By Robert Pollin and Jeff Thompson

STATE AND MUNICIPAL ALTERNATIVES TO AUSTERITY

The pitched battle in Wisconsin last winter over the collective bargaining rights of public sector workers was only the most dramatic expression of a struggle that is ongoing throughout the country over the future of state and local governments. For generations now, state and local governments have been the most important providers in the United States of education, health care, public safety, and other vital forms of social support. State and local governments are also, collectively, the largest employer in the country, responsible for creating thirty million jobs, either directly or through purchasing supplies or services from private businesses. This is 20 percent of the U.S. workforce. The stakes in this battle are obviously huge.

The budget crisis caused by the 2008-2009 Wall Street crash and the ensuing Great Recession is driving the dramatic transformation of state and local government policy. The recession blew a massive hole in state and municipal government finances. Tax receipts—particularly income and sales taxes—dropped severely along with household incomes, spending, and real estate values. Meanwhile, demand for public services, such as Medicaid and heating oil assistance, rose automatically as the recession created worsening circumstances for tens of millions of people.

Leaders of the hard Republican right have eagerly pounced on this Wall Street-induced crisis as a trigger for their agenda to radically downsize state and local governments by cutting taxes, slashing wages and benefits for public workers, and even selling off state-owned facilities, including state prisons. This movement, of course, includes Wisconsin Governor Scott Walker and his financial backers, the notorious billionaire brothers Charles and David Koch. But even preceding the Wisconsin battles, Republican luminaries Jeb Bush and Newt Gingrich had already begun to single out public school teachers, nurses, and other state and local government employees for

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attack, writing in the *Los Angeles Times* last January that "The lucrative pay and benefits packages that government employee unions have received from obliging politicians over the years are perhaps the most significant hurdles for many states trying to restore fiscal health."[1]

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Still, the far right is not alone in advancing various sorts of austerity agendas for states and municipalities. Thus, Jerry Brown, the recently reinstalled (after a twenty-eight-year hiatus) Democratic governor of California is proposing to cut state spending by about $13 billion, or nearly 17 percent of the state's current budget.[2] Moreover, Brown's proposal is widely perceived as representing the outer limits of a politically possible *progressive* agenda, even in Democratic Party-dominated California. What gives Brown's proposal its progressive sheen is that he also supports tax increases to close the other half of an overall $26 billion budget deficit, as opposed to closing the full $26 billion gap through spending cuts.

The fiscal crisis facing states and municipalities is real. However, the dismal austerity options being advanced by Democrats and Republicans alike are by no means the only solutions. We propose here some alternative approaches that can accomplish three things: 1) Close the budget gaps in the short term; 2) Promote a sustainable recovery over the next few years; and 3) Over the long term, help insulate state and local government budgets from the effects of recessions. We develop these proposals after first taking a fuller measure of the causes and severity of the crisis.

HOW SEVERE IS THE CRISIS?

DUE TO THE SHARP FALLS IN incomes, spending, and property values tied to the recession, tax revenues from the two main sources for state governments—income and sales taxes—declined precipitously, and even local property taxes, after expanding continuously for decades, went flat in 2010. By 2010, state tax revenues (adjusted for inflation and population growth) had fallen by fully 13 percent relative to where they were in 2007. By comparison, revenues fell only 7 percent following the 2001 recession. Even during the 1981-1982 recession, the most severe post-World War II downturn prior to 2008-2009, the decline in state tax revenues was less than 2 percent.[3] State tax collections did start growing again in early 2010. But as of the most recent figures for the last three months of 2010, they still remain 4.2 percent below their level for the last three months of 2006, before the recession hit.

The recession also meant that people's needs for state services rose sharply. Thus, four million more people will receive health insurance through Medicaid in 2012 relative to 2008, as people have lost their jobs and employers have cancelled coverage.[4] The number of people seeking assistance from the Low Income Home Energy Assistance Program (LIHEAP) rose by 53 percent between 2008 and 2011, from 5.8 to 8.9 million households.[5] That is, about 8 percent of all households are now seeking this assistance.

The net result of the collapse of tax revenues and the rising demand for state services generated budgetary shortfalls of $191 billion in 2010, $130 billion in 2011, and a projected $112 billion in 2012. The 2011 shortfall is equal to 19 percent of all state spending commitments.[6]

WHAT DIDN'T CAUSE THE CRISIS

It is obvious that the Great Recession caused the state and local government budget crisis. But this has not stopped numerous pundits from claiming otherwise. They assert that the real underlying problems are excessive government spending and/or outlandish public sector pay scales. Thus, Arthur Laffer and Stephen Moore write in their introduction to the 2009 *Annual Report* of the American Legislative Exchange Council (ALEC), "The real problem facing states is the fundamental issue of overspending taxpayers' dollars."[7] Yet, in fact, state and local spending has remained remarkably stable for decades, without having ever produced anything close to the severe budget crisis tied to the 2008-2009 recession. Thus, in 2006, just prior to the recession, spending by state and local governments was 22.2 percent of total personal income, only slightly higher than the average figure over the mid-1990s of 21.5 percent.[8] State and local government spending levels do fluctuate on a short-term basis as the overall economy alternates between phases of growth and recession. Over the longer term, state and local governments do also face rising cost pressures to cover health care expenses. But this is an economy-wide problem, with the federal government and private businesses experiencing similar pressures resulting from the excessive administrative burdens of the U.S. health-care system relative to those of other advanced economies.

It is also untrue that state and local government workers are overpaid, despite widespread claims to the contrary. One widely cited 2009 *Forbes* magazine cover article reported that "State and local government workers get paid an average of $25.30 an hour, which is 33 percent higher than the private sector's $19... Throw in pensions and other benefits and the gap widens to 42 percent."[9]

What such figures fail to reflect is that state and local government workers are older and substantially better educated than private sector workers. *Forbes* is therefore comparing apples to oranges. As John Schmitt of the Center for Economic and Policy Research recently showed, when state and local government employees are matched up to private sector workers of the same age and educational levels, the state and local government workers throughout the U.S. actually earn, on average, about 4 percent less than their private-sector counterparts.[10] Moreover, the results of Schmitt's apples-to-apples comparison are fully consistent with numerous studies examining this same question over the past twenty years.

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WHERE TO GO FROM HERE?

Today, there are viable alternatives to continuing down the austerity path. We present here six possible approaches for managing the crisis, both in the short and long run.

Federal Government Support

The best single short-term solution is for the federal government to provide funds for state and local governments to cover their recession-induced budget deficits. The simple

reason is that the federal government is able to borrow to cover its operating deficits caused by recessions, while the state and local governments are not permitted to do so. The February 2009 Obama stimulus plan—the American Recovery and Reinvestment Act (ARRA)—along with supplemental funds for Medicaid did provide significant support, covering about one-third of the total budget gap generated by the recession.[11] But that did still leave two-thirds that needed to be filled by other means. ARRA funds have now also run out and the Republican-controlled House of Representatives will almost certainly block further such initiatives. This means that the states and municipalities must seek out solutions that they can pursue on their own.

If tax revenues must be raised to help fill deepening budgetary holes, the sensible way to proceed is to focus these increases on wealthier households.

Raise Taxes on the Rich

In 2010, roughly 15 percent of the budget gap was covered by twenty-nine states raising taxes and fees for services.[12] In general, raising taxes during a recession is not good policy, since what is needed most during recessions is for spending to increase from both the public and private sectors. This requires people to have more money in their pockets, not less. But if tax revenues must be raised to help fill deepening budgetary holes, the sensible way to proceed is to focus these increases on wealthier households. Their ability to absorb such increases is obviously the strongest, which means that, unlike other households, they are not likely to cut back significantly on spending in response to the tax hikes. In fact, ten states—New York, Illinois, Connecticut, North Carolina, Wisconsin, Oregon, Hawaii, Vermont, Rhode Island, and Delaware—have raised taxes progressively in some fashion in 2009 and 2010.[13]

Of course, the wealthy do not want to pay higher taxes. But over the economic expansion and Wall Street bubble years of 2002-2007, the average incomes of the richest 1 percent of households rose by about 10 percent per year, more than three times that for all households. As such, the richest 1 percent received fully 65 percent of all household income growth between 2002 and 2007.[14] Moreover, poll numbers throughout the country consistently find that sizable majorities would prefer to raise taxes on affluent households than enact further budget cuts. Thus, a Marist Poll of New York State residents found that 64 percent—including majorities of Democrats, Republicans, and Independents—favored keeping that state's higher tax brackets on millionaires.

Such increases could also make a large difference.[15] For example, in Connecticut, a 2 percent surcharge on incomes above $200,000—which would apply only to the richest 5 percent of households—would generate $900 million.[16] This would eliminate one-third of the anticipated state budget shortfall for 2012.

One charge against raising state taxes in a progressive way is that it will encourage the wealthy to pick up and leave the states that impose higher taxes. But research on this question shows that this has not happened in the past and is not likely to occur in the future.[17] We can see why by considering the 2 percent surcharge on Connecticut's richest 5 percent of households. This would reduce the average after-tax income for these households—i.e.,

money they have available to spend or save—from $440,000 to $431,000.[18] In other words, it would hardly make a dent in the living standards of these households, much less push them to relocate out of state.

Pressure Banks to Stop Hoarding Cash

One of the biggest single barriers to a robust recovery is that, as of the most recent June 2011 figures, private banks are sitting on a $1.4 trillion hoard of cash reserves. This is nearly 10 percent of total U.S. GDP and more than double the entire military budget. It's true that a major cause of the financial crash was that the banks let their cash reserves dwindle to dangerously low levels during the financial bubble years. But the current $1.4 trillion in reserves is a good $1.2 trillion higher than necessary to provide an adequate safety cushion. Channeling perhaps $800 billion into new investments would provide a huge boost, given that this figure is equal to roughly half of total investment spending in the U.S. in 2010. Moreover, the banks obtained most of their $1.4 trillion in reserves almost for free, because the Federal Reserve has held short-term interest rates at nearly zero for the past 2 ½ years.

State and local governments have no control over Federal Reserve policy. But they can exercise leverage over private banks because they are themselves, in most cases, among the most prized customers for any individual bank. This is because private financial institutions handle about $8 trillion a year of state and local government funds in various ways. This includes their spending accounts as well as their pension funds and social insurance trust funds.[19] The basic policy approach here would be straightforward: in selecting the financial institutions to which they will award business, state and local governments should give strong preferences to banks that are aggressively committed to injecting credit into local communities to finance job-generating investments. Crucially, such initiatives will entail no new government outlays and can be implemented quickly, in most cases through an administrative decision rather than requiring the passage of new legislation.

Some states have already begun taking steps in this direction. Massachusetts is the most notable thus far, with an initial program to move $100 million in state deposits to banks with a strong small business loan-making record.[20] The initial reaction by the Massachusetts banks has been so responsive that the state now anticipates expanding beyond the initial $100 million threshold.

Loan guarantees are a low-cost strategy for state and local governments to significantly reduce the risks of new private investment projects financed by bank lending.

An argument that is frequently made against such measures is that the private bankers would be making loans for job-generating investments on their own, without requiring government inducements, except that conditions in the market are still too risky and demand for credit from private investors therefore remains weak. But state and local governments do also have the power to reduce these perceptions of excessive market risk, through expanding their existing loan guarantee programs. If managed properly, loan guarantees are a low-cost strategy for state

and local governments to significantly reduce the risks of new private investment projects financed by bank lending. The loan guarantees can therefore provide the carrot of reduced risk, while the banks would also face the stick of governments threatening to withdraw business if the banks keep sitting on their cash hoards.

Put Rainy Day Funds to Work

State and local governments have the ability to accumulate budget surpluses during economic expansions, which can then be drawn down during recessions as "rainy day funds." The rainy day funds thus enable governments to maintain relatively stable spending levels even as their tax revenues fall during a recession. When well managed, state and municipal rainy day funds can operate similar to deficit spending at the federal government level as a tool for fighting recessions.

The use of rainy day funds remains highly restricted. This limits their effectiveness during recessions.

Some states have used rainy day funds effectively. Thus, in 2006, near the peak of the last economic expansion, the states (overall) were holding a total of $70 billion in rainy day funds, equal to nearly 12 percent of total spending for that year.[21] As appropriate during the recession, most states have been drawing down these funds. As of 2010, reserves were at 2.4 percent of total annual spending. Indeed, some states have fully depleted their funds. But other states do still hold significant reserves which they should use now to both avoid further budget cuts and to spur recovery. For example, New York still has well above half of its pre-recession reserve levels available for spending, totaling $1.2 billion.[22] However, in New York as well as other states, the use of rainy day funds remains highly restricted. This limits their effectiveness during recessions—precisely when they are supposed to be mobilized to help counter a state's downturn.

The oil-producing states were able to accumulate the largest reserves during the last expansion, but they have been unwilling to draw on these funds during the recession. Texas is the most egregious case in point. The state currently is still holding $9 billion in rainy day funds, while it faces a projected $14 billion budget deficit for 2012. However, Governor Rick Perry and the Texas legislature are willing to spend only $3 billion.[23] They are choosing instead to enact severe spending cuts in basic education and health care programs rather than mobilize more of their rainy day funds to avoid such cuts.

Push Infrastructure Investments Forward

While state and local governments are mostly prohibited from borrowing to cover operating deficits during a recession, they are permitted to borrow for new capital projects. This includes school buildings and hospitals as well as new infrastructure investments such as roads, bridges, and ports. Indeed, a recession, when the costs of supplies and interest rates are lower, is a favorable time to begin such projects. However, the typical pattern is that state and local governments reduce their capital spending during a recession.

This has been the pattern over the most recent recession. Overall, state-level infrastructure spending did actually increase—specifically between mid-2008 and mid-2010—but only by 1.4 percent, from $62.2 to $63 billion.[24] However, even this slight increase was due to the additional federal government funds provided by the 2009 ARRA stimulus program. But to create an overall stimulus capable of

significantly boosting the economy out of recession, it is counterproductive for the state and local governments to cut their capital spending budgets while the federal government is increasing its support. Rather, state and local governments should also be borrowing more to help finance new infrastructure projects as an anti-recession measure.

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Eliminate Business Giveaways

Over the past four decades, states and municipalities in the U.S. have competed, sometimes intensively, among themselves to attract businesses to locate within their borders. The main weapon in this competition has been various types of tax incentives. These efforts have achieved some minor successes in their primary aim of attracting businesses to their location. But these gains have been achieved almost entirely on a zero-sum basis—that is, by reducing job creation in neighboring states and localities that have not offered the same incentives.[25] These programs have also brought a declining tax base for the state or municipality offering these incentives, which in turn has meant declining budgets for state-level public investment or similar worthwhile activities. One recent estimate sets the revenue losses at more than $70 billion per year.[26] That is, eliminating these incentive programs would itself close roughly half the expected budgetary shortfall for 2012. Of course, it is too late for any such initiatives to help close the existing state budget gaps. Moreover, some states, such as Wisconsin and Maine, are considering new rounds of corporate giveaways as a means of pushing their economies out of the recession and onto a strong growth trajectory at the expense of their neighboring states. But the fact is, for all the states, taking a cooperative approach to advancing new tax, spending, and regulatory measures will yield far more favorable results for all.

AUSTERITY IS NOT THE SOLUTION

The fundamental matter at play here does not concern any specific policy initiative but rather the establishment of what is the real problem that any given set of policy initiatives is trying to solve. Is the goal to manage the budget crises for state and local governments in ways that maintain the integrity of educational, health care, and public safety systems, as well as a decent social safety net; and to perhaps even create conditions under which such programs can expand and improve once the economy has moved into a sustainable recovery? Or is the crisis merely a pretext for dismantling state and local governments as viable institutions supporting their communities? There is little doubt where Wisconsin Governor Walker, Newt Gingrich, the Koch Brothers, and many others of their ilk stand on this matter. But for those who are committed to maintaining decent public schools, hospitals, and the many other programs operated by state and local governments, we have tried to show that there is no reason to surrender to any version of an austerity agenda—neither that of Scott Walker in Wisconsin nor the Jerry Brown scenario in California. Austerity is not a solution, and viable alternatives are at hand.

Notes

1. Jeb Bush and Newt Gingrich, "Better off Bankrupt," *Los Angeles Times*, January 27, 2011, available at http://articles.latimes.com/2011/jan/27/opinion/la-oe-gingrich-bankruptcy-20110127.

2. Governor Brown's budget proposal is available at http://documents.latimes.com/jerry-brown-proposed-budget-2010-2011.

3. Political Economy Research Institute (PERI) analysis of U.S. Census Bureau state and local government tax revenue data. The data are available at www.census.gov/govs/qtax.

4. Michael Leachman, Erica Williams, and Nicholas Johnson, *Governors are Proposing Further Deep Cuts in Services, Likely Harming Their Economies* (Washington, D.C.: Center on Budget and Policy Priorities, March 21, 2011), available at www.cbpp.org/cms/index.cfm?fa=view&id=3389.

5. LIHEAP program usage statistics are from the National Energy Assistance Directors' Association, available at www.neada.org/communications/press/2011-02-08PressReleaseEnergyAssistance.pdf.

6. Elizabeth McNichol, Phil Oliff, and Nicholas Johnson, *States Continue to Feel Recession's Impact* (Washington, D.C.: Center on Budget and Policy Priorities, March 9, 2011), available at www.cbpp.org/cms/index.cfm?fa=view&id=711.

7. The ALEC report is available at www.alec.org/am/pdf/tax/09RSPS/26969_REPORT_full.pdf.

8. PERI analysis of U.S. Census Bureau and Bureau of Economic Analysis data.

9. Stephanie Fitch, "Gilt-Edged Pensions," *Forbes*, February 16, 2009, available at www.forbes.com/forbes/2009/0216/078.html.

10. John Schmitt, *The Wage Penalty for State and Local Government Employees* (Washington, D.C.: Center for Economic and Policy Research, May 2010), available at www.cepr.net/index.php/publications/reports/wage-penalty-state-local-gov-employees.

11. Between FY2009 and FY2011, the cumulative state-level budget shortfalls were $468 billion. Over that same period, the federal aid to states in the ARRA legislation was $158 billion. See McNichol et al., *States Continue to Feel Recession's Impact*.

12. National Association of State Budget Officers (NASBO),"Fiscal Survey of the States," Fall 2010, Table 21, available at www.nasbo.org/LinkClick.aspx?fileticket=C6q1M3kxaEY%3d&tabid=38.

13. Ibid. and NASBO, "Fiscal Survey of the States," Fall 2009, Table A-11.

14. Emmanuel Saez, *Striking it Richer: The Evolution of Top Incomes in the United States* (Berkeley: University of California, Department of Economics, July 17, 2010), available at http://elsa.berkeley.edu/~saez/saez-UStopincomes-2008.pdf.

15. The Marist Poll results are described at http://maristpoll.marist.edu/131-nys-budget-down-the-deficit-say-voters.

16. PERI analysis of IRS income and tax distribution data by state. IRS data available at www.irs.gov/taxstats/article/0,,id=171535,00.html.

17. This research is reviewed in Jeff Thompson, *The Impact of Taxes on Migration in New England* (Amherst, MA: Political Economy Research Institute, April 2011), available at www.peri.umass.edu/236/hash/a26b58a25398181f04eb-843ca7c32171/publication/458.

18. PERI analysis of IRS income and tax statistics, described in Jeff Thompson, *Prioritizing Approaches to Economic Development in New England*, Table 16 updated (Amherst, MA: Political Economy Research Institute, August 2010), available at www.peri.umass.edu/236/hash/3f1bd7d2221409d39332894e8e2e0c72/publication/422.

19. The resources held by state and local governments in commercial banks include total expenditures, employee pension fund assets, and assets in Unemployment Insurance, Workers' Compensation, and other state-administered social insurance programs.

20. The Massachusetts program is described at www.mass.gov/Ctre/docs/sbbpPR05052011.pdf.

21. Elizabeth McNichol and Kwame Boadi, *Why and How States Should Strengthen Their Rainy Day Funds: Recession Highlighted Importance of Funds and Need for Improvements* (Washington, D.C.: Center on Budget and Policy Priorities, February 3, 2011), available at www.cbpp.org/files/2-3-11sfp.pdf.

22. NASBO, "Fiscal Survey of the States," Fall 2010, Table 4, available at http://nasbo.org/LinkClick.aspx?fileticket=EQnlICsAJD8%3d&tabid=38.

23. See "Texas to Use $3.2 Billion from Rainy Day Funds," *Associated Press*, March 15, 2011, available at www.myfoxdfw.com/dpp/news/031511-texas-to-use-$3.2-billion-from-rainy-day-funds.

24. PERI analysis of NASBO data, published in NASBO, "State Expenditure Report: FY2009," available at www.nasbo.org/LinkClick.aspx?fileticket=w7RqO74lIEw%3d&tabid=38.

25. The research literature on tax incentives and economic development policy is reviewed in Thompson, *Prioritizing Approaches to Economic Development in New England*.

26. Kenneth P. Thomas, *Investment Incentives and the Global Competition for Capital* (New York: Palgrave MacMillan, 2010).

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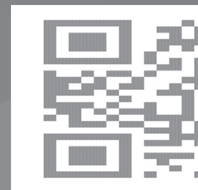

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