The State Fiscal Situation: The Lost Decade*

The fiscal condition of states deteriorated dramatically over the 2007-2009 period due to the depth and length of the “great recession”, and state officials do not expect this situation to improve substantially any time soon. Previous downturns have proven that the worst budget years for states are the two years after the national recession is declared over. States’ recoveries from the current recession, however, may be prolonged with most economists projecting a slow and potentially jobless national recovery. Moreover, even when recovery begins, states will continue to struggle because they will need to replenish retiree pension and health care trust funds and finance maintenance, technology and infrastructure investments that were deferred during the crisis. They will also need to rebuild contingency or rainy day funds and partially fund the Medicaid expansion that was part of national health care reform. The bottom line is that states will not fully recover from this recession until late in this decade.

The Recent Situation – The economic downturn started in December 2007 and likely ended in August or September 2009, making it one of the deepest and longest since the Great Depression. The National Bureau of Economic Research has not yet declared the recession over. State revenues were down 3.9 percent in the last quarter of calendar year 2008, and 11.5, 16.5, 11.4, and 4.0 percent for the four quarters of 2009, respectively. The first quarter of 2010 witnessed a 2.5 percent increase in revenues, the first increase after 5 negative quarters, but the increase was largely because of tax increases in New York and California. If these two states were excluded, the quarter would have witnessed a 1.5 percent reduction. Fortunately, revenues were up again in the second quarter by 2.2 percent. However, revenues were down 17.2 percent relative to the same period two years ago.

Revenues will likely be flat for another several quarters before turning up slowly. This precipitous drop in state revenues is consistent with past recessions in which the trough in state revenues generally coincides with the peak in unemployment. Most economists forecast that unemployment will continue to stay high throughout 2010.

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Similarly, Medicaid spending, which is about 22 percent of state budgets, averaged 7.9 percent growth in FY 2009, its highest rate since the end of the last downturn six years ago. Medicaid enrollment is also spiking, with projected growth of 21 percent over the 2008-2011 period. The combination of falling revenues, which accompany high unemployment, and an explosion in Medicaid enrollment, which occurs very late in an economic downturn, explains why a recession’s greatest impact on state budgets occurs one to two years after the downturn is over.

States’ budget problems are reflected in the latest Fiscal Survey of States, which shows states cut spending by more than $75 billion or 11.1 percent and made tax and fee increases of $23.9 billion in 2010. Even with cuts and tax increases, states are experiencing new budget shortfalls of $137 billion over the next two years, i.e. 2011 and 2012.

The American Recovery and Reinvestment Act (ARRA) – Of the $878 billion in ARRA funds, about $246 billion came to or through states in more than 40 programs. Most importantly, the $87 billion in Medicaid funds and the $48 billion in state stabilization funds were flexible and allowed states to offset planned budget cuts and tax increases. The Medicaid funds allowed states to reprogram state funds that were originally to fund Medicaid expansions, while the education money was targeted for elementary, secondary and higher education, which represents about one-third of state spending. If Congress had not made these funds available, state budget cuts and tax increases would have been much more draconian and devastating to state governments, their employees and citizens. Both the ARRA Medicaid and education funds expire at the end of December 2010.

Federal Medicaid and Education Extensions – Prior to the congressional August recess, Congress passed and the President signed a $16 billion Medicaid extension which would extend funding until June 30, 2011, which takes it through the end of state fiscal year for 2012. The education funding was very different from that included in the ARRA as it required that 98 percent of the funds pass through states to local school districts and it also created state maintenance of efforts (MOE) on both elementary and secondary education and higher education. These required states to put additional funds into education at the same time that locals received the additional funds. While these funds were helpful for many states, it also over funded education in many states, distored state spending priorities, and will cause a huge cliff in 2012 for education funds.

The Recovery Period – While there is still uncertainty regarding the shape of the recovery, there seems to be a growing consensus that it will be slow. Numerous studies project that state revenues will likely not recover to the 2008 level until 2013 or 2014. A recent forecast by Mark Zandi at Economy.com showed
that the national unemployment rate, which straddled 5.5 percent during the 2001–2007 period, will not attain that level again until 2014. Similarly Zandi’s latest forecast indicated that state revenues will not return to the 2008 level in real terms until FY 2013. As mentioned above, until employment improves, state revenues will continue to grow slowly.

Deferred Investments – Even when recovery begins in the 2012–2013 period, states will be faced with a huge “over hang” in needs and will have to accelerate payments into their retiree pension and health care trust funds, as well as fund deferred maintenance and technology and infrastructure investments. They will also have to rebuild contingency or rainy day funds. All of these needs were postponed or deferred during the 2009-2011 period and will have to be made up toward the end of the decade. According to a 2007 Pew Center on the States report, states have an outstanding liability of about $2.73 trillion in employee retirement, health and other benefits coming due over the next several decades, of which more than $731 billion is unfunded.

Medicaid Expansion – In 2014, states will have to expand Medicaid to all individuals below 133 percent of poverty as part of the health care reform bill. For the newly eligible population of about 16 million individuals, the federal government will pay an enhanced match, which will average about 90 percent. The state’s share of this over the next decade is about $20 billion, according to the Congressional Budget Office. Moreover, states will incur other substantial costs as some of the 11-12 million people currently eligible for – but not enrolled in – Medicaid come onto the rolls. Despite this projected increase in Medicaid participation, states would receive only their normal as opposed to enhanced federal match. Furthermore, if states are forced to increase provider reimbursement rates to maintain access they will only receive their normal match for this cost.

The bottom line is that states will continue to struggle over the rest of this decade because of the combination of the length and depth of this economic downturn, the projected slow recovery, the huge list of unmet needs, and the additional Medicaid responsibilities.