How The Recession Affects State and Local Tax Shortfalls — and How Those Shortfalls Affect the Recovery

BY RICHARD KAGLIC

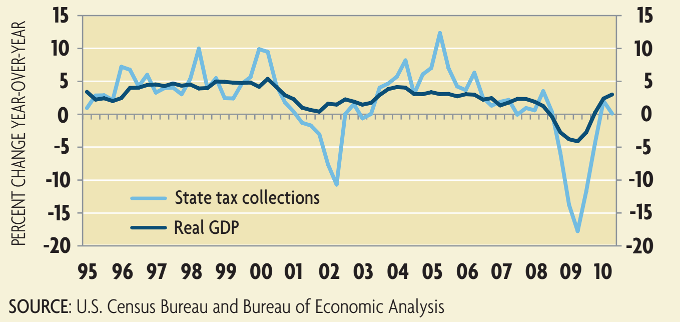
On Sept. 20, 2010, the National Bureau of Economic Research declared an official end to the worst recession in the United States since the Great Depression, pegging the trough at June 2009. But the pace of recovery since that time has hardly been gratifying: GDP growth has averaged less than 3 percent in those five quarters as compared to an average of nearly 7.5 percent in the six quarters following the trough of the 1982 recession. Moreover, the Census Bureau's latest annual report on income, poverty, and health insurance coverage in the United States, also released in September, estimated that the number of Americans living in poverty in 2009 was higher than at any point in the 51-year history of the series. So while it is welcome news that the economy is growing again, the Census report provided a timely reminder that struggles continue for many Americans.

Much of the burden of providing vital services — such as job training, health care, and transportation services — to those who have been adversely affected by the downturn often falls on state and local governments. Yet state and local governments have been battered by the recession as well. Tax revenue collections fell well short of planned levels when the recession was at its worst, and governments faced increasing demand for their services, rendering those revenue declines even more problematic.

While the primary cause of these revenue shortfalls is the severity of the most recent recession, another factor is that governments have increasingly moved to funding long-term and relatively predictable expenditure outlays with cyclical (and often volatile) revenue streams. As a result of this mismatch, budgets appear to have become much more vulnerable to downturns in the business cycle. The problems associated with this imbalance will likely grow worse before they get better. The deep recession and slow recovery have left taxpayers and policymakers with little appetite for new "revenue enhancements." As households struggle to rebuild their own balance sheets, it appears the last thing they feel obligated to do is rebuild the government's, and elected officials have acted accordingly.

This essay examines the effect that the 2007-2009 recession has had on states' fiscal positions and, in turn, how those fiscal positions are affecting the nascent economic recovery, particularly in the Fifth District. The emphasis is on the five states that make up the region: Maryland, North Carolina, South Carolina, Virginia, and West Virginia.

GDP and State Tax Revenues



SOURCE: U.S. Census Bureau and Bureau of Economic Analysis

The Recession's Effect on State Tax Revenues

The immediate problem faced by state and local governments is predominantly a revenue-side phenomenon. This is not to say that expenditures played no role in the yawning budget gaps that emerged during the recession. But it was not a rise in expenditures that threw governments' budgets out of balance; it was a sudden and unexpected fall in revenues. Since nearly all states (including each of the five Fifth District states) are required to balance their budgets, this is a problem.

State and local tax revenue collections are directly related to economic activity. When the economy picks up, firms boost output and hire more workers. When job growth is sustained, those workers are confident enough to increase purchases of goods, services, and new homes. With 43 of the 50 states imposing individual income taxes and all states levying sales taxes in some form, governments see increased revenues from those sources. They will also see increases in real estate transfer taxes and property taxes as housing activity and home prices increase. When the economy contracts, these trends reverse.

While predicting the directional response of tax revenue collections to changes in economic activity is easy, forecasting the magnitude of that response is far more challenging. And it has become more so over the course of the past two decades. Historically, changes in economic growth were accompanied by similar changes in general revenue tax collections. At times, tax collections would change a little faster or a little slower than GDP, but the relationship remained fairly tight.

That tight relationship appeared to break down during the recession that ended in November 2001. During that recession, which was very shallow by most measures, state level tax collections decreased far more than economic output (see chart). In a 2008 working paper, Federal Reserve

Bank of Chicago economists Rick Mattoon and Leslie McGranahan suggest that much of this break can be explained by states' increasing reliance on individual income taxes (and the rising importance of capital gains in state income tax collections) to fund expenditures. Nationwide, the average percentage of total state tax revenues derived from individual income taxes had increased from a little more than 10 percent in the early 1960s to more than 35 percent prior to the recession in 2001. This nationwide trend was evident to varying degrees in each state in the Fifth District.

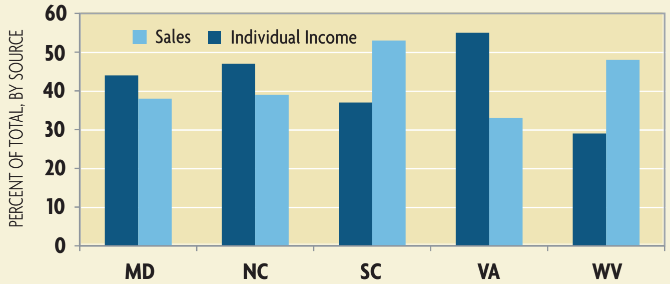
Given the 2001 experience, one could surmise that a significant economic recession would have dire consequences for state governments. The most recent downturn, with its roughly 8.5 million job losses and considerable declines in capital gains, illustrated just that. On aggregate, states saw revenues fall off precipitously in the fourth quarter of 2008 and experienced double-digit declines (year-over-year) in the first three calendar quarters of 2009. And few state governments were able to escape the carnage. According to the Center for Budget Policies and Priorities, only five states saw year-over-year increases in tax collections in fiscal 2009, when the fiscal crisis intensified dramatically. Meanwhile, 14 states experienced declines in excess of 10 percent. So the shortfalls in state tax revenue collections were both severe and widespread across the nation.

Three of the 14 states that experienced those sharp decreases in tax collections — North Carolina, South Carolina, and Virginia — are in the Fifth District. Generally speaking, states in the Northeast, the Midwest, and the West are more likely to rely on personal income taxes to pay for general expenditures, while states in the South lean more heavily on sales taxes. That generality does not always hold in the Fifth District, however (see chart). Virginia, Maryland, and North Carolina relied more heavily on individual income taxes heading into the most recent downturn, while South Carolina and West Virginia relied most heavily on sales taxes. (Even though South Carolina and West Virginia derive a greater share of their tax revenues from sales taxes than do the other three states, they saw the relative share of individual income taxes roughly triple over the past 50 years.)

Given Virginia's heavy reliance on individual income taxes, it is not surprising that its tax collections had the biggest decline among Fifth District states (-12.5 percent) when the national recession was at its worst in fiscal 2009. Yet South Carolina, which relies more on sales taxes, saw a significant drop as well (-10.5 percent). Even though South Carolina is less reliant on individual income taxes than Virginia (34 percent versus 52 percent), job losses in the state during the downturn were more severe. Total nonfarm employment in South Carolina fell about 7 percent as a result of the recession, whereas in Virginia job losses were closer to 4 percent.

Local government tax collections held up well when compared to state tax collections. As mentioned above, state level tax collections turned negative in year-ago comparisons in the fourth quarter of 2008 and remain well below prerecession peaks. As of the first quarter of 2010, local government tax collections had not yet turned negative, although their growth rate had slowed materially.

Tax Revenues by State



SOURCE: U.S. Census Bureau

The primary factor behind the relatively better performance of local tax collections lies in local tax structures. Nationwide, states derive roughly 80 percent of total tax revenues from sales and individual income taxes, on average. By contrast, local governments derive a little more than 20 percent of total taxes from these two sources and rely heavily on property taxes as a source of revenue. In fact, property taxes made up 71 percent of local government tax collections in the year prior to the latest recession. Unlike sales and individual income taxes, which are highly cyclical, the property tax base is a less volatile and more reliable funding source. Property taxes are not a major revenue source for states, typically accounting for 2 percent or less of total state tax collections annually. The one exception in the Fifth District is Maryland, where property taxes account for about 4 percent of total collections.

Budget Gaps

The sudden drop in states' tax collections nationwide left most with substantial gaps between actual and previously forecasted revenues. The tendency of demand for government services to increase during recessions only compounded the problem. Reports by the National Governors Association (NGA) and the National Association of State Budget Officers (NASBO) track the progression of states' difficulties as the economy entered the 2007-2009 recession. They reported in the spring 2007 edition of their *The Fiscal Survey of States* that only three states had to make downward adjustments to their enacted fiscal 2007 budgets, with the total cuts amounting to approximately $170 million. By the spring of 2008, the number of states forced to cut enacted budgets increased to 13 for total cuts of $5.2 billion. By the spring of 2009, 42 states cut their enacted budgets by a combined $46.2 billion. All told, states will have faced budget gaps amounting to nearly $300 billion between fiscal 2009 and fiscal 2012. Federal to state transfers provided by the American Recovery and Reinvestment Act

(ARRA) will offset roughly $135 billion of that, but very little of those funds will be available beyond fiscal 2011.

Although fiscal 2009 (which ran from July 1, 2008 through June 30, 2009) covered the worst of the economic downturn, the problems with state's fiscal conditions continued through fiscal 2010 and will likely persist much longer. In fiscal 2010, each of the five Fifth District states had to cut expenditures after their budgets had already been enacted, with those cuts ranging from $120 million in West Virginia to more than $1 billion in Virginia, according to NGA and NASBO.

The problems at the state level have had, and will continue to have, adverse effects at the local level. For local governments, having a more stable tax base only partially shields them from the deep fiscal duress that states are under. Since tax collections account for just 36 percent of their total revenues, local governments rely heavily on state governments to help them pay the bills. In fact, local governments get roughly 30 percent of their total revenues from the states. In the most recently completed fiscal year (2010), NASBO reported that 22 states reduced local aid to help close budget gaps; among them were Maryland, South Carolina, and Virginia.

In more normal times, local governments receive very little funding from the federal government. But these are not normal times. A large share of ARRA funds were sent directly to local governments as states pulled back on their contributions. With the ARRA funds set to run their course by the end of fiscal 2011, states will inevitably cut transfers to local governments. Thus, local governments still face considerable challenges in coming years.

Effect of Budget Cuts on GDP and Employment

To this point, we have only examined state and local government in terms of revenues. But those revenues pay for the plethora of services provided by state and local governments. And a slowdown in government spending will detract from an already modest economic recovery, at least in the short run. Moreover, the cuts will be more painful in some areas than in others. In particular, rural areas are likely to suffer more than metropolitan areas, for reasons which will be addressed in a moment.

State and local government spending, through the provision of services such as education, police protection, and health care, as well as their investments in roads, bridges, and schools, accounts for nearly 12.5 percent of GDP in the United States. Cuts in those services and investment have already been a drag on GDP growth. State and local government spending made a negative contribution to GDP growth in three of the four quarters during fiscal 2010, with the reduction shaving 0.3 percent off headline growth, on average. State and local government spending made a slight positive contribution to GDP growth in the second quarter of 2010, as those states with fiscal years ending on June 3 released their remaining budgeted expenditures.

State and local budget cuts are also affecting employment. State and local governments employed nearly 20 million workers in the U.S. That is about 15 percent of total payroll employment in the nation, more than the manufacturing and construction industries combined. As a result of the fiscal duress, state and local governments have been cutting jobs and more are likely to follow. Payroll employment in the state and local government has been declining since the recession started in December of 2007. Through the third quarter of 2010, the sector had shed about 300,000 jobs, or roughly 1.5 percent of total sector employment. Compared to the private sector, which lost about 6 percent of payroll employment, this does not look all that bad. While the private sector showed modest increases in payroll employment over the first three quarters of 2010, however, state and local government employment continued to move lower. This trend is likely to persist for several more quarters.

In the Fifth District, state and local government employment currently accounts for about 16 percent of total nonfarm employment. South Carolina, West Virginia, and North Carolina exceed the district-wide and nationwide averages while Virginia and Maryland have slightly lower averages. To date, cuts in Fifth District state and local government jobs have not kept pace with national declines. This scenario is unlikely to persist given the severe revenue declines in Fifth District states.

An important common thread in both levels of government is the preponderance of education jobs. Combined employment in education accounts for more than one half of all government jobs at the state and local levels. Governments are reluctant to reduce funding for education, even in moderately tough economic times. Nonetheless, the severe drop in revenues has led to declines in education funding and education jobs. Overall, state and local educational employment is down between 1 percent and 1.5 percent since its peak in mid-2008, with the majority of that decline at the local level. It is unlikely that state educational institutions can maintain current staffing levels with such severe declines in revenue, even with increased enrollment and an ability to hike tuitions.

The cutbacks in education and other state and local government spending are likely to

QUICK FACT

Localities generally did better than states in maintaining their tax revenues during the recession. On average, states derive roughly 80 percent of total tax revenues from sales and individual income taxes. In contrast, local governments rely mainly on property taxes. In fact, property taxes made up 71 percent of local government tax collections in the year prior to the recession. Unlike sales and individual income taxes, which are highly cyclical, the property tax base is a less volatile and more reliable funding source.

affect rural areas disproportionately. In a 2010 essay for the Federal Reserve Bank of Kansas City, Alison Felix and Jason Henderson show that state government transfers account for a far greater share of rural governments' total revenue compared to their metropolitan counterparts. Likewise, state and local governments account for a larger percentage of total payroll employment in rural counties, and an even larger share of personal income. Inasmuch as West Virginia and the Carolinas have the largest rural populations of Fifth District states, these problems have particular significance.

QUICK FACT

States in the Northeast, the Midwest, and the West are more likely to rely on personal income taxes to pay for general expenditures, while states in the South lean more heavily on sales taxes.

Longer-Term Liabilities

While the general purview of this essay is state and local government deficits, their efforts to eradicate those deficits, and what impact those efforts may have on the recovery, there is a large, longer-term problem looming on the horizon for many states and it would be remiss to ignore the subject completely. And that problem is an alarming underfunding of state and local governments' retirement and other post-employment benefits. Recent research by the Center for Retirement Research suggests that the total liabilities of state and local government post-employment benefits amount to approximately $4.9 *trillion*, of which $2.2 trillion is unfunded. Moreover, as state and local governments continue to struggle with yawning gaps between general fund revenue collections and general fund expenditures, many have slowed their contributions to their already-underfunded retirement funds. While 49 of the 50 U.S. states are obligated to pay for current expenditures with current revenues, few are obligated to properly fund their longer-term expenditure obligations. Unfortunately, few have.

Conclusions

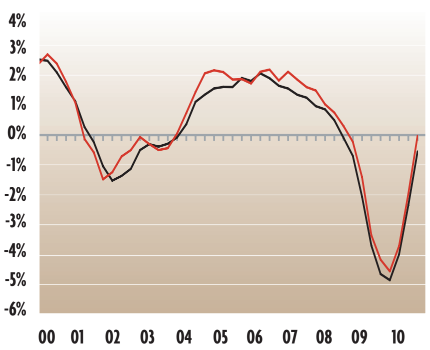
State and local governments are facing their most challenging fiscal positions since at least the Great Depression. While certainly difficult to predict ahead of time, the fiscal crisis is understandable when considering the lessons of the 2001 recession and the severity of the most recent economic downturn, especially the job losses. An inability to pay for key services has already affected economic growth in many areas through cuts to services, investments, and employment (which continues to trend downward). Governments need to find better ways to match their long-term and fairly predictable expenditure plans with similarly reliable funding sources to minimize the gaps that are otherwise bound to form during an economic downturn. This will help limit the effect of downturns on government services. Moreover, policymakers will have to find a way to provide the services and produce the investments that enhance long-term economic growth while also meeting the needs of their most vulnerable citizens more efficiently. Given the magnitudes of the budget shortfalls following the most recent recession, it is unlikely that governments will be able to tax their way out of the crisis. States will probably have to rely on a combination of "revenue enhancements" and spending cuts to get their fiscal houses back in order. **RF**

State Data, Q2:10

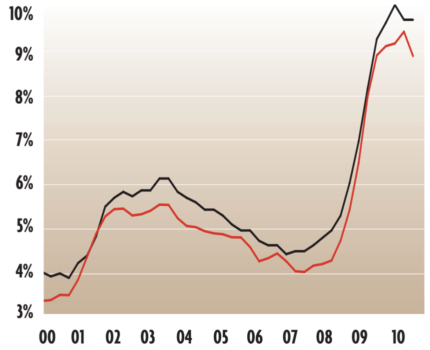
	DC	MD	NC	SC	VA	WV
Nonfarm Employment (000s)	**710.6**	**2,525.9**	**3,891.8**	**1,825.5**	**3,639.1**	**741.3**
Q/Q Percent Change	0.4	1.4	0.7	0.5	1.1	1.0
Y/Y Percent Change	1.2	-0.1	0.0	0.3	-0.2	-0.9
Manufacturing Employment (000s)	**1.4**	**114.6**	**431.6**	**208.2**	**230.2**	**50.1**
Q/Q Percent Change	5.0	-0.8	0.4	0.4	0.5	1.6
Y/Y Percent Change	0.0	-3.6	-4.3	-2.9	-4.1	-1.9
Professional/Business Services Employment (000s)	**151.1**	**389.8**	**473.7**	**213.2**	**641.9**	**58.9**
Q/Q Percent Change	0.2	0.2	1.6	3.3	1.0	0.9
Y/Y Percent Change	2.3	1.5	2.8	7.4	0.7	-1.0
Government Employment (000s)	**249.0**	**498.2**	**749.0**	**360.1**	**702.1**	**150.9**
Q/Q Percent Change	1.1	2.3	2.9	2.3	1.4	0.8
Y/Y Percent Change	3.8	0.8	5.0	3.4	0.0	-0.4
Civilian Labor Force (000s)	**337.5**	**2,965.3**	**4,563.0**	**2,158.6**	**4,190.8**	**786.0**
Q/Q Percent Change	0.4	0.2	0.3	-0.7	0.6	-0.2
Y/Y Percent Change	1.9	-1.1	0.2	-1.2	-0.1	-2.2
Unemployment Rate (%)	**10.5**	**7.3**	**10.4**	**11.1**	**7.1**	**8.8**
Q1:10	11.8	7.6	11.1	12.4	7.1	9.4
Q2:09	9.7	7.0	10.9	11.7	6.8	7.8
Real Personal Income ($Mil)	**38,066.3**	**254,753.4**	**305,343.2**	**137,606.4**	**322,400.1**	**54,137.5**
Q/Q Percent Change	1.3	1.1	1.5	1.6	1.3	1.3
Y/Y Percent Change	1.1	0.6	1.7	1.4	0.6	0.5
Building Permits	**31**	**3,471**	**9,635**	**3,959**	**5,695**	**580**
Q/Q Percent Change	-89.6	16.3	5.5	-10.3	9.7	38.1
Y/Y Percent Change	-11.4	35.9	-3.0	-3.3	-1.6	36.8
House Price Index (1980=100)	**561.5**	**432.3**	**320.3**	**324.2**	**412.0**	**226.8**
Q/Q Percent Change	0.0	-1.0	-0.3	-1.2	-0.2	0.8
Y/Y Percent Change	0.1	-5.6	-4.8	-5.8	-4.3	-1.1
Sales of Existing Housing Units (000s)	**10.4**	**86.0**	**162.4**	**84.8**	**118.4**	**28.4**
Q/Q Percent Change	23.8	16.8	18.7	23.3	8.8	7.6
Y/Y Percent Change	36.8	29.5	31.4	26.9	-6.1	16.4

NOTES:
Nonfarm Payroll Employment, thousands of jobs, seasonally adjusted (SA) except in MSAs; Bureau of Labor Statistics (BLS)/Haver Analytics, Manufacturing Employment, thousands of jobs, SA in all but DC and SC; BLS/Haver Analytics, Professional/Business Services Employment, thousands of jobs, SA in all but SC; BLS/Haver Analytics, Government Employment, thousands of jobs, SA; BLS/Haver Analytics, Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics, Unemployment Rate, percent, SA except in MSA's; BLS/Haver Analytics, Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics, Sales of Existing Housing Units, thousands of units, SA; National Association of Realtors®

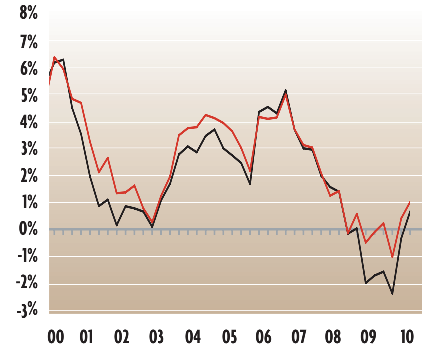
Nonfarm Employment
Change From Prior Year
First Quarter 2000 - Second Quarter 2010



Unemployment Rate
First Quarter 2000 - Second Quarter 2010

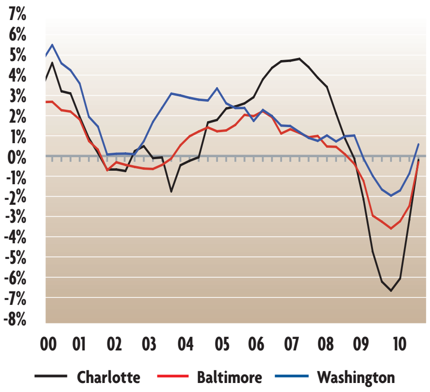


Real Personal Income
Change From Prior Year
First Quarter 2000 - Second Quarter 2010

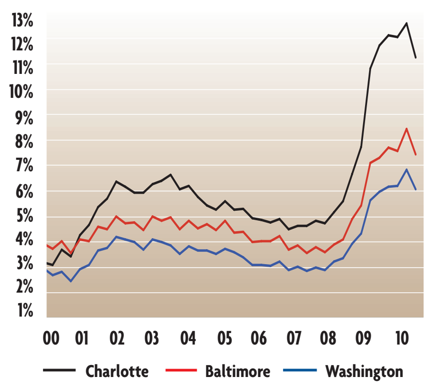


Fifth District — United States

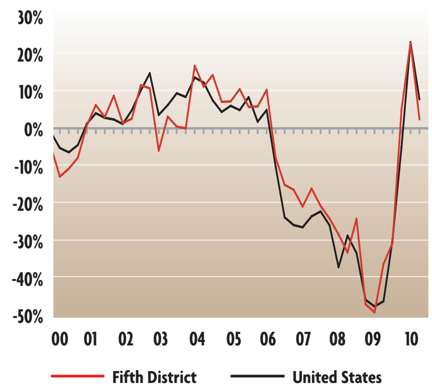
Nonfarm Employment Metropolitan Areas
Change From Prior Year
First Quarter 2000 - Second Quarter 2010



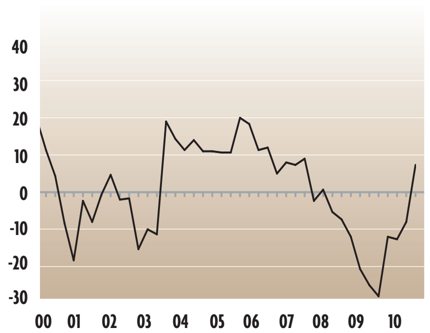
Unemployment Rate Metropolitan Areas
Change From Prior Year
First Quarter 2000 - Second Quarter 2010



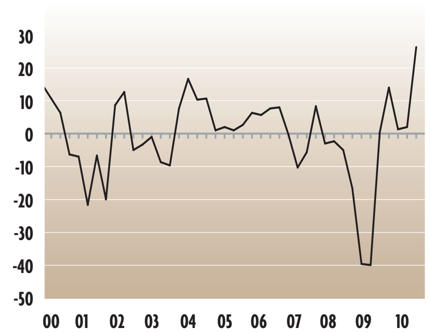
Building Permits
Change From Prior Year
First Quarter 2000 - Second Quarter 2010



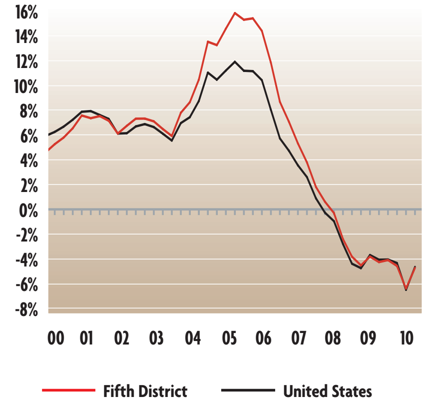
FRB—Richmond Services Revenues Index
First Quarter 2000 - Second Quarter 2010



FRB—Richmond Manufacturing Composite Index
First Quarter 2000 - Second Quarter 2010



House Prices
Change From Prior Year
First Quarter 2000 - Second Quarter 2010



NOTES:
1) FRB-Richmond survey indexes are diffusion indexes representing the percentage of responding firms reporting increase minus the percentage reporting decrease.
The manufacturing composite index is a weighted average of the shipments, new orders, and employment indexes.
2) Building permits and house prices are not seasonally adjusted; all other series are seasonally adjusted.

SOURCES:
Real Personal Income: Bureau of Economic Analysis/Haver Analytics.
Unemployment rate: LAUS Program, Bureau of Labor Statistics, U.S. Department of Labor, http://stats.bls.gov.
Employment: CES Survey, Bureau of Labor Statistics, U.S. Department of Labor, http://stats.bls.gov.
Building permits: U.S. Census Bureau, http://www.census.gov.
House prices: Federal Housing Finance Agency, http://www.fhfa.gov.

Metropolitan Area Data, Q2:10

	Washington, DC	Baltimore, MD	Hagerstown-Martinsburg, MD-WV
Nonfarm Employment (000s)	**2,414.2**	**1,277.9**	**96.9**
Q/Q Percent Change	2.4	3.5	2.6
Y/Y Percent Change	0.6	-0.3	-1.0
Unemployment Rate (%)	**6.1**	**7.4**	**9.4**
Q1:10	6.8	8.4	11.2
Q2:09	6.0	7.3	9.4
Building Permits	**3,157**	**1,314**	**271**
Q/Q Percent Change	-7.1	-10.8	59.4
Y/Y Percent Change	10.3	24.7	54.9

	Asheville, NC	Charlotte, NC	Durham, NC
Nonfarm Employment (000s)	**166.1**	**811.4**	**287.4**
Q/Q Percent Change	2.6	1.9	1.9
Y/Y Percent Change	-0.8	-0.2	0.6
Unemployment Rate (%)	**8.5**	**11.2**	**7.4**
Q1:10	9.9	12.6	8.2
Q2:09	9.2	11.7	8.0
Building Permits	**389**	**1,703**	**505**
Q/Q Percent Change	25.1	-2.5	13.2
Y/Y Percent Change	20.1	-18.4	-16.7

	Greensboro-High Point, NC	Raleigh, NC	Wilmington, NC
Nonfarm Employment (000s)	**341.0**	**498.4**	**138.2**
Q/Q Percent Change	1.3	1.4	2.5
Y/Y Percent Change	-1.0	-0.6	-2.3
Unemployment Rate (%)	**10.8**	**8.4**	**9.7**
Q1:10	12.1	9.3	11.3
Q2:09	11.5	8.9	9.9
Building Permits	**518**	**1,567**	**587**
Q/Q Percent Change	-3.5	4.7	-5.3
Y/Y Percent Change	-22.6	1.0	-25.1

	Winston-Salem, NC	Charleston, SC	Columbia, SC
Nonfarm Employment (000s)	**208.7**	**290.1**	**348.0**
Q/Q Percent Change	1.4	3.0	0.9
Y/Y Percent Change	-0.1	1.1	0.2
Unemployment Rate (%)	**9.6**	**8.8**	**8.8**
Q1:10	10.8	10.2	10.0
Q2:09	10.2	9.5	9.3
Building Permits	**313**	**741**	**842**
Q/Q Percent Change	22.3	-26.1	-9.2
Y/Y Percent Change	-25.8	-19.0	-2.3

	Greenville, SC	Richmond, VA	Roanoke, VA
Nonfarm Employment (000s)	**293.8**	**601.9**	**155.3**
Q/Q Percent Change	0.7	1.9	2.0
Y/Y Percent Change	-0.8	-1.4	-0.7
Unemployment Rate (%)	**9.5**	**7.7**	**7.3**
Q1:10	11.0	8.5	8.3
Q2:09	10.4	7.5	7.2
Building Permits	**379**	**1,029**	**140**
Q/Q Percent Change	-29.2	16.5	30.8
Y/Y Percent Change	-0.3	26.7	33.3

	Virginia Beach-Norfolk, VA	Charleston, WV	Huntington, WV
Nonfarm Employment (000s)	**741.2**	**148.1**	**116.7**
Q/Q Percent Change	2.3	2.7	2.4
Y/Y Percent Change	-0.8	-1.0	0.1
Unemployment Rate (%)	**7.3**	**7.8**	**8.3**
Q1:10	7.9	9.1	9.3
Q2:09	6.7	7.0	8.0
Building Permits	**1,162**	**34**	**8**
Q/Q Percent Change	3.3	-27.7	-33.3
Y/Y Percent Change	-16.2	-10.5	-11.1

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