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At last, a state budget year when the sky is not falling

By Daniel C. Vock
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During the depths of the Great Recession, states had to do many unsavory things to balance their budgets. But few things left a more bitter taste than Arizona's decision to sell off the office space of its state Capitol complex. It helped lawmakers close a gap in one year's budget, even though it meant taxpayers would essentially have to pay rent on the property for the next two decades.

Now, Arizona's budget outlook is showing some improvement: For the first time since 2006, the state finished its last fiscal year with a surplus, which came as a surprise to state financial forecasters. Governor Jan Brewer told lawmakers where she wants to spend some of the \$600 million windfall: buying back the state's buildings from its landlords. "Together," the Republican said during her state of the state speech on Monday, "we can celebrate the burning of that mortgage."

No one is saying Arizona's boom days are back. Its 8.7 percent unemployment rate is slightly higher than the national average and its housing industry is still struggling. Roughly \$1 billion of Arizona's annual revenue will disappear next year when a temporary sales tax expires, an event lawmakers are calling "the cliff." But for the first time in five years, the legislature is in a position to put money toward its top priorities rather than cut, cut, cut.

And that is a pretty good assessment of where a lot of states are, as they head into a new budget season. **According to the Rockefeller**

Institute of Government, at least 45 states saw their revenues [increase](#) over the past year. After a four-year run during which states had to close budget gaps of historic proportions, the term "surplus" is finally making a modest comeback in capitals. Whether they slashed K-12 education during the budget crisis, closed state parks or cut doctors' rates for treating poor patients, many states will start reversing the most painful of their recent cuts in 2012.

There are asterisks on all this positive news, of course. One is that while state revenues are generally up, they fell so far during the recession that most states have not caught back up to where they were before. **"Eight quarters of growth is a good trend," says Rockefeller's Robert Ward. "The problem is that states were down so deep that they effectively have lost three years worth of growth."**

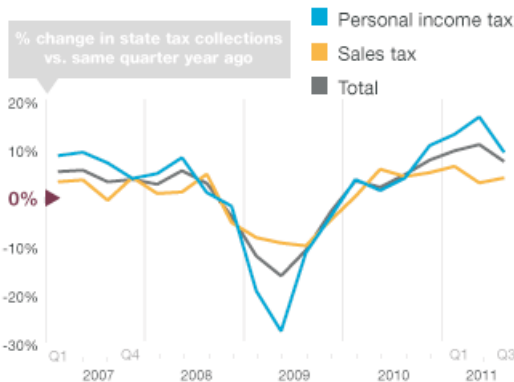
Another point of caution is the economy. Joblessness continues to place huge demands on the social services states provide. The housing market remains soft, and there is a real threat that a European recession could have spillover effects in the United States.

But overall, enough economic vital signs are headed in the right direction that the mood in most states is encouraging. In its most recent [survey](#) of legislative fiscal directors, the National Conference of State Legislatures reported that more states were "cautiously optimistic" or "positive" about the fiscal outlook for the rest of 2012 than "concerned." The number of fiscal directors who said they were "pessimistic" was zero.

Revenue rebound continues



State tax revenues have grown for seven quarters in a row. However, revenues plunged so deeply in 2008 and 2009 that many states have yet to return to their pre-recession levels.



Source: Rockefeller Institute of Government, December 2011

“The odds of a double dip (recession) have certainly diminished,” says Sujit CanagaRetna, a tax and budget expert at the Council of State Governments. But, he adds, “we really cannot afford to have any more of those hiccups in our recovery programs.”

An uneven comeback

Just as the recession did not spread its pain evenly, the economic recovery is not appearing in equal force in every state. Generally speaking, the states can be sorted into three groups.

First are the states that never really felt the brunt of the recession in the first place. North Dakota is the most obvious example, with its recent oil boom. But many of its neighbors, with economies dependent on minerals or agriculture, are doing well, too. North Dakota is one of a small number of states that anticipates ending this fiscal year with enough money in the bank to cover a tenth of its yearly expenses, [according to](#) the National Association of State Budget Officers. The others are Alaska, Delaware, Iowa, Montana, Nebraska, Texas, West Virginia and Wyoming.

On the opposite end of the spectrum are states still wrestling with major budget short-

falls, whether that is because revenues are rising too slowly or because spending demands are rising too quickly. In Washington State, lawmakers met in a December special session to try and close a \$2 billion hole that had developed in their current budget. They only managed to fill about a third of it. And California continues to struggle. The state has a budget gap of \$9.2 billion through the end of its next fiscal year. Democratic Governor Jerry Brown wants voters to approve hikes in income and sales taxes. Otherwise, he says, the state must make painful cutbacks in services, including shortening the school year by three weeks.

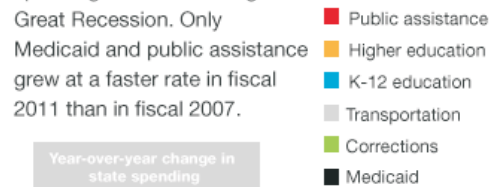
By and large, most states lie somewhere in between the two extremes. They made it through the worst of the fiscal crisis, and now face more manageable deficits than they have in recent years, or even modest surpluses. And like Arizona, they are pondering which of their recession-era cuts they want to undo, especially in education.

In Virginia, Republican Governor Bob McDonnell has said he wants to raise the state contribution to higher education this year, a break from five consecutive years of state cuts.

Ups and downs of state spending



Nearly every category of state spending took a hit during the Great Recession. Only Medicaid and public assistance grew at a faster rate in fiscal 2011 than in fiscal 2007.



Note: State spending includes both general fund spending and federal funds.
Source: National Association of State Budget Officers

Idaho Governor C.L. “Butch” Otter, also a Republican, is calling for a \$32 million boost for public schools and another \$21 million increase for colleges and universities.

On the Democratic side, New York Governor Andrew Cuomo says a \$2 billion hole in next year’s budget should not preclude spending \$1 billion to revitalize the city of Buffalo and to build bridges and improve state parks. In Minnesota, Governor Mark Dayton wants to take advantage of a newfound surplus to support a round of construction projects. And in West Virginia, which also is projecting a surplus, Governor Earl Ray Tomblin wants to reduce property taxes while stashing away money for infrastructure projects.

While the healthier revenues most states are seeing is a positive development, revenue is only one part of the budget equation. According to an analysis by the Pew Center on the States (*Stateline’s* parent organization), Illinois is one of the three states that has surpassed its previous high-water mark on revenues (North Dakota and Vermont are the others.) However, Illinois only got there with an infusion of cash from a major income tax increase, and the state still owes close to \$7 billion in unpaid bills.

The left-leaning Center on Budget and Policy Priorities says there is no reason to celebrate the states’ current fiscal situation. Its [report](#) issued this week painted a more pessimistic budget picture than recent analyses by other groups monitoring state finances. By CBPP’s count, more than half of all states face budget gaps for the year to come or have already closed them. The end of the federal stimulus program, along with increasing K-12 enrollments and escalating Medicaid costs, are still putting massive strains on states. “Even though the revenue outlook is trending upward,” the report says, “states are still addressing large budget shortfalls by historical standards.”

‘It feels different’

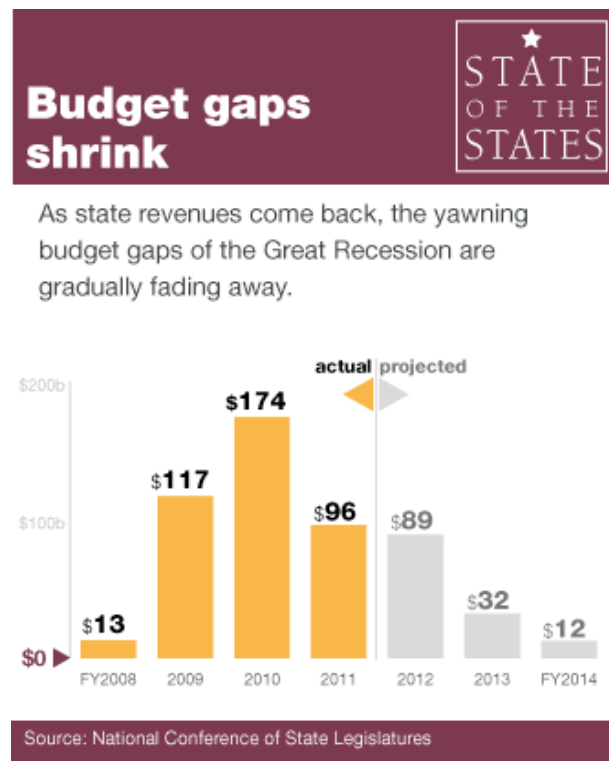
Even some of the states that have had the worst budget struggles, however, are seeing upbeat economic signs.

In Washington State, for example, as lawmakers wrangle a budget deficit in Olympia,

Boeing is [boosting production](#) — and hiring workers — to catch up on a backlog of orders for 4,000 aircraft, or eight years’ worth of work. Microsoft, the state’s other marquee employer, is adding jobs, too. Unemployment claims, while still high, are falling.

Even long-struggling Michigan finally has good news to talk about. After nearly a decade of headlines about job losses and a retrenching auto industry, manufacturing is picking back up. The state’s revenues have improved along with its economy in small but noticeable ways. Tax collections for the state’s two biggest accounts were up 8.6 percent in the last fiscal year. “It feels different for people,” says David Zin, the chief economist for Michigan’s Senate Fiscal Agency. “The changing signs have a pretty significant psychological effect.”

Recent changes in Michigan’s tax laws mean the state will likely see less money in the current year than last year, Zin says, and the revenue increases are not keeping up with inflation. The bigger concern is over how long the economy will take to get into a higher gear. Consumers still worry about their future, preventing them from buying big-ticket items.



And when they have been spending, they had to borrow to get the money. "We are expecting the economy to grow in 2012 and 2013," Zin says, "but a lot less than it did in 2011."

The collapse of the housing market also continues to weigh down the economies of some states. There are simply too many houses available or, alternatively, too few buyers. Florida officials say the amount of unsold houses on the market there continues to grow, because of persistent unemployment and foreclosures. "The state will need significant time to work off the current excess — at least two years in the optimistic scenario, likely longer," the Florida Economic Estimating Conference wrote last fall. "The overall Florida economy is unlikely to significantly improve until new construction comes back to life, and that won't happen until the existing inventory is reduced."

Far from the Sun Belt, the housing glut is putting a damper on the economic recovery in Oregon. Mark McMullen, Oregon's acting state economist, says the logging industry is doing well when it comes to shipping logs overseas. "But that's not nearly the same economic boost as you get from running a mill and coming up with plywood or timber or finished lumber products," he says. "That market is still reeling as a result of their ties to the broader national housing market."

A hazardous climb

Ironically, the other big drag on the economy in Oregon and a number of other states is government itself. State governments shed 5,000 jobs between October and November; local governments lost another 11,000 jobs, more than half of which came from schools. Layoffs by state and local governments are exacerbating unemployment. Normally during an economic recovery, Oregon adds 350 public sector jobs a month. Last year, Oregon lost 615 public sector jobs a month.

State economists also are keeping their eyes on Europe. The U.S. economy is closely linked with Europe's, so a recession there could have an [impact in states](#) with the greatest exposure. An analysis by Wells Fargo Securities noted that Utah's economy benefits from gold exports to

Britain; four cents of every dollar in the West Virginia economy is tied to Europe through coal exports; and Alabama and South Carolina have close economic ties to Europe because of their automobile factories.

"The greatest threat to the U.S. economy remains the European sovereign debt crisis," wrote Washington state forecasters in a December update to the legislature. "If the sovereign debt crisis degenerates into a full-blown banking crisis, it will spread to the United States because of our banks' exposure to European banks. A U.S. banking crisis will push the U.S. back into recession."

The current downturn is unlike most that have come before it in key ways that makes it hard to predict how long and how fully it will take states to recover. Oregon's McMullen points out that the sheer numbers of people who have been unemployed for years is something his state has not seen in recent memory. The recession in the early 1980s put similar percentages of people out of work, but they were not there as long as today's job seekers. It is an important consideration for state lawmakers and budget writers, he says, because the long-term unemployed demand a lot of social services.

For Washington State, the nature of the recession and the state's heavy reliance on sales taxes combine to make this downturn especially difficult. In the recession of the early 2000s, Washington residents kept building houses and buying cars, says Arun Raha, the chief economist for Washington State's Economic and Revenue Forecast Council. So the state fared relatively well. But the state's lack of a personal or corporate income tax means it must wait until people and companies start spending again to shore up its finances.

But CanagaRetna, from the Council of State Governments, says many signs point to an economy that is near recovery. People are shipping more goods through package companies like UPS and FedEx than they ever have before. Companies have amassed \$2 trillion in cash, a higher percentage of the total economy than any time in the last half century. CanagaRetna says that means they will be poised to spend it

soon, either on capital improvements or on hiring new workers.

“For the first time in three or four years, I’m a little optimistic on where the economy is go-

ing,” he says, “but with the cautious note that states still have some sizable challenges to deal with.”