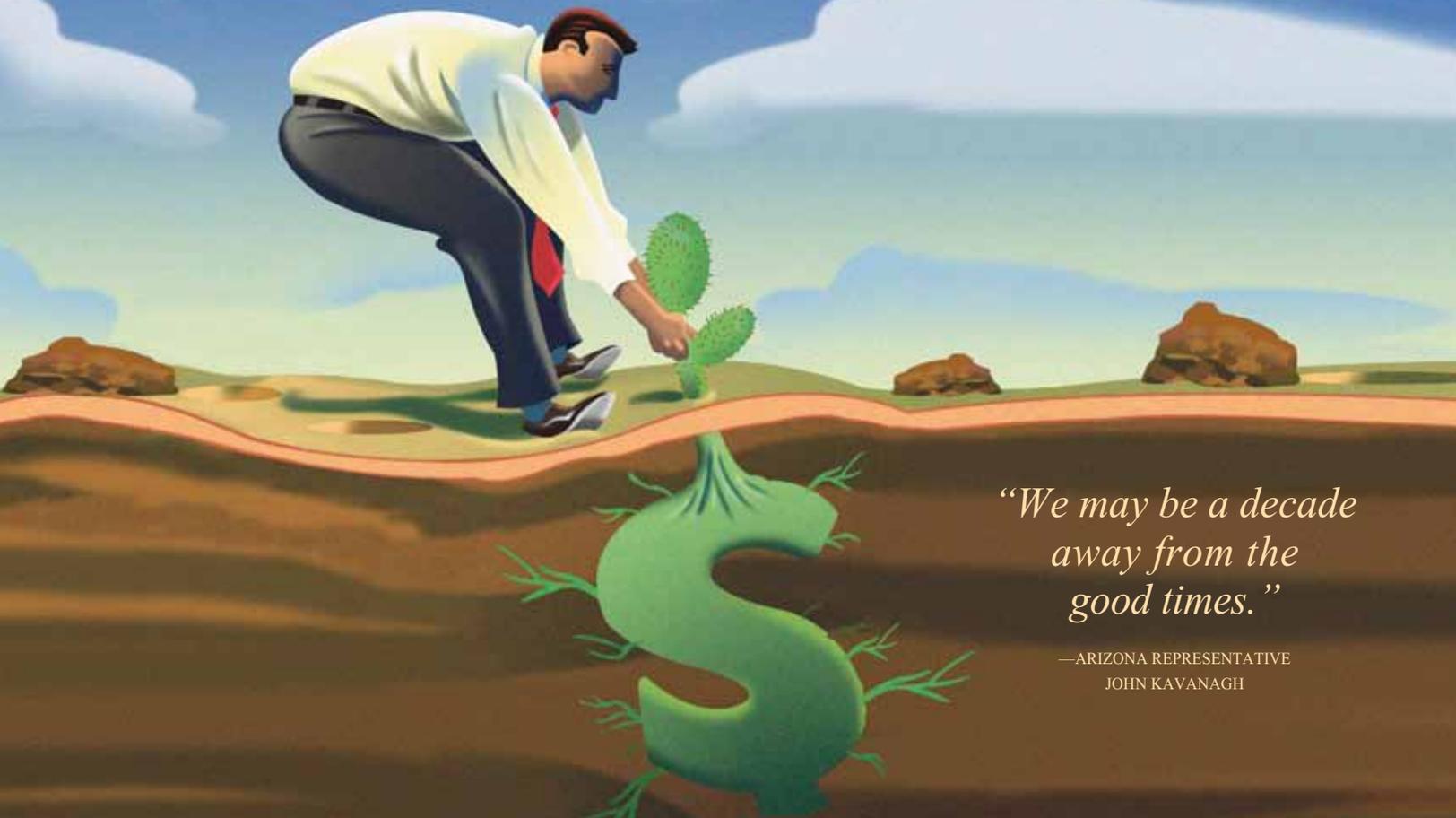


Deep Holes, Few Options

The end of stimulus money and still shaky revenues mean FY 2012 may be the worst budget year yet.



“We may be a decade away from the good times.”

—ARIZONA REPRESENTATIVE
JOHN KAVANAGH

BY CORINA ECKL

Hit with the deepest recession since the Great Depression, state lawmakers in the past three years have confronted ballooning budget gaps triggered by steep revenue declines.

For the first time in a long time, however, there is some good news: FY 2011 state revenues are widely expected to exceed last year's collections. And while the return to pre-recession levels is expected to be painfully slow and uneven across states, at least revenues are on the road to recovery.

So much for the good news.

Corina Eckl is the director of NCSL's fiscal program.

Two factors overshadow the positive trend. Foremost on lawmakers' minds is the virtual end of federal stimulus money that was included in the American Recovery and Reinvestment Act of 2009. This extra money was critical to shoring up state budgets. But the money is running out soon. Today's budget lexicon features a new and widely used term—"the ARRA cliff"—that aptly describes how state policymakers view the end of the stimulus money.

Swelling spending pressure also is troubling lawmakers. Recessions always generate new spending demands because more people become eligible for safety net programs such as Medicaid and Temporary Assistance to Needy Families. But that's not all. Some

programs have been cut so deeply that agencies are seeking supplemental appropriations. Indeed, within the first few months of this fiscal year, half the states reported that spending was outpacing budgeted levels. Medicaid and other health care programs were most likely to be over budget.

These two developments—the end of ARRA funds and rising expenses—represent enormous challenges for state lawmakers as they begin work on their FY 2012 budgets. Even with state revenues starting to improve, the uptick won't be enough to make up for those two factors.

Some lawmakers may look back nostalgically to FY 2011—when there was still stimulus money and revenues were improv-

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—JACK HAILEY, DIRECTOR OF CALIFORNIA’S SENATE COMMITTEE ON HUMAN SERVICES.

ing—as the year before the next, and possibly worst, fiscal storm strikes.

Arizona Representative John Kavanagh, chair of the House Appropriations Committee, put it bluntly. “We may be a decade away from the good times.”

MISERY HAS COMPANY

Deep budget problems have plagued state lawmakers for several years now, with every state except North Dakota falling into the deficit vortex. Going back to FY 2008, when the shortfalls attributable to the latest recession began appearing, states have faced, and largely closed, a cumulative budget gap of nearly \$414 billion. The FY 2011 imbalance already has hit \$110 billion. With several months remaining before this year’s books are closed, the number could rise.

Many of the new imbalances in FY 2011 have an interesting source: the federal government.

One provision of the American Recovery and Reinvestment Act was a temporary increase in the Federal Medical Assistance Percentage or FMAP, the share of total Medicaid costs the federal government pays. The enhanced rate originally was scheduled to expire on Dec. 31, 2010.

Earlier last year, Congress appeared on the verge of extending the enhanced FMAP through June 30, 2011, which is the end of FY 2011 for 46 states. Many state lawmakers, believing the extension was close to a done deal, based their budgets on receiving the more favorable federal rate. Ultimately, Congress did provide a six-month extension,

but at a lower rate than expected. This action created gaps in states where the enacted budget assumed the higher FMAP rate, though it generated a windfall in states that did not count on an extension.

Anemic revenues are contributing to new shortfalls, too. Nearly \$58 million of Colorado’s \$249 million gap is the result of lower than expected revenue. About \$206 million of Arizona’s \$825 million gap stems from a revenue shortfall as well as another \$469 million traced to the Nov. 2 defeat of ballot measures prohibiting fund transfers to the general fund.

Some of the gaps are mind boggling. Consider Illinois. The gap there has snowballed to \$13 billion or about 47 percent of the state’s general fund budget. To make matters worse, about 23 percent of this year’s revenues are needed to cover delayed payments for last year’s bills. The state comptroller reported late last year that the structural imbalance, coupled with higher debt service costs and the loss of federal stimulus funds, “creates the very real possibility that the governor and General Assembly will face a working deficit of \$15 billion or more when the fiscal year 2012 budget is crafted.” Illinois lawmakers are working on that budget right now.

California faces a similar, though not nearly as severe, multi-year problem. Officials there project the state will end FY 2011 with a deficit of \$6.1 billion, with an additional gap of \$19.2 billion—18.7 percent—for FY 2012.

“The hole is so deep and the options so few that, even if tax collections tick up a bit, it’s probably like drowning in 5,000 feet of water instead of 5,050 feet—you don’t really feel much difference,” says Jack Hailey, long-time director of California’s Senate Committee on Human Services.

GAPS IN 2012 AND BEYOND

Illinois and California are just two of the 35 states, along with Puerto Rico, that project imbalances in their FY 2012 budgets. The

Legislative fiscal directors are keenly attuned to the pressures confronting their states, which is why NCSL asked them to identify the top fiscal issues their states expect to address in the 2011 legislative sessions. It is not surprising that budgets are expected to top legislative agendas in nearly two-thirds of the states. Concerns about Medicaid, education, taxes and pensions also loom large for what could be a very difficult budget year ahead.

The following are the top fiscal issues facing states.

◆ Overwhelmingly, states expect the budget to be the top fiscal priority in 2011 sessions. Addressing budget shortfalls and structural gaps, replacing diminishing federal stimulus funds and other one-time budget balancing solutions are expected to capture the most attention.

◆ Medicaid and health care costs will receive priority attention. Issues to be addressed include growth in enrollment and use of services, and the reduction in the Federal Medical Assistance Percentage—the amount of Medicaid costs picked up by the federal government.

◆ Education will be another priority in many states. Discussions will center on adequate funding levels, school finance formulas and increased student enrollment.

◆ A number of states expect tax and revenue discussions to dominate legislative agendas. The focus for most will not be tax increases, but an examination of existing tax and revenue structures.

◆ Also garnering top attention are state pension and retirement issues. Addressing unfunded liabilities and enacting significant reforms may lie in the year ahead for state lawmakers.

◆ Other commonly cited top fiscal issues include state employee benefits and compensation, unemployment trust funds, transportation and other infrastructure projects, and rainy day funds.

All these issues underscore an unfortunate fact: Lawmakers’ endurance to resolve extraordinary fiscal problems will be tested yet again this year.

—Todd Haggerty, NCSL



REPRESENTATIVE
JOHN KAVANAGH
ARIZONA

aggregate estimate so far is \$82.1 billion, but since not all states were able to assign a figure to the projected gap, that number will rise.

One of the biggest concerns about the FY 2012 gaps is their sheer size, which comes on the heels of several consecutive years of big budget gaps. Of the 31 states reporting estimates to an NCSL survey, 28 expect gaps above 5 percent of their general fund bud-

get, with 21 of these expecting gaps above 10 percent. Illinois, Nevada, New Jersey and North Carolina forecast imbalances above 20 percent, with the Illinois gap possibly at 50 percent.

If that wasn't enough, 24 states and Puerto Rico expect gaps in FY 2013, too. The preliminary tally is \$66 billion. Both the number of states and gap tallies are expected to rise as



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more information becomes available.

The end of state fiscal problems is not expected even in FY 2013. Twenty-nine states and Puerto Rico have structural budget gaps, which occur when ongoing revenue growth is inadequate to cover ongoing spending growth. For instance, gaps can develop when K-12 student enrollment increases, health care costs spike and the number of people eligible for programs such as Medicaid increase. Many states report structural imbalances extending to FY 2014 and beyond.

RUNNING OUT OF OPTIONS

Budget gaps are always hard to close, but they become more challenging when they are large or recur year after year. It's simple to explain, but the options available to lawmakers shrink with each successive shortfall.

Some actions, such as using money from other state accounts or delaying a payment into the next fiscal year, can be used only once. Other options, such as tapping rainy day funds, are available only if the fund still has money in it. This recession has been so long and deep that many states have exhausted their rainy day funds. Other alternatives, such as raising taxes or fees, can be politically risky or economically ill-advised. Even so, many states have boosted taxes or fees, and lawmakers may be reluctant to go down that path again. That leaves budget cuts—or in this instance—further budget cuts.

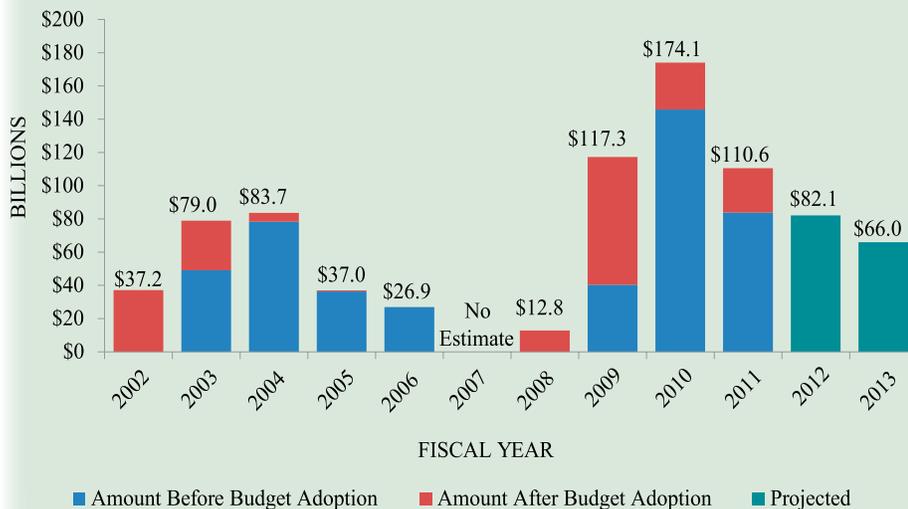
"It's a choice between the disastrous and the unpalatable," says Utah Senator Dan Liljenquist, vice chair of the Executive Appropriations Committee.

Many legislative fiscal directors see FY 2012 as possibly the most difficult budget year yet. At an NCSL meeting of legislators and staff in December, participants were asked to dispute this contention. Not a single one did.

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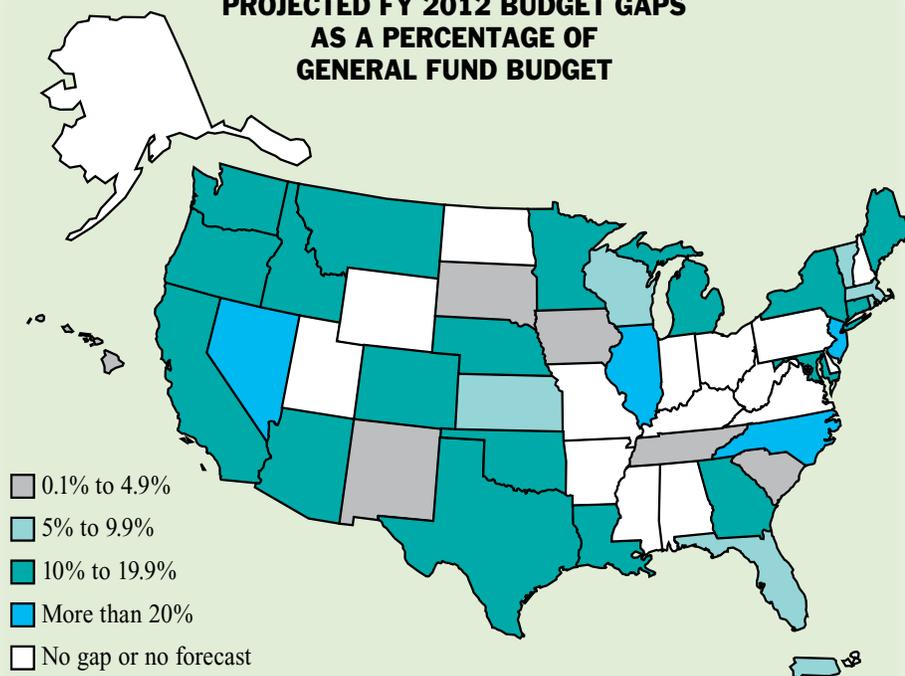
Check out more on the fiscal challenges facing states in NCSL's latest "State Budget Update" at www.ncsl.org/magazine.

STATE BUDGET GAPS



Source: NCSL survey of state legislative fiscal offices, various years.

PROJECTED FY 2012 BUDGET GAPS AS A PERCENTAGE OF GENERAL FUND BUDGET



Source: NCSL survey of state legislative fiscal offices, July 2010.