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Report of the State Budget Crisis Task Force: Unfortunately, The Worst Is Yet To Come

by *David Crane*

The State Budget Crisis Task Force, a bipartisan group led by former Federal Reserve Chairman Paul A. Volcker¹ and former New York Lt. Gov. Richard Ravitch², delivered its report on July 17 in Washington, D.C. The Task Force was funded by foundations established by George Soros, Pete Peterson, and others³.

I⁴ was a member of the Task Force Advisory Board, which also included Nicholas F. Brady⁵, Joseph A. Califano, Jr.⁶, Phillip L. Clay⁷, Peter Goldmark⁸, Richard P. Nathan⁹, Alice M. Rivlin¹⁰, Marc V. Shaw¹¹, and George P. Shultz¹².

The Task Force was assembled to understand the extent of the fiscal problems faced by states, which under the United States Constitution have the principal responsibility for most domestic governmental functions including education, safety, health, infrastructure, administration of justice, and implementation of the social safety net. State and local governments spend \$2.5 trillion annually and employ more than

19 million workers—15 percent of the national total and 6 times as many workers as the federal government.

The study concludes that state governments are coping with unprecedented challenges in attempting to meet obligations to citizens and that the basic problem is structural, not cyclical. While the extent of the challenges varies by state, the magnitude of the problem is great and extends well beyond the consequences of the global financial crisis, subsequent recession, and slow economic growth.

Examining the financial condition of six states—California, Illinois, New Jersey, New York, Texas, and Virginia—the Task Force discovered four common challenges:

1. Certain large expenditures are growing at rates that exceed reasonable expectations for revenues:

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About The Author

David Crane is a lecturer in the Public Policy Program at Stanford University and president of Govern For California. From 2004–2010 he served as a special advisor to Governor Arnold Schwarzenegger and from 1979–2003 he was a partner at Babcock & Brown, a financial services company. Formerly he served on the University of California Board of Regents and the boards of the California State Teachers Retirement System, the California High Speed Rail Authority, the Environmental Defense Fund, Legal Services for Children, and other organizations. Crane received his bachelor's degree from the University of Michigan in 1975 and his J.D. from the University of California, Hastings College of the Law in 1980.



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- At recent rates of growth, state Medicaid costs will outstrip revenue growth by a wide margin, and the gap will continue to expand.
 - Pension funds for state and local government workers are underfunded by approximately a trillion dollars according to their own figures and by as much as three trillion dollars or more according to economists.
 - Unfunded liabilities for health care benefits for state and local government retirees amount to more than a trillion dollars.
2. The capacity to raise revenues is increasingly impaired:
- Untaxed transactions are diminishing the sales tax base.
 - Gasoline taxes are eroding.
 - Income taxes have become increasingly volatile.
3. State actions are having spillover effects on local governments and the federal budget crisis will have serious spillover effects on state and local governments:
- Pressures on local governments are constraining education spending, law enforcement, aid to the needy, and cultural institutions.
 - Cuts in federal grant dollars, lower spending on federal installations, procurement, and infrastructure, and potential changes to

the federal tax code all threaten states' fiscal stability.

4. State budget practices make achieving fiscal stability and sustainability difficult:

- "Revenue" and "expenditure" are not defined terms in state government accounting.
- The use of borrowed funds, off-budget agencies, and the proceeds of asset sales are not uncommon practices, often rendering balanced budgets illusory.
- The lack of financial transparency makes it more difficult for the public to understand the critical nature of problems such as pensions and other payment obligations.
- Opaque and untimely reporting severely hampers efforts to address problems

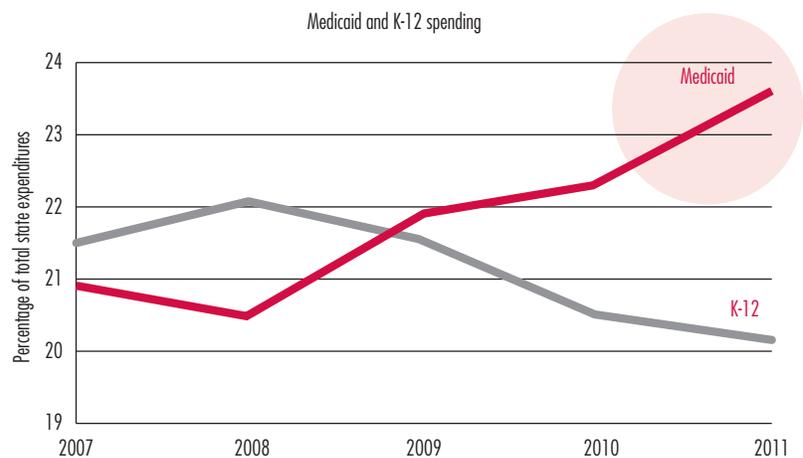
in a serious manner.

- Temporary "one-shot" measures to avoid or delay hard fiscal decisions mask underlying problems.

Because its principal goal was to inform the public of the gravity of the issues and the consequences of continuing to postpone actions to address those issues, the Task Force did not propose changes in programmatic priorities, tax rates, or structures to deal with budgetary problems. But the Task Force did recommend certain procedural approaches:

- The public needs transparent, accountable government. States should develop and adopt best practices to improve the quality and utility of financial reporting.
- Multiyear planning and budgeting approaches

Figure 1
Medicaid Has Surpassed K-12 Ed in State Budgets



Source: National Association of State Budget Officers (NASBO), State Expenditure Report.
Note: Figures are for total state expenditures, including both general fund spending and federal funds.

should be a normal part of fiscal planning.

- States need better tools for managing public finances over the business cycle. A priority for states should be better use of their existing counter-cyclical tools, including “rainy day” funds and repayment of debts in prosperous periods.
- Public pension plans need to account clearly for the obligations they assume and disclose the potential shortfalls and risks they face.
- State and local governments should recognize and account for other post-employment benefits, such as retiree health care, and pre-fund those they intend to retain.

- Prompt attention is needed to the effects that federal deficit reduction and major changes in the federal tax system will have on states and localities.
- States that do not have suitable mechanisms to monitor and assist local governments experiencing fiscal distress should develop them.
- The recurrent problems of state finances and the growing state fiscal imbalance suggest that more fundamental approaches require attention, such as tax reform.
- The apparent growing gap between states’ spending obligations and their available financial resources

points toward a need to reexamine the relationship between the federal government and the states.

What The Report Says About California

California exemplifies the four challenges reported by the Task Force.

- Certain large expenditures are growing at high rates:

According to the Task Force, California has the largest number of Medicaid enrollees, 7.5 million, and among the six study states has the highest percentage of its population enrolled in Medicaid, 29 percent. But California’s annual spending per enrollee, \$3,364, is the lowest among the six study states and well below the national average of \$5,337, and its Medicaid spending as a percent of state General Fund spending is below the national average. Still, Medicaid spending has grown at 6 percent per annum since 2006¹³.

Much faster growing are expenditures on pensions and retiree health care costs, which quintupled and tripled over the last decade. Because a large portion of California’s spending is constitutionally¹⁴, fiscally¹⁵ or politically¹⁶ protected, the burden from increases in retirement costs falls largely on unprotected programs such as the University of California, California State University, parks, welfare, and courts. That’s one reason that state spending on the University of California fell 20 percent over the last decade even though state revenues grew more than 50 percent.

Underfunded Retirement Promises

Pensions – State and Local

- Underfunded by \$1-3 trillion nationally depending on discount rate
- Severe underpayment of contributions in several states

Retiree health benefits – state & local

- Underfunded by more than \$1 trillion
- States generally pay only 20-40% of actuarially determined amounts

Reporting and disclosure is opaque. Mechanisms to enforce contributions are rare

Source: State Budget Crisis Task Force, www.statebudgetcrisis.org

Federal Deficit Reduction Threatens State Finances

Federal grants: \$600+ billion, 32% of state revenue

Other federal spending – impact on state economies

Federal tax changes – municipal bond interest, tax deductibility

Impact on states should be a major consideration in federal decision-making.

Source: State Budget Crisis Task Force, www.statebudgetcrisis.org

Examples: Temporary Resources Used (Beyond Rainy Day Funds and Federal Stimulus)

California	Borrowing for operating purposes over many years created \$28 billion "wall of debt"
Illinois	\$10 billion pension obligation bonds in 2003
New Jersey	Securitized tobacco settlement revenue in 2003 and 2004
New York	Securitized tobacco settlement revenue
Texas	Delayed school aid moved \$2+ billion from one budget period to the next
Virginia	Underpaid pension contributions; accelerated sales tax payments

Source: State Budget Crisis Task Force, www.statebudgetcrisis.org

- The state's capacity to raise revenues is increasingly impaired:

According to the Task Force, California's personal income tax provides more than 60 percent of General Fund revenues and a significant amount of this tax comes from high-income earners, heavily reliant on capital gains and taxed at the highest tax rates. The California sales tax base, like that of most states, has also suffered from the shift of personal consumption toward services and away from taxable goods. In addition, policy actions that dedicated taxes to specific purposes or moved General Fund revenue to special funds have resulted in the erosion of the General Fund revenue base. Over the past 20 years, the proportion of tax revenue going to the General Fund has fallen from 82 percent to less than 65 percent. Also, constitutional limits on property taxation make local revenue increases in California difficult, causing increased pain when

locals face higher costs or the state devolves spending obligations.

- Federal and state actions have real and potential spillover effects:

The Task Force reports that California is one of the states most at risk to the federal government scaling back the deductibility of state and local tax payments.

Regarding state actions, two local California governments—Stockton and San Bernardino—recently declared bankruptcy in large part because of their own debt and retirement benefit obligations but also because of reductions in state support. Likewise, the state recently pushed pension costs formerly paid by the state down to the university level and has indicated that it does not intend to help meet the large unfunded pension liabilities of K-12 school districts, in both cases impacting the level of dollars that make it to the classroom. As reported by its latest actuarial valuation,

the California State Teachers' Retirement System (CalSTRS) needs more than \$3 billion annually to get onto a path toward eventual full funding. According to the Task Force, by economic measures it needs double that amount. In either case, funding for the classroom will be significantly impaired.

- State budget practices are making fiscal stability and sustainability difficult:

According to the Task Force, the just-enacted fiscal year 2012-13 California Budget continues to rely heavily on nonrecurring revenues and gimmicks four years after the recession ended and two years after the federal stimulus was phased out. Among other things, the state treated one-time gains from a mortgage settlement as available for ordinary budget expenditures, borrowed money from special funds including a fund to be filled by its new greenhouse gas emissions law, and deferred recognition of billions of dollars of cost for retiree health care. The state also defers recognition of pension costs through the use by pension funds of unrealistic investment return assumptions. Over the past 10 years, actual pension costs exceeded estimated pension costs by \$20 billion, yet state pension funds continue to assume long-term annual returns that far exceed long-term returns earned in the 20th century. Adjusted for non-recurring revenues, gimmicks, borrowings, non-recognition, and unrealistic assumptions, the California budget deficit is many

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billions of dollars greater than officially reported.

California's state government will spend more than \$2 trillion over the next 10 years. In the absence of *structural* budget fixes, less and less of that money will go to the services citizens generally associate with state governments, such as education, transportation, infrastructure, the social safety net, administration of justice, parks, recreation, safety, and environmental protection. Further, the risks are not just more cuts in important services but also revenue increases of potential harm to private-sector jobs and wages.

Structural state budget issues are already having enormous consequences for the state's social fabric, as more service reductions hit vulnerable citizens every year. Deferring action will only make the ultimate costs—both financial and human—greater. As co-chairs Volcker and Ravitch concluded, "The time to act is now."

Endnotes

- 1 Paul A. Volcker has a long and distinguished career in public service. In 2008 he was appointed by President-elect Barack Obama to a two-year term as chairman of the President's Economic Recovery Advisory Board. He served as chairman of the Board of Governors of the Federal Reserve System from 1979 through 1987. He was a professor of international economic policy at Princeton University and chairman and CEO of James D. Wolfensohn & Co. prior to its sale in 1996. He served as chairman of the first National Commission on the Public Service (the Volcker Commission) in 1988 and the second Volcker Commission in 2002.
- 2 Richard Ravitch is a lawyer, businessman, and public official who has been engaged in private and public business for more than 40 years. He recently completed his term as Lieutenant Governor of the State of New York. Prior to his appointment as Lieutenant Governor, he served as chairman of the New York State Urban Development Corporation, the Metropolitan Transportation Authority of New York, the Bowery Savings Bank, and HRH Construction Corporation.
- 3 The Community Foundation of New Jersey, The Ewing Marion Kauffman Foundation, The Fund for New Jersey, The Geraldine R. Dodge Foundation, The John D. and Catherine T. MacArthur Foundation, The Nathan Cummings Foundation, The Open Society Foundations, The Peter G. Peterson Foundation, and The Robert Wood Johnson Foundation.
- 4 See About The Author.
- 5 Nicholas F. Brady is a former United States Senator from New Jersey and Secretary of the Treasury under Presidents Ronald Reagan and George H.W. Bush. Mr. Brady is a former chairman of the investment bank Dillon, Read & Co. Inc. He serves on several corporate boards and has been a member of numerous Presidential commissions.
- 6 Joseph A. Califano, Jr. was Secretary of the Department of Health, Education, and Welfare under President Jimmy Carter. He served as Special Assistant for Domestic Affairs to President Lyndon B. Johnson, Special Assistant to Secretary of Defense Robert McNamara, and as Army General Counsel. He is the Founder and Chairman Emeritus of the National Center on Addiction and Substance Abuse at Columbia University.
- 7 Phillip L. Clay served from 2001 through 2011 as Chancellor of the Massachusetts Institute of Technology, where he continues as a professor of city planning. He is chair of the board of The Community Builders, Inc., the country's largest non-profit developer of affordable housing, and a member of the board of trustees of the University of North Carolina.
- 8 Peter Goldmark, an independent consultant, was budget director of the State of New York under Governor Hugh Carey and executive director of the Port Authority of New York and New Jersey. He served as president of the Rockefeller Foundation.
- 9 Richard P. Nathan served in the federal government as assistant director of the Office of Management and Budget, deputy under secretary of the Department of Health, Education and Welfare, and director of domestic policy for the National Advisory Commission on Civil Disorders (the Kerner Commission). He is a former director of the Nelson A. Rockefeller Institute of Government and was a professor at Princeton University.
- 10 Alice M. Rivlin is currently Senior Fellow in the Economic Studies Program at the Brookings Institution and Visiting Professor at the Public Policy Institute at Georgetown University. She was vice chair of the Board of Governors of the Federal Reserve System, director of the Office of Management and Budget, and was the founding director of the Congressional Budget Office (1975-1983). In 1998 Ms. Rivlin was appointed by President Bill Clinton to chair the Financial Responsibility and Management Assistance Authority for the District of Columbia, and she also chaired the District of Columbia Financial Management Assistance Authority (1998-2001). In February 2010 Ms. Rivlin was named by President Obama to the Commission on Fiscal Responsibility and Reform. She also co-chaired, with former Senator Pete Domenici, the Bipartisan Policy Center's Task Force on Debt Reduction. Ms. Rivlin received a MacArthur Foundation Prize Fellowship in 1983 and the Moynihan Prize in 2008.
- 11 Marc V. Shaw has served as First Deputy Mayor of the City of New York, Commissioner of the New York City Department of Finance, Director of the New York City Office of Management and Budget, and Chief Operating Officer of the Metropolitan Transit Authority. He is senior vice chancellor for budget, finance, and fiscal policy of the City University of
- 12 George P. Shultz has served as U.S. Secretary of State, Secretary of the Treasury, Secretary of Labor, and director of the Office of Management and Budget. He was chairman of President Ronald Reagan's Economic Policy Advisory Board and is now the Thomas W. and Susan B. Ford Distinguished Fellow at the Hoover Institution. He has been awarded the Medal of Freedom, the Seoul Peace Prize, the Eisenhower Medal for Leadership and Service, and the Reagan Distinguished American Award.
- 13 California Department of Finance.
- 14 The state constitution protects (to varying degrees) K-12 education, community colleges, general obligation bond debt, and pensions.
- 15 E.g., cuts in state funding for Medicaid result in cuts in federal funding for Medicaid.
- 16 E.g., Corrections spending (roughly 10% percent of the state budget) is protected by the powerful political influence of tough-on-crime groups and Corrections employees, in contrast to the much weaker influence of college students, welfare recipients, park users, and courts.