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States Slow to Face New Fiscal Reality

By Steven Malanga

Last week, California Governor-elect Jerry Brown pronounced the state's budget crisis even more dismal than he thought. In fact, Brown suggested California's budget situation right now may be the worst in its history.

Although it's not unusual for a newly elected official to declare that the state's books are in much worse shape than he professed during his campaign, what Brown is now acknowledging is something that many of the country's 23 newly elected governors may also be forced to admit, which is that they are facing an onrushing fiscal train wreck. After two years of relying on federal aid to offset much of the decline in their tax revenues that began in 2008, state and local governments now face a world of only modestly increasing revenues which may not begin to make up for the loss of Washington stimulus dollars, nor provide enough to pay for the continuing growth in spending propelled by public employee compensation costs and programs like Medicaid.

As Brown suggests, next year may actually be worse than each of the last two for some states. Collectively, states have confronted $300 billion in deficits since 2008, but they also received some $200 billion in stimulus money to compensate for a big chunk of that shortfall. And yet now, with only about $40 billion in stimulus money still in their bank accounts, states face as much as another $100 billion in deficits next year.

Their biggest problem has been that until now most state legislatures and governors have continued to see the current downturn as just another budget cycle, albeit a nasty one. In their budgeting, states have acted like they expected tax revenues to bounce back significantly, and so rather than pursuing basic long-term reforms, legislators have used stimulus money and one-time revenue raisers to patch over deficits.

In doing so, governors and legislatures have ignored the counsel of their own advisers. Earlier this year, the Center for Best Practices at the National Governors Association warned that the fiscal impact of this recession would be long lasting and that states would face "new austere realities" that would force them to take a hard look at the services they provide and ask tough questions about what is essential spending. Long-term reform was not only vital but inevitable, the report argued.

One big area of concern is employee costs, including not only pay but benefits. According to the governor's association report, the average state worker now earns $39.83 an hour in compensation, including benefits, compared to an average of $27.49 in the private sector. The big differentials are in health benefits ($4.43 per hour in the public sector vs. $2.01 in the private sector), and in pension costs ($3.23 per hour in the public sector vs. 94 cents per hour in private industry). As the report noted, "To have any hope of achieving fiscal health in the future, states will need to redesign their benefit systems."

But even though a dozen or so states have enacted pension reforms, many have been mild and done little to guarantee the long-term viability of public retirement systems or to lessen the bite that benefits now place on budgets. Illinois, for instance, enacted pension changes for new employees that will take years to make an impact on the budget. Then, in the kind of fiscal sleight of hand that Illinois has become known for, legislators wrote into the legislation a clause that allowed the state to claim hundreds of millions of dollars in those future savings to help balance their current budget, thereby wiping out much of the long-term gain.

The governors' report also acknowledged that states needed to begin pressuring school districts to save money at a time when states have had to cut education subsidies. One prime target is to insist that local school districts consolidate to save money if they are to continue receiving substantial state aid. New Jersey, for instance, has a whopping 591 school districts managing 2,485 public schools, or an average of just 4.2 schools per district. With the median salary of a district superintendent at $169,000 annually and district administrators and supervisors earning $116,000 on average, it's not hard to understand why Jersey has among the highest state and local taxes in the nation. Its school districts are paying nearly $100 million annually just in salary for superintendents.

States also will have to start taking a hard look at institutions like prisons and state run hospitals, which are too often principally operated as sources of government employment and patronage. In New York State, where a legislature beholden to union interests requires that prisons can't be shut down without a year's notice, Governor-elect Andrew Cuomo recently toured a facility with no prisoners left that still employed 30 staffers. Although the state's prison population has slumped to its lowest level in nearly 25 years, the current governor, David Paterson, has been unable to close any facilities because of the law.

The biggest challenge states face is the growing cost of subsidized health care for their citizens, especially the cost of Medicaid programs. Under the health reform act passed by Congress and signed by the president earlier this year, states have limited flexibility in cutting back or redesigning their Medicaid programs, which means that this program, which now constitutes about 20 percent of state budgets, may in fact grow faster than it has been in recent years, squeezing out other spending. Politicians in a few states have actually floated the idea of leaving the Medicaid system to escape the federal mandates and setting up leaner systems without federal subsidies. Indiana Gov. Mitch Daniels even proposed that states band together to set up a multi-state system for the uninsured.

A few state officials have at least acknowledged that the tough new fiscal realities are not temporary. Oregon Governor Ted Kulongoski created a reform group he dubbed the 'reset cabinet' because it was charged with redesigning state government and resetting its priorities in the face of an anticipated steep and long-term downturn. Several other states have commissioned similar efforts.

But governors and legislators always find it easier to create reform commissions than to enact their proposals. New Jersey began facing fiscal problems earlier than other states, and government there produced a number of reform proposals during the tenure of Gov. Jon Corzine from 2005 through 2009. Yet the most serious of these proposals, including significant pension reform, went nowhere. Corzine paid the price when he became a one-term governor. The current crop of new governors may face the same dilemma, that is, having to push through true reforms in the face of stiff opposition from special interests, or facing voters in four years and explaining why little has changed.

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