Over a Cliff

A horrible state budget situation is just getting worse.

BY EDWARD SMITH

The news for state budgets probably could be worse, but it's hard to imagine how.

The latest state budget update report from the National Conference of State Legislatures paints a bleak picture not only for FY 2010, but for FY 2011 and possibly beyond. As more than one fiscal officer observed in the survey released in April, this is the worst situation for state budgets in recent memory.

"This report emphasizes the very difficult road ahead for states in the next two fiscal years," says William T. Pound, NCSL executive director. "Legislators already have made a lot of hard choices. It's tough to see where they can find additional places to cut spending and raise revenue."

The numbers alone are staggering. States already have closed a monumental gap of more than $102 billion for FY 2009. The outlook for FY 2010: a breathtaking $121.2 billion, based on projections by 42 states and Puerto Rico. And no one following the situation thinks that will be the end of the shortfalls for next fiscal year. The report also includes projections from 16 states and Puerto Rico of an additional $44.5 billion shortfall in FY 2011, which means states conservatively are looking at a gap of more than $165 billion in the next two fiscal years.

"The only bright spot," the report says, "is the onset of federal stimulus funds. Without that money, state finances would be even more dismal."

PERSISTENT RECESSION

The federal aid, however, may turn out to be cold comfort given what the future holds, says David Wyss, chief economist for Standard & Poor's.

"We've got another six months to go on this recession, and another year to go before we see a peak in the unemployment," he said in late March. He anticipates the jobless rate reaching 10 percent, just below the 10.8 percent experienced during the 1982 recession.

When it comes to state governments, things are even grimmer. "State government revenues tend to lag the economy, and next year is going to be the worst for state budgets," he said.

The key revenue sources for states—personal and corporate income taxes and general sales tax revenue—all are in a deep trough; they also tend to lag both the economic downturn and the recovery. That means as prospects for other sectors of the economy brighten, states will still be under a heavy fiscal cloud.

Economist Donald J. Boyd, a senior fellow at the Nelson A. Rockefeller Institute who tracks state revenues, says his latest revenue study was shocking.

"We're now really seeing the deterioration in the revenue numbers. It's truly horrible," he says. States expected bad budget news, but "what's happened is worse than anticipated. It's so widespread it's astonishing."

This story went to press before states had firm figures for income tax returns filed in April, but Boyd says there is little question that the news will not be good.

"I think it will be very bad, and probably the first of two years when it will be bad. Next year likely will be down again even over this year."

The reasons are obvious. People who don't have jobs don't pay income taxes. Similarly, as the decline in the stock market persists, revenue from capital gain taxes will also drop.

"We had reached historic highs in terms of capital gains and tax revenues," Boyd says, which means states had a long way to fall when the recession began to bite.

The NCSL survey found that personal income taxes, which account for about 36 percent of all revenues in states that collect them, were below the latest target in 20 states and Puerto Rico. General sales tax and use tax revenues, which account for about 31 percent of state tax collections, were also below the most recent forecasts in 20 states and Puerto Rico.

Corporate income taxes bring in about 7 percent of revenue in most states and were below target in 18 states. In all categories, at least some states already had reduced their projections and still failed to meet them.

CRYSTAL BALL GAZING

So why have states had to revise their shortfall projections so many times in FY 2009 and almost certainly will have to do the same in the next two years? It's because fiscal projections, especially predicting revenue, is a lot like fortune telling.

"We are predicting the future, and that is particularly difficult when it comes to the economy," says Jay Wortley, senior economist with the Senate Fiscal Agency in Michigan, a state with plenty of experience with economic hard times. "If the timing of the recession is missed by a quarter and the depth and breadth of the slowdown is more severe than predicted, then state government revenues will come in significantly lower than expected."

Wortley says another key area that is tough to predict is consumer behavior, which is key to general sales tax revenue. "The more concerned and frightened people are about their job security and financial well-being, the more they will cut back in their spending and postpone more expensive purchases like houses, vehicles and household appliances. Even if economists correctly predict that consumer spending is going to decline, if they are wrong on the magnitude, it can create a serious unexpected revenue shortfall."

All this bad news puts a damper on the one bright spot for states: federal stimulus money, according to Boyd.

"This is all a caution to use the stimulus money as a bridge," Boyd says. "Tax revenue will not recover quickly and substantially."

For his part, Wyss adds a cinematic note to what people should expect as the legislators work on balancing their FY 2010 budgets.

"This is a tough situation though we will get out of it," he says. "But remember the movie: 'There Will Be Blood.' "

Edward Smith is the managing editor of State Legislatures.