# National Conference of State Legislators gathers over 'dire' numbers

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BY MARK FLATTEN — *The numbers are "dire," but even those gathered here for a National Conference of State Legislatures meeting don't know how bad they really are.*

PHOENIX, Ariz. – According to an NCSL report released in conjunction with the meeting, 15 states now have operating budget gaps for the current fiscal year totaling more than $26 billion. Next year they project shortfalls totaling more than $82 billion in 35 states.

California alone is facing a projected operating deficit of $25 billion over the next 18 months.

Illinois is facing a shortfall of almost 50 percent in the current year alone.

A Massachusetts Democrat admitted, "... we are all scrambling right now to get back on track ..." to fund long-term debt adequately while balancing operating budgets.

Tax collections are eking up, but not enough to offset the loss of federal stimulus funds. Accounting tricks have been exhausted. States already raided off-budget accounts and sucked dry rainy-day funds.

Things look even worse in the long term. A recent report by the Government Accountability Office projected that without major changes in the way state and local governments operate, they face deficits, debt and unfunded obligations of $9.9 trillion over the next 50 years.

NCSL is a bipartisan group of lawmakers and staff from all 50 states, so the mood here is grim.

"We've come up against the reality of we can no longer provide everything for everybody," said Arizona Sen. Chuck Gray, Republican Senate majority leader. "We probably never could. We just weren't willing to admit it. Now we are confronting that very issue. The Legislature I don't think has come to grips with admitting it yet. But they are going to have to because as they go into this budget it's going to be the worst of the worst."

The deep recession that has stalled the nation's economy since 2008 is not the only cause of the budget problems states face, according to lawmakers and financial analysts at the NCSL conference. During good times, many states added new programs. In Arizona, one of the most costly was to have the state pick up the tab for full-day kindergarten, which is now costing about $118 million per year, Gray said.

Constitutional requirements, some passed by voters, dictate where most of the spending goes in many states. That, coupled with debt payments that must be made leaves legislators very little flexibility when it comes to state spending. States that took federal stimulus money to balance their books for schools and health care in the current fiscal year also must meet minimum levels of spending they agreed to in taking the money, even though the stimulus funds are going to decline by almost $38 billion next fiscal year before disappearing altogether, according to a report on the economic condition of the states from NCSL.

Sen. Stephen Morris, Republican Senate president in Kansas, said legislators have few options other than to start cutting services that in the past had been off limits. In his state, about 85 percent of the state's general fund budget is spent on education and Medicaid. Another 6 percent goes to fund public employee pensions. Everything else is funded with the remaining 9 percent, he said. And many of those other functions, such as prisons, have very little flexibility, he said.

Some cuts in programs, including education, already have been made, Morris said. Deeper cuts are inevitable.

"At least in the near term, we will see reduced levels of services in most states and most programs," Morris said. "The economy is improving, but it hasn't improved to the point where there's very much difference."

The NCSL report says at least 15 states cannot even balance their current-year budgets. Worst among them is Illinois, which is running a deficit of about $13 billion, or 47 percent of its general fund spending, in the current fiscal year with similar prospects next year, according to the study. Its assessment of Illinois: "The fiscal situation is dire."

California, which has the largest state budget in the nation, must deal with a cumulative budget deficit of $25 billion through 2012, and faces projected shortfalls of $20 billion per year through 2016, according to NCSL.

Other states are not faring quite as badly, but they too have to deal with tax revenues that have plummeted from historic highs, along with increased demands on state health and social services that come with the nation's high unemployment, said Arturo Perez, a fiscal analyst with NCSL and contributor to the report.

While tax collections increased to 2007 levels [1] through rate hikes and tepid economic growth, the gains are small and will not be enough to offset the loss of federal money that propped up past budgets, Perez said.

"Revenues have ended their freefall that basically existed in the last 18 to 24 months," Perez said. "The budget paradox is that revenues are beginning to grow or stabilize, but on the other hand states still face significant budget gaps in the upcoming fiscal years. Revenues are not growing robustly (and) the end of the era of stimulus monies for states will result in a funding cliff."

The NCSL report essentially looked at year-to-year obligations. But other studies on the financial health of the states warn of a deep and growing "structural" shortfall that will last decades. What that means is spending built into state budgets cannot keep pace with the amount of money they can be expected to take in short of dramatic increases in taxes, cuts in services, or both.

A report issued in July, GAO-10-899 [2], showed the "fiscal gap" of state and local governments alone will reach $9.9 trillion by the year 2058 unless dramatic steps are taken. Closing that gap would require that state and local spending be slashed by more than 12 percent each year, the GAO concluded, adding that the longer it takes to fix the problem the worse it will get.

One of the things driving the long-term shortfall in the states is underfunded public pension systems and retiree health-care funds, according to the GAO. Unfunded pension liabilities are not factored into the debt load faced by state governments because, unlike bonds for things such as construction projects, states just don't pay the Annual Required Contributions needed to keep the funds solvent. The just increases the debt and pushes it onto future taxpayers.

Sheila Weinberg, founder of The Institute for Truth in Accounting, which is studying debt and unfunded obligations of states, said unfunded pension and health care obligations for state workers is probably between $750 billion and $3 trillion today. States were not even required to calculate their debt through pension and health care obligations until recently, Weinberg said.

"If you don't measure it you can't manage it," she said. "None of them had to measure it before so none of them managed it. None of them set any money aside to pay for these massive retiree health care benefits that are popping up now."

Gabriel Petek, a ratings analyst for Standard & Poor's, said states are struggling to fully fund their pension obligations at the same time they are closing budget shortfalls. But underfunding pension and health funds for retired government workers magnifies the long-term deficits that will have to be made up in the future, which is reason for concern among financial analysts who determine bond ratings for state and local governments, he said.

"They are paying what they have to pay to fund the payments that are going out to the beneficiaries now," Petek said of the pension and health care problems many states face. "It's a short-term benefit to their budgets, but in the long run it's going to generate a longer term cost. They are going to have even more to pay later on. It's a short-term gain but it has long-term obligations."

Petek said the $9.9 trillion figure cited by the GAO is based on estimates of how much retirement funds will be able to earn through long-term investments, and states still maintain relatively high bond ratings on traditional debts. However, unfunded liabilities are a growing concern, particularly as states let payments slide in tough budget years, he said.

"That is a potential risk that we see, that in these tough budget times the ones that are being pressured to not fund these un-bonded obligations will only face more challenging decisions later on," Petek said. "It's not going to get easier. It won't make the problem go away."

Massachusetts Rep. Jay Kaufman, a Democrat and House chair of that state's joint revenue committee, said lawmakers have been slow to recognize that scrimping on payments to retirement and benefits funds for government workers is nothing more than a short-term fix. Lawmakers in Massachusetts have been making payments to the state's pension system, and the long-term plan is to have its pension obligations fully funded by 2028. Realistically, fully funding retirees' health care benefits plans will probably not be addressed until the pension fund is sound, he said, acknowledging the payments made in the last few years have been "extraordinarily modest."

Kaufman, chairman of NCSL Budget and Revenue Committee, also said he believes the health-care benefits the state pays to retired workers needs to be changed. Currently, the state pays full medical benefits to retired workers who have at least 10 years of service. Kaufman said he believes some phase-in of benefits would be more appropriate, with the state picking up half of the retired worker's health care costs after 10 years and the full cost after 25 years.

"Most states were beginning to responsibly address their obligations before the bottom fell out of the economy," Kaufman said of the need to fully fund pension and health benefits for retired workers. "I think we are all scrambling right now to get back on track. The short term challenge is to get back on track even as we are trying to do something with balancing our own budgets. We are going through a period right now where we know we should be doing a better job, in many cases we were doing a better job, and we know we have to get back to doing a better job."

Some states are bucking the trend and funding virtually all of their pension and health care liabilities, according to Petek. Those states tend to be faring far better than the rest both in their year-to-year budgets, and in their bond ratings for conventional debt, he said.

Texas, for instance, is essentially fully funding its constitutional obligations for schools, debt service, pensions and retiree health care, according to Petek. Rep. Dan Flynn, a Texas Republican, said the state has taken steps to control pension costs, eliminating cost-of-living increases for retired workers until the retirement funded is funded to the level it needs to be. The state also has increased the amount of time government employees must work to qualify for a pension, and increased the amount of money state workers must contribute to their retirement plans, said Flynn, vice chairman of the House Committee on Pensions and Investment.

Aside from the spending priorities set by the Legislature, Texas has also been aggressive in creating a favorable business climate even during the recession, which helped stabilize state revenues, Flynn said.

"We've got a business climate that people can count on," he said. "We have a business climate and regulatory environment they can live with."
Rep. RaeAnn Kelsh, a Republican from North Dakota, said her state has benefitted from oil revenues and a fairly conservative legislature that controlled state spending even before the recession hit. Kelsh, who chairs the House Education Committee, said that has helped the state weather the economic downturn. Sales and income tax collections are increasing, and the state's unemployment rate is below 4 percent.
In fact, there are plans to cut property taxes in the state, she said.
As for pensions and health costs, state lawmakers will consider a series of reforms to control future costs, such as raising the retirement age and increasing contribution rates for state employees. Also on the table is moving to defined-benefits plans similar to 401(k) retirement accounts rather than guaranteed retirement benefits for life, she said.

"We are trying to get ahead of the curve," she said. "We are not going to be reactive."

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[1] 2007 levels: **http://www.census.gov/govs/qtax/**
[2] GAO-10-899: **http://www.gao.gov/products/GAO-10-899**

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