After the Fact | [What's Happening in the States]
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TRANSCRIPT

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Chris Hoene, executive director, California Budget & Policy Center: *It's largely that the scale of things is daunting for state lawmakers. Uncertainty is certainly the big theme of this budget.*

Dan LeDuc, host: That's Chris Hoene, who leads the California Budget & Policy Center, talking about the uncertainty facing many state legislators around the country as they meet and start to prepare their budgets. We'll talk with him later in this episode. As we look ahead to a new year, it's a time when state lawmakers are looking ahead, too.

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Dan LeDuc: I'm your host, Dan LeDuc, and this is "After the Fact," where we tell the story behind the numbers shaping your world. And in today's episode, we're discussing the dollars and cents that make up a state's budget, and that leads us to our data point for this episode: 21. Twenty-one states—that's nearly half—have yet to see tax revenues recover from the levels they were at before the Great Recession a decade ago. On the minds of many legislators is how to plan for their policy priorities this year—and much of that work is tied to the state budgets. To learn more, I spoke with Kil Huh, who directs Pew's work on state and local fiscal health.

So, Kil, as we sit here in Washington, all over the country the state legislators are meeting in state capitols. And they are grappling with their budgets. And that's a big deal, because it determines a lot on how people get programs and how much they'll pay in taxes. And what's especially important in the states is they all have to balance those budgets. Which means they have to make some hard decisions over these coming months. What's going on out in the states?

Kil Huh, senior director, The Pew Charitable Trusts: Well, the U.S. has been in expansion for more than eight years. The unemployment rate is just about 4 percent. And personal incomes have largely recovered since the Great Recession. But this positive economic news hasn't generally translated into a strong state revenue growth or stable budgets for states. And it's left a lot of policymakers with little wiggle room to balance their budgets, and with concerns looking ahead.

Dan LeDuc: But how do—let me—I'm sorry to interrupt. But it sort of seems like, why is that happening? Why aren't states seeing—feeling better?

Kil Huh: At a recent conference in November of 2017, there was a gathering of state legislative fiscal leaders. And an economist from Moody's was presenting. And he asked lawmakers, you know, "Which of you are feeling good about your state finances right now?" And in a room of about 35 states, only two raised their hand.

Dan LeDuc: Wow.

Kil Huh: Yeah, Utah and Minnesota. And I think what was alarming in that sort of exchange was that if you're not feeling good now, when are you going to feel good? Because—

Dan LeDuc: Right.

Kil Huh: We are in the third-longest economic expansion in U.S. history. And right now, if you're not feeling good about where you are, there's really some cause for concern. Because in the next two years, Moody's is anticipating a possible economic downturn.

Dan LeDuc: So they're already starting to just face big, big challenges on the spending side, right. But the money coming in on the other end isn't even keeping up with some states for where they were pre-recession.

Kil Huh: Oh, that's exactly right. As of the most recent data, 21 states have yet to recover to their pre-recession levels. And as you mentioned, over the last decade, spending has grown very modestly. But at the same time, the bills that are past due—like pensions and infrastructure—have grown significantly and are crowding out other budget items. There is some cause for optimism in the next fiscal year. Again, unemployment is very low, wages are rising. But rise in personal income is not a panacea for the budget troubles that they have.

Dan LeDuc: For any lawmaker who was around 10 years ago, it had to be really hard. I mean, states have to balance their budgets, right? So that means that there is no revenue, they've got to cut programs. Is there a hangover effect?

Kil Huh: I think that's a good way of putting it. The Great Recession still looms large in a lot of the challenges that state lawmakers are facing. But I would even suggest that it predates the Great Recession.

The other thing that's challenged is if you pile on the economic and demographic trends that we're seeing—a lot of the automation trends, a lot of industries that, by and large, carry large parts of this country—like the Midwest, for example, agriculture—those are struggling. And there's a ton of automation as well as e-commerce happening. And states are only beginning to really sort of catch up and grapple with some of those trends that they've seen on the horizon for a long time.

Dan LeDuc: Yeah, let's talk about that for a minute. I mean, these are not, like, surprises. Anybody who's sort of been paying attention to the news knows that these trends have been a force in our society for a while. Why are we moving a little late in the states on this?

Kil Huh: Well, I think that states have been in reactive mode. They haven't been as attuned to the need to plan over the long run. But that's been changing, and we see some progress on that front. But that said, you know, by 2030, 20 percent of the U.S. population is going to be over 65. And with that, we're going to see changes in income. Incomes are going to decline for that group as they retire from their jobs. And their spending needs are going to change. They're going to move away from purchasing durable goods like cars and home appliances to investing more in health care.

Dan LeDuc: And that stuff—some of that stuff used to generate sales tax revenue. Health care, not so much.

Kil Huh: Exactly. And so the tax bases of each of the states may change. And state lawmakers are not really prepared for what's coming next. And that continues to be a challenge for them.

Dan LeDuc: Let's go back to demographics for a minute. It's more than just a revenue question. It's also a cost question, right? As people's—as the various states' populations get older, that increases health care costs, social programs, all of that sort of stuff?

Kil Huh: That's absolutely right. As the population gets older, they're going to want more health services, as well as assistance to essentially live their lives. And so states are going to have to—or communities, rather—are going to have to adapt to that growing elderly population.

Dan LeDuc: So one of the things that also is going on is states are—at least some places—trying to get better about saving for that rainy day. They actually have what they call rainy day funds. What are those?

Kil Huh: Rainy day funds are essentially reserves that are used to deal with multiyear budget gaps. Many states have them in place. What's interesting is that Moody's just did an analysis of whether or not states could withstand a moderate recession. They did what we call a budget stress test. And what was interesting is that they found that only 16 states would have the funds needed to withstand a mild recession. Nothing that—

Dan LeDuc: In other words, the adequate savings to sort of make up for lost revenue that recession brings about?

Kil Huh: And when Pew did its own analysis, we found that there was a significant number of states—you know, more than 40 percent—that didn't have the adequate funds in place to actually operate for a month on savings. And so that's actually alarming. And it just demonstrates that, again, it's a missed opportunity. In the midst of an economic expansion, states weren't thinking ahead. They were really only focused on sort of their current budget challenges.

Dan LeDuc: We have states at sort of both ends, probably, of how they're contending with these times. Some are probably, you know, forging ahead and finding their way. Others are probably struggling. Where is a place that's having some problems?

Kil Huh: Two states that come to mind are Illinois and Connecticut. Both states are struggling with long-term obligations that have resulted from missed opportunities to fund these programs adequately. And as a result, they're causing major budget trade-offs right now as states try to put together their budgets for the next fiscal year. In Connecticut alone, in order to address their yawning pension and debt obligations, they are aggressively putting money aside in order to pay for future downturns but at the same time pay down a lot of that debt while sacrificing investments in health care and education and other key services.

Dan LeDuc: What about at the sort of other end? There's got to be some states that are, you know, starting to put these best practices into place. Tell us about some of those.

Kil Huh: Well, Utah is a state that's done an exceptional job of planning for the future. Utah is a state that really values data-driven policymaking and has put in place policies to weather the long term as effectively as possible. On the heels of the Great Recession, able to expand a major interstate to promote economic activity. Partly because they were very strategic about how they manage their cash, and when and how they borrowed. And because they were able to invest in an important infrastructure project, it was also stimulative for their state.

Dan LeDuc: Right. So there's an added benefit there?

Kil Huh: So there was an added benefit there. And, as the economy started to recover in the region and as the Utah revenue coffers started to build up, you know, they were very conscientious about paying down that debt to give them more flexibility looking ahead. And putting aside money for that proverbial rainy day.

Dan LeDuc: So, over the coming months, legislators are going to be making some hard decisions about their budgets and a host of other issues in all the states. What are you going to be looking for?

Kil Huh: State lawmakers have to be thoughtful in terms of planning for that inevitable downturn that we will see. Whether it's putting money away in their rainy day fund, investing in programs at work that have a high return for taxpayer dollars, or really just managing their current budgets effectively so that there aren't any unanticipated surprises down the road.

These are the things that lawmakers can do now in order to plan for what comes next. What's driving a little bit of uncertainty is what's playing out at the federal level. We just had a major tax reform, which is driving some uncertainty at the state level in terms of whether or not programs—tax programs or credits—get expanded, or whether additional revenue comes in as a result of the broadening of the base with the tax reform. In a bit of good news for states, they may get some fiscal help from ongoing economic expansion in 2018. They will see a growth in wages and capital gains tax collections.

At the same time, rising wages are not a panacea. And while they should help boost tax collections to some extent as worker income expands and consumers increase spending, it's not going to necessarily be a long-term trend that they can count on. The other silver lining is that state lawmakers are beginning to think more long term. And they're really looking to harness some of the good times that they're seeing right now to gird against future downturns. And that's a very positive step.

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Dan LeDuc: There are states and there are states. California is the most populous state, and it’s the world’s sixth-largest economy. What happens there reverberates beyond its borders. Chris Hoene of the nonpartisan California Budget & Policy Center is on the line with us from Sacramento to talk about what’s happening there now.

Dan LeDuc: You know, one of the reasons we wanted to talk to you in California is just because the sheer size of California says so much about what's happening at the state level and has ramifications that sort of rattle across the state lines. And I guess every state budget is really—it's partly about money, but it's really about policy priorities. Tell us a little bit more about California.

Chris Hoene: Well, uncertainty is certainly the big theme of this budget. The governor's office hasn't really had time to incorporate what the potential changes would be of the federal tax bill that was passed before Christmas. And we know that there are budget proposals coming from Republicans in Congress that could potentially make major changes to Medicaid or other safety-net services and other discretionary types of budget cuts, all of which could have implications for the state budget in California. And so it's pretty difficult to craft a budget in early January of 2018 with all of that uncertainty at the federal level.

And then you couple that with—this governor has warned for multiple years now that we are in a long period of economic growth that will eventually turn, and there will be a recession someday. And the nature of the state's tax system is such that we have to be ready for that potential downturn. And so he's taking what is a pretty good budget outlook overall and growing revenues and putting the bulk of those revenues into the state's rainy day fund.

Dan LeDuc: You know, a lot of states are going to have to be making very similar decisions, maybe not at the dollar level that California is. Where are the states in terms of sort of the post-recession years, where we're almost 10 years now since the Great Recession ended? Are they fully recovered and moving on, or is there a hangover yet from that difficult time?

Chris Hoene: There's still a hangover, particularly in the safety-net services arena, where most states make significant cuts when there are economic downturns and had to make even more significant cuts due to the scope and scale of the Great Recession. Most states, including California, have not built those systems back to the levels that they were at. And so the recipients of those systems, like Medicaid or TANF, the Welfare to Work program, are all operating at public assistance levels that are well below where they were prior to the Great Recession. There has been some building back in places like K-through-12 education. We've certainly been making some investments in higher education in California. And there have been some other successes in terms of increasing the funding. But there is still a pretty good hangover, particularly in that safety-net arena.

Dan LeDuc: And you're talking about a state that had, what, I think I read a $19 billion budget surplus. That's like 10 percent of the spending plan overall, right?

Chris Hoene: Well, I'd be cautionary about calling it a surplus. At this point, it's revenues that are above and beyond what the state has allocated. But the budget process itself is a process of allocating those dollars. So, you know, where we end up at the end of the year is still in question. But you are right. There is a significant amount of money on the table. Both the governor's budget and the Legislative Analyst's Office, which produced a forecast a couple of months ago, are saying that there's about $7 billion on the table for state leaders to consider either putting into the rainy day fund, or spending, or whatever the case may be.

Dan LeDuc: You mentioned a moment ago that this is all so new. The federal tax legislation was just passed, right before Christmas, as you mentioned. So this is all getting sorted out. And there's not a lot known now. But what will happen in California? And given your expertise with other states, what's going to happen in the coming months? How will lawmakers in California and elsewhere learn these ramifications? How will they sort through how to figure out how their state budget fits in with now what's being done in Washington?

Chris Hoene: So we'll have the next six months of budget process to learn some very important information. Perhaps the most important bit of information will be the effects of the tax bill on the next quarter or so in terms of how the state's revenues are impacted. So, you know, we've had all of this coverage around the country of people potentially paying their tax bill early in order to shift some of the taxes they pay into the 2017 year to avoid changes that would be made in the 2018 year. And that could potentially mean because people would be paying taxes earlier, that the state sees some influx of revenues.

But some of the other changes could mean that the state loses some revenues. And so the Department of Finance that works for the governor's office will learn a lot more about what's happening with the state's revenues in the next three or four months. And that will impact the governor's revised proposal to his budget, which is due out in mid-May. So that's a big piece of how the process will move going forward.

The other big variable there is really what happens on the federal budget front. And potential major cuts in that arena could also impact the levels at which California's spending go forward in its own budget process in the coming months. We haven't had tax cuts of this scale that were just passed since the mid-1980s. And so much of that is unknown in terms of what it does to federal and state revenues. So it's largely that the scale of things is daunting for state lawmakers as they try to figure out how to make what are usually incremental changes, you know, positive or negative depending on how the economic cycle is going.

Dan LeDuc: California is one of those places known for property taxes, just like smaller states and New Jersey are also known for that. What's the appetite in the Legislature there about some sort of legislative addressing of that issue?

Chris Hoene: Well, I think that there's a pretty solid appetite for some types of tax responses to what the federal government might do. So they're in a wait-and-see mode, obviously, around the federal tax bill’s ramifications for California. As they know more about that, I think options for how the state could change its own tax code, based on its own policy priorities, are certainly going to be there and on the table. We often do tax policy through ballot measures here in California. And we have a ballot measure year this year. 2018 is a statewide election year. And so we'll certainly probably see some ballot measure responses, particularly to federal budget cut proposals that could emerge in the coming weeks.

Dan LeDuc: Are there things about, you know, the cost of living in California or other sort of ways that people actually go about their day-to-day lives that the Legislature is going to be taking on there?

Chris Hoene: So what the governor's budget proposal this year does is largely reflect policy decisions that were made in prior years, particularly these last couple of years. So he continues to propose to fund the state's earned income tax credit, which is a tax credit for working households who don't make a lot of money, providing them some additional cash assistance. The budget reflects a housing package deal that Governor Brown and state legislators reached this past year providing some funding mechanisms and some new money for affordable housing development. And this year's budget reflects the first year of those revenues being available. And so there's elements in the state budget that are about addressing the affordability issue.

Dan LeDuc: So let me ask you, what are your top two or three things, beyond the fiscal things that we've talked about, that you're going to be watching most closely?

Chris Hoene: Well, the first one is really what happens with the federal budget to see what the kinds of proposals are and what the scale of the cuts might be that could be passed, and what those implications would be for California. Because if, for instance, the scale of the cuts to Medicaid that were proposed by Republicans in Congress this last fall were to actually be implicated, that would produce a budget hit here that would be akin to what we experienced during the Great Recession. So there's not a bigger issue in terms of implications for this state. If that doesn't come to pass, or the scale of potential cuts is much lower, I think the other issues we're going to be watching then are how the state leaders use the room that they have in what is a very good budget year, for the most part, of growing revenues and what the balance is that they strike between saving for a rainy day and making some investments in affordability in a state that's already a very high-cost place to live.

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