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The states' budgets

Time to turn out the lights

State fiscal crises may deepen America's downturn

APRIL is always a tense month in America. Their tax forms due in, Americans scramble to organise a year's worth of assorted paperwork. Post offices stay open long past their usual closing times on the 15th, as last-minute filers dash to send off their returns and beat the deadline.

This spring promises to be even more nerve-racking than usual for treasurers in the 50 states who wonder how much, or how little, the tax filers will send them. As America's economic doldrums persist, some states' budgets are feeling the pinch. California has told 20,000 teachers and support staff that they may be sacked. People whose health insurance is subsidised by their state may face higher fees in Vermont or be cut out entirely in Maine. Massachusetts's governor wants to legalise gambling in order to raise revenue.

Economic downturns depress tax receipts and boost demand for state-provided social services. And while the federal government can weather a slide in revenue by borrowing, most states are required by law to balance their operating budgets every year, leaving the cash-strapped with two unattractive options: raise taxes or cut spending. State legislatures usually take the second course, scaling back public services or freezing hiring.

The consequences, though, can be nasty. State and local government spending accounted for 13% of GDP in the last quarter of 2007, so spending cuts put further pressure on demand and employment. That, at least, is what happened the last time America slipped into recession, back in 2001. During the worst quarter of that episode, real state revenue

plummeted 14% (see chart), and did not begin to grow again until the end of 2003. The Centre on Budget and Policy Priorities, a think-tank, calculates that 1m people were thrown out of public health-care programmes during the slump. Another 1.5m, says the centre's Iris Lav, would have followed if the federal government had not stepped in to help in 2003. Now her outfit is calling for a similar federal relief package, sooner than last time.

The last recession was unusually bad for states' budgets. Donald Boyd of the Rockefeller Institute of Government, the public-policy research arm of the State University of New York, found that in the recessions of the early 1980s and 1990s state tax revenues declined at about the same rate as the national economy. In the last recession, however, the decline in real state revenue was vastly disproportionate to that of the economy as a whole, mainly due to a big drop in capi-



tal-gains-tax receipts. The question for the states is which downturn the current one will look like.

Ms Lav frets that, in terms of the number of states facing problems and the scale of their difficulties, the picture looks much as it did heading into the last state-level budget crisis. Seventeen states are now considering cuts in everything from public-health services to higher-education funding in the next fiscal year, which for most states begins on July 1st. Over half of all Americans now live in a state facing fiscal problems.

The worst off are those at the centre of the housing crisis: Arizona, California and Florida. Although states get little revenue from property taxes, the subprime bust has hit sales-tax revenue as fewer people buy durables for new homes, and unemployment in construction cuts into income-tax receipts. Sinking home prices also sap consumer confidence.

California now faces a \$16 billion budget shortfall. The obvious remedy is out: crisis or no, raising taxes in California remains extremely unpopular. The state's otherwise puny Republicans have the power to block tax increases, which require a two-thirds majority vote. Arnold Schwarzenegger, the governor, proposed very few tax hikes in his budget (and naturally did not call them that). One would have closed a loophole on yachts and aeroplanes, bringing in perhaps \$21m to the state. Republicans reacted as though he had proposed a levy on first-born sons.

They are no keener on a plan to reduce the state prison population by 20,000 and the number of parolees by a similar number. Cutting spending on prisons and rehabilitation, which accounts for an eye-opening 10% of California's budget, is in any case virtually impossible because of the enormous power of the prison guards' union. Cuts to primary and secondary education will be opposed by the even mightier teachers' unions. The budget will probably

be balanced by cutting spending on universities and health-care programmes, by a few "fees" (not taxes, you understand) and by a dollop of accounting wizardry. Possible victims include AIDS services and the Medi-Cal programme, which serves children and the elderly.

The aggregate national outlook is better than California's, but hardly encouraging. Real state revenue fell in the last two quarters for the first time since 2003, despite a sharp increase in tax receipts from export industries booming on the back of the weak dollar. Some of the pain has been self-inflicted. Heading into the current downturn, almost half of states faced structural deficits as non-discretionary spending outpaced revenue growth. And some states' income forecasts were too optimistic. For now, states can close the resulting budget gaps by raiding rainy-day funds. But if their revenue continues to decline, many more will resemble California.

The National Governors Association estimates that budget problems could afflict 35-40 states in fiscal 2009. Growth in sales-tax revenue, a critical source of state income, has tumbled and will struggle as long as consumer spending does. The other big revenue source for most states is their income tax. The returns Americans are rushing to finish now will be coloured by economic weakness at the end of 2007. Next year's receipts may be far worse.

A distinctive feature of the current downturn, moreover, is that it began in the housing market. Property taxes are usually relatively buoyant during downturns. But plummeting home prices affect property-tax revenue as values are reassessed, which will pinch local governments that rely on them. Fewer home sales also mean less money for cities from property transfer taxes. The hangover from America's latest slump could be painful indeed.