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Budget Solution$
Closing Texas' Budget Shortfall
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Don't Chase Federal Funds

by Arduin, Laffer & Moore Econometrics

Despite conventional wisdom, federal funds are not "free" and, in fact, contribute a great deal to the unsustainable growth of state government and a resulting decline in economic growth.

In response to the Great Recession, policymakers in Washington, D.C. the last few years have chosen massive increases of federal spending, tax rebates, and temporary tax cuts as the means to increase aggregate demand. They have also allotted money for state governments in order to maintain their spending and ensure that aggregate demand is not offset by state efforts to lower spending. This has in turn encouraged states—even those that are generally fiscally responsible like Texas—to spend beyond their means.

These spending policies have not produced the desired results with economic weakness returning in the second quarter of 2010 and likely continuing well into the future. The reason: economic prescriptions focused on increasing aggregate demand wrongly take into account the impact that government spending has on the economy. Increases in federal, state, or local government spending change the underlying incentives in the economy and reduce its growth potential, especially given that the levels of government spending prior to the current spending sprees were already excessive. A strong negative relationship between economic growth and government spending is expected based on basic economic principles. That is why the current trend of increased reliance of states—including Texas—on federal funds is problematic.

Large portions of the increased federal expenditures have been administered and spent by the states or localities. The American Recovery and Reinvestment Act (ARRA) allocated $282 billion to the states or localities. According to the Government Accountability Office (GAO), "Across the United States, as of August 20, 2010, the Department of the Treasury has paid out $150.6 billion in Recovery Act funds for use in states and localities. Of that amount, $97.6 billion has been paid out since the start of fiscal year 2010 on October 1, 2009."[1] "About 68 percent of the federal outlays has been provided through the increased Medicaid Federal Medical Assistance Percentage (FMAP) and the State Fiscal Stabilization Fund (SFSF) administered by the Department of Education."[2]

Due to the excessive level of federal expenditures, control of expenditures at the state and local levels is more crucial than ever. However, the ARRA funds co-opted states into keeping state spending at levels that they—more precisely, their citizens—cannot afford. This reliance on the federal government to keep state spending high worsens two troubling trends.

First, greater reliance on federal funds by states also means greater control of state programs by federal authorities. As of 2008 (the year for the latest data are available) federal funds already accounted for 20 percent of total state general revenues—according to the Census Department.[3] Due to the ARRA, this figure has undoubtedly increased in 2009 and 2010. Increased federal spending and federal control is particularly problematic for states like Texas that have managed their finances better than most. The increased federal spending is a transfer from states that have managed their finances well to states that have not. In the process, greater control has been given to Washington, D.C., which, arguably, has managed its finances worst of all.

This leads to the second troubling trend created by the increased dependence on federal funds—the higher bias towards greater spending. Using Texas and California as examples, **Figure 1** illustrates that the tax and expenditure burden in Texas is significantly less than in both California and the United States. This is a strong competitive ad-

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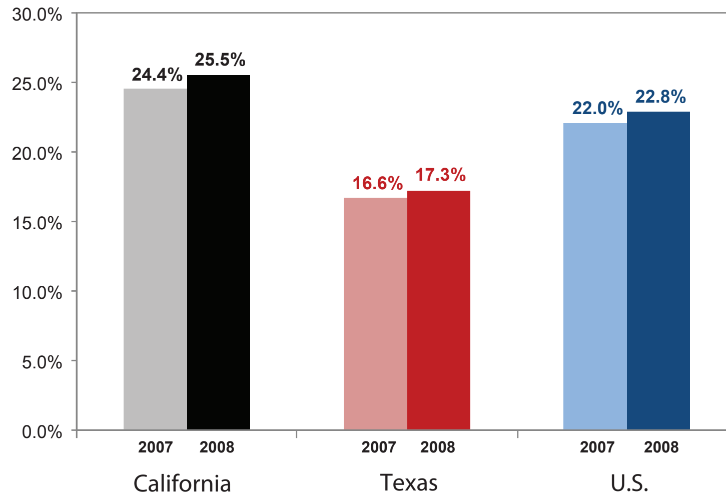
Figure 1: Total State and Local Expenditures as a Percentage of Private GDP California, Texas, U.S. (2007 & 2008)[4]

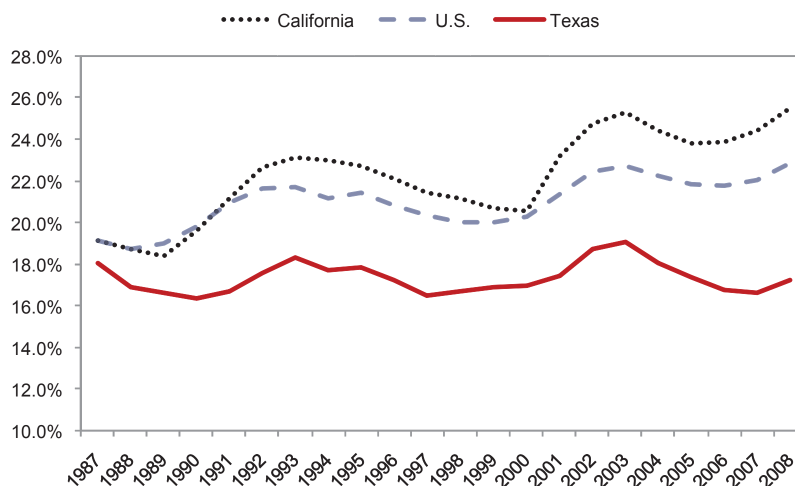


vantage for Texas. However, in both states, as well as for the United States overall, the total state and local expenditure burden on the private sector grew in 2008 (again, the most recent year for which data are available).*

And though the growth in the state and local expenditure burden in Texas (+0.6%) was smaller than the growth in either California (+1.0%) or the U.S. (+0.8%), such growth will still have negative consequences should the growth in the spending burden become permanent.

Figure 2 shows that Texas' policy since 1987 has led to the gap in spending burdens between Texas compared to California and the United States. Following the economic recessions of 1991 and 2001, the expenditure burden relative to the size of the private economy rose in Texas, California, and the nation overall due to the sluggish/negative growth in the private economy compared to continued growth in overall state and local government expenditures. Such a result is not unexpected. However, only Texas reduced its expenditure burden back to historical levels after the reces-

Figure 2: Total State and Local Expenditures as a Percentage of Private GDP California, Texas, U.S. (1987 through 2008)[5]



* Due to the growth in expenditures between 2008 and 2010, coupled with the declines in GDP, the burdens have only become worse since 2008.

sions—California and the rest of the country (on average) allowed spending levels to permanently remain higher. The difference is quite obvious after the 2001 recession when in 2003 Texas met the challenge by balancing the state's budget without raising taxes. Because of this policy decision, Texas' 2008 spending burden remained slightly below its 1987 levels—a major accomplishment. But the decision to rely on federal funds to balance the budget in 2009 has created significant challenges for Texas.

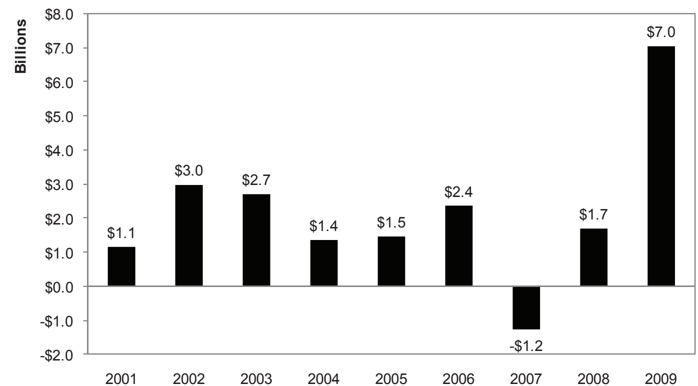
Not only does relying on larger federal contributions to state programs lead to shorter higher spending, but the federal spending mandates that often come with them result in greater federal control on state and local governments that increase spending in the long term. Greater federal spending mandates put upward pressure on total state spending levels. This becomes obvious when examining the role of federal stimulus funding in Texas' current budget shortfall.

Texas' total federal funds in 2009 were $35.7 billion, or 43.6 percent of total state revenues in Texas. Between 2000 and 2008, federal funds were, on average, 37.0 percent of Texas' total revenues. The increased reliance on federal funds—funded by the American Recovery and Reinvestment Act (ARRA)—supported ongoing expenditures and now pose a threat to Texas' historic ability to maintain a stable state and local government expenditure burden over the business cycle.

Figure 3 presents the extreme growth in federal funds in 2009 compared to the growth in federal funds between 2001 and 2008. On average, between 2001 and 2008 total federal funds grew $1.5 billion annually compared to the $7.0 billion increase in 2009. This extreme increase in federal funds has propped up overall Texas expenditures by $5.5 billion compared to the historical average.

The growth in federal funds is also reflected in the growth in the total expenditure burden, which increased from an average of $79.22 per $1,000 of personal income to $92.68 per $1,000 of personal income in 2009. However as discussed above, total expenditures should become a larger burden compared to personal income during recessions. During the 2001 recession and its aftermath, total expenditures peaked at $83.05 per $1,000 of personal income. In 2008, total expenditures were a similar $84.43 per $1,000 of personal income. Based on the 2008 expenditure level, these numbers indicate that expenditures are $7.5 billion higher than they should be.

Figure 3: Growth in Federal Funds in Texas (2001 through 2009)[6]



Based on current law, the federal support to the states should be winding down. Consequently, if the extra $5.5 billion to $7.5 billion in Texas spending that is being financed to a large extent by the federal government is not reduced, the total expenditure burden levied on Texans will end up being permanently increased. The historical precedent of maintaining spending discipline following recessions will have been broken. Due to the negative impacts excessive government spending imposes on economic growth, Texas' economy will suffer a reduction in its long-term growth potential. Based on our analyses, maintaining the current expenditure burden on the Texas economy will diminish its growth, as measured by state GDP, between $1.3 billion and $1.8 billion based on the 2008 level of Texas' GDP (the latest data available). Accordingly, Texas should avoid reliance expansion or extension of federal fund relief in its 2011 budget but instead begin to address the excessive levels of government spending. ✮

[1] "GAO Releases Its Most Recent Report on the Recovery Act," http://www.gao.gov/recovery/.
[2] Ibid.
[3] "State & Local Government Finance: 2008" *U.S. Census*, http://www.census.gov/govs/estimate/.
[4] Laffer Associates calculations based on U.S. Census and Bureau of Economic Analysis data.
[5] Laffer Associates calculations based on U.S. Census and Bureau of Economic Analysis data.
[6] Laffer Associates calculations based on "Texas Comprehensive Annual Financial Report For the Year Ended August 31, 2009", http://www.window.state.tx.us/finances/pubs/cafr/09/.

About the Authors

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Donna Arduin, Partner, ALME, served as California Governor Arnold Schwarzenegger's Director of Finance from November 2003 until October 2004, where she was the Governor's chief fiscal advisor and was a member of over 70 boards and authorities. Prior to her appointment as Director, Schwarzenegger asked Arduin to undertake an outside, independent audit of California government and state finances. Prior to working for Governor Schwarzenegger, Arduin served governors from three additional states, including Florida, New York, and Michigan. She was Governor Jeb Bush's Director of the Florida Office of Policy and Budget for five years, where she managed the formulation of the governor's policy and fiscal recommendations, created the nation's first interactive "e-budget," and implemented performance-based budgeting and long-range planning.

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Dr. Arthur B. Laffer, Partner, ALME, is the founder and chairman of Laffer Associates. Dr. Laffer's economic acumen and influence in triggering a world-wide tax-cutting movement in the 1980s have earned him the distinction in many publications as "The Father of Supply-Side Economics." One of his earliest successes in shaping public policy was his involvement in Proposition 13, the groundbreaking California initiative drastically cutting property taxes in the state. Dr. Laffer was a member of President Reagan's Economic Policy Advisory Board for both of his two terms (1981-1989). He was formerly the Distinguished University Professor at Pepperdine University and a member of the Pepperdine Board of Directors. He also held the status as the Charles B. Thornton Professor of Business Economics at the University of Southern California from 1976 to 1984.

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