Don't Hold Your Breath

The recession may be over, but states will continue to face high unemployment and lower revenues well into the next decade.

BY EDWARD SMITH

The good news is that state economic forecasts over the past two years have been consistent.

The bad news is they've been consistently bad.

That pattern persists in the new year as lawmakers take stock of what happened in FY 2010 and look at how FY 2011 budgets are shaping up. Even as the stock market continues to rise and the 2009 third quarter gross domestic product showed growth, states are facing slow revenue recovery, persistent high unemployment and an increased demand for services.

"I think we've hit bottom, but I think we're going to spend a fair amount of time bouncing along the bottom. This will not be over quickly," says David Wyss, chief economist for Standard & Poor's. "It's better than no recovery. But just because you're recovering doesn't mean revenues will turn on a dime."

Tax revenues lag the economy—income taxes and capital gains taxes are paid at the end of the year, and people out of work or suffering losses in the market pay fewer taxes. Consumer spending, which accounts for two-thirds of the U.S. economy, is expected to remain weak, especially as high unemployment persists.

"All that suggests tax revenues are going to get worse," Wyss says.

That perspective is backed up by the latest "State Budget Update" from the National Conference of State Legislatures, released in December. It found 39 states and Puerto Rico expect general fund revenues in FY 2010 to be lower than FY 2009 collections.

"State revenues performed so poorly in FY 2009 that some officials thought the hemorrhage had ended. That was wishful thinking," writes Corina Eckl, NCSL's fiscal director. "Instead, general fund revenues in FY 2010 are expected to recede even further, falling below last year's collections in the vast majority of states—depressing news indeed."

A key driver of recovery in the states is employment and wages, says Donald J. Boyd, a senior fellow at the Nelson A. Rockefeller Institute of Government, who tracks

REPRESENTATIVE
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TEXAS

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state budgets.

"If you look at the last recession from the point at which the GDP began to recover, it was 17 quarters before employment wages got back to where they were when it started," he says. "Consumption is typically highly related to people's incomes. You expect consumer spending to take a little time to recover. There are reasons to believe it will take a long time."

BATTERED BUDGETS

The sagging revenues are a key reason behind the ongoing grim numbers in state budgets. States closed a cumulative gap of $145.9 billion to enact FY 2010 budgets. An additional $28.2 billion gap has opened since those budgets were completed in July 2009, according to NCSL's budget update.

All this comes on top of FY 2009, when lawmakers closed a cumulative gap of more than $117 billion.

Looking ahead, 34 states and Puerto Rico project budget gaps in FY 2011 of $55.5 billion. The numbers get worse for FY 2012, with 23 states and Puerto Rico projecting a $68.8 million gap.

"A contributing factor to future state budget gaps is the end of federal stimulus funds," the report says, noting that, as the money begins to drop off in 2011, it will leave big holes in state budgets—what many officials are calling the "cliff effect." It means at least two more tough years for states, says NCSL Executive Director William T. Pound.

"The combination of continuing state revenue shortfalls and the decline in federal stimulus funds over the next two years," he says, "points to a very difficult road ahead for the states."

UNEMPLOYMENT PERSISTS

Economists agree that employment will recover slowly, and nowhere is that more apparent than in Michigan, which has the highest unemployment rate in the states at 14.7 percent as of November. Nationally, only Puerto Rico exceeds it, with a 15.9 percent rate.

So what does an improving economy mean for Michigan? Not much, says Mitch Bean, director of the House Fiscal Agency.

"What's important to most people is employment," he says. "People who are looking for work are not going to recognize the end of a recession because they are either unemployed or underemployed."

And Bean says there's more pain to come, recession or not. "I think our unemployment will hit 16 percent before it gets better. I think it will exceed 15 percent into 2011. I hope I've got it wrong."

The picture is not much rosier in other parts of the country when it comes to a robust rebound in employment. "Don't hold your breath," says Wyss. "I think we've got at least four or five years before we get back to anything approaching normal, much less the superheated conditions we saw" in the past few years.

Even in Texas, which has fared far better than many states and had an unemployment rate of 8 percent in November, there are plenty of fiscal challenges.

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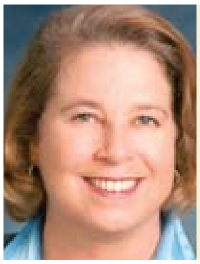
"I have the same concern as a lot of people, which is what the impact is on employment," says Texas Representative John Otto, a member of the Appropriations Committee. "States and local governments are not seeing any growth in their revenues until the consumer is convinced."

Consumer spending is especially important in Texas, one of only nine states that do not levy a broad-based personal income tax. As a result, the state relies on sales taxes for a lion's share of its general fund revenues. "Consumers are driving this economy and you've got to get their confidence back to have job growth," Otto says.



SENATOR
DENISE DUCHENY
CALIFORNIA

California Senator Denise Ducheny, chair of the Joint Legislative Budget Committee, says if the recession is over, it's welcome. But she's not celebrating yet. "I don't know if it's ended yet. If it does end, it will mean some stabilization. We're seeing tiny upticks in things like new housing starts and retail sales. Everything is not dropping as much."

But California, she says, is seeing a decline in property values for the first time in 30 years, which will affect state revenues. "This year it's not going to be flat. We're going to have a negative property tax from one year to the next."

DEMAND ON STATES

Even as states look at a future of anemic employment growth and sluggish state revenues, demand for state services is growing.

"The awkward part for all states is when the most demand on state services is being made, our revenues are going down," Ducheny says.

NCSL's budget update found that, while most of the fiscal problems are caused by dropping revenues, higher-than-projected costs were causing problems for some states, especially in Medicaid, criminal justice, social services and education.

Baby boomers retiring from state jobs also will put a load on state budgets. "It puts pressure on state pension funds that are severely underfunded," Wyss says. "There also are retiree health care costs with serious funding shortfalls."

From Boyd's perspective, the end of the recession means states probably have a few more years before they see recovery. "By FY 2013," Boyd says, "we will see a recovering economy and some growth in revenue for states. By then, lawmakers will have grappled with some of the most difficult problems because they will have to balance their budgets absent the federal stimulus money and other one-time sources of revenue."

Ducheny points out that lawmakers in California and other states already have cut deeply. They will be hard-pressed in the next two years to find more cuts or revenue opportunities.

"We cut $60 billion over the last two years. We've already cut everything to the bone."

CHECK OUT NCSL's latest State Budget Update at ww.ncsl.org/magazine.