ESSAYS ON ISSUES

THE FEDERAL RESERVE BANK OF CHICAGO

OCTOBER 2011
NUMBER 291b

Chicago Fed Letter

State budgets under stress: Paths to sustainability

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State governments have been noticeably absent in contributing to U.S. economic growth since the recession of 2008–09. Despite some recovery in tax revenues, many states are still reporting budget shortfalls and spending pressures for pensions and health care.

More information on the conference is available at www.chicagofed.org/webpages/events/2011/state_budgets.cfm.

Fiscal stress at the state level is filtering down to local governments in the form of reduced aid, and this in turn is reflected in the loss of 539,000 state and local government jobs since August 2008. Are these budget woes primarily due to the fallout from a particularly harsh recession or are they the result of underlying structural problems in the state government sector that require new policy responses?

On June 23–24, the Federal Reserve Banks of Chicago, New York, and Philadelphia, in conjunction with the John D. and Catherine T. MacArthur Foundation and the National Association of State Budget Officers, convened a conference to examine how states are dealing with immediate fiscal pressures and whether new policies and governance structures are needed to improve the fiscal sustainability of the sector in the future.

Former New York Lieutenant Governor Richard Ravitch provided the opening keynote address. Ravitch stressed the importance of state and local governments as providers of critical public services such as health care, education, and infrastructure and argued that many members of the public seem unaware of the importance of the sector. Recently, many states' program commitments have been outdistancing their resources. Therefore, improving budgeting performance is critical to sustainability in the sector. Ravitch said that better budgeting transparency and accountability would improve the framework for making fiscal adjustments in the sector. In the current environment, it is often easiest to balance budgets through expedient cuts to spending in education and infrastructure, where the costs of underinvestment will not show up for years. These cuts are often made in the absence of comprehensive information about the nature of state spending. To create a framework for improving budgeting and fiscal transparency, Ravitch announced the formation of a study commission, chaired by himself and former Fed chairman Paul Volcker, that will examine a group of five large states to develop systematic budgeting tools for monitoring fiscal behavior, while developing possible options for dealing with longer-term fiscal pressures such as the rising costs of pensions and health care.

Budget pressures in Illinois, Wisconsin, and New York

Laurence Msall of the Civic Federation described Illinois's ongoing budget dilemma as a product of poor budgeting practices and a lack of preparation for dealing with the economic downturn. He characterized FY09, FY10, and FY11 budgets as having been balanced with pension borrowing, delaying bill payments, and fiscal gimmicks. This has led to Illinois having significant pension underfunding—the state is ranked the worst in the nation, with just 45% of its pension obligations funded. In addition, Illinois has the second-lowest-quality bond rating in the nation. The state has borrowed heavily, particularly for pensions, and has tripled its level of indebtedness to over $30 billion since 2002.

The FY12 general fund budget of $33.2 billion, while balanced on paper, still incorporates hidden liabilities in the form of costs that the state will incur that will not be covered in the budget. This includes a backlog of unpaid bills approaching $4.6 billion—despite the state's significant increase in personal and business income tax rates in January 2011. While these increases are scheduled to largely phase out by 2025, the new revenue is still not sufficient for the state to escape future deficits. Msall concluded by suggesting that much unfinished business lies ahead for Illinois, including potential efforts to reform current employee health care and pension costs.

Wisconsin's FY11–13 budget development has followed a different path from that of neighboring Illinois, according to Todd Berry of the Wisconsin Taxpayers Alliance. Wisconsin's fiscal problems had their roots in the 1990s, when a relative boom in revenues led to a series of overcommitments in funding for schools, prisons, welfare, and Medicaid. In addition, Wisconsin cut taxes repeatedly, leading to what Berry described as 15 years of structural imbalance. By the time of the latest recession, the state was woefully unprepared and was able to avoid fiscal calamity primarily thanks to $2.2 billion in federal stimulus aid.

With the arrival of Governor Scott Walker in January 2011, Wisconsin had approximately a $3.6 billion deficit, comprising unpaid bills and new Medicaid demands. Given that the new governor had campaigned on a platform of limiting tax increases, budgetary austerity became the mechanism for balancing the new budget. This included reducing the rate of growth for Medicaid, cutting all other major appropriations, including school and municipal aid and higher education. Employee benefits were trimmed and collective bargaining rights were revoked for all unionized state workers, except public safety workers. While these cuts have been far from popular, Berry suggested that they have put the state on a more sustainable fiscal footing.

In January, the state of New York also found itself with a new governor, Andrew Cuomo, who had vowed to put the state's fiscal house back in order. Donald Boyd of the Rockefeller Institute reported that while New York had avoided much of the worst of the latest recession in terms of employment and housing declines, state tax revenues had not fared so well. Boyd said this is because New York's state income tax is highly reliant on the high-wage earners, whose incomes did falter in the recession. In response to this budgetary strain, the state's FY09–10 budget had introduced a three-year personal income tax rate increase on high incomes and other temporary tax increases, while cutting Medicaid and school aid. In addition, the state received over $6 billion in federal stimulus funds. Boyd characterized budgets prior to FY11–12 as heavily reliant on temporary resources.

Governor Cuomo faced an estimated budget gap of $10 billion. He announced that he would not extend the temporary income tax increase on high incomes and would freeze wages for state employees and support a tax cap on local property taxes. He also announced a series of commissions to redesign various aspects of state government. While most of these commissions are charged with identifying significant cost savings, it is not clear how these savings will actually show up in the budget. The governor has also asked the state legislature to help him enforce budget discipline through a series of mechanisms, including near-term targets and multiyear appropriations. In all, spending cuts comprise 85% of the state's balanced budget plan. While the new budget shows that a governor can encourage more long-term fiscal thinking, Boyd said, these efforts may not persist without institutions in place to support them.

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The view from Wall Street

Two credit analysts, Gail Sussman from Moody's and Matt Fabian from Municipal Market Advisors, provided a perspective on how investors are responding to state budget pressures. Sussman focused on the spillover to the municipal bond market. Moody's has had a negative outlook for state and local governments for three years and has seen credit rating downgrades outpacing upgrades for nine straight quarters. Despite this trend, Sussman noted that defaults of rated municipal bonds have been infrequent (from 1970 to 2009, only 54 of Moody's rated issuers defaulted and nearly 80% of these were in the nonprofit hospital and housing sectors). In addition, the average recovery on these defaulted bonds has been almost 60% of par, compared with 37% for defaulted corporate bonds. However, Sussman said she does expect muni default rates to increase in 2011—possibly to two or three times the 2008 level.

Sussman suggested that the extent of future debt problems will depend on the willingness of states to face tough decisions. Issues such as pensions do not pose an immediate threat for most states but do present a long-term challenge. She concluded by saying that states currently face a revenue and spending crisis, not a debt crisis.

Fabian said that the municipal debt market is battling several performance issues. These include a decline in bond insurance, which has reduced the supply of highly rated municipal bonds; delays in going to market by issuers dealing with budget crises; and media scares that have conflated budget and default risk, prompting investors to flee the market. Fabian agreed with Sussman that recent defaults have been concentrated in nonrated, relatively risky sectors, particularly in real estate.

Longer-term issues

Federal aid, pensions, bankruptcy, and structural adjustment were the focus of an academic panel. John Karl Scholz, University of Wisconsin, asked, "Can the federal government solve or at least help solve state budget problems?" He said that while the answer in the near term is likely to be "no," in the longer run it changes to "possibly." To begin with, the federal fiscal situation is dire. Work by Auerbach and Gale (2011)[1] suggests that the federal debt will be between 4.1% and 5.5% of gross domestic product (GDP) in 2015 and between 4.9% and 6.5% of GDP by 2021, even after assuming many years of nearly full employment. This situation could deteriorate even faster after 2021 as baby boomer retirements drive health care costs.

However, Scholz suggested that there may be untapped revenue capacity in the federal tax base. Federal taxes as a share of GDP are at their lowest levels since 1950. At the same time, the average tax rates of affluent households (who have had large income gains) have fallen. Scholz argued that the federal government has the ability to raise more revenue without substantially jeopardizing economic performance and that some of this increased revenue could be channeled to the states. This could be accomplished specifically by tax base broadening or by trimming tax expenditures—e.g., by limiting the value of various tax preferences to 28% rather than the taxpayer's marginal rate. In addition, tax rate increases could be considered, such as restoring rates to those in existence during the Clinton administration.

Another very interesting idea, Scholz said, is the introduction of a value-added tax (VAT) at the federal level. All OECD countries have such a tax. It is administratively efficient, he added, and as a consumption tax it encourages savings. The states could piggyback on the federal VAT, creating an efficient tax source for the states. Still, Scholz noted that for political reasons, the introduction of such a tax nationwide is a remote possibility.

Randal Picker, University of Chicago, discussed whether bankruptcy is an option for financially distressed states. Picker reviewed the history of federal bankruptcy laws and their potential extension to state governments. While municipalities were eventually permitted to file for bankruptcy protection under Chapter 9 of the bankruptcy code (with significant state restrictions in many cases), states were excluded as sovereign governments. Chapter 9 filings have been infrequent and many states have intermediary processes to discourage or prevent such a filing.

To close current budget gaps, states have enacted tax increases that peaked at $22.5 billion in 2010. However, most of the budget balancing has occurred on the spending side.

In cases where bankruptcy may be considered for local governments, Picker said there are three key issues to evaluate. First, the terms in existing collective bargaining agreements; second, pension solvency; and third, asset sales and tax increases and their role in promoting fiscal balance. All three of these factors will have a direct effect on the fiscal flexibility that a locality will have in meeting its financial obligations. In particular, Picker noted that states such as Illinois that have constitutional protections against changes to pension benefits for employees face uncertain waters as they attempt to reduce or restructure benefits for current workers, regardless of whether this action is seen as a necessary component of future fiscal solvency.

Tracy Gordon, University of Maryland/The Brookings Institution, focused on the budget trade-offs states are making. To close current budget gaps, states have enacted tax increases that peaked at $22.5 billion in 2010. However, most of the budget balancing has occurred on the spending side. Spending cuts have been implemented across all government services, including K–12 education, higher education, health care, elderly and disabled care, and employee compensation. In addition, a number of fiscal gimmicks have been used, including asset sales, delaying bill payments, borrowing from special funds, increasing income tax withholding, and tax amnesties.

Gordon identified some structural and institutional issues for the longer term. While virtually all states (49) have balanced budget requirements, many (30) also have tax and expenditure limits, requirements for either super majorities or voter approval for tax increases (16), and debt limitations (46). Structurally, states are facing more volatile revenues over the business cycle, increases in countercyclical spending pressure, and projections that show health care expenditures exceeding all non-health-care expenditures by 2049.

To improve states' fiscal performance for the future, Gordon suggested that the development of an early warning system that focuses on key budget drivers might be helpful. In particular, better budgeting systems might address problems related to both the flow of state government funds and the stock of government assets and liabilities. Including

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Chicago Fed Letter is published by the Economic Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.

ISSN 0895-0164

stock measures would provide a better sense of outstanding commitments.

A better way to monitor state and local budgets

Robert Inman, University of Pennsylvania, concluded the conference with a keynote address on constructing a better monitoring system for assessing state and local budget performance.[2] Inman began by suggesting that the performance of state and local finances is important because the sector: 1) is an important provider of public goods and services; 2) is a significant holder of household wealth in the form of public assets and liabilities; and 3) is a potential source of financial instability. The key question for analysts is: What do they need to know to see a default coming? To help answer this question, Inman described the Monitoring Project that was developed in 1976 to examine the Philadelphia city budget. The goal is to define the state and local surplus or deficit, where the surplus or deficit equals current revenues minus current spending. However, the components of revenue and spending in the project are much broader than in many common definitions, Inman explained. Revenues include taxes, fees, aid, interest earnings, and profits; spending includes wages and benefits, transfers, interest/principal, and depreciation.

Inman suggested this form of financial accounting would enable average citizens to see how much money is being retained in the government's public purse. The problem is that assembling these data is complicated and expensive, and the process likely requires an outside monitor. Inman suggested that Federal Reserve economic research departments might be a suitable home for such a function. He concluded with a possible project outline for such an effort. The monitor would develop a contemporaneous surplus/deficit and public wealth measure for all states and major cities on a regular basis using the prescribed common methodology. These results would be announced to the public and would allow for more accurate assessment of the sector's financial behavior.

Conclusion

State budgets appear to be far from out of the woods. Fiscal stress is still apparent, even with recent improvements in state revenues. However, pinpointing the exact depth of the problem is still difficult for analysts. Budgets lack transparency and are often difficult to compare across states. To avoid future fiscal mischief, systematic monitoring of the state government sector's finances may be needed.

1 Alan J. Auerbach and William G. Gale, 2011, "Tempting fate: The federal budget outlook," Brookings Institution, paper, updated June 30, available at www.brookings.edu/papers/2011/0208_budget_outlook_auerbach_gale.aspx.

2 Robert P. Inman, 1995, "Do you know how much money is in your public purse?," *Business Review*, Federal Reserve Bank of Philadelphia, July, available at www.phil.frb.org/research-and-data/publications/business-review/1995/brja95ri.pdf.