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Red Ink in States Beginning to Hurt Economic Recovery

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Having already stripped the nation of a source of economic growth, the budget crises in California and in almost every other state are now beginning to drag down the national economy, prolonging the weak, jobless recovery, the latest budget numbers show.

Over the past two years, the states have gradually cut between $20 billion and $40 billion — no one knows exactly how much — from their spending. Billions more in cutbacks are coming in the fiscal year that started July 1. In California alone, a tentative budget deal will presumably require the state to rid itself of at least $8 billion in current spending, with the cuts likely to fall most heavily on education and aid to the poor.

The numbers are hard to add up, but even the most optimistic accounting has state spending slowing sharply while tax rates rise along with a variety of fees. Just three years ago, the states were still a plus for the economy. While the private sector had begun to limp, state spending had remained strong and so had revenues, despite cuts in tax rates in several states.

Today the opposite is happening, and that makes the states a net minus for the national economy. Without that reversal, some economists say, the economy would probably be growing at an annual rate of more than 3 percent, enough to create jobs rather than eliminate them.

"It is reasonable to think that the response by the states to the fiscal crisis is taking at least half a percentage point out of the growth rate of the national economy," said Nicholas Johnson, director of the State Fiscal Project at the Center on Budget and Policy Priorities in Washington. The annual growth rate has averaged 2.6 percent for the last 15 months.

The cuts in state spending are just starting to be felt, with the impact landing disproportionately on the poor. "We have been shifting a lot of spending for social services from the feds to the states," said Robert M. Solow, an economist at the Massachusetts Institute of Technology and a Nobel laureate. "And that means the cuts that are taking place are hurting people at the bottom of the income distribution."

That shows up clearly on the ground in California, which has cut spending by $12 billion over the past two years, by far the largest cutback of any state. At James Monroe High School in North Hills in the San Fernando Valley, to take one of thousands of examples, state funding for a technician to service the school's 900 computers disappeared, and state subsidies for teacher aides also dried up, even though enrollment has jumped by nearly 20 percent, to 5,000, since 1998.

Child Support Services in Los Angeles County, which helps single parents collect support payments from former spouses, also got hit, losing $10.6 million in state funds last April, or 7 percent of its budget. In response, 107 temporary employees were laid off, and 100 full-time workers were notified that they could soon lose their jobs, although in the end only 32 will probably go, according to Philip Browning, the agency's director.

Across the state, tens of millions have been cut and continue to be cut from funding for child care and job training, to computerize high schools, pay performance bonuses to public school teachers, purchase library books for elementary schools, subsidize research at state universities, and maintain the value of assets in state employee pension plans. "The fewer deposits in the pension plans mean your budget shortfall is less, but you can't do this for very long," said G. Eugene Steuerle, a senior fellow at the Urban Institute in Washington.

Medicaid outlays are still rising in California, but no longer by enough to cover inflation or the growing number of poor people seeking care, although as part of the Bush-sponsored tax cuts enacted in May, the states are getting a $20 billion one-time infusion of federal money, with half of it earmarked for Medicaid. California's share is $2.4 billion. "It is part of the solution to the $38 billion cumulative budget problem," said Brad Williams, a senior economist at the California Legislative Analyst's Office. "It helps a lot."

That huge deficit is far and away the largest ever accumulated by a state and is a major issue in the recall vote that Gov. Gray Davis faces in November. In the attempt to whittle down the deficit, $560 million came out of state spending in California for kindergarten through 12th grade in the last fiscal year, and more than $530 million disappeared from the $10 billion earmarked by the state for Medicaid, according to Jean Ross, executive director of the California Budget Project, a research organization in Sacramento.

The pain would be worse were it not for some budgetary sleight of hand performed by a legion of state officials across the country. "Their bag of tricks is impressively deep," Mr. Johnson said. "Take Illinois. The state government has sold its big glass office building in downtown Chicago and pocketed the sales revenue, but instead of moving out, it is renting back the building."

Many state governments have been reluctant to lay off workers, preferring instead to freeze hiring and wages and not replace workers who retire or resign. Some states have raised tax rates to help cover salaries and thus minimize layoffs. And a great variety of court fines and fees for service have gone up. Minnesota even came up with a new one: public defenders are no longer furnished free; defendants now pay $50 or more.

The resistance to layoffs has limited the drop in state employment across the nation. Employment hit a peak of 5.023 million state workers in June of last year and has fallen since then by 91,000, or less than 2 percent, the Bureau of Labor Statistics reports. At the local government level, employment finally stopped rising this year and flattened out at 13.8 million people, without falling.

The California experience is more extreme by far than what is happening in the other states, but the maneuvering in California to avoid more outright spending cuts is illustrative of maneuvering in state capitals everywhere. In February, for example, the Davis administration sold for $2.5 billion California's right to collect over the next 25 years a total of $5 billion or more in tobacco settlement money. Roughly $30 billion of the $38 billion deficit, in fact, is being dealt with through "borrowing, payment deferrals and other one-time actions," Mr. Williams said.

Then there is the growing practice, evident in California and Minnesota, among other states, of adopting optimistic forecasts of future economic growth and assuming that tax revenues will rise as the forecasts materialize. Minnesota, for example, is counting on the gross domestic product to be growing by early fall at a 3.5 percent annual rate, not the current 2.6 percent.

In still another maneuver, some states have reduced the spending that appears on their books for a given fiscal year by delaying the payment of June subsidies to school districts until July, the start of the next fiscal year in most states. "What it means is that the school districts have to borrow more money so they can get by in June," said William Marx, chief fiscal analyst for the Minnesota House of Representatives.

The states experienced a similar deficit problem in the early 1990's, during the last recession-and-recovery period, but the amounts involved were much less and the impact on the economy almost nil. This time, total spending by the states, which nearly doubled over the decade to more than $1.1 trillion a year, has slowed to a growth rate of barely 1 percent annually from an average of nearly 7 percent in the 1990's.

The slowing has been in response to a sharp drop in state tax revenue, which rose precipitously in the booming late 1990's, in part as a result of the stock market bubble and the capital gains taxes collected on market profits. As tax revenue rose, spending by the states also increased. So did each state's rainy day reserves, even though many states cut taxes during the good years. Now the reserves have been depleted, forcing the states to increasingly cut back spending or find other ways to balance their budgets — as every state except Vermont is required to do by law.

Because state tax collections are indirectly linked to those at the federal level, the Bush administration's tax cuts have fed through to the states as parallel cuts. But the hardest-hit states, California and Minnesota among them, have been those with progressive income taxes, charging upper income households at considerably higher rates than those at the low end. As incomes have fallen, tax collections have fallen faster in these states than in those without progressive tax rates.

Mr. Marx in Minnesota is counting on a rebound in the economy by early fall to increase employment, incomes and tax collections. His projections of the tax revenues that the state will collect in the current fiscal year rely on the rebound occurring on schedule.

"We are optimistic in this projection," Mr. Marx said. "But the projection is based on a forecast that was produced for us in February, and the rebound has not happened yet."