SPECIAL REPORT

TD Economics

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STATE FINANCES AND THE BUDGET CONTROL ACT : GOING THE DISTANCE

Highlights

- Currently state tax revenues are still 3% below pre-recession levels from FY 2008. But, this understates the needed recovery to restore services and goods. Taking into account population growth and inflation, we find that state revenues are still 12% below pre-recession levels. States are unlikely to close this gap until the end of the decade, although the Northeast region should recover faster than the rest.
- Potential cutbacks from the BCA could prolong what is already a long, drawn-out recovery in state finances. State governments would get pinched through reduced federal funding next year, with grant money and procurement spending, especially on defense, representing critical components for some state and local economies.
- The impact of the BCA cuts could vary by state. Assessing states on their economic and fiscal vulnerability reveals that those in the South, such as South Carolina and Virginia, are particularly sensitive to potential cutbacks, especially when current budgetary revenue gaps are taken into account. In contrast, lower dependence on procurement contracts, military wages and other federal discretionary spending places states in the Northeast, such as New York and Connecticut, near the bottom of our vulnerability scale.

State tax revenues have been on the rise for seven consecutive quarters, stoking optimism that one of the toughest budget fights in history is nearing an end. By the end of fiscal year 2013, aggregate tax revenues likely will have made a full recovery. However, it will take years before states' fiscal wounds are completely healed.

Claiming victory when revenues return to pre-recession levels assumes that time stood still during the recession, when it did not. With over 10 million more Americans today than in 2007, demand for government services grew during the economic downturn even as tax revenues contracted. The prices of goods and services haven't remained fixed at 2007 levels either. After accounting for population growth and inflation, we estimate that aggregate state revenues won't return to pre-recession levels until 2018, clearly much longer than the nominal numbers suggest.

Before their finances have healed, states are being challenged by a new opponent in the ring: the federal government. Federal stimulus aid from the American Recovery and Reinvestment Act (ARRA) is set to fully expire this year. And, under the Budget Control Act, the federal government plans to reduce defense and other non-discretionary outlays by $109 billion a year through 2021.

Although there is uncertainty over whether the BCA will be implemented in its current form, the legislation likely won't be revisited until after the presidential election. That poses a challenge for states, who will have to incorporate the BCA cuts into their budget plans well before they are actually implemented. Even if the BCA is eventually modified, future federal fiscal restraint is certain. For those states with heavy exposures to the defense industry and federal grant money, reductions in federal spending

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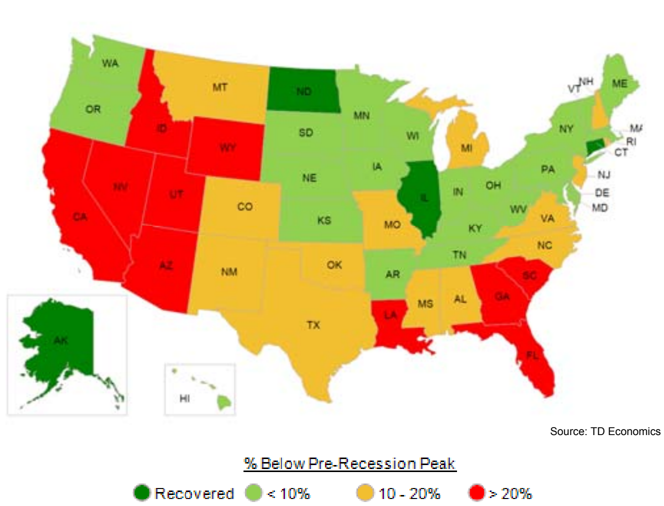
threaten to undercut finances at a time when a full recovery is still a long way off. States are already feeling battered and bruised and, unfortunately, there are more rounds left in this fight.

Round 1: Population growth puts states up against the ropes

Federal funds played a crucial role in stabilizing state budgets during the recession, helping to limit the degree to which states were forced to cut back on services and jobs. Over the last two-and-a-half years, ARRA money helped plug state funding gaps to the tune of $135-140 billion.[1] However, those funds are now mostly spent. For FY 2013, a mere $200 million remains in the kitty, amounting to 0.5% of projected state funding gaps. By comparison, the previous years of federal aid helped plug 30-40% of states' financing shortfalls.

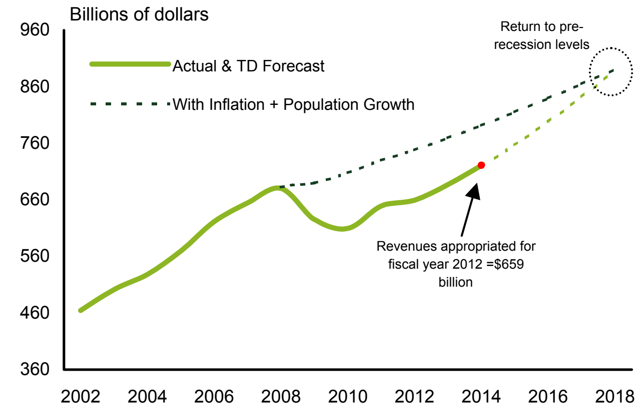
ARRA aid was never intended to be permanent, but the recovery in state revenues has been shallower than in previous business cycles. The termination of federal aid is occurring at a time when aggregate state revenues are still 3% below their pre-recession levels. Although this may not seem like much of a gap, the number grossly understates the true underlying demand for state government services. Because states' populations have grown since the downturn, they need to generate more revenue today in order to fund the same amount of spending per person as before the recession. Inflation has lifted that target even higher. After accounting for population growth and inflation, we calculate that state revenues are in fact 12% below levels consistent with a full recovery. We will refer to this measure from here on as the adjusted-revenue gap.

FY 2012 POPULATION-ADJUSTED REVENUE GAPS



Source: TD Economics

STATE GENERAL FUND REVENUES



Source: TD Economics, National Association of State Budget Officers

The map below highlights the extent to which states adjusted revenue gaps still have to recover. Forty-six states are collecting less per person today than before the recession, including 17 of the 20 states where revenues have already surpassed their pre-recession levels in nominal terms. For some, the difference between the nominal revenue gap and the adjusted revenue gap is substantial. Florida's revenues, for example, are still 9% off pre-recession levels in nominal terms, but because its population growth is now outpacing the U.S. average, the true gap is about 21%. South Carolina is in even worse shape: nominal revenues are 18% below their pre-recession levels, but their population-adjusted gap is 29%.

It could take at least another five years before most states' adjusted-revenues recapture, let alone surpass, their pre-recession levels. On average, state revenues need to grow about 3% a year just to keep pace with population growth and inflation. So, in order to make significant headway in closing the gap, states would need to generate consistent revenue growth of 5% or more.

That sort of revenue growth is going to be difficult to sustain in an economic cycle that is still working through structural problems related to household debt burdens and an overhang of housing supply. Historically, state revenues tend to grow at about the rate of nominal GDP. Our national nominal GDP growth forecast doesn't top 5% until 2014, which leaves adjusted-revenues still 7% below their pre-recession levels by 2015. Assuming revenues continued to grow at 5.5% a year thereafter – consistent with the Federal Reserve's long-run economic growth projections – revenues wouldn't fully recover until 2018. And, even if revenues were to grow by a more optimistic 7% a year beginning today, they still wouldn't surpass their pre-recession peak until at least 2016.

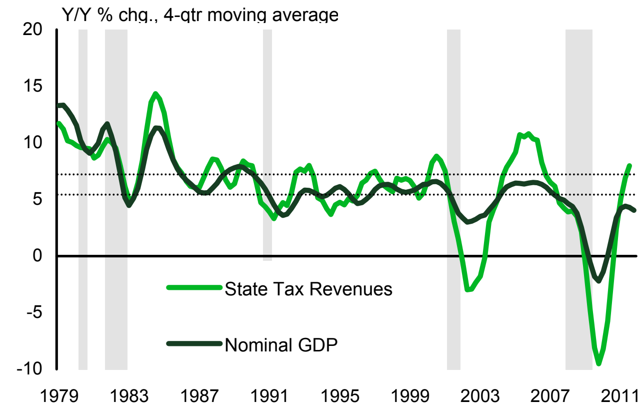
To be sure, some regions are likely to close the gap faster than others. The Northeast has the slowest population growth in the country, so by comparison the increase in demand for government services has been more muted. For example, the Department of Education projects that there will be 78,000 fewer students enrolled in public K-12 education in the Northeast by 2015.[2] By contrast, enrollment is projected to rise by 78,000 in the Midwest, 717,000 in the South, and 521,000 in the West. While these regions will face escalating education cost pressures, falling enrollment in much of the Northeast will allow funds to be redirected to other areas.

Adjusted-revenues in the Northeast will likely surpass their pre-recession level by 2015, with New York set to close the gap by next fiscal year. Connecticut is in the most favorable position, with adjusted-revenues having already surpassed pre-recession levels. In contrast, New Jersey, Pennsylvania, New Hampshire and Maine will face more drawn-out revenue recoveries relative to their peers. New Jersey, in particular, faces a difficult fiscal outlook. Demands on the state's public education system are projected to rise, rather than fall in line with the rest of the region, and the state's public sector pension and retiree health care schemes will absorb an increasing chunk of tax revenue, leaving less money to fund expenditures elsewhere.

Unlike the Northeast, adjusted-revenues in the South Atlantic states are set to remain below pre-recession levels well beyond our forecast horizon. Here again, some states will fair better than others. Maryland and West Virginia have some of the lowest adjusted-revenue shortfalls in the country, and so we expect them to recapture their pre-recession levels within the next four years. But for the majority of states in the region, the recovery will be a long one. South Carolina, for example, has one of the largest adjusted-revenue gaps in the country, with Georgia and Florida not too far behind. In fact, South Carolina's fiscal hole is so deep that even if revenues were to grow at 7% a year, the state wouldn't close its adjusted-revenue gap until 2021.

For those familiar with South Carolina's fiscal health, this may seem like an odd turn. In some ways, the state can be considered a success story for managing budget shortfalls through extremely difficult economic times. After battling years of steep expenditure cuts, the state closed fiscal year 2011 with a general fund operating surplus and was able to be re-direct some of these funds to fiscal year 2012 to help produce a repeat performance. Unfortunately, there was a steep price paid to restore fiscal balance. Real per student K-12 education funding is 24% below 2008 levels – the largest funding gap of any state in the country.[3] While the state was actually one of the few to increase school funding in the current fiscal year, restoring that funding will take time.

STATE TAX REVENUES VERSUS NOMINAL GDP



Source: Census Bureau, Bureau of Economic Analysis, TD Economics

State revenues already face a long convalescence after the recession dealt them a blackening blow. Unfortunately, the Budget Control Act (BCA) threatens to make additional cuts to federal transfers to states beginning in January 2013. While it is still too early to know exactly where these cuts will fall, or the extent to which states have planned for them in their upcoming fiscal year appropriations, one thing is certain: they will further undermine states' fiscal health at a time when revenues are still on the mend.

Round 2: Federal cuts could feel like a body blow to states that are already winded

Federal funds account for roughly one-third of total state expenditures, and are the single most important source of state revenue after taxes. Much of this money consists of grants-in-aid for "mandatory" programs that are exempt from the cuts specified in the BCA, including Medicaid – the nation's primary health insurance program for low-income families. However, that still leaves about one-fifth of all federal transfers to state governments on the chopping block – "discretionary" funding for everything from special education programs to healthcare research and agriculture subsidies. The Federal Funds Information Services, an agency that tracks the impact of federal funds on state budgets, estimates that states could see a $9 billion reduction in federal transfers next year relative to current levels if the

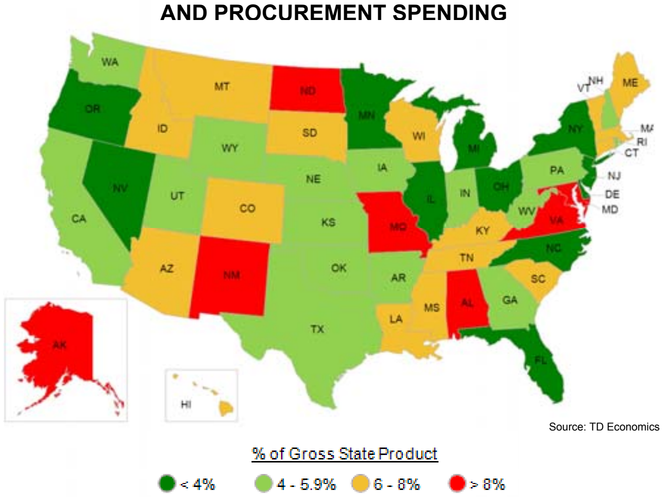
BCA sequester goes through in its current form.[4]

However, the actual economic impact could be greater. Many non-governmental organizations, universities, and businesses receive money directly from the federal government, and that funding is also liable to be cut. Federal grants to the private sector gives a better sense of how vulnerable states are to potential expenditure cuts. For example, Maryland ranks among the lowest in the nation for per capita federal discretionary funding when you only consider federal dollars as they effect the state's budget. But, when Federal transfers to non-government entities within the state are included, Maryland ranks among the top ten recipients of federal funds as a percent of its gross state product.

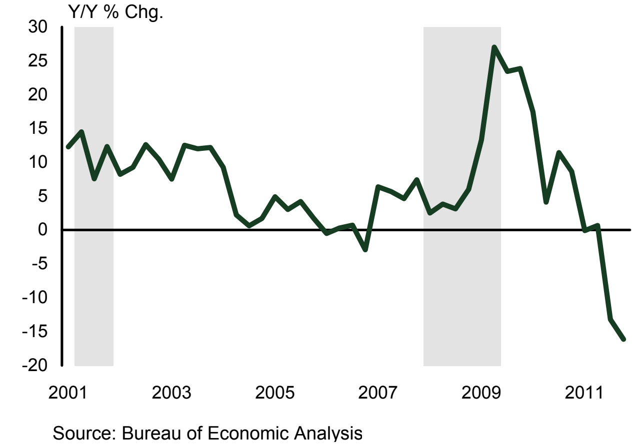
The map below shows states' exposure to discretionary federal transfers and government procurement spending, including federal grants to the private sector net of ARRA funds.[5] However, there are some nuances to be mindful of. For instance, on the surface, Massachusetts does not appear to be the worst of the lot. The state's unique concentration of high-skilled labor, world-class universities, and venture capital firms have transformed it into a thriving center for healthcare research and innovation. But, Massachusetts has an acute vulnerability within the healthcare industry, which is heavily dependent on federal funding. Over 40% of all discretionary federal transfers to the state in 2010 supported healthcare research and development. This amounted to $900 per person − the highest in the country − compared to a nationwide average of $253 per person. If federal transfers to the state are crimped, Massachusetts' valuable health research clusters would likely be impacted.

To the south, states like Virginia, Maryland and South Carolina are also vulnerable to a swing in federal funds, but for entirely different reasons. These states are heavily exposed to federal defense spending, which the BCA sequester has slated to cut by $54.7 billion a year for the next decade. Those cuts would come on top of the $487 billion in defense spending reductions that are already required by the BCA legislation over the next decade.

FY 2010 FEDERAL DISCRETIONARY TRANSFERS AND PROCUREMENT SPENDING



FEDERAL GRANTS-IN-AID TO STATE AND LOCAL GOVERNMENTS



Defense cuts can feed through to states via two channels – procurement contracts and military wages. If procurement contracts are reduced, then organizations that rely exclusively on these contracts will have to cutback or diversify their operations. This could result in a lower level of economic growth in the short term. If the unwinding of the Iraq war and other defense cuts lead to military base closures and fewer "boots-on-the-ground", then the economic activity generated by military operations in these states will be negatively impacted as well.

Virginia and Maryland are particularly vulnerable on the procurement side. The states have some of the largest exposures to federal defense procurements in the nation, at 14% and 9% of gross state product, respectively. The Secretary of Defense recently announced that major procurement contracts would be spared from impending cuts next year; however, some army contractors will feel the pinch in the medium-term as the military makes a strategic shift away from investing in ground wars towards developing a more sophisticated aerial and naval presence.

Regional economies in North Carolina and South Carolina are also vulnerable to defense cuts through the second channel – military wages. In previewing his upcoming budget, the Secretary of Defense acknowledged that personnel costs were unsustainable in their current form.[6] He also said that the Department intended to close a number of bases, as well as reduce the size of the army and marines by around 100,000 troops over the next four years. Military pay as a proportion of overall wages and salaries in these states are among the highest in the country alongside Virginia, Alaska, and Hawaii. South Carolina is home to five military installations, while four of the top 12 employers in North Carolina are military installations.

Round 3: Fights by Weight Class

Based on the above analysis, we developed a ranking of states' economic and fiscal vulnerability that takes into account how far their adjusted-revenues have still to recover, as well as their degree of exposure to potential cutbacks under the BCA. A full ranking of all 50 states can be found on the next page.

The states that ranked atop our list are a diverse bunch, each represented for very different reasons. South Carolina scores poorly due its large adjusted-revenue gap at 30%, second only to Arizona. While Virginia and New Mexico's adjusted-revenue gaps are less severe, their economies are at risk with their outsized exposures to federal procurement spending. Louisiana did not rank the worst performer in any of the individual risk categories we looked at, but its large adjusted-revenue gap and economic exposure to federal discretionary spending helped land it a spot in the top five.

Picking out some of the states in TD's footprint, North Carolina is burdened by a significant revenue gap and a relatively large share of total wages derived from military pay. And while Florida has comparatively little reliance on federal discretionary transfers and defense expenditures, its revenue gap is the second-worst among the states in TD's footprint.

New Jersey, Massachusetts, New York and Connecticut appear in the bottom half of the entire 50 state list. While New Jersey has a substantial revenue gap, it has one of the smallest exposures to military expenditures and federal discretionary transfers. As a result, it is less vulnerable to forthcoming BCA cuts. Massachusetts and New York stand out with revenues that are close to recovering their pre-recession peaks, while Connecticut has already done so. A favorable revenue outlook in all three of these states gives them more fiscal wiggle room to plug any holes left by transfer cuts at the federal level.

It is important to recognize what this ranking is trying to capture, and what it is not. These rankings do not account for longer-term budgetary problems such as debt interest costs and underfunded pension liabilities. For that we have developed a separate vulnerability index, which we wrote about **here**. These rankings also do not account for revenue shortfalls in other state funds besides the general fund. The general fund is a state's primary repository of broad-based income and sales tax collections, and constitutes over 40% of total state expenditures. However, about one-quarter of state spending is derived from taxes and fees ear-marked for a specific purpose, such as a gasoline tax dedicated to a highway trust fund, which is not included general fund revenue.[7]

Finally, this analysis does not assume that a sucker punch is thrown into the mix, such as another downturn in the business cycle. In such an event, all bets are off. State government revenues would once again backslide, and the federal government has limited room to offer assistance. The likely response would have to be more aggressive expenditure cuts and tax hikes to fill in the gaps.

Conclusion

State finances are recovering from the darkest days of the downturn, but they still have a long way to go. Unfortunately, the process of restoring fiscal health at the federal level will have knock-on effects to the state level (as well as to local governments, which we did not discuss in this report due to the broad scope). Exposure to Federal budget decisions filters through to the state level across a number of lines. First, a state's fiscal starting point is instrumental in determining the degree to which it can absorb Federal transfer cuts, while simultaneously restoring services to its population base. We accounted for this measure through the adjusted-revenue gap, in which Arizona, South Carolina and Utah grabbed the unenviable top three spots. Second, the impact of cuts delivered through the Budget Control Act will not be uniform. A number of states are uniquely vulnerable as determined by their economic dependence on procurement funding, military wages and other federal discretionary transfers. While there is still a lot of ambiguity surrounding the extent to which the BCA cuts will be implemented given that it is a Presidential election year, there is little doubt that a trigger is going to be pulled and states will be caught in the line of fire. The bottom line is that even as tax revenues continue to recover alongside the economy, the fight to fully restore state budgets will persist for many years yet.

TD State Revenue Vulnerability									
Overall Rank (1 = Most Vulnerable)	State	Adjusted Revenue Gap, Pre-Recession to Current, %		Federal Discretionary Spending, % GSP		Federal Procurements, % GSP		Military Wages, % Non-Farm Wages	
		Rank		Rank		Rank		Rank	
1	New Mexico	11	-19.8	9	3.5	2	9.4	13	2.5
2	Arizona*	1	-33.8	41	1.8	6	5.1	28	1.5
3	Louisiana	5	-26.1	6	3.6	21	3.3	16	2.1
4	South Carolina*	2	-29.1	37	1.9	9	5.0	7	3.4
5	Virginia	20	-14.7	39	1.9	1	13.8	3	4.8
6	Wyoming*	4	-26.3	4	3.9	44	1.5	17	2.1
7	Montana	15	-16.5	2	4.8	33	2.3	18	1.9
8	Utah*	3	-26.9	20	2.5	22	3.3	33	1.2
9	Georgia*	6	-25.7	40	1.9	23	3.1	12	2.9
10	Idaho	8	-23.0	25	2.4	10	4.8	23	1.6
11	Hawaii	39	-4.7	19	2.5	13	4.1	1	11.5
12	Alabama	17	-16.1	22	2.4	4	6.1	19	1.8
13	Oklahoma	12	-19.8	29	2.3	32	2.3	11	2.9
14	Maryland	35	-6.4	5	3.7	3	9.0	21	1.8
15	Missouri	18	-15.9	15	2.8	5	5.3	32	1.3
16	Mississippi	21	-13.4	10	3.3	27	2.7	9	3.0
17	California	9	-21.9	42	1.8	24	3.0	31	1.4
18	Nevada	7	-25.1	50	1.2	38	1.9	26	1.6
19	Colorado	16	-16.3	31	2.1	14	4.0	14	2.4
20	South Dakota	30	-7.9	3	4.5	31	2.3	15	2.3
21	North Dakota	47	3.7	1	6.5	37	2.0	8	3.3
22	Florida*	10	-20.7	47	1.5	29	2.4	27	1.5
23	Texas	14	-16.7	45	1.6	19	3.4	20	1.8
24	North Carolina	22	-13.0	34	2.0	46	1.4	4	4.5
25	Massachusetts	28	-8.2	7	3.5	12	4.2	49	0.4
26	Rhode Island	24	-10.5	12	3.2	35	2.0	22	1.7
27	Kentucky	37	-5.9	26	2.3	11	4.6	5	4.3
28	Vermont	33	-7.0	8	3.5	17	3.6	35	1.0
29	Maine	27	-8.7	16	2.7	20	3.4	30	1.4
30	Michigan*	19	-15.8	35	2.0	42	1.7	50	0.4
31	New Jersey	13	-16.9	48	1.4	34	2.1	48	0.4
32	New Hampshire	23	-12.8	32	2.1	30	2.4	45	0.5
33	Washington	36	-6.3	27	2.3	25	2.9	10	2.9
34	Tennessee	32	-7.1	23	2.4	15	4.0	37	0.7
35	Nebraska	34	-6.6	13	2.9	45	1.5	25	1.6
36	Pennsylvania	29	-8.0	30	2.2	18	3.4	46	0.5
37	Oregon*	25	-9.4	24	2.4	48	1.2	42	0.5
38	Wisconsin	38	-5.8	28	2.3	16	3.9	47	0.4
39	West Virginia	40	-4.7	21	2.4	26	2.8	34	1.1
40	Kansas*	44	-2.6	33	2.1	28	2.4	6	3.5
41	Minnesota	26	-9.2	38	1.9	49	1.1	44	0.5
42	Arkansas	43	-3.2	17	2.7	41	1.7	29	1.4
43	Iowa	42	-3.3	14	2.8	43	1.7	39	0.6
44	Indiana	45	-1.7	18	2.6	36	2.0	41	0.6
45	Delaware	31	-7.1	49	1.3	50	0.6	24	1.6
46	Ohio	41	-4.3	43	1.8	39	1.8	40	0.6
47	New York	46	-0.0	36	2.0	47	1.2	43	0.5
48	Alaska	50	26.2	11	3.3	8	5.0	2	8.2
49	Connecticut	49	6.5	46	1.5	7	5.0	38	0.6
50	Illinois	48	5.7	44	1.8	40	1.8	36	0.7

*Denotes states with revenue peak in FY 2007. All others reached peak in FY 2008.

Adjusted-revenue gap determined using general fund revenues as originally appropriated in FY 2012. Gap between current and pre-recession peak is adjusted for population growth and inflation. All other data presented in table is from FY 2010. Discretionary federal spending is net of ARRA funds and excludes programs exempt from the BCA sequester. Procurement data includes ARRA funds.
Source: TD Economics, FY 2010 Consolidated Federal Funds Report, ARRA Recipient Activity Reports, Federal Funds Information Service

End Notes

1 McNichol, Elizabeth, Phil Oliff and Nicholas Johnson, "States continue to feel recession's impact," Center on Budget and Policy Priorities, 9 January 2012.

2 Hussar, William J and Tabitha M. Bailey, *Projection of Education Statistics to 2020,* NCES 2011026, 21 September 2011.

3 Oliff, Phil and Michael Leachman, "New school year brings steep cuts in state funding for schools," Center on Budget and Policy Priorities, 7 October 2011.

4 "State-by-state analysis of BCA sequester," FFIS Special Analysis 11-06, Federal Funds Information For States, 2 December 2011

5 Note to map on p. 4: Discretionary transfers are defined as non-exempt federal grants and non-exempt federal direct payments to non-individuals, net of ARRA funds, as listed in the FY 2010 Consolidated Federal Funds Report (Census Bureau). Data excludes federal direct transfers to individuals as these are mostly exempt from the BCA sequester. A program was deemed non-exempt if its corresponding treasury account did not appear in the list of exempt accounts provided in the BCA legislation. We excluded ARRA funds by subtracting recipient-reported Recovery Act amounts by program code from the corresponding amounts reported in the CFFR. Procurements include three categories of spending. By far the largest is spending by the Department of Defense. The other two are spending by the U.S. Postal Service, and all other federal government contracts other than DoD and USPS. Procurement data includes ARRA funds.

6 Garamone, Jim, "Panetta announces fiscal 2013 budget priorities," Armed Forces Press Service, http://www.defense.gov/news/newsarticle.aspx?id=66940, accessed 26 Jan 2012.

7 National Association of State Budget Officers, *State Expenditure Report 2010,* Washington, DC, 2011.