The State Fiscal Situation: The Lost Decade

The fiscal condition of states deteriorated dramatically over the last two years because of the depth and length of the economic downturn, and state officials do not expect this situation to improve any time soon. Previous downturns have proven that the worst budget years for a state 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. The bottom line is that states will not fully recover from this recession until late in the next decade.

The Current Situation – The recent 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. State revenues were down 4.0 percent in the last quarter of calendar year 2008, and 11.7 and 16.6 percent in the first two quarters of 2009, respectively. These findings are consistent with the *Fiscal Survey of States* estimate that state revenues declined 7.5 percent in fiscal year (FY) 2009, which for most states ended June 30, 2009.

Revenues will likely continue down for another one or two quarters before turning up slowly. This precipitous drop in state revenues is consistent with past recessions in which the trough in state revenue generally coincides with the peak in unemployment. Most economists forecast that unemployment will continue to increase for several months and possibly into the first quarter of 2010.

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 6.6 percent in FY 2010 compared with 5.4 percent in 2009. The combination of falling revenues, which accompany high unemployment, and an explosion in Medicaid enrollment, which occurs very late in an economic downturn, explain 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 closed budget gaps of $72.7 billion in FY 2009 and $113.1 billion in FY 2010. This includes tax and fee increases of $23.8 billion in 2010. Even with cuts and tax increases, states are experiencing new budget shortfalls totaling $14.5 billion for 2010 and $21.9 billion for 2011. Given projected revenue shortfalls, however, these shortfalls will increase dramatically over the next several months.

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. States must plan for the serious cliff in revenues they will face at that time.

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 until 2014 or 2015. 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 struggle. Work by the Nelson A. Rockefeller Institute of Government similarly indicates that per capita real revenues will not reach the 2007 level until 2014. Making matters worse, economist Robert Kuttner has indicated that the states' fiscal shortfalls will be about $350 billion over the next several years.

Deferred Investments – Even when recovery begins in the 2014–2015 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.

The bottom line is that states will continue to struggle over the next decade because of the combination of the length and depth of this economic downturn and the projected slow recovery. Even after states begin to see the light, they will face the “over-hang” of unmet needs accumulated during the downturn. The fact is that the biggest impact on states is the one to two years after the recession is over. With states having entered the recession in 2008, revenue shortfalls persisting into 2014 and a need to backfill deferred investments into core state functions, it will take states nearly a decade to fully emerge from the current recession.