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Updated October 10, 2008

STATES FACE TWO IMMEDIATE FINANCIAL ISSUES: SHORT-TERM BORROWING AND BIG BUDGET DEFICITS

By Nicholas Johnson

States face two distinct financial problems right now. First, California and Massachusetts officials last week raised concerns about their states' ability to access credit markets for short-term borrowing. Second, most states have been facing budget deficits that have forced, or are now forcing, them to raise taxes, cut spending, or do both to balance their budgets.

These issues are serious, but they are distinct from one another. To better understand them, and to understand what the federal government should do to resolve them, we should take a closer look at each.

I. States Concerned About Short-Term Borrowing

Many states and localities routinely use short-term borrowing to manage their short-term cash flow. State income tax and other kinds of revenue come in more strongly in the second half of most states' fiscal years than in the first. Thus, they borrow to meet their spending obligations when revenues are temporarily insufficient. Indeed, they issue what are called "tax anticipation notes" or "revenue anticipation notes" for just this purpose.

Thus, such short-term borrowing is a routine part of state fiscal practices and not normally a problem, even during recessions or other state fiscal crises. States are reliable borrowers, and they repay their loans when tax revenues come in.

Currently, however, states are facing the same problem faced by millions of businesses across the country – tightening credit markets. Lenders are reducing lending, so states are concerned they may not be able to borrow when they need to. That's why California and other states and localities may seek to borrow their needed funds from the federal government. The Treasury or Federal Reserve may have to serve as the lender of last resort for them.

II. States Face Bigger Challenge Balancing Budgets in Weak Economy

The biggest challenge for most states right now is not credit, but rather the weak economy that is throwing their budgets out of balance. Rising joblessness and falling consumer spending are generating less income and sales tax revenues than states expected when they wrote their budgets. At the same time, the need for public services in areas like health care, education, human services, and public safety is as strong as ever. In fact, need rises as residents lose jobs and income and become more reliant on public services.

Three months into their fiscal year, the budgets of at least 21 states have opened new gaps. Seventeen of those 21 states are among the 29 that already cut spending, used reserves, or raised revenues in order to adopt a balanced budget at the start of the current fiscal year (July 1 in most states). Now, their budgets have fallen out of balance again, raising the likelihood of reduced public services or higher taxes and fees. More states will likely make similar announcements in coming weeks and months. Additional budget gaps are projected in many states for 2010.

Even if states get the short-term loans that they anticipate (per the explanation in the previous section), that won't help them balance their budgets for the current year. Unlike the federal government, states can't borrow their way out of a budget shortfall. Rather, they typically must cut spending or raise revenue, either of which can exacerbate a recession by reducing aggregate demand in the economy.

Because state spending cuts or revenue increases are likely to worsen the economic downturn, many economists, including those at the Congressional Budget Office and others, have argued for a program of increased federal assistance to states.

In the recession in the early part of this decade, the federal government provided $20 billion in fiscal relief in the form of increased Medicaid match and general grants to states. The package averted even deeper cuts in public health insurance than actually occurred and helped prevent cuts in a wide variety of other critical services.

This year, it may be necessary to enact a *larger* package of fiscal relief than was enacted in 2003. It seems increasingly likely that this recession will be more severe than the last recession, and thus state fiscal problems may be worse than they were in 2003. This is true for at least three reasons:

- Unemployment, which peaked after the last recession at 6.3 percent, has already reached 6.1 percent, and many economists expect it to rise to 7 percent or even 8 percent. This would reduce state income taxes, and increase participation in Medicaid and other services, to a greater degree than in the past.

- The decline in the stock market now has matched the decline in the last recession by some measures and may yet fall further. This affects states' capital gains taxes, which in many states are a major component of income taxes.

- Consumers' access to home equity loans and other sources of credit is far less than it was in the last recession, so consumption expenditures and therefore sales taxes are likely to fall more steeply than in the past.

For these reasons, state budget problems likely will be worse in the coming year than they were earlier this decade, and therefore an effective package of state fiscal relief would need to be greater than the $20 billion enacted in 2003.