The State Budget Crisis Task Force and Fiscal Challenges Ahead

By Audrey Wall [1]
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The State Budget Crisis Task Force, established by Richard Ravitch and Paul Volcker, examined major threats to state fiscal sustainability, including federal deficit reduction, underfunded retirement promises, rapid Medicaid growth, and narrow and eroding tax bases. It recommended better federal-state communication, improved state budgeting and reporting practices, and broader state tax bases.

About the Author

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Introduction

Our federal system gives state governments responsibility for providing most domestic governmental functions such as public education, health and welfare services, public safety and corrections, and essential infrastructure for transportation, water supply, and sanitation. States oversee the elementary and secondary school systems that educate the nation’s future voters, jurors and workforce and, together with localities, pay more than 90 percent of the cost of this education. State and local public colleges and universities educate more than 70 percent of the students enrolled in this country’s degree-granting institutions. States spend more than $200 billion annually for health care for the poor and medically needy. States and their localities finance nearly three-quarters of all public infrastructure—schools, highways and transit systems, drinking water, and other projects crucial to economic growth and public health and safety. They employ 19 million workers—15 percent of the nation’s workforce and six times as many workers as the federal government employs. In total, state and local governments combined spent $2.5 trillion in 2010, which is more than the federal government spent on direct implementation of domestic policy. 1

State and local governments face serious long-term threats to their ability to meet these responsibilities. In April 2011, former New York Lt. Gov. Richard Ravitch and former Federal Reserve Board Chair Paul Volcker established the State Budget Crisis Task Force [3] to examine these threats. Ravitch, a major player in the New York City fiscal crisis of the 1970s and more recently chairman of the state’s Metropolitan Transportation Authority, had deep and broad experience tackling public sector fiscal problems. In 2009, Gov. David Paterson appointed Ravitch as lieutenant governor to help restore New York’s fiscal health.

As lieutenant governor, Ravitch examined the budget challenges faced by New York and became concerned that
many states faced similar threats. Ravitch and Volcker assembled a board of budget and public policy experts, obtained funding and formed the State Budget Crisis Task Force. The task force has three main goals: to analyze fiscal condition and structural budget gaps in six large states—California, Illinois, New Jersey, New York, Texas and Virginia; to analyze the fiscal decision-making environment in these states; and to engage state and federal policymakers in the problems state governments face.

In July 2012, the task force released a main report and it subsequently released a report on each state in the study. The task force concluded that although state politics, policies, economies and demographics differ, states share many problems, including six major fiscal threats that will remain even after the economy recovers:

- Federal deficit reduction threatens state economies and budgets.
- Underfunded retirement promises create risks for future budgets.
- Medicaid spending growth is crowding out other needs.
- Narrow, eroding tax bases and volatile tax revenues undermine state finances.
- Local government fiscal stress poses challenges for states.
- State budget laws and practices hinder fiscal stability and mask imbalances.

These threats do not come as a surprise to public finance economists and budget policy analysts, but an important contribution of the task force was to examine them in detail, bring them together in one place, and raise them to the attention of federal and state policymakers.

In this chapter we review the current recovery, discuss major threats to state fiscal sustainability, and describe the recommendations of the task force and its next steps.

**The Recovery from the Recession Continues to Be Slow**

The sharp deterioration in state finances as a result of the 2008 financial collapse and associated recession hit state government tax revenue much harder than the overall economy. Although real gross domestic product declined by 5.1 percent during the recession, the components of personal income typically taxed by state governments declined by 10 percent; and consumption of items typically subject to state sales taxes declined by 11 percent. Many economists believe the economy will grow sluggishly for years as it works off the excesses of the credit and real estate bubbles and endures slow employment growth.

State tax revenues have been recovering slowly but as of 2012 year end remain below their pre-crisis levels, contributing to continuing stress. (See Figure A.)

States responded rapidly to severe revenue declines by drawing reserve balances down, in aggregate, from 11.5 percent of general fund expenditures in 2006 to 5 percent in 2010; balances have begun rising again but remain below pre-recession levels. In addition, states received more than $150 billion of nonrecurring budgetary relief from the federal stimulus package. States also relied on many other nonrecurring resources and budget gimmicks.

As the crisis progressed, states made increasingly deep cuts to services and employment. They also enacted $23.9 billion in tax increases for the 2010 fiscal year and by $19 billion in other years of the crisis, but these increases were smaller than those in the recessions of 1980–82 and 1991; many increases were temporary and have since expired.

**Longer-term Threats Identified by the State Budget Crisis Task Force**

**Federal Deficit Reduction**

Recent battles over sequestration are not likely to be the end of federal deficit reduction efforts. Those efforts will affect state and local budgets in three main ways: direct impacts through reductions in grants; indirect effects of cuts in federal spending on state economies and concomitant effects on state revenue, spending and need for services; and impacts of federal tax changes on state tax systems and on state capacity and willingness to finance services.

**Cuts in Federal Grants to State and Local Governments**

Federal grants to state and local governments account for about 16 percent of federal outlays and a much larger share of spending most likely to be cut. States rely on grants for about a third of their general revenue. Grants are a much
smaller share of local government budgets, but some grants to states are passed through to local governments and affect their budgets as well.

Total grants exceeded $600 billion in 2012. Approximately 60 percent of grants were payments for individuals; Medicaid and the Child Health Insurance Program, or CHIP, dominate these grants. The next largest category is grants for education and training, exceeding $100 billion, followed by grants for infrastructure and other physical capital investment, which approached $100 billion. (See Table A.)

Medicaid and many other grants are exempt from sequestration and cuts have not posed a major short-term threat to states, but over the longer term all grants may be at risk. That risk could come in the form of a block grant for programs such as Medicaid, which avoids immediate cuts but eliminates future growth, or variants that limit the federal government’s exposure to future growth as in the budget plan of U.S. Rep. Paul Ryan and the Simpson-Bowles proposal.

Although cuts in federal grants generally will have a larger direct impact on state governments than on local governments, some local governments would suffer from direct cuts to certain education grants, urban transportation aid and some community development block grants. Some federal grants, particularly for education, are channeled through state governments but ultimately benefit local school districts. In addition, some federal grants go directly to local governments.

The extent to which states rely on federal aid varies dramatically, with per capita aid in 2010 ranging from $1,327 in Virginia to $4,657 in Alaska. New York had the highest federal aid among the study states, at $3,163 per capita. It is hard to generalize about what drives differences across states, but Medicaid and highway grants are two important factors in making per capita federal grants higher in Northeastern and Mountain states. (See Figure B.) Northeastern states, with their relatively generous and expensive Medicaid and social assistance programs, tend to receive larger Medicaid grants per capita, despite the fact that the federal government reimburses a lower percentage of their expenditures than it does in many other states. Mountain States, with their vast driving distances and low reliance on mass transit, tend to generate substantial per capita federal gas tax revenues, which are returned to these states through federal grants.

If grants were cut by 10 percent, the loss to state and local government budgets would be more than $60 billion annually. That is more than the total of tax increases enacted by states for 2008 through 2012, in response to their deepest fiscal crisis in more than 50 years. Cuts this large certainly would cause considerable fiscal stress. Among the states in the study, California and New York each would lose more than $6 billion, and Texas would lose more than $4 billion.

**Other Impacts**

Cuts in federal spending on procurement, personnel and other items will affect state economies and will have concomitant effects on state revenue, spending and on the need and demand for services.

Federal tax changes could affect state and local budgets in two important ways. First, finances would be affected through linkages to the federal tax system through which states either conform automatically to federal changes or face great pressure to conform; all but five states with an income tax use a “federal starting point” for calculating the state tax. Depending on the federal change, the impact on state finances could be positive or negative.

Second, other tax changes could affect the capacity and willingness of governments to finance infrastructure and services. For example, scaling back the deduction for state and local taxes—whether directly or through overall limits on the value of itemized deductions, such as limits for high-income taxpayers reinstated in the American Taxpayer Relief Act—raises the effective cost of tax-financed state and local government services. Similarly, if federal tax preferences for municipal bonds were curtailed, the costs of financing infrastructure would rise.

Any of these changes would have very different impacts on different states.

**Absence of Formal Dialogue between the Federal Government and the States**

There are no formal mechanisms for regular evaluation, before legislation is voted on, of how federal actions will affect states and localities. Furthermore, the task force concluded the federal government and the states have little dialogue
about these issues, but that dialogue is needed.

**Underfunded Retirement Promises**

State and local government retirement systems cover more than 14 million workers, about a sixth of the U.S. workforce, and more than 8 million beneficiaries. About a quarter of state and local government workers are not covered by Social Security, and many workers, beneficiaries and their families rely primarily on public pensions for retirement security. Retirement benefits have played an important role in attracting and retaining workers for the crucial services state and local governments deliver.

Public pensions are underfunded by as much as $4 trillion if their liabilities are valued using discount rates that economists would recommend, although no formal estimates of underfunding are regularly prepared on this basis. Unfunded liabilities reported by public pension funds using discount rates they choose based on assumed rates of investment return lead to higher reported levels of funding, but still leave them actuarially underfunded by approximately $1 trillion.

Underfunded pensions result primarily from shortfalls in earnings relative to investment returns the funds assumed they would earn, but other factors are at work, too. Some governments have contributed far less than actuaries recommend, exacerbating funding shortfalls. From 2007 through 2011, governments underpaid requested contributions by at least $62 billion. These underpayments were heavily concentrated in a few states, with governments in California, New Jersey, Illinois and Pennsylvania each underpaying by $9 billion or more, often as part of a longer pattern of underpayment.

Government contributions to pension funds have been rising dramatically to make up for recent earnings shortfalls, placing stress on many state and local budgets.

Just as the problem varies, so do potential solutions. Some states with deep pension problems also provide extraordinarily strong legal protections to pensions, constraining their policy options significantly so that major cuts in services or increases in taxes are likely in order to improve the funding levels of their pension systems. Others facing contribution increases provide weaker protections and may be more likely to cut benefits, such as cost-of-living adjustments for retirees, or benefits attributable to future service of existing workers. State laws defining how pensions are protected are evolving and it is not possible to make many generalizations. Many questions, such as whether a state may change how benefits are calculated for future service, or whether it may change cost-of-living adjustments, will not be answerable until states adopt laws that are challenged and then resolved by state-specific litigation.

In addition to underfunded pensions, state and local governments provide retiree health care benefits, and the task force estimated these benefits are underfunded by approximately $1 trillion, largely because very few governments have set aside any funds for these benefits. Retiree health care benefits generally have far less protection than pensions, and governments are likely to scale back these benefits if their costs become unaffordable. Although this appears likely to be legally permissible, it will be an unpleasant change to many workers and retirees who expected their future health insurance costs to be paid for substantially by their former employers.

**Medicaid**

Medicaid costs have been growing faster than the economy since the program’s inception and generally have grown faster than state revenue. These costs have been driven by several factors, including rapid enrollment increases and increases in overall health care costs. When the program was only a small part of state spending, states were able to fund this imbalance in growth, but Medicaid is now such a large part of state spending—24 percent of total funds and 16 percent of state general funds—that this can no longer be absorbed without cuts to other state programs, tax increases or both. This trend is likely to continue, because health care costs are projected to keep growing faster than the overall economy and Medicaid caseloads will be fueled in part by aging baby boomers. (See Figure C.)

Medicaid recently surpassed K–12 education as the largest area of state spending when all funds, including federal funds, are considered; and, despite recent slowing, Medicaid appears likely to continue to claim a growing share of state resources. During the deepest part of the recent fiscal crisis, states cut education aid, adjusted for inflation and pupil enrollment growth, while Medicaid spending continued to grow, driven in part by recession-related enrollment growth.

All six states in the study struggled to finance Medicaid in recent years and considered significant reforms that required federal approval and often involved tension with the federal government. The Affordable Care Act will contribute to
states’ increased Medicaid costs while greatly reducing the number of uninsured, but those increases are small relative to underlying growth in spending.

The March 2012 report of the Office of the Actuary of the Centers for Medicare and Medicaid Services estimates that total spending for Medicaid in the current decade will increase by an average of 8.1 percent per year assuming full implementation of the act and by 6.6 percent without the act. This is likely to outstrip the pace of economic growth and state tax revenue growth. Because so much of Medicaid spending is driven by demographic forces and underlying growth in health care costs that affect both public and private sectors, the fiscal problems caused by Medicaid growth are likely to continue until health care costs more broadly are restrained.

**Narrow, Eroding and Volatile Tax Revenue Structures**

One main goal of tax policy—adequacy—is to raise enough revenue to fund services the population requires. Adequacy has two elements: the ability to fund service demands over the long run and stability over the business cycle. Unfortunately, many states’ tax systems have been failing on both counts. The tax revenues needed to fund state and local government services have been eroding for decades and are increasingly volatile.

On average, sales taxes account for about a third of state tax revenue. The sales tax base—that is, the value of taxed goods and services—declined from 55 percent of personal income in 1970 to 35 percent in 2010 because of consumer spending shifts toward lightly taxed services, the difficulty of collecting taxes on Internet-related transactions and state choices that narrow their tax bases. All six study states had double-digit declines in the breadth of their sales tax bases. In response to this erosion, many states have raised tax rates substantially. Between 1970 and 2000, the mean state sales tax rate increased steadily from 3.5 percent to 5.5 percent.

Excise taxes on specific goods, particularly motor fuel, also have eroded significantly. These taxes are usually levied in fixed amounts on the quantity of goods sold—such as 10 cents per gallon—rather than as a percentage of value; thus, they don’t keep pace with inflation as closely as sales taxes do. Motor fuel tax revenues also have declined because automobile gas mileage has improved. Between 1960 and 2010, state and local motor fuel taxes declined relative to the economy by 60 percent. While motor fuel taxes make up only 5 percent of state tax revenues, they often are dedicated to funding roads, highways, bridges and transit; thus, their decline has increased the challenges that states face in these areas.

Beyond these two specific cases of erosion, many states have made their tax bases narrow through exemptions, credits and other mechanisms that favor specific industries, taxpayer groups and activities. While these preferences often are adopted for laudable purposes, they require tax rates to be higher than they otherwise would need to be, distorting economic decision-making; they create inequities by treating similar taxpayers unequally; and they encourage evasion and avoidance, making tax systems more difficult and expensive to administer and enforce.

A second problem is volatility. The personal income, sales and corporate income taxes are states’ most economically sensitive and volatile revenues. Together they accounted for only 38 percent of state tax revenue in 1950, but had grown to 72 percent by 1990, contributing to increased overall volatility. Since 1990, states’ reliance on the income tax has continued to increase and the tax has become more volatile. Recent research confirms that state tax revenues have become far more sensitive to changing economic conditions since 2000 and that increasing responsiveness in the individual income tax has been an important source of this increase. Increased volatility makes it more difficult for states to balance their budgets and makes it more likely that they will cut services or raise taxes in an effort to stabilize finances.

**Other Threats**

The task force examined local government stress in the six states. It found great variation in the degree of stress, the extent to which states monitor and are aware of that stress, and the extent to which they intervene in the problems of local governments. The task force recommended more careful monitoring of the finances of local governments.

Finally, the task force noted that state budgeting is focused on short-term cash-basis budgeting, despite highly sophisticated longer-term projections in several states. This focus encourages gimmickry and the accumulation of underfunded obligations.

**Policy Implications, Conclusions and Next Steps**

The task force’s main recommendations, detailed in its July 2012 report, fell into three main categories:

- The federal government needs to examine and understand how deficit reduction measures are likely to affect
states and the services they support. It needs to institutionalize this analysis and communication so Congress understands impacts before it acts on legislation.

- The federal government should enact legislation paving the way for states to collect already-owed sales taxes on goods and services sold over the Internet.
- States should improve their budgeting and reporting so they plan further ahead, disclose liabilities and risks more clearly, contribute fully to pension funds and manage volatility more effectively.

The Ravitch-Volcker Task Force has embarked on a second phase focused on engagement and dialogue with stakeholders in four areas: managing the impact of federal deficit reduction, underfunded pensions, underinvestment in transportation infrastructure and Medicaid spending growth. It will report on these efforts in the second half of 2013.

Notes
2. The source of the data is the Bureau of Economic Analysis, National Income and Product Accounts (NIPA). Our proxy for components of personal income typically subject to state income taxes is the sum of wages, proprietors' income, and dividends, interest and rent. The decline in taxable income is actually worse than this suggests because realized capital gains, which are not included in the NIPA, declined by more than 70 percent from 2007 to 2009. Our proxy for consumption components typically subject to state sales taxes is the sum of durable goods, nondurable goods other than food purchased for off-premises consumption, plus services related to recreation, food, and accommodations.
8. Per capita aid to the District of Columbia was $16,436.
14. Many economists have concluded that pension liabilities should be calculated by discounting future benefit payments with interest rates that reflect the risk of those liabilities, rather than by using the current actuarial practice of discounting future benefits by an investment earnings assumption. (For example, see J. Brown and D. Wilcox, "Discounting State and Local Pension Liabilities," American Economic Review 99, no. 2 (2009): 538–542, George Pennacchi and Mahdi Rastad, "Portfolio Allocation for Public Pension Funds," Journal of Pension Economics and Finance 10, no. 02 (2011): 221–245, doi:10.1017/S1474747211000102). Donald Kohn, “The Economic Outlook: Speech at the National Conference on Public Employee Retirement”[9] (Vice Chair), May 20, 2008. Alicia H. Munnell et al., “Valuing Liabilities in State and Local Pensions,” Issues in Brief (2010), Frank Russek and others, The Underfunding of State and Local Pension Plans, Economic and Budget Issue Brief (Congressional Budget Office (CBO), May 2011). Because pension benefits have strong legal protections in most states, many observers believe the risk that pensions will not be paid is low, although recent pension changes have made it clear that benefits sometimes can be reduced. In the current interest rate environment, low-risk interest rates are far lower than retirement system earnings assumptions, and liabilities calculated with these rates are much higher than actuarial liabilities. There is no widespread agreement on the right low-risk discount rate to use, however, and relatively small changes in discount rates can lead to relatively large differences in estimated liabilities.
15. This is separate from how pensions should be funded or how retirement system assets should be invested.
For example, see David Rosnick and Dean Baker, Pension [10]Liabilities: Fear Tactics and Serious Policy [10] (Center for Economic and Policy Research, January 2012). The report notes, “It is standard to use a risk-free rate of return in calculating future liabilities. Arguably this should be used with pension liabilities as well,” but argues that for funding purposes pension systems should value liabilities using a discount rate that partially reflects expected stock market returns, adjusted in a way that dampens the rate when the market appears overvalued and increases the rate when the market appears undervalued. Also Munnell et al., “Valuing Liabilities in State and Local Pensions,” argues that (1) “valuing liabilities is only one factor entering the funding calculation, and that using a riskless discount rate does not necessarily mean that contributions should increase immediately” and (2) “selecting a discount rate and choosing whether or not to invest in risky bonds and equities are quite separate decisions.”

16. In R. Novy-Marx and J.D. Rauh, “The Liabilities and Risks of State-Sponsored Pension Plans,” The Journal of Economic Perspectives 23, no. 4 (2009): 191-210, the authors estimated that liabilities discounted using Treasury rates were approximately $2.2 trillion higher than amounts reported based on earnings-assumption discounting (Table 2, p.19). Interest rates have since fallen significantly, and so discounted benefits would be higher now. In Munnell et al., “Valuing Liabilities in State and Local Pensions,” the authors estimated that liabilities of major plans would be about $800 million higher than reported if a 5 percent discount rate were used, and $1.3 trillion higher if a 4 percent discount rate were used. The estimates developed by economists using lower-risk discount rates usually use a slightly narrower definition of liability than that typically used by actuaries, but the difference in discount rates more than makes up for the narrower definition.

17. Unfunded liabilities for major retirement systems tracked by the National Association of State Retirement Administrators Public Fund Survey [11] were $843 billion, per data accessed February 19, 2013. Data from the Center for Retirement Research’s Public Plans Database, [12]generally show similar results. The $2.616 trillion market value of assets in the NASRA Public Fund Survey was 86.4% of the $3.027 trillion total assets for all state and local government retirement systems at the end of 2011 reported by the U.S. Bureau of the Census [13]. Applying the same proportion to unfunded liabilities suggests that aggregate underfunding of all systems likely approaches $1 trillion on an actuarial basis.

18. Donald Boyd, “The State Budget Crisis Task Force” (presented at the Federal Reserve Bank of New York, Fiscal Breakfast Meeting, New York, NY, January 16, 2013). This analysis was based upon data in Chris Mier and Ann Kibler, Tenth Annual Public Pension Funding Review (Loop Capital Markets, September 2012). The underpayments in California were the result, primarily, of underpayments to the California Teachers Retirement System and the California Judges Retirement Fund; governments in California normally must, and do, make required payments to most funds in the California Public Employees Retirement System.


22. Based on results for the median state, as reported in John L. Mikesell, “The Disappearing Retail Sales Tax,” State Tax Notes 63 (March 5, 2012): 777-791.

23. The bases of some other excise taxes, particularly those on cigarettes and hard liquor, have declined as a result of consumption declines.

24. They declined from 0.65 percent of GDP to 0.26 percent. Task Force analysis of motor fuel tax receipts data [14] from the Federal Highway Administration, and GDP from the U.S. Bureau of Economic Analysis.


26. There is some evidence that broad-based sales taxes have been slightly less affected by recession than narrow, suggesting that as sales tax bases narrow they may become more volatile, but it does not appear to be substantial. See in John L. Mikesell, “The Disappearing Retail Sales Tax,” State Tax Notes 63 (March 5, 2012): 777-791.


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