A Grim Forecast

The fiscal crisis slamming states won't be letting up soon.

BY EDWARD SMITH

Rising unemployment, dropping income tax revenue, the ongoing foreclosure debacle and a deep crisis in consumer confidence leave states facing the worst fiscal crisis in more than 50 years.

The double whammy of a drop in sales and income tax revenues means most states will limp through the remainder of this fiscal year and into the next. "It's probably a perfect storm for states," says economist Donald J. Boyd, a senior fellow at the Nelson A. Rockefeller Institute of Government who tracks state budgets.

A survey of all the states and Puerto Rico by the National Conference of State Legislatures released in December came up with sobering figures that could easily worsen as the recession continues to unfold.

"I think this recession will be worse than 2001 and likely the worst since World War II," says William T. Pound, executive director of NCSL. "States are now the primary financial and administrative support for health and education in ways that were not true of the past. The effect of a significant downturn in state revenues will be more broadly felt."

States are facing a $137-billion budget shortfall for fiscal years 2009 and 2010. Thirty-one states and Puerto Rico had to close a $40-billion shortfall when they approved budgets for the current year, which for most states started July 1. In addition, 38 states and Puerto Rico have reported that an additional $32-billion shortfall has developed in the last several months.

"This sum is expected to grow as states get updated revenue and expenditure reports," the study says.

Even grimmer news comes in projections for FY 2010. Based on estimates from 26 states—other states were unable to make projections at the point the survey was taken—officials are anticipating a $65 billion shortfall for that year and most think that number will increase.

"This recession is just getting to the worst part," David Wyss, chief economist for Standard & Poor's, said in December. "We think the fourth quarter of 2008 and the first of next year will be the worst. By mid-year next year we expect the economy to pick up.

"But it could be worse than that. This could still end up being a mega-recession."

DROPPING REVENUE

The current downturn particularly hurts states because of where they draw most of their revenue and where they spend the money. States are required to balance the budget each year, unlike the federal government, which can run a deficit.

A sharp downturn in personal, capital gains, sales and corporate taxes is ganging up on states. For the 41 states with personal income taxes, rising unemployment and plummeting capital gains will be especially painful this time, as it was in 2001.

"If you had to point to a single reason why the last fiscal crisis was so bad," it was the drop in capital gains, Boyd says. "It appears it's going to happen again. But given how steep the drop was last time, it's a little hard to imagine they will fall quite so sharply this time."

The collapse of the financial markets is drying up those capital gains revenues, reducing income from state investments, and in some states, such as New York and Delaware, leading to big job losses among high-income people.

"The people who are losing their jobs in the financial sector in New York on average make four times what people make in other sections of the economy," Boyd says.

Massachusetts Senator Steven Panagiotakos, chairman of the Ways and Means Committee, says his state was hit hard by the drop in capital gains in the 2001 recession, and things are not shaping up well this time, either.

"During our last recession, we saw a 70 percent decrease in capital gains," he says. "Right now our budget gap reflects a 30 percent decrease. Most of us believe that number will be significantly higher and result in a much bigger gap."

The NCSL survey reported personal income tax

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Pension Plans Hammered by Market's Fall

While individual investors worry about their plummeting 401(k) plans, there has been a dizzying drop in the value of pension plans that cover 80 percent of state and local government employees. Overall, the plans have lost more than 40 percent of their value in the past year.

The plans guarantee employees a lifetime retirement annuity. The amount is based on their years of service and compensation at the time they retire. They're called "defined benefit" plans because the benefit generally is defined in law.

Collectively the plans represent a future government obligation measured in the trillions of dollars, and collectively state and local governments have planned ahead to meet it, amassing trust funds that in June 2008 held more than $2.8 trillion in assets. That includes almost $1 trillion in corporate stocks, almost $500 billion in corporate bonds, and the rest in a wide range of other assets. At that time, it appeared that, as a group, state and local pension funds held assets that would cover 80 percent of their expected obligations. Not an outstanding balance, but a perfectly respectable and manageable level.

As of June 2008, asset values were down a bit from June 2007, when it looked as though state and local funds were about to break through the $3 trillion level. Since then, the financial storm that has crashed through all asset values has brought appalling losses to governmental pension trust funds. It's a loss, by one calculation, of $1 trillion from October 2007 to October 2008, 42 percent of the value they held in October 2007.

What do these precipitate losses mean for the near and distant future? Any definitive answer must wait until we know how long and deep the recession will be and how long market recovery will take. It took nine years for the Dow Jones Wilshire 5000 to regain its 1999 peak. But here are a few things we do know:

◆ Beneficiaries of the overwhelming majority of public pension funds don't have to worry about their benefits. Assets are there to cover benefits in almost every instance, though it's possible plans that were weakly funded in 2007 could be sorely pressed in 2009.

◆ State and local employees probably won't be faced with a demand for added contributions to help shore up retirement funds. In most cases—depending on state laws and constitutions—governments cannot require increased retirement contributions from members of retirement plans.

◆ Legislators will be hit with a demand for increased employer contributions to public plans. Not only will plan administrators for state plans point out that decreased assets mean higher contributions are needed to amortize long-term obligations, but also in states where local government plans exist, legislators may be asked to come to their aid as well.

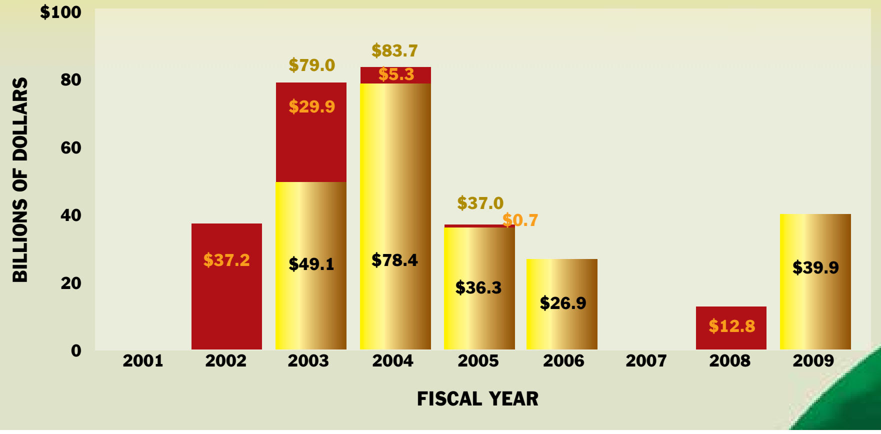
◆ Legislators will consider basic plan redesign with the goal of addressing long-term plan liabilities. There probably will not be a strong push to replace defined benefit plans with the 401(k) or defined contribution plans that predominate in the private sector because they've been hit so hard by collapsing asset markets. Right now, there's the beginning of a national debate on whether the private sector went the right way. But legislatures might consider following the lead of Georgia, Kansas and Rhode Island, which in recent years have changed fundamental policies to reduce the long-term accumulation of pension costs.

—Ron Snell, NCSL

CHECK OUT additional information about defined pension plans and reseources on pensions at www.ncsl.org/magazine.

FISCAL SHORTFALL

This chart shows the budget gaps that states needed to close since the 2001 fiscal year. The gold portion on the bars shows the amount of budget gap that had to be closed before enactment of a final budget. The red portion shows the portion of the budget gap that opened after the budget was passed and had to be closed.



SENATOR
STEVEN
PANAGIOTAKOS
MASSACHUSETTS

collections, which include taxes on capital gains, were below estimate in 18 states. Income taxes, in those states that collect them, provide on average more than a third of state revenue. None of the figures included Arizona and California, where officials did not provide estimates but did note that deep shortfalls plague all major sources of revenue. Collections were on target in nine states and above target in nine others. The full impact of the income tax shortfall will become clearer in April when most tax returns are filed.

The other shoe falling on state revenue is a drop in general sales tax revenue, also about a third of state revenues. Consumers' attitudes toward the economy, as measured by the closely watched Conference Board Consumer Confidence Index, fell to an all-time low in October, just before the holiday season. It bounced back a bit the following month, but remains at historically low levels. Consumer spending already had slowed in the fall and weakened further during the holidays.

Twenty-six states in NCSL's survey reported that sales tax revenue was below forecast in the early months of fiscal year 2009. This is a change from the 2001 recession. Then consumer spending remained robust even as revenues fell in the income tax categories.

Corporate tax collections account for about 7 percent of revenue in most states. They were below target in 21 states, and seven of those already had reduced their forecasts once, according to the report. Severance taxes on oil and gas are also expected to decrease as the price of energy drops in the growing recession.

TOUGH SPENDING CHOICES

On the spending side, states face grim choices. On average, states spend about two-thirds of their budgets on K-12 education, Medicaid, higher education and corrections, all areas that are tough to cut.

"From what state budget folks and past recessions show, in the near term the work force will be on the table. Layoffs and restrained salary settlements will be part of the solution. Higher ed appears to be part of the solution," Boyd says. "I don't see governors or budget directors talking about tax increases. They well could go there but it's not an early part of the solution."

Twenty states either have or are considering across-the-board spending cuts to close the gaps. Targeted reductions are aimed at Medicaid, higher education, corrections and K-12 education, according to the NCSL study. Individual programs within those areas could be cut or eliminated.

Nineteen states have instituted hiring freezes, 14 have banned travel and four states have frozen salaries. In eight states, positions have been abolished, though in many cases those were unfilled jobs.

Wyss puts the situation bluntly: "It means severe budget cuts because revenues are going to be really lousy and demands on spending are going up." Legislators will have to "bite the bullet and recognize they're going to have to cut services, and probably taxes will have to go up."

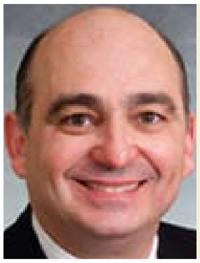
The most substantive cuts states can make are on the executive side, but some legislatures also are looking at trimming their own expenses, even though their budgets average only 0.5 of 1 percent of overall state spending. Massachusetts cut 10 percent of its legislative budget, and Washington is likely to impose a 20 percent cut in legislative staff. Oregon is planning a 5 percent cut, and Kansas cut 2 percent earlier in the year.

States also are seeing expenses rise in some areas related to the recession. Medicaid, the joint state-federal program that serves 59 million needy Americans and costs $330 billion annually, is facing greater demand as more people lose their health coverage along with their jobs.

Unemployment is causing problems for states on two levels: dropping personal income tax revenues and rising demands on unemployment trust funds.

"Our unemployment rates have risen a full percentage point to 7.3," says Oregon Senate Majority Leader Richard Devlin. "Some

SENATE MAJORITY LEADER
RICHARD DEVLIN
OREGON



REPRESENTATIVE
PRYOR GIBSON
NORTH CAROLINA

HOUSE SPEAKER
JOE HACKNEY
NORTH CAROLINA

are predicting we might get to 9 percent or 10 percent, which has a significant impact on the budget," since the state gets nearly 70 percent of its revenue from the personal income tax.

By mid-December, the unemployment funds in more than 30 states were at risk of becoming insolvent. Indiana and Michigan already had run out of money and were forced to borrow from the federal government, according to the National Association of State Workforce Agencies. The federal government is required to make loans to keep the funds solvent.

GETTING WORSE?

At first blush, this recession might not seem quite as bad for states as the one in 2001. The worst two years following that downturn—and the worst budget time for states almost always arrives after the recession ends—came in FY 2003 and FY 2004. States faced a total budget gap of nearly $163 billion then. That's about $30 billion more than current two-year projections for this recession.

Those numbers, however, are final tallies made after the fact. That the numbers look so bad at this point is a harbinger of an even worse recession.

In the NCSL survey, Arizona takes the dubious award of having the largest anticipated budget gap in percentage terms for fiscal year 2010—24.2 percent. That means a $2.6 billion shortfall.

Other states looking at yawning gaps for 2010 include New York (20 percent, $12.5 billion), California (18 percent, $19.5 billion), Wisconsin (17.2 percent, $2.5 billion), Minnesota (14.7 percent, $2.6 billion), Kansas (14.5 percent, $958.5 billion) and Washington (14 percent, $2.3 billion), according to the survey.

As evidence of how quickly the situation is changing, California reported after the NCSL survey was released that it expects its budget gap for the remainder of FY 2009 and for FY 2010 to reach nearly $42 billion, up from an earlier estimate of $29 billion. Governor Arnold Schwarzenegger characterized the situation as "heading toward a financial Armageddon."

Boyd expects the FY 2010 gap to increase beyond the $65 billion now estimated by the 26 states in the survey.

"I don't have a specific projection, but I think it could be considerably greater, based on my analysis of the last several downturns and the ways in which this one is likely to be worse than previous ones," he says.

At the individual state level, there is a similar sentiment, and that means more hard choices ahead. "The most truthful answer is we just don't know yet where the bottom is," says Representative Pryor Gibson of North Carolina, co-chairman of the Finance Committee. "We will be doing a lot of cutting in North Carolina. … I anticipate we'll have substantial furloughs, freezes or layoffs."

Wyss says the "economy is going to hit bottom around the middle of the year with a sluggish recovery starting." But he also cautioned that if the credit remains locked up and oil prices start rising any recovery could be stalled.

HELP FROM WASHINGTON

State leaders are hoping the Obama administration, together with Congress, can craft a stimulus package that will go into effect quickly. As of press time in early January, a stimulus package of as much as $775 billion—split between stimulus spending and a tax cut—was under discussion. Earlier, the incoming president promised to create the largest public works project since the interstate highway system, a plan that goes far beyond traditional road and bridge infrastructure projects.

That promise came in the wake of a devastating November report that the country had lost more than 530,000 jobs for the month. During an earlier meeting with governors in Philadelphia, Obama promised that help was on the way. State legislative leaders, in a letter to the congressional leadership, suggested key areas where aid is needed.

"A significant investment in a broad array of infrastructure projects will create jobs and satisfy identified public needs," the letter says. "We recommend an immediate investment in transportation and public infrastructure, clean water and safe drinking water projects, public university facilities and a temporary waiver of state matching requirements to ensure that these projects get started quickly."

The leaders also are pushing for a temporary increase in the federal Medicaid match, additional food stamp benefits and an extension of unemployment insurance benefits for those who have exhausted state benefits. Additional Medicaid funds would free state money for other expenses, and food stamps and unemployment compensation would be spent quickly and help with general sales tax revenues.

Joe Hackney, president of the National Conference of State Legislatures and speaker of the North Carolina House, is hoping the new administration will back the streamlined sales tax agreement, which will allow states to collect sales tax on Internet purchases. "This will add several billion dollars to state treasuries and not cost the federal government anything," he says.

But it's unclear if the stimulus efforts will be enough to make a dent in the growing budget gaps states face for the rest of this year and into the 2010 fiscal year.

Boyd expects the fiscal stimulus package to help states stave off additional spending cuts and tax increases in the 2010 fiscal year. But he said spending on public works projects will take a while to show up in state revenues.

Pound agrees, saying additional help with health-care expenses will make a big difference.

"Infrastructure spending will create jobs, and greater federal spending on Medicaid will not only maintain program levels," he says, "but can free up state money for support of education and other important programs."

CHECK OUT the full State Budget Update and an interactive map on the budget gaps faced by the states at www.ncsl.org/magazine.