OnTheRecord

A Conversation with **Jason Saving**

Texas in Better Fiscal Shape than Most Other States

The hardships of recession aren't confined to the private sector. Dallas Fed regional economist Jason Saving takes a look at how state budgets are faring in the long, deep slump—starting with Texas.

Q. What can you tell us about Texas' state finances?

A. Texas hasn't had the same tax revenue losses as many other states. Our economy has generally fared better than the nation's during this recession. The state unemployment rate has been a percentage point or more below the national rate. Job losses have been smaller. Personal income has fallen at a slower rate, and the same is likely true for total output.

Faring better hasn't meant escaping recession, and the state did confront some fiscal turbulence in 2009. Several one-time revenue gains, including $6 billion in federal stimulus funding, offset declining tax receipts and enabled Texas to maintain services without drawing down the state's rainy-day fund.

State sales tax revenue has softened considerably during the recession—for example, the second quarter saw a 6.5 percent decline from the same period last year. At the same time, outlays in key programs, including Medicaid, continue to increase. This suggests a more challenging fiscal environment in 2010 as policymakers attempt to reconcile greater demand for state services with shrinking revenue.

Q. Has the recession been as hard on states as it's been on the federal government?

A. The federal deficit has more than tripled, going from $454 billion in 2008 to $1.4 trillion in 2009. This expansion has had two main causes—a dramatic increase in spending aimed at getting the economy moving again and a dramatic reduction in tax revenues as firms and individuals face lower profits and incomes.

Almost every state has had to confront—or is still confronting—budgetary shortfalls since the start of the recession. Taken together, the shortfalls are in the neighborhood of $100 billion in fiscal 2009, and they're expected to total about $170 billion in fiscal 2010.

At first glance, it might seem the recession has been far easier on states than the federal government. But this would be incorrect. It's important to remember that states, with the exception of Vermont, are required to balance their budgets year-in and year-out.

The federal government can spend more as revenues decline, but states have to make difficult decisions that often impose real and immediate pain on ordinary citizens. When revenues can't cover expenditures, states are required to raise taxes or scale back spending—typically at a time when cash-strapped citizens need all the help they can get.

Q. Why has Texas had fewer fiscal problems than most other states?

A. Several factors are at work. One is a business-friendly environment, which has helped keep alive firms that might have succumbed to the recession elsewhere. Another is a rise in state government spending that was slower than the national average after the 2001–02 recession, creating less of a spending overhang to pare back in hard times. Yet another is that the Texas economy entered recession later than other states, partly due to such factors as high energy prices and the friendly business climate.

But a key factor often missed in these kinds of discussions is Texas' reliance on sales taxes rather than income taxes. Income takes a much bigger hit than consumption during economic downturns because people try to maintain their living standards while enduring temporary wage cuts or unemployment spells. So income tax revenue tends to fall further than sales tax revenue during recessions, leaving income-tax-reliant states facing deeper fiscal shortfalls.

We've seen this during the recession. In the second quarter, overall revenue from state income taxes fell 15 percent from the same period last year, whereas sales tax revenue across the 50 states was down only 6 percent. The flip side is that income-tax-reliant states have greater room to increase spending during recoveries. That's not receiving a lot of play at the moment—for obvious reasons.

Q. Does Texas face any significant budget issues?

A. Texas certainly faces fiscal challenges. A short-term issue is the newly reformed franchise tax, which is generating about $1 billion less in annual revenue than forecast. Only part of that gap can be attributed to the recession. Recent changes to the tax have actually further reduced revenue—for example, by raising the income threshold at which taxes must be paid. The franchise tax provides less than 10 percent of state revenue, but this is still an issue the state will have to deal with in the near future.

An intermediate-term issue is Medicaid, which has almost doubled in size over the last decade in Texas and now consumes a quarter of the state's overall budget. Getting those outlays under control would free up money for other priorities, but virtually every state has struggled to reach this goal in an era of rapid increases in health care costs. The federal government's health care reform has the potential to slow the rise in costs, but most

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proposals now on the table would also dramatically expand Medicaid rolls. If not properly handled, reform could actually worsen Texas' fiscal strains.

Over the longer term, the most important fiscal issue will be improving education and infrastructure without sacrificing the low taxes and business-friendly climate that have helped the state's economy grow faster than the nation's. If the state fails to improve graduation rates among Hispanics or fails to modernize its highway network, for example, economic growth and tax revenue could suffer over time. On the other hand, failing to maintain a low-tax policy environment may also slow growth and exacerbate state fiscal imbalances.

Q. Besides Texas, are other states doing reasonably well on the fiscal side?

A. A number of Great Plains-area states managed to get through fiscal 2009 without significant fiscal shortfalls, including Arkansas, Iowa, Kansas, Montana, Nebraska and the Dakotas. Most are states with the fewest job losses in this recession, including one—North Dakota—that has actually gained jobs over the past nine months.

But the best available estimates suggest that even these states face significant fiscal pressures in 2010 and 2011, partly because of the sheer depth of the recession and partly because of fluctuations in the food and energy prices that help drive their economies.

Q. Which states are facing the biggest budget messes?

A. The state facing the greatest fiscal challenge—bar none—is California, where legislators wrestled with a shortfall of almost $40 billion in fiscal 2009 and face even greater fiscal pressures in 2010. Spending in the previous five years rose 3 to 4 percentage points faster than inflation and population growth. Then the recession hit. Revenue from the state's steeply progressive income tax has fallen by a whopping 20 percent over the past year, so the spending levels simply couldn't be maintained with available revenue.

Other states that face an especially challenging 2010 include Arizona, Nevada and New York. Each of these states increased spending at a relatively rapid rate during expansion, and each is now struggling to close very substantial shortfalls.

Q. When states cut spending, what usually gets the ax?

A. State spending is divided into three broad categories of roughly equal size: social services, education and criminal justice. All are valuable and all tend to be trimmed when states face recession-induced budget shortfalls. Eligibility requirements are tightened for welfare programs and checks are reduced; funding for schools is curtailed and elementary and high school class sizes are increased; judicial backlogs grow and enforcement efforts can suffer.

Unfortunately, these cutbacks often occur at precisely the time the programs are needed most, when poor job market prospects induce individuals to seek social assistance, return to school or perhaps even commit crimes.

Q. How can states prepare themselves for the fiscal shock of recession?

A. They can do a couple of things to be better prepared for adverse economic circumstances. One is to lessen reliance on taxes that are strongly tied to current economic conditions, so that tax revenues will be less likely to plunge precisely when demands for state services are greatest.

Another is to resist the temptation to dramatically ramp up spending during recoveries, so that fewer cuts will be needed during recessions. Balancing the budget over time requires saving during booms—whether we're talking about states or individuals. The strategy can be hard to do at times but pays dividends when the economy worsens.

The most important thing a state can do to prepare for the fiscal shock of recession is offer a business-friendly environment. Doing so helps states enter recession with a relatively strong tax base and helps sow the seeds of a relatively quick recovery because startups can make profits earlier in the business cycle.

Texas has done relatively well along most of these dimensions, generally relying on taxes that don't swing wildly with current economic conditions and providing a conducive tax and regulatory environment for business. It's important to bear in mind, though, that no state can fully insulate itself from recession or its fiscal consequences.

Q. Will economic recovery be enough to resolve most states' budget troubles?

A. It typically takes two to three years for state fiscal pressures to abate, in part because firms don't hire as quickly as consumers would like and consumers don't open their pocketbooks as quickly as firms would like. Going by historical record, it wouldn't be at all surprising to see further tax hikes or spending cuts at the state level in 2010 or even 2011 as policymakers struggle to get back on an even keel.

Some analysts believe the depth and breadth of the current recession could extend these postrecession blues by an additional year or two beyond the norm. It's too early to say whether this scenario will play out, but it's fair to say the onset of economic recovery won't immediately take care of state fiscal woes.