State-Local Government Fiscal Conditions After the Great Recession

by Ronald C. Fisher and Robert W. Wassmer

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In this edition of State Fiscal Affairs, Fisher and Wassmer explore the post-Great Recession fiscal outlook of states and localities, noting that their fiscal footprint has decreased and that if the trend continues, it may reframe state and local governments' role in the U.S. economy.

How are state and local governments faring more than six years after the Great Recession formally ended? The short (and depressing) answer is that on average, they have not recovered. States and localities as a whole are spending less, investing less, and employing fewer people today than before the Great Recession. Of course, some states are doing much better than others, with quite dramatic differences. The state-local sector has largely been left out of the national economic recovery that has led to a halving of the national unemployment rate from 10 percent to 5 percent.

That the financial market crisis and subsequent Great Recession had a historically substantial impact on the states and localities is well known. The Great Recession began officially in December 2007 — during fiscal 2008 for most state and local governments — and ended in June 2009, the end of fiscal 2009. Revenue declined substantially, initially for states and later for local governments, requiring adjustments in spending, employment, and services. The federal government response to the recession included additional resources and financial options for states and localities, which partially mitigated the fiscal effects — but only temporarily.

Spending Levels

State and local governments are spending less than before the Great Recession. Real per capita spending (in 2010 dollars) in fiscal 2013 ($9,269) remained below the level of spending in fiscal 2007 ($9,363), just before the Great Recession. Per capita spending increased substantially in 2009 and 2010 as a result of the federal government stimulus, a pattern similar to employment, but has been decreasing since. Similarly, total state and local government spending amounted to 23.7 percent of personal income in fiscal 2007 but only 22.8 percent in fiscal 2013.

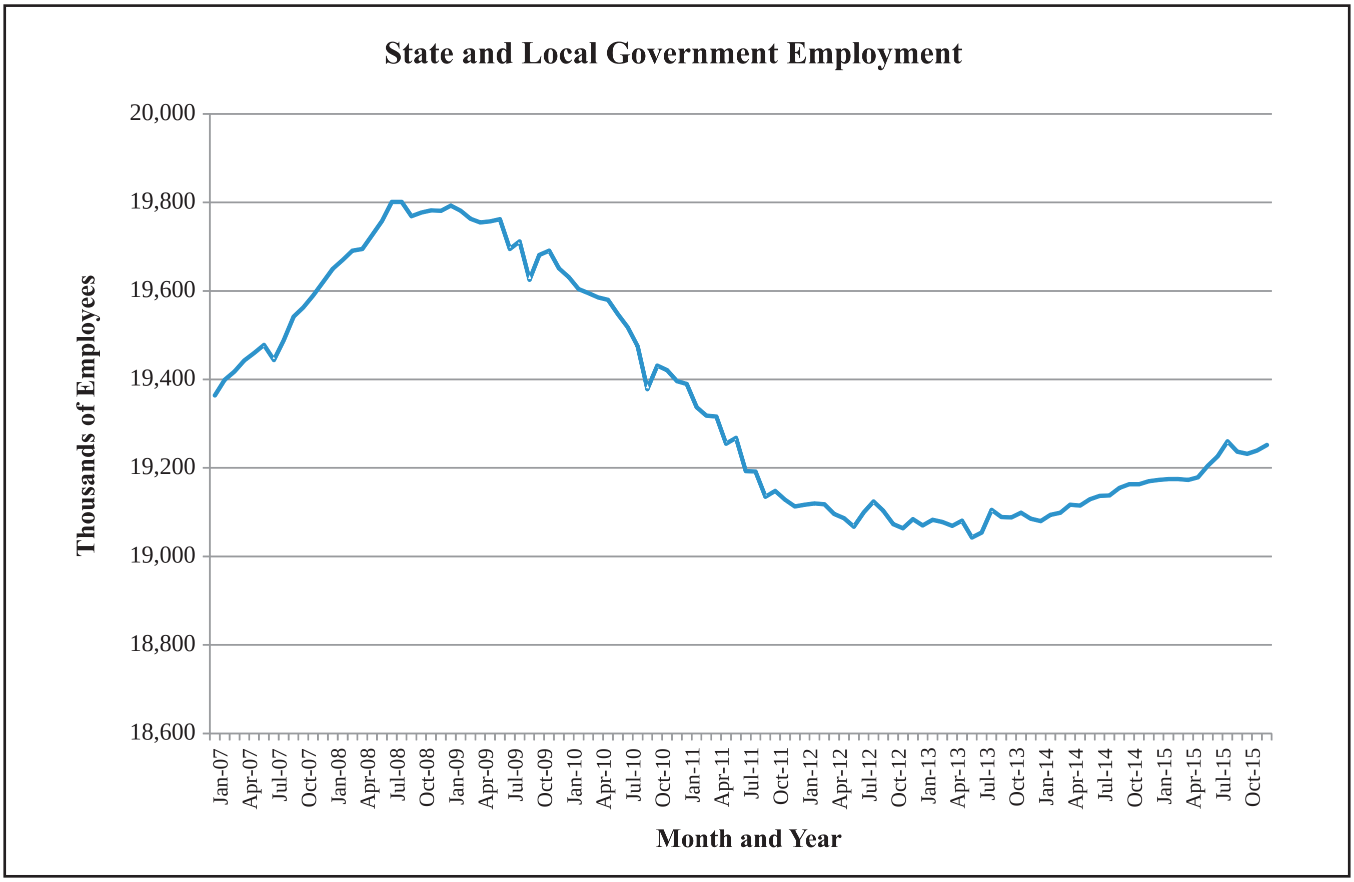
Revenue

One reason for the decline in spending relative to population and income is that revenue changes between 2007 and 2013 (before the Great Recession compared with the most recent census data year) have been less than the growth of population and prices and the growth of income. Total real general revenue of states and localities in 2013 is about the same as in 2007. However, both real general revenue per capita ($7,783 in 2013 vs. $8,180 in 2007) and general revenue as a percentage of personal income (19.1 percent in 2013 vs. 20.7 percent in 2007) are lower in 2013 than 2007. Of course, revenue growth is the result of a combination of changes in economic conditions and political choices.

Employment

Employment has not only failed to recover, but has suffered substantial decreases. There were 380,000 fewer state and local government employees as of November 2015 than at the start of the Great Recession in December 2007, about a 2 percent decline. Almost all of them — 346,000 — were local government employees, and 280,000 were local education employees. With the state-local government sector employing nearly one in seven of all workers nationally, such a decline has an important effect on the overall employment picture.

After the recession began, state-local employment continued to grow until July 2008, after which decreases began. Employment today is 560,000 less than at that peak. State and local government employment reached its lowest level in June 2013. Modest increases since then have not offset



the declines associated with the recession. State and local government employment today is at about the same level as in the spring of 2011.

Infrastructure Investment

State and local spending on infrastructure has declined substantially in the last several years and is now less than before the Great Recession. States and localities spent a nominal amount of about $325 billion on capital expenditure in 2007, rising to $357 billion in 2009 as a result of the federal government stimulus, and then falling to $323 billion in 2013. However, those nominal amounts mask real declines in value. State-local capital spending was 2.3 percent of GDP in 2007 but only 1.9 percent in 2013. Adjusting for changes in population and prices, real per capita state-local capital spending declined from $1,162 in 2007 to $952 in 2013.

Moreover, state and local governments together were spending more than 12 percent of their budgets on capital investment in 2007 but only about 10 percent in 2013. So public capital investment has declined not only because state and local governments are spending less overall but also because capital investment has become relatively less important. This trend has serious potential implications for the quality of public infrastructure in the future.

Revenue Mix

Comparing fiscal 2013 to before the recession, there has not been a dramatic effect on state and local revenue sources. Obviously, the importance of federal aid increased substantially for several years, but has returned to a similar level of importance as before the recession (20.1 percent of general revenue in 2007 compared with 21.7 percent in 2013), even though the federal government share of Medicaid increased for those states that adopted expansion as part of the Affordable Care Act. But the relative importance of the big three — property, sales, and income taxes — changed little as a result of the Great Recession. One interesting observation is that the relative importance of user charges has increased, from 15.1 percent of general revenue in 2007 to 16.5 percent in 2013.

Expenditure Mix

Just as with revenue, there have been few major changes in the distribution of spending. The importance of public welfare has increased, consistent with growing healthcare costs and expansion of Medicaid. The importance of education spending decreased a bit (34.4 percent vs. 33.2 percent), consistent with evidence that local governments decreased the number of education employees substantially. And as noted, the share of spending going to capital investment decreased by 2 percentage points.

Fiscal Balances

Not surprisingly, given the rest of the fiscal picture, states have not been able to return fully to the reserves before the Great Recession. The National Association of State Budget Officers (NASBO) reports that:

> Budget reserves reached a low in fiscal 2010 due to the severe decline in revenues and rise in expenditure demands tied to the recession. Since that time, states have made progress in rebuilding budget reserves. In fiscal 2014, total balances amounted to . . . 9.9 percent of general fund expenditures.[1]

This compares with state fiscal balances of 11.5 percent of general fund expenditures in 2006 and 10.1 percent in 2007. NASBO also notes that reserves vary substantially among the states, and that "a majority of states project total balance levels of 5.0 percent or more in 2016" — implying that numerous states are expecting substantially lower balances.

State Differences

As is common in state-local finance, an individual state's status often differs from the "average" or aggregate position of the overall state-local sector, which is true in this instance. Some states have returned to the fiscal status that prevailed before the Great Recession much more so than others. The differences can be substantial. Real per capita spending in North Dakota *increased* by more than $2,400 from 2007 to 2013, whereas real per capita expenditure *decreased* by more than $1,200 in Florida over that time. Other states with large decreases include Arizona, Georgia, and Nevada, whereas real spending per person increased substantially in Alaska. A similar pattern of state differences applies to revenue. Numerous factors likely account for these differences, including changes in energy prices, differential economic growth, the changing pattern of federal aid, as well as state political decisions.

The unavoidable conclusion is that state and local governments in aggregate have a smaller fiscal footprint today than before the Great Recession. Although the picture is clear, the reasons are not. Although income and employment have returned to pre-recession levels, state and local revenue has not. This may partly reflect the continuing lag in catch-up of property taxes, but it may also imply that states and localities have not been willing to increase revenue sufficiently. Attitudes of both public officials and citizens may have changed — temporarily or permanently — leading to a smaller subnational government sector. If permanent, the Great Recession may become an important factor in reframing the role of state and local governments in the U.S. economy. ✰

[1]National Association of State Budget Officers, "Fiscal Survey of the States" (Spring 2015).