Current Issues

International topics

Deutsche Bank Research

December 8, 2011

Fiscal policy in US states

The recession caused fiscal stress for state and local governments in the US. Tax revenues at the state level declined for five consecutive quarters beginning in Q4 2008. And although revenues started to recover in 2010, they are currently still well below pre-recession levels. Revenues at the local level proved to be more stable due to their great reliance on property taxes.

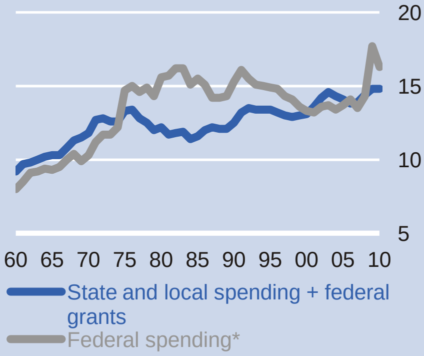
A satisfactory assessment requires the separation of cyclical revenue problems from long-term challenges in pensions and healthcare. While operating shortfalls require immediate actions in order to comply with balanced budget rules, necessary structural reforms of public pension and healthcare programmes can be well implemented over the medium term and would not trigger a fiscal meltdown in the next few years.

The slump in revenues and counter-cyclical spending forced states to close nearly USD 430 bn in shortfalls between FY 2009 and FY 2011. For the current FY 2012, that began on July 1, 2011, 42 states projected that they would face another USD 103 bn in shortfalls. With tax revenues recovering only sluggishly and federal funding provided under the American Recovery and Reinvestment Act of 2009 being phased out, states will continue to face fiscal challenges.

The debt situation of state and local jurisdictions has been over-stated by pessimistic observers. State and local debt outstanding accounted for only 16.7% of US GDP (FY 2010) – similar to levels seen in the 1980s and 1990s. Interest payments on debt recently accounted for just 4-5% of current expenditures.

Though the fiscal situation is undoubtedly challenging, warnings of state bankruptcies and mass defaults at the local level are unduly exaggerated. Under current law, states are not able to legally declare bankruptcy. Governors strongly oppose adding such a chapter to the bankruptcy code as they fear the mere option might damage credit ratings and increase the costs of borrowing.

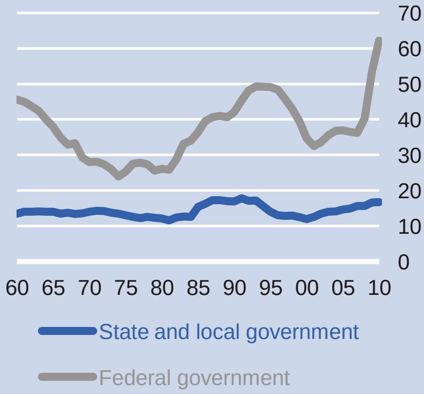
Public spending
% of GDP



*Without defence spending

Source: OMB

Debt held by the public
% of GDP



Sources: Federal Reserve, BEA, OMB

www.dbresearch.com

Author
Annika Kasparek

Editor
Klaus Deutsch
+49 30 3407-3682
klaus.deutsch@db.com

Technical Assistant
Judith Runge

Deutsche Bank Research
Frankfurt am Main
Germany
Internet: www.dbresearch.com
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

Managing Director
Thomas Mayer

Contents

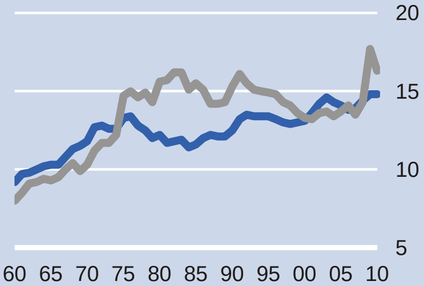
1. The role of the US subnational government sector

The economic relevance of the state and local government sector

The United States of America is composed of 50 states which are further subdivided into about 3,000 counties, 36,000 municipalities (cities, towns, villages, and boroughs), 37,400 special districts, and 14,600 public school systems. With public interest mostly centering on political events at the federal level, the US state and local government sector often does not receive much attention. Yet, in aggregate, it plays a vital role within the US economy.

In fact, according to historical data provided by the US Office of Management and Budget (OMB), state and local spending from own sources plus federal grants has grown almost steadily over the last 50 years and recently accounted for about 14% of US GDP. In most fiscal years since 2000, the subnational government sector even outspent the federal government. However, this trend was reversed in 2009 due to a sharp increase in federal spending intended to soften the impact of the recession.[1]

Public spending
% of GDP

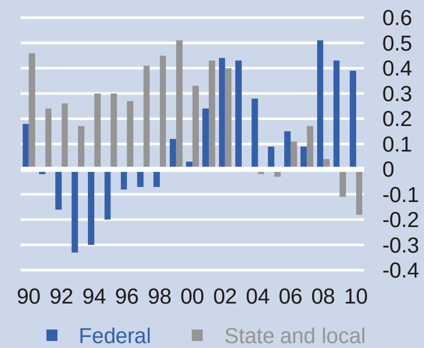


*Without defence spending

Source: OMB 1

During the 1990s as well as during the first two years of the following decade, the state and local government sector contributed around a third percentage point to real GDP growth each year. In post-recession years (2002-2004, as well as 2009/2010), however, their contribution has been negative.

Contribution change in real GDP
%



Source: BEA 2

Also, though states and localities significantly reduced their staffing levels via numerous layoffs and furloughs in response to the economic slowdown, the subnational government sector is the nation's largest employer, being responsible for about one in seven jobs.[2]

State and local responsibilities

State and local governments provide those public services that are most visible to citizens. The states' main focus is on education and healthcare. Other services funded comprise corrections, pensions and healthcare benefits, assistance to low-income families, economic development, environmental protection and aid to local governments.

County and city governments provide services such as policing, transportation, welfare payments, and job training. Special districts, the smallest governmental entities usually have a singular purpose, such as providing water or treating waste.

Healthcare and education as main spending items

According to the National Association of State Budget Officers (NASBO), Medicaid spending, representing the single largest spending item, accounted for 21.8% of total state spending in fiscal year 2010. Taken together, outlays for healthcare (Medicaid) and education (elementary, secondary, and higher education) are responsible for about half of total state spending. With respect to local jurisdictions, the most recent data on spending by type refers to 2008 when localities spent most on education (38%), followed by

1 This is true when comparing state and local outlays from own sources as well as federal grants to states with federal outlays less national defense spending and grants provided to state and local governments according to data provided by the US Office of Management and Budget.

2 Gordon, Tracy (2011). State and local finances: Where we're going. State Tax Notes, pp. 339-346. January 31, 2011.

Components of state spending
FY 2010, estimated

Medicaid	21.8%
Elementary and secondary education	20.8%
Higher education	10.1%
Transportation	8.1%
Corrections	3.1%
Public assistance	1.7%
Other expenditures	34.4%

Source: NASBO, Fiscal Survey of States, Spring 2011 3

Revenue structure of the local government sector
FY 2008

Transfers from state governments	33.3%
Property taxes	28.3%
Current charges	15.9%
Miscellaneous general revenue	7.5%
General sales taxes	4.5%
Transfers from federal government	4.2%
Other taxes	2.0%
Personal income taxes	1.9%
Selective sales taxes	1.9%
Corporate income taxes	0.5%
Transfers from local governments	0.0%

Source: US Census Bureau 4

Revenue structure of the state government sector
FY 2008

Transfers from Federal Government	28.0%
Personal income taxes	18.4%
General sales taxes	15.9%
Current charges	11.3%
Miscellaneous general revenue	8.9%
Selective sales taxes	7.8%
Other taxes	4.1%
Corporate income taxes	3.4%
Transfers from local governments	1.5%
Property taxes	0.8%
Transfers from state governments	0.0%

Source: US Census Bureau 5

spending on social services, housing, and transportation (18%) and other items such as utilities (11%) public safety (9%) and the environment (7%).

Revenue structure of state and local governments

With respect to the main sources of their revenue streams, state and local governments differ significantly. As services in some critical areas are provided in tandem with the federal government, inter-governmental transfers play an important role within the revenue structures of state and local governments.

While most states predominantly rely on their own tax revenues, primarily from personal income and sales taxes, they receive slightly more than a quarter of their revenues directly from the federal government. Local governments, for their part, derive around one-third of their receipts in the form of state aid to localities, about one-quarter from property taxes, one-tenth from sales and other taxes, and only 4% as transfers from the federal level. The rest is derived from fees and miscellaneous revenues.[3] Special purpose districts, for their part, are funded mainly by utility fees and, in consequence, have not been impacted by the recession as harshly as other localities' revenues.

State spending

States perform their fiscal activities via different funds. Unlike the federal government, most states have separate capital and operating budgets (general fund). The general fund is used to perform most discretionary expenditures of revenue derived mostly from state taxes and other continuing revenues. Federal funds represent the largest part of states' non-general fund and are received directly from the federal government. Other state funds comprise expenditures from revenue sources that are restricted by law to specific governmental services (e.g. a gasoline tax dedicated to a highway trust fund or, in case of Medicaid, provider taxes, fees, donations, assessments, and local funds). States also make use of so-called *rainy day* fund accounts to save general fund surpluses in times of prosperity in order to cushion deficits that arise when continuous revenues fall short of ongoing spending needs. Finally, borrowing through bonds is generally used to finance capital projects.[4]

Due to increased federal aid, total state spending rose in almost all categories in both FY 2009 and 2010, though a great number of governors cut back general fund spending at the same time. Along with infrastructure outlays, Medicaid spending experienced the largest increase. However, this development was not only a result of the American Recovery and Reinvestment Act of 2009 (ARRA) funds directed to states. In fact, in the course of the economic slow-down, demand for publicly financed healthcare and other public services experienced a sharp increase.

Fiscal diversity among states

As indicated, state taxes represent the most important source of revenue to state governments, with personal income tax and general sales tax representing the largest single sources of income.

---

[3] US Census Bureau (2008). Annual Surveys of the State and Local Government.
[4] National Governors Association and the National Association of State Budget Officers (2010). The Fiscal Survey of States. Fall 2010. Washington. Bohn, Henning and Robert Pinman (1996). Balanced Budget Rules and Public Deficits: Evidence from the US States. NBER Working Papers 5533.

However, the aggregate assessment of the relative importance of different tax types masks the fiscal variety that exists across states.

To name some examples, while being an important source of revenue for most states, Alaska, Delaware, Montana, New Hampshire, and Oregon do not collect a general sales tax (although they might levy various types of selective sales taxes). And of those states that collect a general sales tax, only 14 tax food purchases. The states of Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not levy personal income taxes on their residents. States that do not impose a corporate income tax are Nevada, Washington, Texas, and Wyoming.

State specific tax structures

State-specific tax structures often mirror the area's economic conditions. Those, for instance, that have significant mineral deposits (such as Alaska, Montana, New Mexico, North Dakota, and Oklahoma) rely disproportionately on severance taxes (10.5-74.5% of total revenue). 14 states do not collect any severance taxes. Florida and Hawaii, on their part, heavily rely on sales taxes to take advantage of their large numbers of visitors. Another graphic illustration of the fiscal diversity among states is the difference in tobacco excise taxes, which vary from USD 3.46 per pack in Rhode Island to only USD 0.07 in South Carolina.[5]

Stringent fiscal rules

Different balanced-budget-rules: Not all enforce budget discipline at the end of the year

State governments are facing significantly stricter revenue and spending limitations than the federal government. As is often highlighted, all states except Vermont are subjected to constitutional or statutory balanced-budget requirements. In general, these are limited to the operating budget (general fund spending). However, having such rules in place does not imply that states are not able to present a deficit at the end of a fiscal year. The differing requirements vary greatly from state to state, with some being stricter than others, and even states with such rules in place may find ways to circumvent them. Some requirements merely demand that a balanced budget be submitted by the governor or be passed by the legislature and thus do not necessarily impose fiscal discipline at the end of the year. Other states are allowed to carry over a deficit to the next fiscal year. Hence, these states are never required to actually eliminate their shortfalls. In fact, only states facing a no carry-over constraint are required to reduce their deficits to zero by the end of the fiscal year by either tapping their *rainy day* funds, enacting budget cuts, or creating additional revenue streams.

2. States still feeling repercussions of the economic downturn

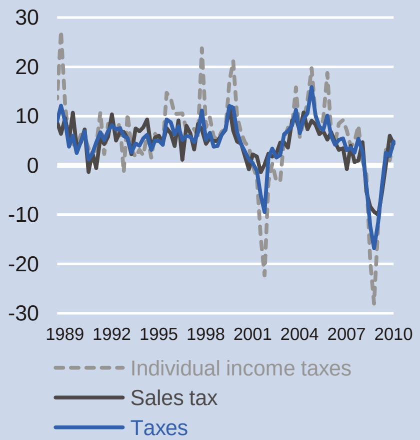
Pro-cyclical revenue structure, counter-cyclical spending

Revenues closely tied to the overall state of the economy

Due to the great dependence on tax receipts, the revenue structure of states results is strongly pro-cyclical, with revenue streams being highly dependent on the prevailing economic situation. The recent economic crisis caused state tax revenues to decline for five consecutive quarters, starting in Q4 2008. The dramatic decrease in state tax revenue was led by a sharp decline in personal income tax

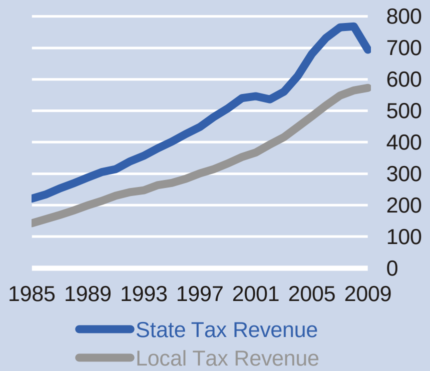
[5] Fischer, R.C., The State and Local Government Finance, contributed to a conference co-hosted by the Federal Reserve Bank of St. Louis and the Weidenbaum Center on the Economy, Government, and Public Policy at Washington University in St. Louis, April 9, 2010.

Tax revenue
% yoy, Q3 data



Source: US Census Bureau 6

Recession curbing state and local tax collections
USD bn



Source: BEA 7

receipts, mirroring significant declines in wages, salaries, capital gains, and profits that citizens experienced during the recession. Compared to previous year's levels, personal income tax revenue declined by an enormous 28% in the second quarter of 2009. With respect to the extent to which revenue declined as a result of the economic crisis, the aggregate numbers hide large differences between the individual states. US Census Bureau data for FY 2010 (ending in June 2010) shows that all states except North Dakota reported lower nominal state revenues than two years earlier. Alaska (-48%), Arizona (-22.5%), Louisiana (-20.4%), Idaho (-19.2%), and Georgia (-18.2%) suffered the largest declines in tax revenue. Towards the bottom of the list, however, West Virginia, Wisconsin, Arkansas, Maryland, New York, Vermont, South Dakota, Iowa, and Oregon merely suffered declines in tax receipts of less than 5%.

In a speech held in March 2011, Ben Bernanke highlighted that over time state revenues have become even more tied to the overall state of the economy. As a reason, he cited the growing importance of capital gains as a source of personal income taxes. In comparison to wage and salary income, capital gains are highly volatile, thus leading to instable state revenue streams. Furthermore, cyclicality of revenues is also increased by the general tendency to exempt certain necessities for which demand is relatively more stable.[6]

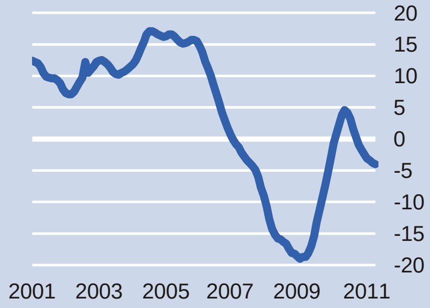
Modest hopes were sparked by state tax revenues which have been showing signs of recovery since the beginning of 2010. However, estimates by the Center on Budget and Policy Priorities (CBPP) in Q1 2011 report revenues down 9% on pre-recession levels. According to the National Conference of State Legislatures (NCSL), for 42 states, FY 2008 represented the peak year for state tax receipts. Only two states were expected to return to peak levels in FY 2011, nine more states expect revenues to fully recover by FY 2012. However, 22 states do not expect to return to peak levels until sometime between FY 2013 and 2020. For Michigan, a rebound in state revenues is not expected until FY 2020 or later.[7]

Local governments to feel recession's impact with considerable lag

Due to their heavy reliance on property taxes – a relative stable source of funds – local revenues have been less adversely affected than revenues at the state level. However, the drastic decline in house prices indicates that receipts will probably fall in the coming years as property tax assessments will be updated in order to reflect lower market values. According to the Congressional Budget Office (CBO), on average, property tax revenues lag behind changes in house prices by three years.[8] For Q1 2011 the U.S. Census Bureau reported a 1.7% decline in locally collected property tax revenue compared to the previous year's levels, marking the second quarter in a row that property tax revenues dropped from the year before. Anticipating this potential threat to revenues, several local governments increased their property tax rates in order to offset the decline in housing values.[9] In addition, current housing price developments are spurring concerns that the situation in the US housing market will not recover any time soon but is more likely to

[6] Bernanke, Ben (2011). Challenges for State and Local Governments. Speech held at the 2011 Annual Awards Dinner of the Citizens Budget Commission. New York. March 2, 2011.
[7] Several states currently do not have projections as to when tax collections will return to their peak levels. National Conference of State Legislatures (2011). State Budget Update: March 2011. Washington. April 19, 2011.
[8] Congressional Budget Office (2010). Fiscal Stress Faced by Local Governments. Economic and Budget Issue Brief. Washington. December 9, 2010.
[9] Bernanke, Ben (2011).

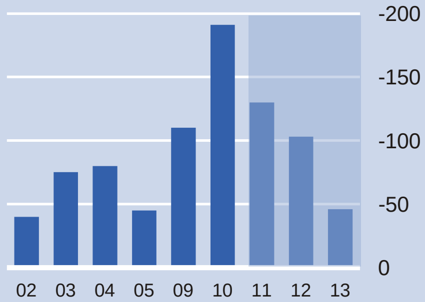
House prices boding ill for local revenues
Percentage change vs. previous year*



* S&P Case-Shiller 20-City composite not-seasonally adjusted

Source: S&P 8

State budget shortfalls in post-recession years
USD bn, 2002-2005 vs. 2009-2013



Source: CBPP survey, June 2011 9

further deteriorate. In March 2011, the S&P Case-Shiller Index, which measures the development of housing prices in 20 cities, fell by 3.8% compared to the previous year to an eight-year-low of 138.16 points. This was the sharpest decline since the end of 2009.

Probably even worse, for FY 2011, some 20 states reported reducing needed aid to local governments by redirecting funds to other program areas in order to make up for reduced tax receipts. Further cuts are envisaged for 2012, although they are being considered by a smaller number of governors. States in this context reduced and/or envisage reducing funding for specific programs run by local governments, such as K-12 education, road maintenance, as well as property tax relief in certain states.[10]

On the spending side of the ledger, states are experiencing counter-cyclical spending pressures due to an increased demand for publicly financed services, especially for healthcare, in times of economic slowdown. Along with the increase in unemployment, Medicaid enrolment during the crisis rose significantly as individuals lost job-based coverage and suffered declines in income. Also, with the number of unemployed increasing, demand for job training programs and services provided by social welfare offices rises.[11] According to the National Association of State Budget Officers (NASBO), Medicaid enrolment increased by 8.1% in FY 2010 and is estimated to increase by 5.4% in FY 2011 and by another 3.8% in FY 2012 – adding up to a 17.3% increase over the three-year period. Due to the end of higher medical support provided under the ARRA, which was phased out by June 2011, federal funds for funding Medicare are to decrease significantly, while state funds need to be increased.[12]

Large budget shortfalls throughout 2013

Unprecedented declines in state revenues along with increased spending demands forced states to close nearly USD 430 bn in shortfalls between fiscal year 2009 and 2011. Shortfalls arise if projected state revenues fall short of spending obligations. And though tax revenues are picking up, fiscal year 2012 possibly will not offer much fiscal relief. In June 2011, CBPP reported that thus far some 42 states and the District of Columbia had closed or were in the act of closing budget shortfalls totalling USD 103 bn for fiscal year 2012, adjusting downwards their March projections by USD 9 bn. CBPP further compares size and duration of the budget shortfalls that resulted from the most recent recession to gaps reported during economic slowdowns at the beginning of the decade, as well as in the early 1990s and early 1980s. They find that, in all cases, state fiscal problems lasted for several years after the recession ended. With the recent downturn having been deeper and longer-lasting than the downturn at the beginning of the decade, states probably will continue to face persistent fiscal challenges.

Revenues to recover only sluggishly

Indeed, though the state and local revenue outlook has improved over recent months, with sector tax revenues marking the sixth consecutive quarter of positive year over year growth in Q1/2011 and fewer states reporting mid-year shortfalls in FY 2011 than in the two previous years, there are still significant hurdles to fiscal recuperation. Economic recovery in the US recently lost momentum,

[10] However, for fiscal year 2012, few states have announced increases in aid to local governments.
[11] Congressional Budget Office (2010).
[12] National Governors Association and the National Association of State Budget Officers (2011). The Fiscal Survey of States. Spring 2011. Washington.

Recovery of main revenue drivers falls short of expectations

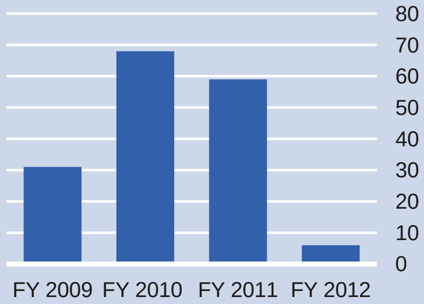
impeding necessary job creation. With US GDP increasing by only 1.8% in Q1 2011, economic growth fell short of expectations. National unemployment rose from 9.1% in May 2011 to 9.2% in June. Sluggish job growth will weigh on income tax receipts and further drive demand for Medicaid and other public services provided at the state level. Economic uncertainty and stubbornly high unemployment in addition to households' diminished wealth due to declining property values will continue to put the brakes on private consumption, further hampering the recovery of sales tax receipts. Moreover, in March 2011, the S&P Case-Shiller Index measuring house prices in the 20 largest cities fell to an eight-year-low, illustrating the backsliding of the American housing market that will affect government revenues at the local level. The assessment of the recent development of major revenue drivers for state and local governments highlights that budget gaps are likely to remain large. Looking ahead, already about 24 states are projecting aggregated budget gaps of USD 46 bn for FY 2013.[13]

Further budget cuts and revenue measures necessary

Federal assistance running out

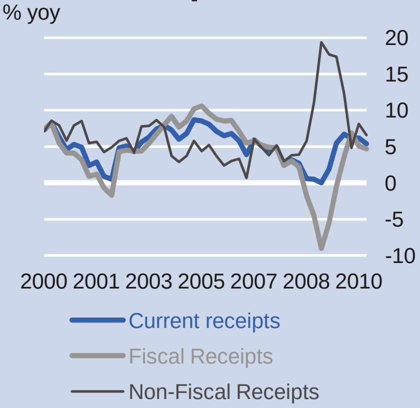
According to CBPP, federal funds provided to states under the American Recovery and Reinvestment Act (ARRA) enacted in February 2009 to help states maintain current activities totalled about USD 135 bn over a two and a half year period. Put differently, the extraordinary federal funding covered between 30% and 40% of the shortfalls for FY 2009, 2010 and 2011. Most of the money was transferred to states in the form of increased Medicaid funding and a *State Fiscal Stabilization Fund*. In August 2010, extra Medicaid funding was prolonged through June 2011 and USD 10 bn were added to the State Fiscal Stabilization Fund.[14]

American Recovery and Reinvestment Act Funds
Including August extension, USD bn



Source: CBPP, June 2011 **10**

Shift in state and local revenue components
% yoy



Source: BEA **11**

Under the ARRA, federal grants are estimated to have reached a historic peak in nominal terms and as a share of GDP and temporarily produced a shift in the revenue structure of the state government. While revenues from almost all other sources declined drastically in response to the economic downturn, federal funds increased to make up a more important share of state and local governments' total receipts.

Though – if compared to FY 2009 and 2010 – states' fiscal conditions at present appear somewhat brighter in FY 2011, the withdrawal of the ARRA stimuli, combined with the slow recovery in states' own receipts, poses significant budgetary challenges for state governors. For FY 2012, CBPP estimates that only USD 6 bn in federal ARRA dollars remain available to assist states in closing their budget shortfalls, representing only a small fraction of total ARRA transfers paid in 2009, 2010 and 2011.

Options to address shortfalls become fewer and more difficult

Partly driven by their balanced-budget rules, state governments enacted a number of measures in order to address emerging budget gaps. These include making use of federal ARRA dollars, tapping their rainy day funds, cutting spending on important public services, or raising additional revenue via taxes and fees. For FY 2012, revenues are set to still fall short of pre-recession levels and federal aid will no longer be an option to fill gaping budget holes. With costs

[13] Not all states had prepared their estimates yet. Thus, this number is likely to grow. CBPP March estimates projected 2013 gaps as high as USD 75 bn.

[14] McNichol, E., Oliff, P., Johnson, N. States continue to feel recession's impact. Center on Budget and Policy Priorities, Washington. Issues updated on March 9, 2011 and June 17, 2011.

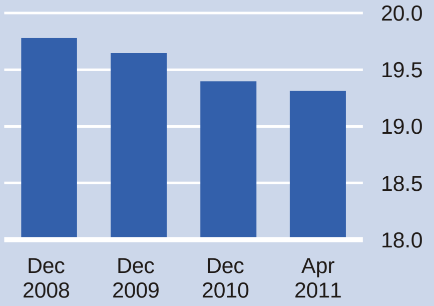
Projected FY 2012 budget shortfalls

	USD bn	% of budget FY 2012
New Jersey	10.5	36.0%
California*	23.0	27.2%
Texas	9.0	20.5%
Minnesota	3.8	20.3%
New York	10.0	17.6%
Illinois	5.3	16.0%
Connecticut	2.9	14.7%
Pennsylvania	3.7	13.4%
Florida	3.7	11.5%
Ohio*	3.0	11.1%

* California's shortfall includes an USD 8.2 bn shortfall carried forward from FY2011. After measures taken, California's remaining shortfall is USD 9.6 bn. Ohio's shortfalls are one half of the states' total projected shortfalls for the 2011-2013 biennium. Estimates of Ohio's two-year shortfall range from USD 6 bn to USD 8 bn.

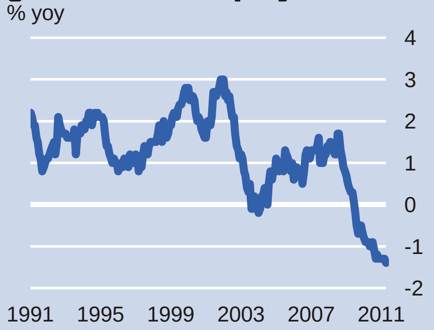
Source: CBPP, June 2011 **12**

State and local government employees
Million



Source: BLS **13**

State and local government employees
% yoy



Source: BLS **14**

to meet demand for publicly financed services continuously rising, further unpopular revenue measures and/or painful spending cuts will be necessary in order to balance budgets.

48 states have released initial budget proposals for FY 2012 – Kentucky and Wyoming operate biennial budgets and are not required to release a budget this year. While the importance of the governor's budget varies from state to state, these budgets form the baseline from which state legislative debate begins. In fact, for the fourth consecutive year, these budgets include proposed deep cuts to education, healthcare, and other core public services that will probably delay the nation's recovery, undermine necessary job creation, and imperil critical investments that will determine the future prosperity of states.

According to a CBPP report published in March, 35 out of 44 states that released the necessary data plan to spend less in 2012 than in 2008, although they face increased demand for public services. Only Alaska and North Dakota plan to increase spending. In total, CBPP estimates that general fund spending will be at 9.4% below 2008 inflation-adjusted levels.

Expenditure on the two main spending items – education and healthcare – will not be spared from cuts, although in 2012 there will be 260,000 more children in public schools, 960,000 more students enrolled in public colleges and universities than 2007-2008, and some 4 million more people enrolled in Medicaid than in 2008. Initial budgets of at least 21 states have proposed deep cuts in pre-kindergarten or K-12 spending and at least 20 states plan to curtail higher education spending. Governors of 25 states envisage cuts to healthcare-related spending.

In addition, at least 15 states have proposed layoffs or cuts in public employee payments or benefits. Since August 2008, over 450,000 jobs have been eliminated by state and local governments via massive layoffs of school teachers, university workers, police officers, firefighters, correction workers, highway and transit workers, public hospital employees, public utility employees, and park and environmental workers.

On the revenue side, more than 30 governors have proposed to balance spending cuts by raising additional revenue through the extension of expiring tax surcharges, the repeal of tax credits or deductions, the broadening of tax bases for some tax types, or by increasing tax rates. Six states propose new revenue measures in FY 2012. For instance, California's governor proposed the extension of previously enacted tax increases, including increases in income taxes, sales taxes, and vehicle license fees, in addition to major new spending reductions. In addition, Illinois enacted an increase in personal income tax and corporate tax just before its governor's budget was published. [15]

On the other hand, for the first time since the economic downturn caused state tax revenues to dwindle, there are governors proposing large tax cuts, mostly for corporations and other businesses. For instance, Florida's governor suggested cutting the state's property and corporate income tax rates. The corporate tax rate would be reduced from 5.5% to 3% next year and then be trimmed by 0.5% in each subsequent year, so that it would be entirely eliminated by 2018. Though Florida intends that this

[15] Center on Budget and Policy Priorities (2011b). Governors are proposing further deep cuts in services, likely harming their economies. Washington. March 21, 2011.

generous measure will create 700,000 jobs within seven years, the loss in revenue will have to be counterbalanced by even deeper spending cuts in order to comply with balanced budget requirements.[16]

Though most states have drained their rainy day funds in an attempt to cushion the recession's impact, eight of those states that are projecting a shortfall for FY 2012 still have access to large reserves they could tap and thus reduce the need for painful spending cuts.[17] However, only some of them envisage making use of rainy day funding to help fill the 2012 budget hole. Nebraska, for instance, has proposed using 40% of its rainy day funds in FY 2012 and an equal amount in FY 2013, leaving USD 62 million in the fund at the end of fiscal 2013. Texas' legislators agreed – albeit grudgingly – to spend USD 3.97 bn from the rainy-day fund to cover the current biennium's shortfall.[18]

Revenues to recover along with the business cycle

Though governors are struggling to balance their budgets, there are also external factors that influence the fiscal position of state and local jurisdictions in the short run. As the sector's revenues are closely tied to the business cycle, fiscal stress will ease somewhat along with expanding payrolls, rising corporate profits and revived consumer spending. However, with unemployment remaining stubbornly high and the housing market still being depressed, crucial revenue sources at both the state and local level are to recover only slowly.

Deficit-cutting actions on the federal level might worsen state and local budget woes

In addition, with the beginning of FY 2012, states are not only losing increased emergency transfers and Medicaid funds. In fact, with the federal government strongly envisaging cutting its large deficit and reducing national debt, state and local budgets could be significantly affected. According to CBPP, about one-third of what is known as federal non-security discretionary spending flows through state governments as funding for education, healthcare, human services, law enforcement, infrastructure and other areas. Congressional policymakers have proposed significant cuts to this budget item.[19] For instance, the budget compromise found in April to avert a looming government shutdown made cuts to the Community Block Grant that helps cities to improve housing options for low-income families.[20] Furthermore, states fear cuts to the federal state Medicaid program, representing around 22% of total state spending. The federal government currently contributes 56% of total Medicaid costs. With healthcare being the largest unsustainable cost driver at the federal level, future deficit-reducing measures, e.g. in the context of a compromise to lift the debt-ceiling or to agree on the FY 2012 budget, are more than likely to entail cuts to Medicaid, potentially shifting a higher burden to states or cutting coverage or eligibility.

Persistent short-run challenges

Thus, though tax revenues are recovering, the state and local short-run fiscal position remains challenging. With federal stimulus funds having largely run out and easy one-time fixes like tapping emergency funds, deferring obligations or the sale of assets being

---

16 Austerity Parade – Is Rick Scott cutting too deep. The Economist. March 17th, 2011.

17 Alaska, New Hampshire, North Dakota, West Virginia, and Wyoming also have substantial reserves but do not project a shortfall for 2012. Center on Budget and Policy Priorities (2011b).

18 Closing the gap – Texas legislature reaches for the axe. The Economist. May 26, 2011.

19 Center on Budget and Policy Priorities (2011c). States Continue to Feel Recession's Impact. Washington, March/June 2011.

20 Pew Center on the States (2011). The Debt Ceiling Debate. How a Federal Default Could Impasse States and Cities. Washington. July 2011.

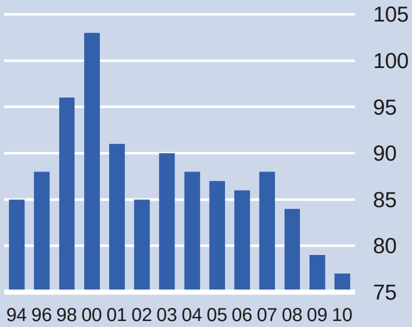
exhausted, deficit-cutting federal actions that reduce revenues or shift higher costs to the subnational level would make the sector's budget problems even worse. As a result, still deeper budget cuts might become necessary, which would impede economic recovery even more than is already likely to be the case.

3. Looming long-term pressures

Cyclical revenue problems vs. structure long-term challenges

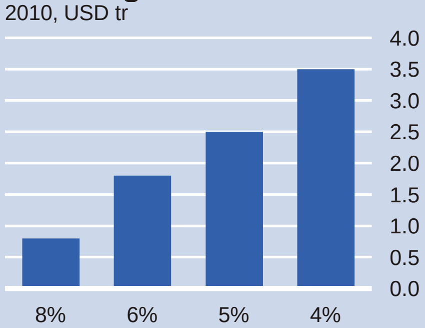
On the back of the short-run fiscal turbulences states and municipalities have been experiencing since the beginning of the 2007-2009 recession, issues related to state and local finances excited politicians and the media. Drawing an overly dire picture of states' and localities' fiscal situation, some observers in this context often failed to distinguish between temporary cyclical revenue problems brought about by the economic downturn – visible in the form of recent years' large operating budget shortfalls – on the one hand, and longer-term challenges – mainly related to bond indebtedness, unfunded pension obligations, and retiree health insurance liabilities, which existed well before the crisis set in – on the other. However, while the former call for near-term actions in order to comply with states' balanced-budget-rules, the latter demand strategic long-term solutions to be enacted over the next several years.

Funding ratios of state and local pension funds
%



Source: Munnel et al. **15**

Unfunded liabilities based on a range of discount rates
2010, USD tr



Source: Munnel et al. **16**

State pension obligations

Observers warning of a near fiscal collapse of state and local government finances frequently refer to the *unmanageable* amount of unfunded pension obligations for future retirees that has been accumulated by states and localities over the last years. However, retirement schemes represent only a very small fraction of state and local budgets (about three to four percent of spending).[21] Further-more, state and local pension contributions are not paid from operating revenues. Instead, benefits are financed by contributions from state and local governments, employees, as well as income from plans' assets. In general, state and local pension plans are defined-benefit plans, in which pre-determined benefits are calculated based on factors such as the employee's recent salary or total years of service.

Over the last decade, two main factors have led to the gradual accumulation of large shortfalls in pension funding. First, two global downturns significantly reduced the value of assets in state pension funds. Second, the sharp decline in state revenues made it difficult for states to fund pensions every fiscal year.[22] In 2000, prior to the most recent economic slowdowns, pensions – overall – were fully funded. As a consequence of the bursting of the tech bubble, funding levels dropped before restabilising with the stock price hike that reached its peak in 2007. The 2008 collapse in market asset values again induced funding ratios to decline. According to the PEW Center on the States, the nation's pension plans on average suffered a 19.1% decline in their assets' market value in FY 2009.

The Center for Retirement Research (CRR) at Boston College finds that the ratio of assets to liabilities for a sample of 126 pension plans

[21] National Association of State Retirement Administrators (2011). State and Local Government Spending on Public Employee Retirement Systems. Issue brief. Washington. January 2011.
[22] The Pew Center on the States. The widening gap – The great recession's impact on state pension and retiree healthcare costs. Washington. April 2011.

declined from 79% in 2009 to 77% in 2010, if future liabilities are discounted by the expected long-term yield of 8%. However, there are substantial variations between the funding levels of different pension plans and states. Among the poorly-funded funds there are several large plans such as those in Illinois and Connecticut. According to CRR data, almost two thirds of the surveyed plans fell short of the officially recommended minimum funding level of 80%.[23]

Large variation in the amount of unfunded liabilities estimated

Estimates of the total dollar amount of unfunded liabilities range between USD 800 bn and USD 3.5 tr, depending on the modelling assumptions used. The considerable variation in the estimates is due to the discount rate, i.e. the interest rate used to calculate the present value of future pensions.[24]

State bankruptcy as a way to escape pension obligations?

In the eyes of pessimistic policy watchers, the only way to reduce these enormous spending pressures would be to legally declare bankruptcy. This would not only affect pensioners but also municipal bond holders. Under current law, however, states – unlike localities – are not allowed to legally declare bankruptcy. There is absolutely no doubt that improvements to pension plans' policies are inevitable although, to some extent, pensions' funding will recover automatically as the economy recovers, leading to higher returns on assets.

First reform steps already taken

In 2010, state and local governments already implemented modifications to improve the long-term sustainability of their retirement plans. According to CBPP information, more than 20 states reduced pension costs in recent years by raising the length of service and age requirements for receiving a pension or reducing the factor that determines the percentage of salary that an employee receives as a yearly pension payment. Other states increased the contributions that employees themselves need to make towards their pensions.

Pension obligations do not pose bankruptcy risk to states

As uncomfortable as the situation may be, unfunded pension obligations currently do not expose state and localities to the risk of being forced to legally declare bankruptcy or force them to seek federal financial assistance. In fact, most plans are able to cover benefit payments for the next 15 to 20 years.[25]

Retiree healthcare bills

State and local retiree health plans

Some jurisdictions guaranteed health insurance benefits to their employees that will continue into retirement and bridge the gap between retirement and Medicaid eligibility at age 65. Retiree health plans differ widely in terms of the share of the premium that is subsidized by the state (ranging from 0 to 100%).

For FY 2009, the Pew Center on the States estimates states' liabilities from retiree healthcare benefits at about USD 635 bn – of which only 5% have been funded so far. Even worse, they find that just two states, Alaska and Ohio, accounted for more than half of total contributions made in FY 2009. Nineteen states were found to have not set aside anything to fund retiree healthcare commitments made. Instead, they fund health insurance benefits on a pay-as-you-go basis, from operating revenue. Especially for those states that

[23] Munnell, Alicia H., Jean-Pierre Aubry, et al. (2011). The Funding of State and Local Pensions in 2010. Center for Retirement Research, Boston College. State and Local Pension Plans No. 17. May 2011.

[24] The 8 percent rate mirrors the historical return on plans' assets over the previous two decades; 4 to 5 percent estimates rely on the returns from the safest investments, e.g. Treasury bonds.

[25] Center on Budget and Policy Priorities (2011a). Misunderstandings regarding state debt, pensions, and retiree health costs create unnecessary alarm. Washington. January 20, 2011.

have made large commitments, this might result in an enormous fiscal burden.

Subnational governments have flexibility to modify conditions

Yet, as the CBPP counters, retiree health benefits are not generally legally binding – in contrast to pension commitments. States and localities thus have the major advantage that they have the flexibility to modify provisions, the duration of services, or the share of the premium that retirees must pay themselves in order to ensure that their obligations remain affordable, given that healthcare cost growth is projected to continue to outpace revenue growth.[26]

Structural problems

Besides long-term pension and retiree healthcare issues, several states are confronted with substantial structural problems arising from high rates of cost growth for their main spending items, outdated revenue structures, and flaws within their budget processes.

Outdated tax systems

Causes of deep shortfalls often include unbalanced or outdated tax systems that have not been altered to keep up with the structural changes which the US economy has undergone over the last few decades. This leaves important revenue potential untapped. Texas, for instance, does not impose taxes on personal income or capital gains but instead relies heavily on sales tax revenues and receipts from property tax and various business taxes. Efforts to raise additional revenues by imposing new taxes are highly unpopular.[27] Illinois has a flat, low-rate income tax that fails to adequately capture income growth and in addition exempts most types of income earned by elderly people.

Unbalanced tax systems

Many states rely largely on revenue derived from personal income taxes, which are highly volatile and thus resulting in unstable revenue streams, impeding efficient financial planning. Furthermore, California, for instance, derives an important share of its revenues from capital gains, which are subject to even greater swings.[28]

Services often go untaxed

“Amazon” tax

Sales tax revenues tend to be more stable. However, although the consumption of services represents a rising share of consumer spending, many state and local retail sales taxes often do not apply to sales or consumer purchases of most services. And despite the fact that internet commerce has gained importance and telecommunications and exotic forms of commerce have multiplied, since internet sales companies are not physically present in most states, state sales taxes cannot be applied to online sales. However, to tap this revenue potential, California recently passed a bill that obliges online sales companies to charge and transfer a sales tax. The measure is supposed to generate additional state revenues of USD 200 m.

Tax systems do not reflect demographic realities

Furthermore, states have failed to adjust their tax systems to factor in important demographic changes. Though income has become more concentrated among the wealthy, most state tax systems fail to tax the rapidly growing incomes of the top 1-5% of earners. State and local income taxes also often provide preferential treatment for retired individuals. Illinois, as indicated, which is chronically short of revenues, exempts most of the income received by elderly individuals, regardless of their income levels.[29]

Reforms necessary

Though state and local tax revenues are to recover along with the overall state of the economy, reforms to tax systems need to be

---

[26] ibid.
[27] The Texas Budget: Closing the gap, The Economist, May 26, 2011.
[28] Hube, Karen (2011). Instead of signs of recovery, a sucker punch for state budgets. The Washington Post. May 28, 2011.
[29] Fischer, Ronald C. (2010); Center on Budget and Policy Priorities (2011a).

enacted in order to reduce volatility of revenues and unlock untapped revenue potential. The introduction or an increase of sales taxes could reduce uncertainty in states that overly rely on unstable income tax revenues. An extension of the sales tax base in order to apply to services and internet sales furthermore is necessary to adjust states‘ revenue structures to today’s economy. Furthermore, with the US population aging, the cost of preferential treatment of income received by elderly people is expected to rise significantly.

Accurate multi-year budgeting required

As CBPP criticises, only a few states’ budgets include accurate projections of revenues and expenditures, adjusted for expected cost inflation and utilization changes, for as much as four years into the future. Such information, however, is necessary when trying to assess the long-term impact of budget measures taken, especially when they are enacted over several years.[30]

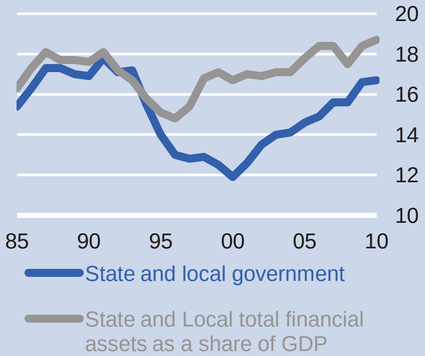
Unsustainable cost growth

On the spending side, unsustainable rates of cost growth for health-care and education represent the biggest challenge. Healthcare costs are projected to grow faster than revenues over the next few years and also education spending growth has already exceeded GDP growth over the last 20 years. While states struggle to improve efficiency in these areas, there are limited opportunities to effectively reduce cost growth of these items.

4. Bankruptcy debates

State and local assets vs. debt outstanding

%



Sources: Federal Reserve Statistical Release, Flow and Funds Accounts of the United States; BEA 17

Should states be allowed to declare bankruptcy?

States can look back on a strong record of repaying their debt. About half of them attribute high or even highest priority to debt service. The only default observed in more than a century was in Arkansas back in 1933. Under federal law, states currently are not able to declare bankruptcy since they are considered sovereigns. In January 2011, with fiscal conditions in most states still tense, a fierce debate emerged on the question of whether to allow states to file bankruptcy in order to give them a chance to restructure their obligations. State governors largely rejected the proposal, fearing that a mere option could severely damage credit ratings and increase the cost of borrowing. In fact, state governors have at their disposal a number of other effective instruments like the power to cut spending or raise additional revenue in order to deal with fiscal challenges. As a report issued in February 2011 by the National Association of State Budget Officers concludes, although the states’ fiscal situation is undoubtedly challenging and will demand some painful measures, recent warnings on dramatic events such as state defaults and bankruptcy are unduly exaggerated.

Defaults and bankruptcies at the local level

Around the turn of the year, warnings of catastrophic mass defaults in the US municipal bond market grew louder resulting in increased yields on municipal bonds and even inducing some investors to quit the market. Though some cities are still struggling, by May 2011, yields had fallen again and investors re-entered the stage. Unlike states, local governments that are unable to shoulder their fiscal burden any longer may legally default on their debt or file for bankruptcy. However both events are extremely rare. The great majority prioritize debt payments over spending for other government services.

[30] Center on Budget and Policy Priorities (2011a).

Defaults of cities and counties are rare

In fact, of the 18,400 municipal bond issuers rated by Moody's from 1970-2009, only 54 defaulted. Of these, only a small fraction came from cities and counties as these primarily made use of other measures to weather temporary revenue crises, such as cutting spending or raising new revenues. Examples of localities that were forced to default on their debt are Orange County, California (1994) and Vallejo, California (2008), which is currently emerging from bankruptcy. Jefferson County, Alabama, that already filed for chapter 9 protection in 2003, finds itself confronted with a USD 3.2 bn debt owed as part of a massive sewer project in the 1990s.[31]

Between 1988 and 2009 about 170 jurisdictions have declared bankruptcy. The municipal bankruptcy process is established in federal law and enables local governments to restructure its debt and obligations. Laws in 26 states allow local governments to file for bankruptcy. The advantages that come along with such a process are for instance the possibility to implement debt restructuring programs without the consent of every creditor or to reduce labour costs more easily, by facilitating the agreement of employee unions to changes in labour contracts. For instance, Vallejo, California – which filed for bankruptcy in 2008 – was able to significantly reduce labour costs by restructuring its labour arrangements and reducing healthcare obligations to retirees.

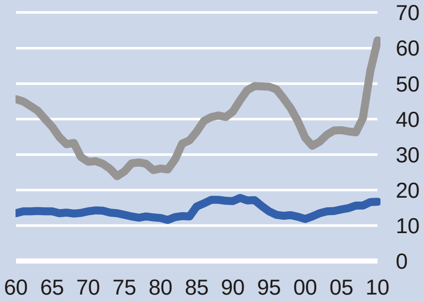
No catastrophic increase in default levels expected

Though observers forecast that there might be somewhat greater numbers of municipal defaults over the next few years, starting from a historical default rate of less than one-third of 1% the situation should become anything but catastrophic.[32]

5. Conclusions

Debt held by the public

% of GDP



Sources: Federal Reserve, BEA, OMB **18**

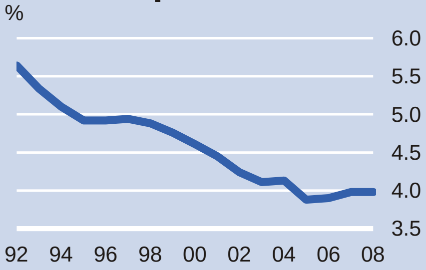
The debt problems of states have been exaggerated. Compared to the federal level, state and local debt levels are moderate. State and local government debt outstanding amounted to 16.7% of GDP at the end of FY 2010. Apart from a brief low of 12% in 2000, this is similar to the average levels seen between the mid-1980s and the mid-1990s. According to US Federal Reserve data, the amount of municipal bonds outstanding amounted to USD 2.925 trillion at the end of 2010, of which USD 2.450 trillion were issued by state and local governments. During the recent downturn, the amount of bonds outstanding has risen only slightly, mostly induced by the Build America Bond (BAB) programme enacted by the federal government to encourage infrastructure development and thereby create jobs. The federally subsidised bond programme was part of the ARRA and expired in December 2010.

Most debt issued by subnational governments is long-term debt issued to finance capital expenditures such as infrastructure projects. However, there have been some exceptions where states issued bonds in order to finance their ongoing spending needs. Interest payments on municipal bonds recently accounted for only 4-5% of current expenditures, no more than in the late 1970s. Though the amount of debt that can be issued is limited by state law or the state constitution, states' and localities' ability to raise revenue from the sale of bonds is ultimately restricted by the interest they

31 Everett, Burgess (2011). Alabama county faces bankruptcy. POLITICO, July 26, 2011. CBO (2010).

32 National League of Cities. Crying Wolf on Municipal Defaults. Part 2. National League of Cities. January 12, 2011.

Interest on debt as a share of total expenditures



Source: US Bureau of the Census 19

need to pay on their debt. Historically, interest rates on municipal bonds have been tied closely to Treasury securities. Rating agencies have already announced that a potential credit downgrade of the US would immediately lead to lower credit ratings for several states and a large number of local issuers. Furthermore, in the context of the federal government focusing on deficit reduction, states and cities worry that the federal tax exemption for newly issued municipal bonds could be eliminated, inducing investors to demand higher returns on municipal debt.[33]

However, states and localities have at their disposal a considerable amount of assets standing towards their explicit debt and implicit pension and other liabilities. As for the end of 2010, they held USD 2.7 trillion in financial assets (18.7% of GDP) apart from employee retirement funds and nonfinancial assets such as buildings.

State and local debt

— Debt levels for the sector have increased but remain moderate. The total amount of municipal bonds outstanding – having been stable during the 1990s – more than doubled after 2000, reaching USD 2.9 tr in 2010. Total municipal issuance surpassed USD 434 bn in 2010, exceeding the 2007 record of USD 429.9 bn.

— Municipal bonds tend to be sold internally. Most state and local bonds pay investors interest that is exempt from federal income taxes (BABs being an exception).

— Local governments account for roughly 61% of the debt issued, a share that did not change significantly during the 1995-2008 period.

— As of 2010, 94% of state and local debt outstanding was long-term in nature. Short-term notes are issued to balance short-run cash-flow mismatches.

— The majority of long-term bonds are revenue bonds, secured by receipts derived from the facility funded by the debt issued (e.g. roads, bridges, schools, etc.). According to S&P information, only USD 470 bn or 16% of state and local debt outstanding at the end of 2010 took the form of general obligation bonds, secured by the full faith and credit of the issuer.

— Borrowing in order to fund ongoing spending needs is prohibited in many states. Over the last four years, fewer than a dozen states issued as little as USD 18 bn in debt for budget management purposes – California, Connecticut, Illinois and Arizona accounting for roughly 87% of this debt.

Sources: S&P, US Census Bureau, US Federal Reserve

The U.S. state and local government sector undoubtedly faced significant short-run challenges brought about by the 2007-2009 recession which are likely to partly persist over the next few fiscal years. Yet, a thorough assessment of the sector's fiscal position - properly separating cyclical short-term revenue problems from long-run structural challenges – illustrates that the overall situation is not as dire as pessimistic observers indicate. Admittedly, the aggregate perspective masks major differences between the states.

While states at present are waiting for their revenues to fully recover, local jurisdictions' strong reliance on property tax receipts means that they probably haven't seen the worst of recession's impact yet. With tax receipts dwindling and spending pressures especially on healthcare services soaring along with the economic downturn, states over the last few years have had to close large budget gaps by cutting spending on vital services or enacting unpopular revenue measures. As budget shortfalls in some states are to persist at least throughout 2013, the withdrawal of increased federal funding and the fact that easy spending cuts and light revenue measures have been exhausted, more painful spending

33 Pew Center on the States (2011).

cuts, massive layoffs, and unpopular revenue measures are to expect, which will further weight on economic growth. Deficit-cutting actions at the federal level in addition might potentially result in reduced assistance for critical co-funded programs. In this context, compromises on the federal debt ceiling and the FY 2012 federal budget produce hightened fiscal uncertainty to state and local governments as they might entail pernicious reductions in assistance for Medicaid and education. More, a potential credit downgrade of U.S. Treasury bonds might result in lower credit ratings for a number of states and many localities, raising borrowing costs and access to capital markets.

Other than at the federal level, municipal debt increased only slightly on the back of the recession and, cumulatively, state debt levels remain low. Debt issuance for budget management purposes has been limited so far, mainly due to legal restrictions that curb states from borrowing for spending purposes other than capital infrastructure expenditures. Furthermore, contrary to the doom-and-gloom spread by pessimistic observers, neither unfunded pension obligations nor retiree healthcare commitments currently put states at immediate risk of bankruptcy. At the local level, once recession's full impact translating into local revenue, bankruptcy and default numbers might increase moderately, although both events are expected to remain rare. However, there is no doubt that state and local policymakers urgently need to address looming long-term challenges, which are otherwise likely to translate into serious fiscal problems in the future. Although they do not pose an imminent threat yet, state and local pension funds and retiree healthcare commitments are in dire need of reform in order to keep them affordable. Moreover, to improve their finances, subnational jurisdictions need to correct the structural flaws in their revenue systems and budget processes and increase the effectiveness of spending to curtail the unsustainable ballooning of costs.

Annika Kasparek

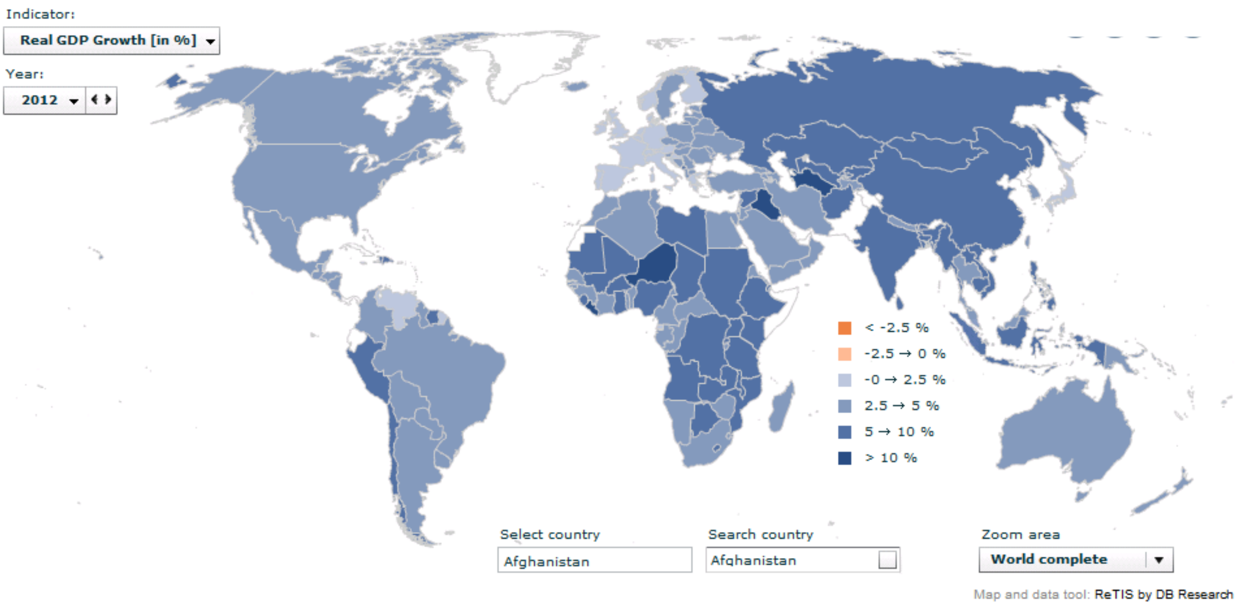
Contact: Dr. Klaus Deutsch (+49 30 3407-3682, klaus.deutsch@db.com)

Interactive maps from DB Research are a unique solution for efficiently presenting large volumes of data in such a way that important correlations can quickly be detected. All our interactive maps comprise statistics, charts, graphs and maps in a user-friendly design that can be flexibly integrated in Microsoft Office applications.

Global forecast map

The latest addition to this offering is the Global forecast map with Deutsche Bank forecasts of economic and financial market indicators for the most important Developed and Emerging Markets. OECD and IMF time series and forecasts are also included. The Global forecast map is available exclusively for clients and staff of Deutsche Bank Group.

You can find our interactive maps here: **www.dbresearch.com/imaps**



Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

ISSN Print: 1612-314X / ISSN Internet and e-mail: 1612-3158