Part 1

Introduction

Even if the recession is technically over, by any measure the U.S. economy is a long way from whole, with unemployment still at 9.1% as of May 2011. As well, the economic downturn has put a great deal of pressure on state budgets. As economic activity declines, states collect less tax revenue. As people lose jobs and incomes drop, demand increases for state services like job training, health care support, welfare and unemployment compensation. The combination, it is often argued, throws state budgets out of balance and, because states are generally required to enact "balanced budgets," often leads to dramatic cuts in state services or even tax increases.

The news these days is still full of stories that reflect this imbalance. The fight between Governor Scott Walker and state workers in Wisconsin over budget cuts and the shutdown of the state government in Minnesota were but the most visible example of what is going on in many states as many new governors and state legislatures find the level of state spending to be no longer sustainable. A February 2011 *USA Today*/Gallup poll found that 64% of those surveyed said their state is in a budget crisis.[1] The Center for Budget Policies and Priorities pegs states falling short of desired revenue by $112 billion in the coming fiscal year.[2]

State leaders have responded to these drops in revenue with warnings of dire budget cuts and tax increases. Of course, the cuts are always calculated from what spending would have been if they had continued to increase it, not measured from any objective assessment of need. Hence the logic of tax increases is compelling to those who can only see spending increasing. In 2009 and 2010 36 states raised taxes or fees, including:

- New York: Total enacted and proposed new taxes, 2009–2011: $8.2 billion; $419 per person.
- California: Total: $11.5 billion; $312 per person.
- Delaware: Total: $253 million; $286 per person.
- Wisconsin: Total: $900 million; $159 per person.
- Arizona: Total: $1 billion; $154 per person.
- Kansas: Total: $425 million; $151 per person.
- Washington State: Total: $982 million; $147 per person.
- Oregon: Total: $541 million; $141 per person.

- Massachusetts: Total: $890 million; $135 per person.
- New Hampshire: Total: $161 million; $121 per person.[3]

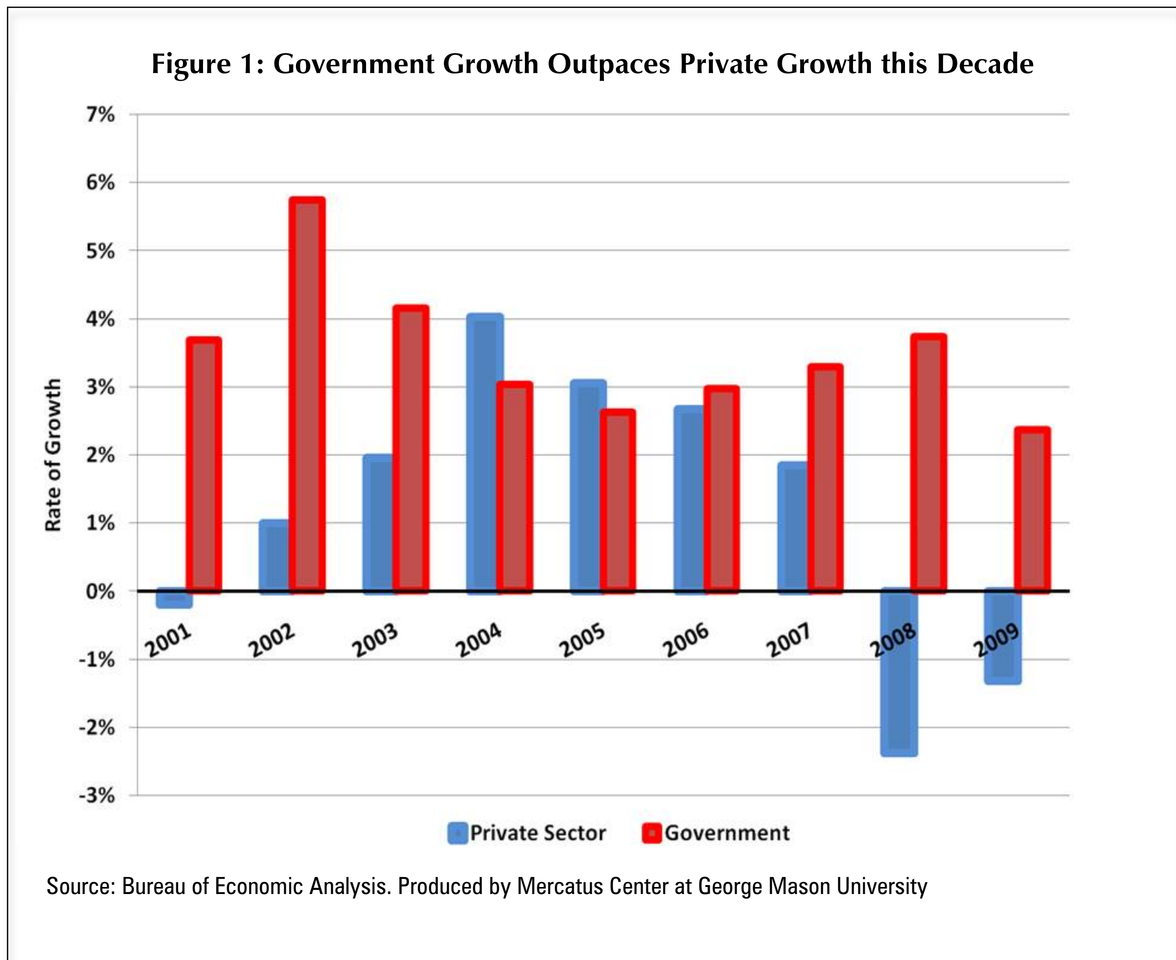
Meanwhile the "stimulus" bill, the American Recovery and Reinvestment Act (ARRA), sent unprecedented sums from the federal Treasury directly to the states. *Federal Funds Information for the States* estimates that over $200 billion of the spending in ARRA was routed through state government.

Routing these federal funds through the states is partly explained by the evolution of the relationship between the federal and state governments. Originally construed as "separate, but co-equal" branches of government, state governments are, to a certain extent, subsidiary branches of the federal government. Many federal programs, like job training and welfare programs, are administered by state governments. In programs like education, the federal government provides states with financial support to meet federal priorities. For programs like Medicaid and transportation, the federal government provides general financial support—along with many strings—for states to operate their own programs. Today, on average, for every dollar state government spends, around 28 cents comes from the federal government.

What's missing from discussions of state budget crises is any context. Even if one accepts the "shortfall" numbers at face value, it is not immediately clear to what extent the budget shortfall is due to the general economic downturn, or to policy decisions made by state leaders. For example, if a state has built a budget around revenue growing by 10% and revenue only grows by 8%, one could argue the state is experiencing a "shortfall", but not in a way that is meaningful to most people. If the economic downturn were the only culprit, all state budgets would be compromised, which is not the case. Missing from most stories are the answers to questions like: How do current revenue and spending compare to past years? How do they compare to population growth and inflation? What sources of revenue are falling? How has spending in different areas changed?

Nor do we know whether the current or projected budget is built on years of rapid increases in overall spending. If your current budget is built on several years of rapid expansion, a projected cutback may seem more severe than it actually is. If over the last six years you had received 10% raises each year, and spent them on a new car, RV and nicer vacations, yet this year you have to take a 20% cut, it may seem like a "shortfall." But in fact your income is still nearly 50% above where it was six years ago—not much of a hardship. Looking at state government's revenue and spending over the past decade tells a similar story.

Indeed, during the past decade, government grew considerably faster than the private sector. As Figure 1 shows, "[W]ith the exception of 2004 and 2005, government consumption and investment have grown more quickly than private expenditures and investment every year this decade. In the last ten years, the private sector has, on average, grown 1.2% annually, while the government has, on average, grown 3.5% annually."[4]



Looking at state budgets in one- or two-year time frames is interesting, but ultimately irrelevant. It is worth asking, are we treating an illness or a hangover? Have the states been efficient stewards of public resources that now, reeling from an economic calamity, need federal support? Or, have they been on a spending bender during a robust economy, like other sectors of the economy, living as if the boom-years would never end? Will a federal infusion now merely put off the necessary steps that need to be taken to put state budgets on a more sustainable footing? Do we feed the addiction or feed the recovery?

To help answer these questions, we looked at Census data on state government finances from 2002–2008, and the picture is revealing.[5] Census data provide a fairly thorough and consistent way to compare state revenue and spending over the years, though the most recent year of data is 2008. This comparison shows not only total revenue and spending trends, but shifts in where revenue has come from and where it has been spent. The years 2002–2008 provide a picture over a seven-year span, beginning just after the dot-com bust and going into the first year of the most recent recession and the beginning of the state budget crisis.

Those years between the two recessions also shed light on the philosophy of government spending. These were boom years for the economy and thus for government revenue. If the theory of

stimulus says that during a recession the government must spend more to stimulate the economy, then if follows that during and economic boom, there is less need for government spending. So we should wonder if state governments cut back during these boom times and saved for a rainy day.

Ranking all the states in every category shows how each compares to other states and the national average. But perhaps most importantly it allows a comparison of all the states to the "baseline"—the growth of population and inflation (see Box). Over the span of seven years, some could argue that state revenue and spending has to grow with population and inflation as they increase the level of services required and the cost of providing them. To address this concern we combine a 20% inflation from 2002 to 2008 with the average state population growth of 5% to set a baseline of 25%. State revenue and spending growth that significantly exceed that baseline are excessive, and our findings demonstrate excessive state-level government growth during these years. This study concludes that the perceived "shortfall" that has driven many states into a financial crisis is no more than the consequences of spendthrift states being forced to rein in years of profligate spending.

The "Baseline"

In this study we compare state revenue and spending trends with a "baseline" level of growth. Since one might expect revenue and spending to rise as population and inflation rise, we calculate a baseline rate of growth by combining inflation rate of nearly 20 percent from 2002 to 2008 with the average population growth rate of 5%. Some states had population growth rates substantially different from 5%. Rhode Island and Louisiana lost population during that time period, while Utah, Arizona and Nevada had population growth of over 15%. See Appendix 2 for a table of state population changes from 2002 to 2008. For most states, the difference between their population growth rate and the average won't affect the big picture comparisons in this paper. In Appendix 1 where we provide state by state analysis, we use baselines based on each state's growth.