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Before the Senate Human Services Committee

"Maximizing Federal Funds for Human Services"

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The Great Recession is over, and an economic recovery has begun. Economic output in California grew at a strong pace during the second half of 2009, powered by the unprecedented federal monetary and fiscal stimulus and a massive inventory swing.

Although California's recession has likely ended, the recovery will not evolve into a self-sustaining economic expansion until businesses respond by hiring more workers. It is therefore particularly worrisome that employment continues to decline and the unemployment rate remains near double digits. Layoffs have slowed since the financial panic and recession were at their most severe a year ago, but they remain uncomfortably high. Worse, hiring and job creation remain dormant.

The job market's struggle represents the most serious threat to the fledgling recovery. In turn, the fiscal crisis faced by state and local governments represents a primary downside risk to the outlook for renewed job gains. Yet another round of painful belt-tightening measures are now being enacted by policymakers, with tax increases and spending cuts kicking in during fiscal 2011, just as private-sector hiring finally gets under way.

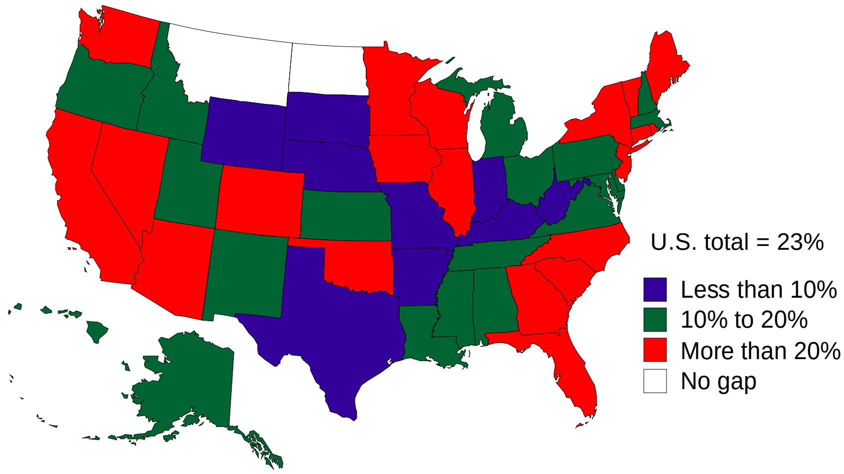
## Public Sector Woes

While output growth has now resumed in the private sector, more pain lies ahead for state and local government budgets. Despite a generous federal aid package, state budget shortfalls remain wide. Most forms of tax revenue are still depressed, and the need for government services continues to grow. With aid to states and localities from the American Recovery and Reinvestment Act set to fade next year, policymakers are being forced to consider increasingly drastic measures.

Although few state governments are free from major fiscal problems, the challenges faced by California are particularly daunting. Not only has California's revenue downturn been relatively severe, but the outlook for near-term growth in state tax revenues is also very weak.

Through fiscal 2009, the worst state and local budget problems were seen in regions that also suffered the sharpest housing downturns. The first two years of the revenue crisis were characterized by historic weakness in general sales tax revenues. Sales of big-ticket durable goods such as vehicles, home furnishings and electronics dominate overall sales tax collections. Before they make such large purchases, most households need to be confident about their future spending power, and most depend on credit markets for financing. Not only have general economic conditions been disproportionately weak in areas where house prices collapsed, these areas have also seen the largest disruption to credit markets.

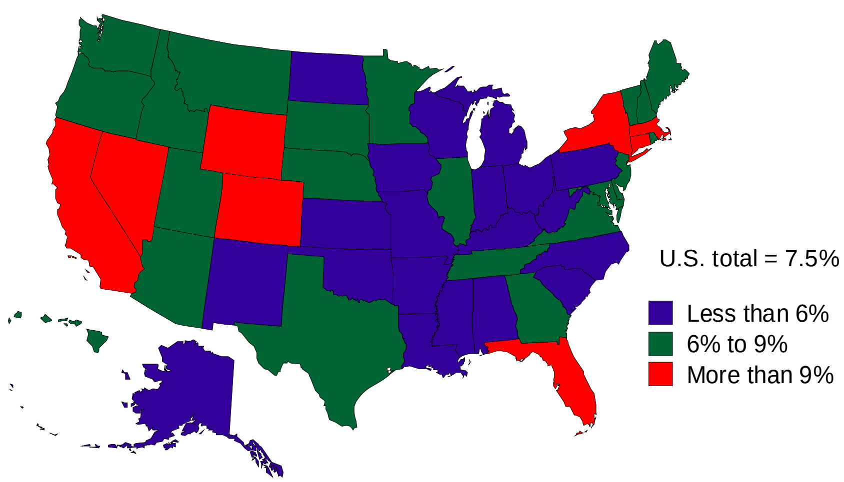
Chart 1: Pronounced Budget Gaps Where Housing Fell
*Resolved & unresolved fiscal 2010-2011 shortfalls, % of general funds*




Source: Center on Budget and Policy Priorities

In recent months, consumer spending on taxable goods has begun to stabilize even in many of the hardest hit housing markets. Now, the chief concern of state budget officers has become a lack of taxable nonwage income such as capital gains. Unfortunately, California is highly exposed to this sort of income.

Chart 2: Exposure to Capital Gains…
*Realized capital gains, % of AGI, 1997-2007*

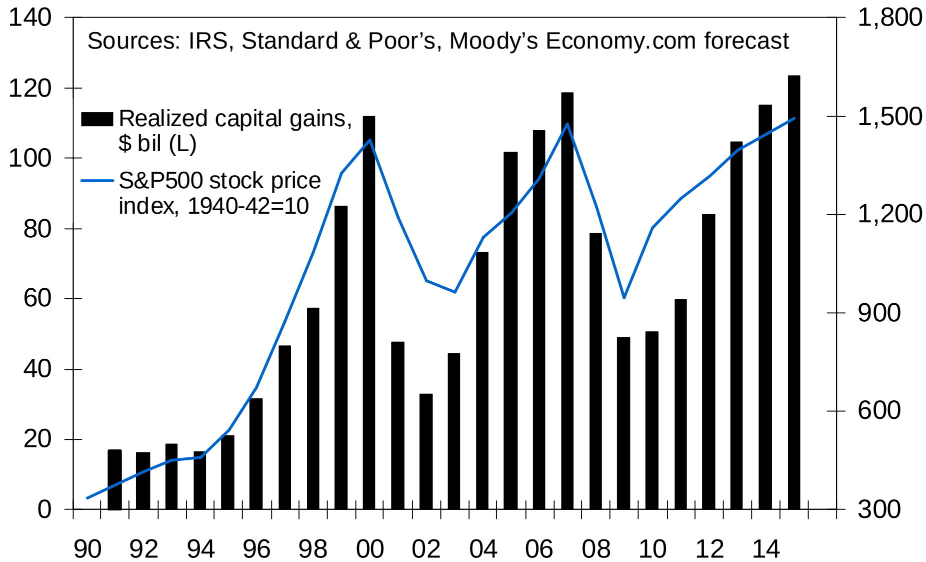



Source: IRS

Over the next two fiscal years, budget problems will be most severe in states such as California and those in the Northeast that are home to many wealthy residents. Although wage growth will begin to improve later in the year, nonwage forms of taxable income will remain depressed for some time.

Many states saw tax receipts from nonwage income rise well into the credit crisis, as investors cashed in earnings from earlier in the decade. This dynamic has now played itself out. Realizations of capital gains have been running hotter than have underlying equity and property prices for several years, suggesting that some correction is due. Now, it will be capital losses rather than gains that are carried forward into future tax years.

Chart 3: …Will Hold Down Income Tax Collections




**Fiscal Stimulus**

The goal of any fiscal stimulus is to give a near-term boost to economic growth without weakening the economy's longer-term prospects. This requires that the stimulus be implemented quickly and that its benefits go first and predominantly to those hurt most by the economy's problems. As such, state-administered income support and healthcare programs are often a good avenue through which to deliver aid, since they are means-tested and already running.

To provide the largest bang for the buck, a well-designed stimulus plan should include some temporary increases in public aid and human-services spending. Such spending benefits the economy as soon as the money is disbursed, and the economic benefit is less likely to be diluted by purchases of goods and services from outside of the state. The most efficacious forms of stimulus spending include extending federal TANF and unemployment insurance benefits and expanding the federal food stamp program.

Extra benefits for workers who exhaust regular unemployment insurance benefits and expanded food stamp payments have been part of the federal response to most recessions, and for good reason: They are the most efficient ways to prime the economy's pump. Simulations of the Moody's Economy.com California model show that every dollar spent on UI benefits generates an estimated $1.56 in near-term state output. Boosting food stamp payments by $1 increases GSP by $1.70, while increasing TANF payments by $1 increases GSP by $1.66. Increases in in-home care benefits raise GSP by a somewhat smaller $1.47.

**Table 1: Bang for the Buck from Fiscal Stimulus**

*Source: Moody's Economy.com*

| | Bang for the Buck |
|---|---|
| **Spending Increases** | |
| General State Spending | 1.36 |
| Unemployment Insurance | 1.56 |
| Food Stamps | 1.70 |
| TANF | 1.66 |
| In-home Services | 1.47 |
| Infrastructure | 1.50 |
| **Temporary Tax Increases** | |
| Personal Income Taxes | 1.16 |
| Sales Taxes | 1.20 |

*Note: The bang for the buck is estimated by the one-year dollar change in Gross State Product for a given dollar reduction in state tax revenue or increase in spending.*

People who receive these benefits are hard-pressed and will spend any financial aid they receive very quickly. Another advantage is that these programs are already operating and can quickly deliver a benefit increase to recipients. The virtue of extending public assistance benefits goes beyond simply providing financial aid for the jobless and needy to more broadly shoring up household confidence. Nothing is more psychologically debilitating, even to those still employed, than watching unemployed friends and relatives lose their sources of support.

Increasing infrastructure and other types of state spending would also boost the economy, although most such measures take longer to deliver and result in less local spending than do federal public assistance programs.

Tax cuts may also be part of a well-designed fiscal stimulus plan, as they also can be implemented relatively quickly, and can help to distribute aid more broadly. However, state tax cuts will generally result in less immediate bang for the buck than will spending increases.

Households that bear the largest burden from state taxes will typically return a smaller share of any aid they receive to the regional economy than will their peers who receive public assistance. Given high average income levels, households with large tax bills will save a relatively large share of any tax reduction. A larger share of their spending will also take place out of state. In general, a sales tax cut would constitute a somewhat more effective form of stimulus for California than would a personal income tax cut, since the sales tax is less progressive.

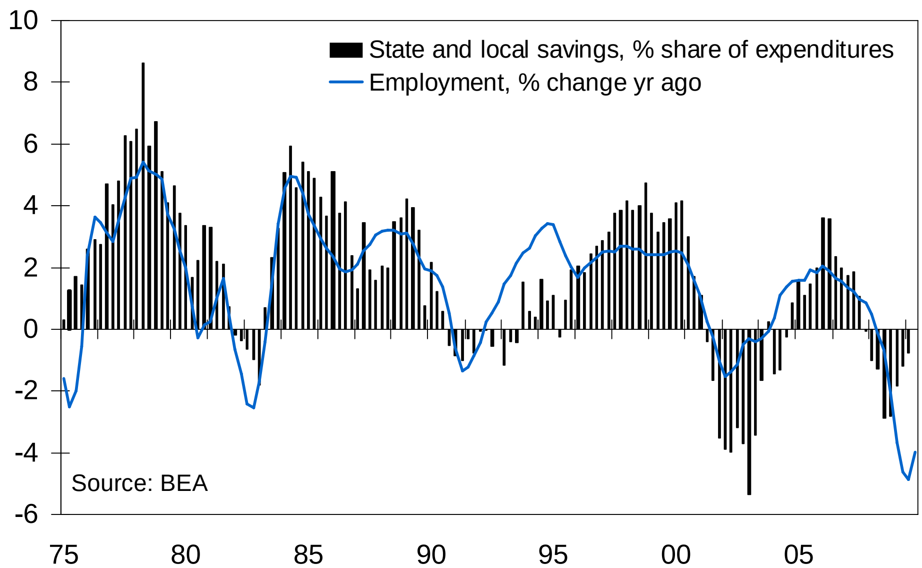
State expenditure increases have a further advantage relative to tax cuts, in that the direct benefits of tax cuts often flow to households and firms from other areas. In 2006, part-year residents and nonresidents accounted for 26% of California's taxable income. Similarly, according to the California Travel and Tourism Commission, visitors from out of state spent nearly $100 billion in California during 2008. This amounts to 19% of overall retail sales. State tax breaks become a less effective form of fiscal stimulus to the extent that they are enjoyed by individuals and firms from outside of California.

**Borrowing**

The merits of state tax cuts and spending increases as forms of fiscal stimulus can alternately be thought of as the relative costs of employing tax increases and spending cuts as budget-balancing measures. Spending cuts in public assistance and human services programs tend to be relatively costly, since they take benefits away from people who will spend a large proportion quickly and locally. Also, the burden of tax increases can partially be shifted to taxpayers from outside of the state.

Given the severity of the budget gap, California policymakers need to depend on more than just tax increases and expenditure cuts to bridge the shortfall. Borrowing or tapping outside funds will also be required. Despite balanced-budget restrictions in virtually all states, policymakers can still borrow, and do so as a matter of course during downturns. If such deficit spending is ever appropriate, it is when the private sector is operating below capacity and at risk of re-entering recession.

Chart 4: States Borrow Despite Balanced Budget Rules
*U.S. total*




The business cycle aside, to respect the spirit of balanced budget requirements, borrowing should be limited to funding public investment. The popularity of balanced budget rules suggests that voters will do all they can to prevent policymakers from spending beyond their means in search of short-term gain. Even so, voters will support borrowing for public investment if the expected returns are large enough.

Capital projects often have large up-front costs and yield benefits over many years. As such, they do not fit neatly into an annual balanced budget framework. In most states, capital budgets are every bit as large as general funds. Even so, capital budgets do not include all state investment spending. Many highly profitable public investments are made using general funds alone. In particular, investments in human capital, including programs to boost educational attainment and public health, typically draw from general funds, while investments in physical capital such as bridges or telecommunications equipment are financed through borrowing.

Although investments in the skills and wellbeing of California's workforce have not traditionally been financed in the same way as infrastructure investments, it does not mean that the returns to such investments in human capital are not large. In particular, young, skilled workers will be at a premium over the next two decades as the baby boom cohort exits the workforce. The influx of young, working-age households to California represents a growing competitive advantage relative to other states, provided these workers are healthy and possess the skills to serve growing industries.

Among potential human-services investments, such as immunization and nutrition programs, some low-hanging fruit is likely available. For such investments, analysts from across the political spectrum may agree that the returns likely exceed any associated borrowing costs. Looking outside of thinly stretched general funds to pay for such programs becomes appropriate.

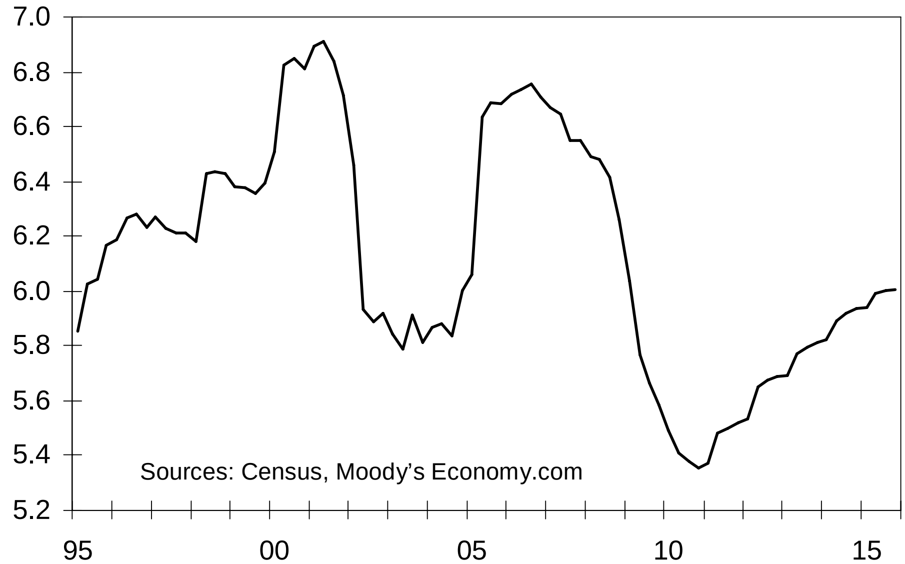
**Structural Gap**

Unfortunately, the problems faced by state general funds go beyond the wide shortfalls created by the recession, and cannot be addressed by borrowing alone. Even after the economy recovers and tax revenue begins to grow again, state tax instruments will not regain their effectiveness, while the demand for state services will continue to grow rapidly. As a result, large structural deficits will emerge in the coming decade in the absence of major policy reforms.

In particular, as the population of retirees grows, consumption patterns will shift from purchases of vehicles and other durable goods, which are taxable, toward health services and other untaxed goods and services. Also, as the working-age cohort shrinks, so will the wage base underlying the personal income tax. All told, state taxes are expected to equal only 6% of gross state product at the peak of the next expansion, well below the effective tax rate seen during previous cycles.

Chart 5: State Tax Instruments Become Less Effective

*California state tax revenues, % share of GDP*

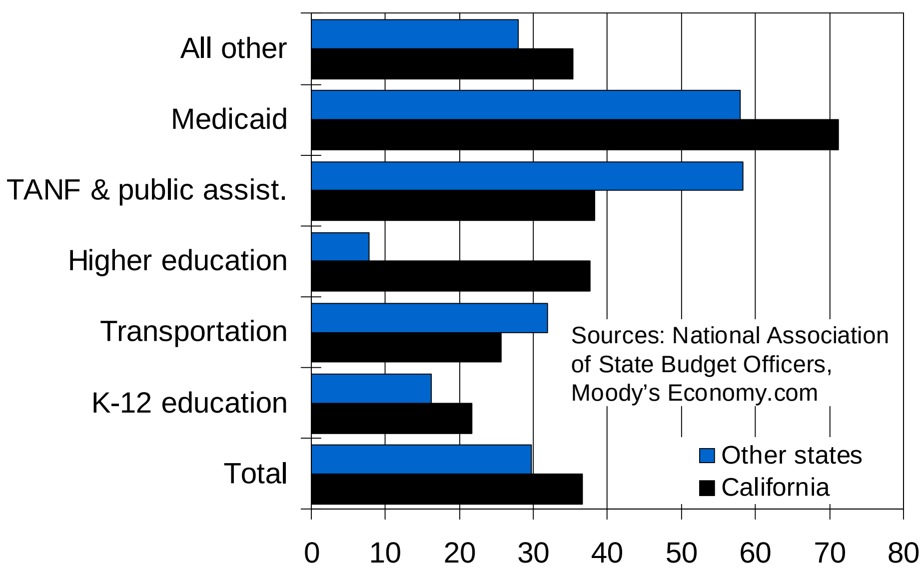



Reaching consensus on the spending and tax reforms needed to address looming structural budget shortfalls will not be easy. Nevertheless, policymakers must avoid temporary fixes and address as much of the structural deficit as possible when filling the current cyclical budget hole, lest they be forced to repeat their efforts two or three years from now.

Unfortunately, major reforms on the expenditure side are particularly difficult right now given the uncertainty surrounding federal spending policies. The primary long-run risk to state spending is the federal Medicaid program and the extent to which it continues to be subsidized by the federal government. State-administered federal spending programs such as Medicaid, and other implicit and explicit spending mandates, increasingly frame all state spending. Until the dust clears, major expenditure reforms would be risky. For now, the focus should be on keeping up with the evolving rules for federal spending and ensuing that California gets its due share.

Chart 6: Tapping Federal Resources

*% share of spending from federal funds, fiscal 2009, capital inclusive*




With major expenditure reforms on hold for now, reforms to state tax revenue instruments will be required to bridge California's structural budget gap. All of California's major tax instruments should be improved to align with the changing demographic and industrial mix of the state.

The sales tax base must be broadened to reflect the evolving pattern of household spending. In particular, more consumer and business services must be made subject to tax, and remaining barriers to the taxation of interstate trade need to be overcome.

As baby boomers exit the workforce, leaving a smaller population of working-age individuals behind, some tax burden needs to be shifted from current wages and toward wealth. Property tax reforms are a natural way to accomplish this, despite their historical unpopularity in the state.

Although small relative to other tax sources, California's corporate tax system is becoming less effective as well, in part because of increased competition among jurisdictions offering tax incentives to attract employers. California's corporate tax code is far more sophisticated and efficient than that of the typical state. Nevertheless, further gains could be made encouraging R&D among existing and emerging industry clusters, in exporting tax burdens to out-of-state shareholders who profit from doing business in California, and in providing additional incentives for sustainable development.

Reforms to personal income taxes will likely prove the most useful in avoiding future shortfalls. As was made painfully clear during the last two recessions, California's dependence on nonwage forms of personal income has increased the volatility of its overall tax revenues. Unlike wage and salary withholding or retail sales taxes, taxes on nonwage income are generally not paid until well after they are incurred. Capital gains tax revenues thus remain inflated for some time after asset prices drop, as investors cash in on earnings made over the last cycle. When taxable gains finally do correct, they remain depressed well after underlying asset prices begin to recover, as taxpayers carry forward old losses and build up a new stock of unrealized gains.

Making matters worse, the large portion of California's personal income tax that is taken from standard wage income is relatively volatile as well. California's highly progressive tax code and multiple tax brackets lead to cyclical swings in collections. As households lose jobs and income during recessions, they move down tax brackets and are subject to lower rates. During expansions, not only do income levels grow, so do tax rates for many.

Reducing the volatility of personal income tax revenues is of paramount importance in avoiding future shortfalls. Revenue smoothing can be accomplished using expanded rainy-day funds or by securitizing future revenue streams.

**Conclusion**

There is no painless way to resolve California's ongoing budget woes. To date, the revenue downturn has been severe mainly because of the state's pronounced housing correction. Going forward, state tax revenues will continue to perform poorly, with nonwage forms of taxable income remaining depressed.

In general, most types of human services and public assistance spending make for effective near-term fiscal stimulus and are bad candidates for program cuts. Human services dollars are often directed to needy individuals who will spend most of the funds quickly and locally. Also, direct human services expenditures go to residents of the state, unlike tax cuts, whose benefits are shared by taxpayers in other states.

Some human services spending can be considered investment, with the expected returns on state spending outweighing the cost of funds. For programs likely to yield a long-term profit for the state, it may be appropriate to relax balanced-budget restrictions and seek funding from special funds and capital markets.

Unfortunately, California's fiscal problems will not clear up as economic growth revives this year. Structural budget deficits loom. The ability of California's policymakers to reform expenditure programs is limited by uncertainty surrounding the future of federal rules. As such, reforms to the tax system will be needed to bridge the gap. California's tax system must be modernized and tailored to match both the evolving mix of industries and the evolving pattern of household spending within the state.