SouthPoint - Federal Reserve Bank of Atlanta

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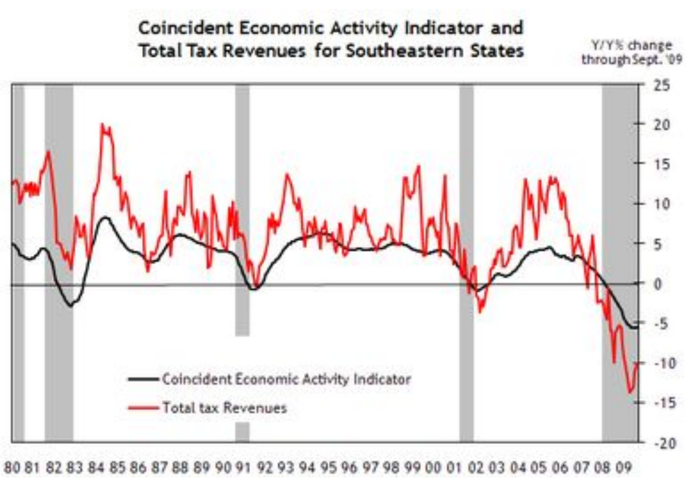
State revenues and recessions, part two

Last week we noted that this recession has hit state government finances hard. Declines in revenue have been deep, and Southeastern states are no exception. The reason is rather straightforward—the economic downturn was deep in the region, and the falloff in economic activity led to unprecedented declines in state revenues. States in the region responded by reducing spending, cutting services, and reducing employment. Direct federal assistance to state governments through the American Recovery and Reinvestment Act (ARRA) has helped mitigate revenue shortfalls, but pressure on budgets remains significant. How long this pressure remains is an important component of the outlook for 2010 and beyond.

Gauging the downturn and its impact on state finances

Since state level GDP data are only available on an annual basis, we look to higher-frequency series to more closely track economic activity. The Federal Reserve Bank of Philadelphia produces a monthly coincident index for each of the 50 states. The coincident indexes combine four state-level indicators to summarize current economic conditions in a single statistic. The four state-level variables in each coincident index are nonfarm payroll employment, average hours worked in manufacturing, the unemployment rate, and wage and salary disbursements deflated by the consumer price index (U.S. city average). The trend for each state's index is set to the trend of its gross domestic product (GDP) so long-term growth in the state's index matches long-term growth in its GDP.

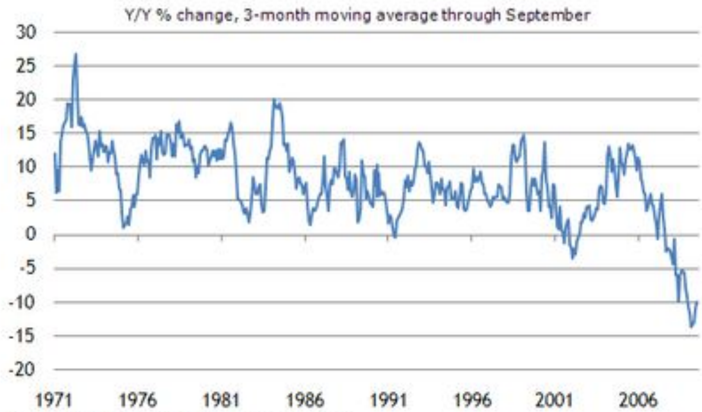
Chart 1 shows the year-over-year percent change in the weighted average coincident indicator for the six states in the Sixth Federal Reserve District (Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee) and total tax revenues for these states. The current downturn represents the deepest decline for both measures, and it also reveals how the two are related as the decline in economic activity hits revenue resources—especially sales tax intake—quite hard during recessions.



Source: State Department of Revenues, FRB Philadelphia, and FRB Atlanta

The current decline in Southeastern states' revenues is also deeper than in previous downturns. Chart 2 takes the data used in Chart 1 for total state tax revenues back to the early 1970s. In April 2009, the year-over-year measure reached –13.7 percent before improving to –10.2 percent by September. Before the current year, the deepest decline in total state tax revenues for the region was –3.5 percent, reached in March 2002.

Chart 2
Southeastern States Total Tax Revenue



Sources: State Departments of Revenue, FRBA

The impact on state budgets

State spending is generally procyclical. When economic activity is positive and tax revenues are strong, states tend to spend more on services and programs like education and transportation. During economic downturns, states tend to spend more on social welfare programs. However, this spending is constrained by limited revenues. State budget shortfalls have been significant in the region. The table below estimates these shortfalls for the current fiscal year.

STATES WITH FY2010 BUDGET GAPS		
	FY2010 Total Budget Shortfall	FY2010 Total – Shortfall as percent of General Fund Budget
Alabama	$1.2 billion	16.70%
Florida	$6.0 billion	23.30%
Georgia	$4.3 billion	24.90%
Louisiana	$1.8 billion	21.60%
Mississippi	$655 million	13.20%
Tennessee	$1.0 billion	9.70%

Source: Center on Budget Policy and Priorities

States have responded by cutting spending and services. According to [The Center on Budget and Policy Priorities (CBPP)](), four Southeastern states have enacted cuts in Medicaid or children's health insurance programs: Florida, Georgia, Louisiana, and Tennessee. Cuts include reduced or frozen reimbursements to health care providers. The CBPP also reported that several states have also made cuts to education budgets, including K-12 and higher education budgets. In addition, state employment has also been curtailed. For example, Georgia imposed furloughs and/or pay cuts for some state employees, and Tennessee's governor announced the elimination of more than 2,000 state positions, about 5 percent of the state workforce. Hiring freezes have also been ordered in Alabama, Florida, and Georgia.

The American Recovery and Reinvestment Act

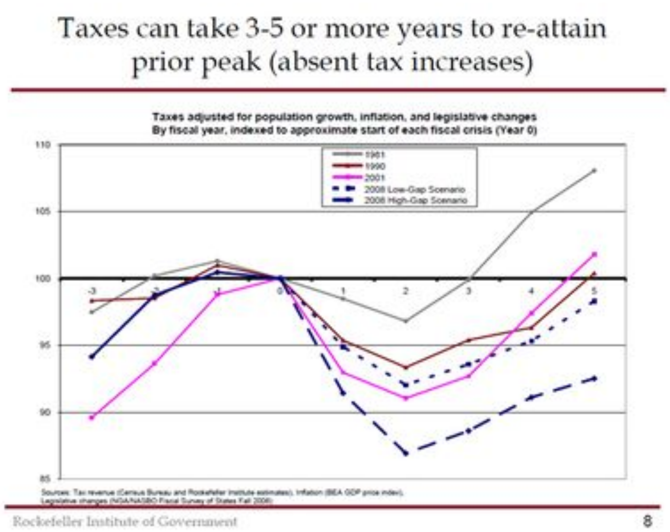
Christina Romer, chairman of President Obama's Council of Economic Advisors, testified before Congress in October that a total of $43.8 billion in federal stimulus has been devoted to state fiscal relief. An informal Atlanta Fed survey of Southeastern state budget officials found that the majority of these funds was being applied to address budget shortfalls in Medicaid and education. But as noted earlier, budget gaps persist. While it's clear the ARRA has helped states under fiscal stress, it has not completely bridged budget gaps.

Outlook

FRB Atlanta President Dennis Lockhart noted in a September 30 speech in Mobile, Alabama, that "I agree with all who are declaring that a technical recovery is under way."

Improvements can also be seen at the state level. Two Southeastern states showed monthly increases in their coincident economic activity indexes in September compared with zero in July and one in August. For those states that continued to experience month-to-month declines, the rate of the deterioration was much smaller than earlier in 2009. Unfortunately for states budgets, the emerging recovery will not result in immediate relief.

The Rockefeller Institute of Government estimates that it takes three to five years after the onset of serious revenue declines before states again reach their precrisis levels. The chart below, taken from a September presentation by Senior Fellow Donald Boyd, plots this analysis.



Summing up, the impact of the recession on state government finances has been and remains severe. The downturn in economic activity has led to declines in state sales tax intake as well as drops in other revenue resources. Budget cuts have been enacted, and the relief from federal stimulus funds has not fully mitigated the budget shortfalls. As a result, pressure on state budgets remains significant. Despite the fact that the economy is growing again, state finances are expected to remain challenged over the next several years.

By Michael Chriszt, an assistant vice president in the Atlanta Fed's research department

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