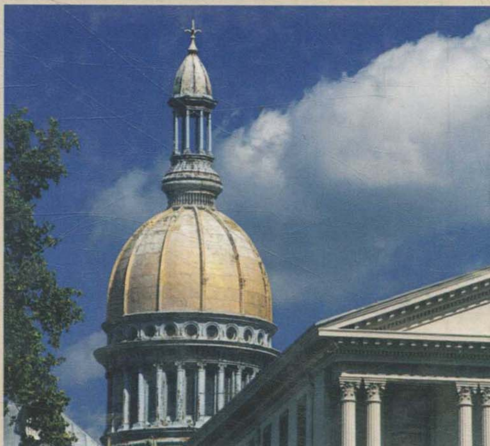
# SUSTAINING THE STATES

## The Fiscal Viability of American State Governments



Edited by
Marilyn Marks Rubin • Katherine G. Willoughby

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# Preface

The United States provides a classic example of a bottom-up system of federalism. It was created in 1787 when representatives of the then-thirteen colonies convened to ratify a constitution under which both the central government and the states would be sovereign entities. Within certain constitutional and statutory constraints, state governments thus (1) develop and execute their budgets without review and modification by the federal government, (2) determine their own revenue structures and levels and types of expenditures, and (3) borrow and manage debt. The U.S. system stands in contrast with nearly all other top-down nation-states in which the established central government constitutionally or legislatively assigns expenditure responsibilities and revenue raising authority to subnational units of government.*

State fiscal decisions have a significant impact on this nation's economy. Together, with their more than 90,000 local governments, states account for almost 12 percent of gross domestic product (GDP) and 60 percent of all government expenditures.† Taken together, subnational governments in the United States employ more than one out of every eight workers and provide the bulk of all basic governmental services consumed by individuals and businesses.

The purpose of this book is to provide a comprehensive and timely knowledge base of trends in, the current status of, and future prospects for the fiscal sustainability of state governments. Upon reading the following chapters, you should come away with a comprehensive view of the very broad reach and multiple contributions of state governments to individuals and communities across the nation. You should be well versed in the resources that states generate and use to conduct the business of government. You will be exposed to the very real and significant constraints on

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* Kincaid, J., The Constitutional Frameworks of State and Local Government Finance, in *The Oxford Handbook of State and Local Government Finance*, ed. Robert D. Ebel and John E. Petersen, New York, Oxford University Press, 2012, pp. 45–82.

† Calculated by authors using data from the U.S. Census Bureau and the U.S. Bureau of Economic Analysis.

state ability to fulfill their responsibilities, and you will be introduced to several key challenges that state governments face and actively address to reach and maintain fiscal sustainability. Hopefully, you will gain a clear, realistic understanding of state operations and financing in the United States, as well as a sense of optimism for the capacity of these governments to move forward.

# Editors

**Marilyn Marks Rubin** is professor of public administration and economics at John Jay College of City University of New York and director of the college's MPA program. She has authored several publications on fiscal policy and budget-related issues and was an advisor to the Korean Women's Development Institute on gender budgeting. Professor Rubin is a fellow of the National Academy of Public Administration and a past chair of the Association for Budgeting and Financial Management.

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# *Chapter 1*

# Sustaining the States: An Introduction

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*National Association of State Budget Officers*

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## Contents



## State Roles and Fiscal Sustainability

The 50 state governments in the United States play a dominant role in the delivery of a wide range of public services (see Figure 1.1). States spend approximately $1.7 trillion annually and, together with local governments, account for close to 12 percent of the nation's gross domestic product (GDP). States are engaged in educating and protecting their residents, caring for natural resources, building and maintaining infrastructure, and promoting economic development. States help to keep millions of people

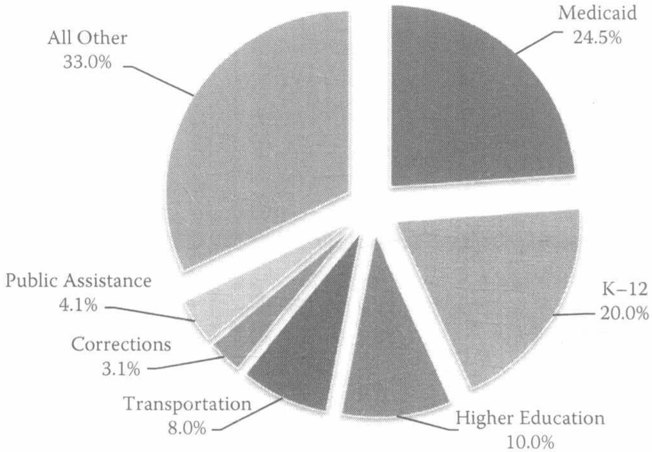


**Figure 1.1 Total state expenditures, FY2013 estimated. Total state expenditures are all federal and state funds. (From NASBO State Expenditure Report, State Expenditures by Function, Estimated Fiscal 2013, November 21, 2013, 2. Available at: http://www.nasbo.org/sites/default/files/State%20Expenditure%20Report.Summary_0.pdf.)**

healthy through massive health care expenditures, including Medicaid, and by way of nutritional support programs. Although almost entirely funded by the federal government, other health-related programs such as the highly utilized Special Supplemental Nutrition Program for Women, Infants, and Children (WIC) would not be available without the involvement and service infrastructure provided by state governments. WIC alone provides benefits for 9 million people each month.

States also play a critical role in keeping the public safe by funding state police and correctional facilities. More than 85 percent of the nation's inmates are the responsibility of state governments, and millions more are monitored by states after their release. One of the most basic ways an individual in this country shows identification is through a driver's license, with licensing generally handled by state motor vehicle agencies. In terms of education, the largest public support of universities and community colleges comes from state government, as does a major portion of the funds for K–12 education.

Especially in light of these critical responsibilities, the states face significant challenges as we near the midpoint of the second decade of the 21st century. The biggest concern is the new "fiscal normal" following the most dramatic economic downturn experienced in this country since the Great Depression—the Great Recession that lasted from December 2007 to June 2009 (NBER 2012). This new normal is characterized by modestly growing state revenues, but growth that is insufficient for meeting the spending demanded by politicians and voters. Federal Reserve Chairman Ben Bernanke explained it well when he said that we are facing "the still-moderate underlying pace of economic growth."* Modest growth in state revenues means modest growth of state budgets prospectively, at least compared to the decades prior to the Great Recession.

The states have weathered recessions in the past, attesting to state government resiliency. There were 11 business cycles in the latter half of the 19th century and 22 more since 1900 (NBER 2012), two of which occurred in the first decade of this century. Boyd (2003) writes that the bull economy of the 1990s, followed by the first recession of the 21st century in 2001, contributed to the weaker position of states for weathering the Great Recession.

State income and sales tax receipts especially benefited from the run-up of the economy in the 1990s, as did state pension investment returns. Conversely, "state spending pressures were minimal" during the period (Boyd 2003, 324). Restructured federal funding to states for public welfare and new tobacco settlement monies† provided an added fiscal cushion for states, allowing many to expand programs, cut taxes, enrich pension benefits for employees, and fill reserve funds. Total state government revenue at the start of the 21st century stood at $1.26 trillion, spending equaled $1.08 trillion, and indebtedness, $548 billion (Wulf 2002).

The stock market slump of 2000 and the recession that began in March 2001 reduced the growth of state revenues. The downturn ended in November 2001 but had a much longer-lasting impact on state finances than was recognized at the time (Boyd 2003). Unrealistic forecasts related to both tax receipts and pension investment return rates, the timing of the decline in state revenues, and in many cases, following the path of least resistance in terms of engaging fiscal management solutions, hampered the ability of states to react quickly and to plan for recovery.

On the expenditure side, continually growing Medicaid costs, increasing education needs, and widespread losses in pension portfolio values resulted in significant state budget gaps. Table 1.1 shows state deficits as a percent of national GDP, indicating the severity of the 2001 recession compared with the one preceding it that ran from July 1990 to March 1991 (NBER 2012). State deficits as a percent of GDP in 2002, the year following the end of the 2001 recession, are almost twice the size of those in 1992, the year following the end of the 1990–1991 recession.

The states recovered slowly after the 2001 recession, but the basis of recovery was both insubstantial and fleeting. State surpluses and rainy day funds grew into the mid-2000s, and state reserve balances peaked at $69 billion in fiscal 2006. But, these reserves provided little protection for states when faced with the looming deficits resulting from the 18-month Great Recession.

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* Chairman Ben S. Bernanke, *Semiannual Monetary Policy Report to the Congress*, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC, February 26, 2013, available at http://www.federalreserve.gov/newsevents/testimony/bernanke20130226a.htm.

† In the 1990s, tobacco companies settled a lawsuit brought by state governments and agreed to pay billions of dollars in fines to states to compensate for state expenditures related to smoking.

**Table 1.1 Impact of Recession on State Budget Deficits during Most Recent Downturns**

| | *State Deficits (Billions of $)* | *National GDP (Billions of $)* | *State Deficits as % of GDP* | *State Deficits as % of State–Local Spending* |
|---|---|---|---|---|
| **Fiscal Year** | | | | |
| ***Downturn of 1990–1991*** | | | | |
| 1991 | –8 | 5,896 | –0.14 | –1.16 |
| 1992 | –13 | 6,167 | –0.21 | –1.79 |
| ***Downturn of 2001*** | | | | |
| 2002 | –40 | 10,464 | –0.38 | –3.15 |
| 2003 | –75 | 10,892 | –0.69 | –5.64 |
| 2004 | –80 | 11,506 | –0.70 | –5.79 |
| 2005 | –45 | 12,254 | –0.37 | –3.10 |
| ***Downturn of 2007–2009*** | | | | |
| 2009 | –110 | 14,244 | –0.77 | –6.16 |
| 2010 | –191 | 14,390 | –1.33 | –10.73 |
| 2011 estimated | –130 | 14,930 | –0.87 | –7.25 |
| 2012 estimated | –112 | 15,500 | –0.72 | –6.20 |

*Source:* Ebel, R., Estimated Deficits: 1991–1992 (NASBO annual surveys), 2002–2005 and 2009–2012 Estimated (Center for Budget Policy and Priorities), GDP (Bureau of Economic Analysis, National Income Accounts), Table 1.1.5; estimated for fiscal years by using average of adjacent calendar years.

The NBER (2012) determined that the recession ended in June 2009. But, the unemployment rate that stood at 4.4 percent in 2007 spiked to over 10 percent in 2010, and the poverty rate increased to 15.9 percent in 2011, the highest since the early 1960s (Bishaw 2012). State constant dollar revenues were at about the same level as those a decade earlier (Ward 2010). Referring to Table 1.1, state deficits as a percent of GDP indicate heavy fallout in the first full year after the official end of the recession—state budget gaps as a percent of GDP stood at 1.3 percent; state deficits as a proportion of total state and local spending reached almost 11 percent.

Since 2009, with one exception, the annual state budget growth rate has averaged about 4 percent—less than half the 9.4 percent rate as late as 2007.* The sustained fiscal stress brought about by the Great Recession is perhaps evidenced most clearly by gubernatorial "funnel vision." For several years after the recession was officially declared to be over, the number of issues discussed by governors in their state of state addresses declined. For example, in 2007, at least two-thirds of governors discussed eight issues in these speeches: education, health care, natural resources, taxes, jobs, public safety, performance, and budget balance. But, in 2012, just three issues were addressed by at least 66 percent of state chief executives: education, jobs, and taxes (Willoughby 2012). Even with revenues growing slowly, governors are still shy of turning to new or increased taxes for budget solutions. "Governors recommended fewer revenue increases in fiscal 2014 compared to 2013," and they were as likely to push for decreases as increases (NASBO 2013a, 40).

While the recent 4 percent annual state budget growth is positive, it is lower than the average 5.5 percent annual increase in state budgets from 1977 until the start of the Great Recession. This slowdown is significant given that voter desires for state services coupled with ongoing pressures for tax cuts far surpass a 4 percent budget growth rate. For example, state governments' share of spending on Medicaid is growing at about 6 percent annually. If state revenues are growing at 4 percent annually, but Medicaid spending is increasing at 6 percent annually ... well, you do the math!

To a certain extent, state revenue changes during and immediately following the Great Recession pale in comparison to the continued hammering on expenditures by states to solve their budget problems. Spending cuts have been a staple throughout the recovery period. By far, the top strategy used by states for reducing or eliminating budget gaps remains targeted, then across-the-board spending cuts. In 2013, there were 21 states that made targeted cuts; 9 made across-the-board expenditure cuts. For 2014, there are 16 states recommending targeted, and 4 across-the-board cuts; targeted and across-the-board cuts are recommended by 8 states for 2015. Increasing expenditures on health care, including for Medicaid, continue to crowd out spending for everything other than education.

To address an impending budget imbalance today, a state would have to cap parts of Medicaid services and programs, cut spending for other state functions, raise revenues, increase borrowing, or engage a combination of some or all of these strategies. Some states have already started to take extreme actions. For example, in 2009, Arizona stopped Medicaid funding of organ transplants because state

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* NASBO reports 4.9 percent growth in state general funds in 2008, 3.8 percent growth in 2009, and a decline of 5.7 percent in 2010. The growth rate rebounds to 3.8 percent in 2011 and an estimated 4.1 percent by 2014. See National Association of State Budget Officers, *The Fiscal Survey of the States*, Spring 2013, p. 2, available at http://www.nasbo.org/sites/default/files/Spring%202013%20Fiscal%20Survey%20of%20States.pdf.