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CONVERTING STATE FISCAL RELIEF TO LOANS WOULD RENDER IT INEFFECTIVE AS STIMULUS

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Senate Minority Leader Mitch McConnell's recent suggestion that the federal government give states loans, not grants, for fiscal relief would make the recovery package considerably less effective in stabilizing the economy and preventing the recession from becoming deeper and more prolonged. Loans, unlike grants, would almost certainly be ineffective in averting deep budget cuts and substantial tax increases in states across the country that would place a large drag on the economy. The proposal reflects misperceptions about why states face large deficits, how state budgets and constitutions work, how states would use fiscal relief, and what will happen if they do not receive it.

- **State fiscal problems stem from the recession, not from fiscal mismanagement.** The evidence here is clear. Prior to the recession, states not only balanced their budgets every year but also had built up the largest budget reserves in recent history (a far cry from what federal policymakers have done). Unfortunately, the current recession will be sufficiently deep and long — clearly the longest since World War II — that states are depleting these large reserves and will face extremely large shortfalls. State deficits over the next 2½ years are projected at approximately $350 billion.

- **States would not "misuse" the fiscal relief.** The grim reality of state budgets punctures another misperception that appears to underlie the "loan proposal" — that states would use fiscal relief to launch an array of costly new spending programs. This is not the case. The fiscal relief under consideration would equal only a fraction of the state budget shortfalls, and states would need to use the fiscal relief to lessen the magnitude of the steep program cuts and tax increases they otherwise will have to impose, not to launch expensive new endeavors.

- **Most states would not be able to accept or use federal loans.** Most important, many states have constitutional or other legal barriers that explicitly *prohibit* them from borrowing funds to cover operating expenses. Other state constitutions or laws strictly limit the amount of debt a state may incur, and the proposed loans could breach these limits. Moreover, most state balanced budget requirements bar states from accepting loans for state operating budgets. In short, most states likely would be unable to accept loans to help them cover rising health care costs and address their looming budget shortfalls. (In addition, many or most states that do *not* face such a legal barrier would likely feel compelled to decline such loans for sound reasons, as explained below.)

- **If fiscal relief is replaced by loans, most states will institute deep budget cuts and, in some cases, hefty tax increases to balance their budgets.** For states to take such steps in the middle of the most severe recession in at least a quarter century would be dangerous for the faltering U.S. economy.

The Fallacies Behind the Proposal to Convert Fiscal Relief to Loans

Most economists agree that states need substantial, temporary federal fiscal relief to help them balance their budgets during the recession *without* imposing deep program cuts and/or tax increases that would constitute a serious drag on the economy. Senator McConnell's suggestion that the federal government provide this assistance as loans and require states to repay it appears to reflect the belief that temporary grants would reward or encourage fiscal irresponsibility by the states. This is not the case, for several reasons.

First, states' budget problems stem from the recession, not fiscal mismanagement. States prepared better for this recession than for any previous recession. At the end of fiscal year 2006, state reserves — in the form of general fund balances and "rainy day" funds — totaled 11.5 percent of annual state spending, the highest level on record.

In recent months, the weakening economy has opened up large deficits in most states by greatly reducing projected tax revenues and increasing the cost of services for newly unemployed workers. Total projected state shortfalls totaled $88 billion for fiscal year 2009 and are likely to approach or exceed $150 billion in each of the next two fiscal years. Over the next 2½ years, therefore, state deficits are likely to total $350 billion to $370 billion.

To meet their balanced-budget requirements, states have largely depleted their reserves, and 30 states already have cut services to vulnerable residents in areas such as health care, services to the elderly and disabled, K-12 education, and higher education. In addition, more than a dozen states have raised revenues. State budget cuts and tax increases will become much deeper and more widespread over the next few years.

Second, states would use federal fiscal aid to lessen the magnitude of program cuts and tax increases, not to launch new programs. The amount of fiscal relief under consideration for state operating budgets would close only a portion of states' total projected budget shortfalls for the coming years. Even with this aid, states will have to reduce programs substantially and/or increase revenues in order to balance their budgets. Most states would use the fiscal aid solely to reduce the severity of the politically unpopular program cuts and tax increases they will have to impose.

Third, reducing the extent of state budget cuts and tax increases will soften the recession. When states cut spending, they lay off employees, cancel contracts with vendors, reduce payments to businesses and nonprofits that provide services, and cut benefit payments to individuals. All of these steps remove demand from the economy, which worsens a downturn. Tax increases also remove demand from the economy by reducing the amount of money people have to spend. By reducing the need for such measures, federal fiscal relief would help stabilize the economy while also lessening the degree to which states cut services for struggling families already hit hard by the recession.

Finally and most important, if federal relief took the form of loans, most states would be unable, or unwilling for good reason, to accept them. Many states face fundamental legal barriers to accepting such loans. The constitutions of a number of states explicitly bar the state from borrowing funds to cover operating expenses. Other state constitutions or statutes strictly limit the amount of debt that the state may incur, and in some states, such loans would exceed the limit. In addition, most states have balanced-budget requirements that may bar them from accepting operating-budget loans. As a result, most states likely would not be able to accept federal loans.

Even states allowed to accept such loans would likely be wary of doing so. State fiscal crises brought on by major recessions tend to be prolonged. In the last two recessions, the fiscal crisis in most states continued *two to three years* after the economy hit bottom and the recession officially ended. Some states that accepted loans could face requirements to make large loan repayments to the federal government while their budgets were still in distress and their economies, although beginning to recover, were still weak. Moreover, after every recession, some states recover more slowly than others; the loan repayment requirements could impose particular hardship on slowly recovering states.

Moreover, states will already face the equivalent of a large repayment obligation when fiscal conditions improve. States will have to rebuild their depleted reserves and replenish their rainy day funds in order to prepare for the next downturn, as they have done in the past. It can be difficult for a state to simultaneously replenish its reserves *and* restore normal services in the aftermath of a major recession. A large repayment obligation to the federal government added on top could place burdens on some states beyond what they could shoulder. Accepting such a loan also could reduce a state's bond rating, another factor that would discourage states from accepting the loans.

Still another obstacle is that in some states, a voter referendum is required for the state to incur debt. This would delay state acceptance of loans for months (if the loans were ultimately approved), with these states required to institute economically damaging budget cuts or tax increase in the interim, especially since policymakers would have no assurance that the borrowing would win voter approval.

In sum, if the federal government fails to provide assistance that states actually can use to lessen the magnitude of their burgeoning budget shortfalls, states will have to enact exceedingly deep budget cuts and tax and fee increases that will undercut the stimulus the federal government is trying to provide. The proposal to convert fiscal relief into loans consequently would lead to a further weakening of the economy, thereby costing jobs and prolonging the recession.