Struggling to Grow

With few promising signs on the horizon for state budgets, lawmakers face another year full of difficult decisions.

BY CHRISTOPHER THORNBERG

To say it has been a rough few years for state and local governments would be an understatement. Although the economy has been modestly expanding since 2009, the public sector in aggregate has continued to run deficits for almost five years. This has never happened in the time since officials began collecting reliable data following World War II. The deficit today is still roughly 6 percent of revenues—the same as it was in 2009, according to the U.S. Bureau of Economic Analysis. The result has been the ongoing contraction in the provision of basic public services.

Indeed, the slower-than-normal growth experienced in the U.S. economy over the last two years can be chalked up almost exclusively to budget issues at the state and local government level.

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Since 2010, the private sector has been growing at an annual rate of 3.2 percent compared to 3.4 percent between 1995 and 2007. The public sector, on the other hand, has been contracting by roughly 2 percent a year in real terms—and this is the drag that is pushing down overall U.S. growth to the 2 percent range.

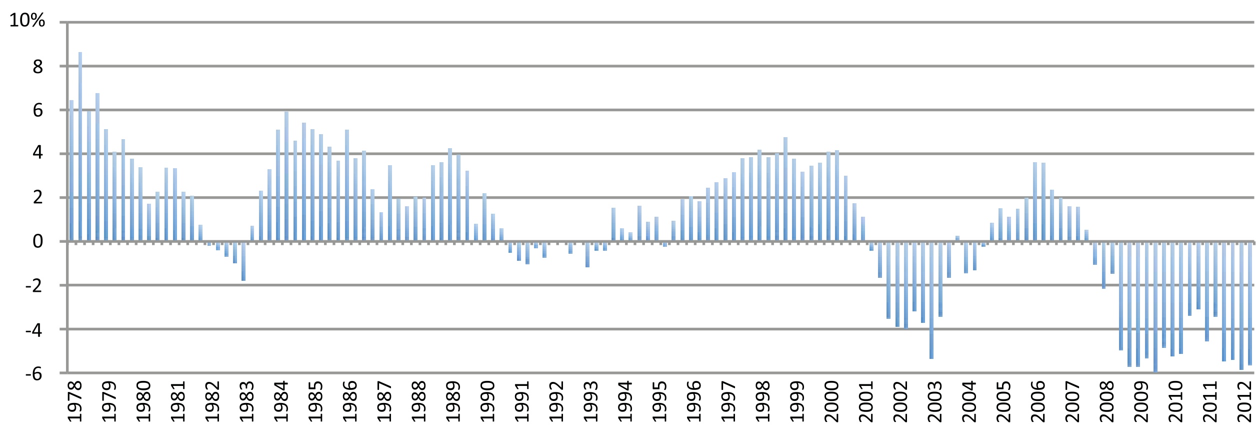
Deep and Wide

Why the ongoing difficulties? There are a number of causes. One is the depth of the downturn that hit the U.S. economy. But more significantly is the weak recovery. The common strategy used by state and local governments when dealing with cyclical budget gaps is often the 'kick the can down the road' option—using stopgap measures and temporary cuts. And this isn't a bad method if revenues come back strongly during the recovery period, as they typically have. Employing temporary and stopgap measures avoids intensifying the strength of a downturn by not adding public spending cuts to an already weak private sector.

This time, however, the recovery in state and local revenues

Dogged Deficits

Although the broader economy is bouncing back, budget deficits for state and local government have not improved since 2009.



STATE AND LOCAL GOVERNMENT BUDGET GAPS AS SHARE OF REVENUES, SEASONALLY ADJUSTED

From the Trenches: Top Budget Threats

The prevailing economic outlook among legislative fiscal directors at the start of fiscal year 2013 was one of continued growth but at a slow to moderate pace. At the same time, an air of uncertainty hung over most economic outlooks.

NCSL asked the fiscal directors to identify the top threats to their state budgets. The following summarizes the responses and reflects what will likely occupy lawmakers during much of their legislative sessions this year, and beyond.

- The rising costs of Medicaid and carrying out federal health care reform, 22 states.
- Ambiguity regarding federal deficit reduction decisions, 10 states.
- The sustainability of pensions, eight states.
- Slow revenue performance, eight states.

Other concerns included slow growth in employment, low energy prices (in energy producing states), supplemental spending demands, and transportation and infrastructure costs.

—Todd Haggerty

has paralleled the overall weak recovery of the economy—implying this same strategy has done little more than push the deficit down the road. Added to this has been a general reluctance to raise taxes (given the potential impact on the weak recovery), and a decline in federal support as the stimulus programs have faded away. Moreover, several states have seen many of their expenditures put on autopilot through voter referendums and public union contracts, limiting lawmakers' choices greatly.

Where's the Light?

So is there any light on the horizon? Yes and no. On one hand there are a number of solid signs pointing to recovery in real estate markets. Sales are on the rise, inventories are shrinking and prices are finally starting to increase. The latest Case Shiller index figures show prices up on a year-on-year basis in all of the 20 major markets they track, as well as on a national basis. Housing permits are also rising. This will help bump property tax revenues starting this year.

Other revenues are also bouncing back. Tourism has returned. Visitors are filling hotels and bringing transient occupancy tax revenue increases with them. And because real personal incomes have increased in absolute terms over the course of the last year, and there have been rebounds in the equity markets, the 43 states that levy an income tax (all except Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming) will see a solid bump in revenue next year.

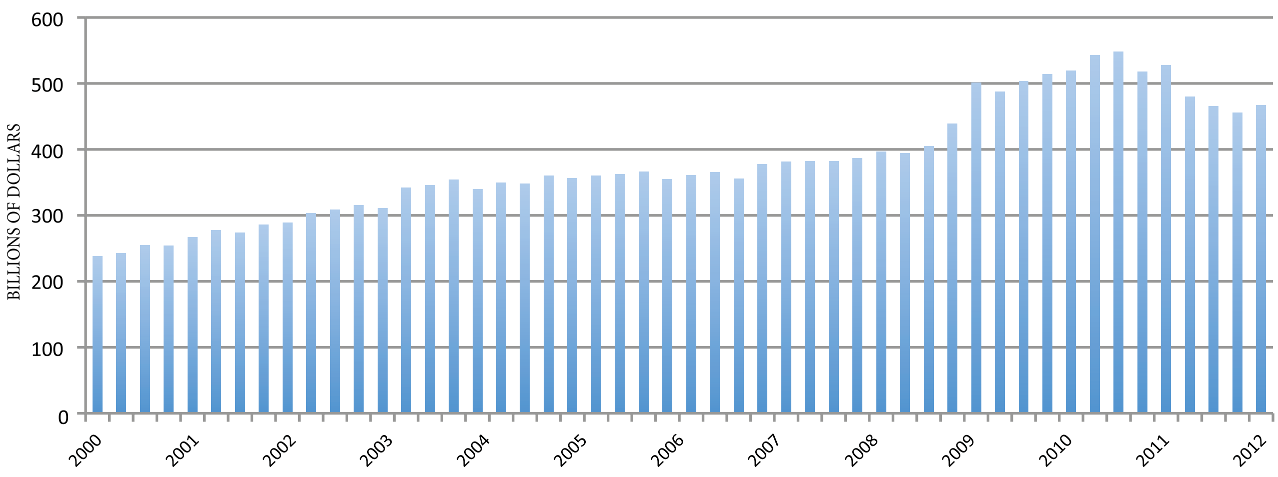
This will be, however, at least partly offset by weaker results elsewhere on the balance sheet. Even though corporate profits are up from a year ago, they have been flat in recent months. This implies that the healthy gains states with corporate taxes have enjoyed may have come to an end.

The Federal Factor

An even more important concern is what path the federal government will take to close the deficit at the national level of the economy.

Falling Federal Funding

Federal assistance to state and local government has decreased in the last two years, further compounding their budget troubles.



FEDERAL TRANSFERS TO STATE AND LOCAL GOVERNMENTS

What's Up With State Tax Collections?

For the third consecutive year, state officials have forecasted higher tax growth compared to the previous year. But the growth has been slow since the end of the "Great Recession," and projections for FY 2013 reflect a continuation of that trend. Officials in 45 states and the District of Columbia expect total tax collections to be higher this year, although the vast majority of them expect only modest growth of 1 percent to 5 percent. Only Alaska (oil prices) and Kansas (enacted tax changes) anticipate total tax collections to decline by at least 1 percent.

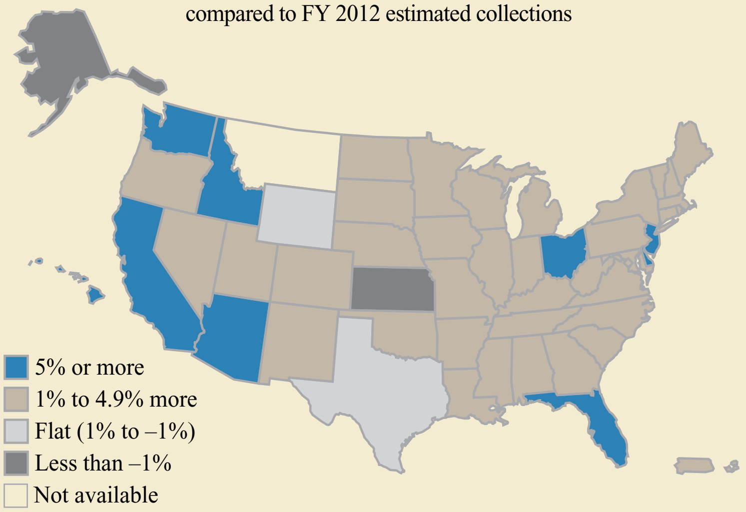
Predictably, the forecast for individual tax categories mirror the trend of measured growth found in the total or aggregate forecast. Personal income and general sales and use tax collections, which represent about 66 percent of all state general funds, are projected to increase in nearly all states that levy them. But again, most states anticipate growth of less than 5 percent.

States also rely on a variety of miscellaneous taxes—on oil and gas production, real estate transfers, tobacco, restaurant meals and hotel rooms, insurance premiums, gambling, estates and others. The forecasts for these vary, although there is a common theme: State revenue continues to improve, albeit at a leisurely pace.

—Todd Haggerty

What's Ahead?

Total tax revenue forecast for FY 2013, compared to FY 2012 estimated collections



Slow Growth

Projected changes in state tax collections, from FY 2012 to FY 2013

PROJECTED CHANGE	NUMBER OF STATES	
	PERSONAL INCOME	SALES
5% or more	14	6
1% to 4.9% more	24	35
Flat (1% to –1%)	1	3
Less than –1%	2	1
Do not levy	7	4

Note: Projections were not available from Hawaii, Montana and New Hampshire for personal income taxes and from Hawaii for sales taxes.

Source: NCSL survey, 2012

Negotiations between the newly reelected Democratic president and the Republican controlled House are sure to be tense, and may even take us past the January 1 deadline. However, Beacon Economics doesn't see the so called "fiscal cliff" (the large federal tax increases and spending cuts set to occur on January 1) as a concern by itself. It's clear neither side wants to be held responsible for another recession that would most likely result if a budget plan isn't put into place before the second quarter of 2013.

Still, even a successful negotiation implies a reduction in spending that will have to come in part out of federal aid grants to state and local governments. And although these represent only 12.5 percent of all federal expenditures, they make up more than 40 percent of all non-defense and non-social insurance programs. Indeed, this federal aid represents 25 percent of state and local revenues at the moment, a record high level. In addition, any agreement on an increase in taxes could eventually limit consumer spending and the sales tax revenue it generates.

The Pension Problem

Then of course there is the issue of pensions. Ongoing low interest rates are making current assumptions regarding long-term returns in public pension portfolios look more and more out of touch with reality. Eventually these unrealistically high expectations will need to be reduced, increasing the funding requirements.

For example, officials at Calpers, the California Public Employees' Retirement System, have for years been using an 8 percent expected long-run return for their actuarial estimates used in calculating participants' and governments' contribution levels. Officials recently lowered this to 7.75 percent, but given that long-term treasuries are running less than 2 percent, this will have to be lowered even more, which will require raising contribution levels. For the state, this will eat up revenues that could have gone to other programs.

Tough Decisions

All this adds up to more tough decisions for government officials at state and local levels in the coming year. The recent election demonstrated very mixed public opinions about these options.

Tax hikes received varying degrees of success. In California, voters approved Proposition 30, which will raise the state sales tax as well as the marginal income tax on high-income earners. Yet citizens in Nevada and Arizona said no to any tax increases, by large margins.

Ultimately, lawmakers will have to decide what works best for their states, as usual. Some will make permanent cuts to programs. Others will seek new revenues. But it remains to be seen if the intransigence to tax increases will diminish among local electorates as inevitable cuts to programs and services are felt at the local level.