Report of the State Budget Crisis Task Force

FULL REPORT

State Budget Crisis Task Force

Dedicated to Donald D. Kummerfeld

With the deepest sadness and appreciation we dedicate this report to our friend and colleague, Donald Kummerfeld, who passed away on July 5, 2012. Don's career spanned public service, investment banking, and publishing. As New York's Budget Director, First Deputy Mayor, and Executive Director of the Emergency Financial Control Board, Don played a critical role in rescuing the city from the fiscal crisis that threatened it in the 1970s, a period during which he worked closely with board co-chair Richard Ravitch. Don understood the real world of government decision making and helped in many ways to make it more effective. He brought insight, rigor, passion, and a life's wealth of experience to all aspects of this project, which is immeasurably better for his contribution. We will miss him greatly.

More information is available at www.statebudgetcrisis.org

State Budget Crisis Task Force, Revised July 31, 2012

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A Statement From the Task Force Co-Chairs

July 17, 2012

Our purpose in assembling the State Budget Crisis Task Force has been to understand the extent of the fiscal problems faced by the states of this nation in the aftermath of the global financial crisis. While the extent of the challenge varies significantly state by state, there can be no doubt that the magnitude of the problem is great and extends beyond the impact of the financial crisis and the lingering recession. The ability of the states to meet their obligations to public employees, to creditors and most critically to the education and well-being of their citizens is threatened.

The United States Constitution leaves to states the responsibility for most domestic governmental functions: states and their localities largely finance and build public infrastructure, educate our children, maintain public safety, and implement the social safety net. State and local governments spend $2.5 trillion annually and employ over 19 million workers—15 percent of the national total and 6 times as many workers as the federal government. State governments are coping with unprecedented challenges in attempting to provide established levels of service with uncertain and constrained resources.

Within the limits of time and resources, we have examined the financial condition of six heavily populated states—California, Illinois, New Jersey, New York, Texas and Virginia. While each state varies in detail, a common thread runs through the analysis, supported by information available for states generally.

What we found will not be surprising to many knowledgeable observers, but the facts have never been assembled in a way that reflects the totality of the problems.

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

- Medicaid programs are growing rapidly because of increasing enrollments, escalating health care costs and difficulty in implementing cost reduction proposals. 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 actuaries and by as much as $3 trillion or more if more conservative investment assumptions are used.

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- Unfunded liabilities for health care benefits for state and local government retirees amount to more than $1 trillion.

The capacity to raise revenues is increasingly impaired:

- Untaxed transactions are eroding the sales tax base. Gasoline taxes are eroding as well, making it more difficult for states to finance roads, highways, and bridges.
- Income taxes have become increasingly volatile, particularly during and after the recent economic crisis.

The federal budget crisis will have serious spillover effects on state and local governments, and state actions will have spillover effects on local governments:

- 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.
- Pressures on local governments, caused by the weak economy and cuts in state aid, are constraining education spending, law enforcement, aid to the needy, and the institutions that make up the culture of our cities. Local government cuts pose a significant risk to the overall economic and social fabric of states.

State budget practices make achieving fiscal stability and sustainability difficult:

- While almost all states have constitutional or statutory balanced budget requirements, "revenue" and "expenditure" are not defined terms. 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. Temporary "one-shot" measures to avoid or delay hard fiscal decisions mask these underlying problems.
- Opaque and untimely reporting, coupled with nonexistent multiyear planning, severely hampers efforts to address these problems in a serious manner.

The Task Force is not in a position to propose changes in programmatic priorities, tax rates or structures to deal with budgetary problems. Such decisions are properly subject to the values and politics of a democratic society. Our essential goal is to inform the public of the gravity of the issues and the consequences of continuing to postpone actions to achieve structural balance. We do, however, believe that certain basic procedural approaches should be introduced and followed by all states and urge that prompt attention be given to financial relationships among all levels of government.

- The public needs transparent, accountable government. Individual states, existing associations of states, and advisory and standard-setting bodies should develop and adopt best practices to improve the quality and utility of financial reporting.

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- Multiyear planning and budgeting approaches should be a normal part of fiscal planning.
- States need better tools for managing 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.
- Pension plans need to account clearly for the obligations they assume and disclose the potential shortfalls and risks they face. Legislators, administrators, and beneficiaries alike need to develop and adopt rules for the responsible management of pension plans and mechanisms to ensure that required contributions are paid. States should recognize and account for post-employment benefits, such as healthcare, that they intend to continue.
- 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.
- Looking ahead more broadly, the recurrent problems of state finances and the growing state fiscal imbalance suggest that more fundamental approaches require attention. Tax reform at the state level may be needed to achieve revenue systems that are adequate and predictable and that minimize volatility.
- 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.

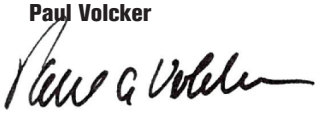
The threats and risks vary considerably from state to state, but the storm warnings are very serious. Only an informed public can demand that the political systems, federal, state and local, recognize these problems and take effective action. The costs, whether in service reductions or higher revenues, will be large. Deferring action can only make the ultimate costs even greater.

The conclusion of the Task Force is unambiguous. The existing trajectory of state spending, taxation, and administrative practices cannot be sustained. The basic problem is not cyclical. It is structural.
The time to act is now.

Respectfully submitted,

Richard Ravitch

Paul Volcker



Chairmen

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Foreword

Former New York Lieutenant Governor Richard Ravitch and former Federal Reserve Board Chair Paul Volcker created the State Budget Crisis Task Force because of their growing concern about the long-term fiscal sustainability of the states and the persistent structural imbalance in state budgets, which was accelerated by the financial collapse of 2008.

After extensive planning and fundraising in 2010 and early 2011, Messrs. Ravitch and Volcker recruited a board of individuals with extensive and varied careers in public service and public policy. The Task Force was officially launched in April, 2011.

In addition to the co-chairs, the board of the State Budget Crisis Task Force includes these members:

Nicholas F. Brady
Joseph A. Califano, Jr.
Phillip L. Clay
David Crane
Peter Goldmark
Richard P. Nathan
Alice M. Rivlin
Marc V. Shaw
George P. Shultz

The executive director of the Task Force is Donald Boyd, on leave from his responsibilities as senior fellow at the Rockefeller Institute of Government. Ravitch and Boyd worked together to assemble a core team of experts with budget and financial planning experience at the national, state, and local levels and practical experience derived from the management of previous fiscal crises. The names of the full project team can be found on the Acknowledgements page at the end of this report.

The Task Force decided to focus on the major threats to states' fiscal sustainability. Since it was not feasible to study each of the 50 states in depth, we decided to target six states—California, Illinois, New Jersey, New York, Texas and Virginia—for in-depth, onsite analysis. In each state, the core team worked closely with experts who were deeply familiar with the substance, structure, procedures, documents, and politics of the state's budget. The names of budget experts consulted in each state can be found on the Acknowledgements page at the end of this report. The core team and state experts conducted detailed inquiries into major issue areas including Medicaid, pensions, tax revenues, debt, the fiscal problems of local governments, and state budgeting and planning procedures. In doing so, the core team and state experts reviewed budget documents and data from the respective states and interviewed key budget officials.

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, sanitation and environment. 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 2009, which is more than the federal government spent on direct implementation of domestic policy.

States have been grappling with their most serious fiscal crises since the Great Depression. Even before the 2008 financial collapse, many states faced long-term structural problems, and now they face additional threats.[1]

To understand the threats to fiscal sustainability, we examined six states - California, Illinois, New Jersey, New York, Texas, and Virginia—in depth. While all states are different, these states reflect important geographical and political differences within our country. They account for more than a third of the nation's population and almost 40 cents of every dollar spent by state and local governments. All six states face major threats to their ability to provide basic services to the public, invest for the future, and care for the needy at a cost taxpayers will support.

While the study states differ along many dimensions, including politics, policies, economies, and demographics, they share many problems, including these six major fiscal threats:

- Medicaid Spending Growth Is Crowding Out Other Needs
- Federal Deficit Reduction Threatens State Economies and Budgets
- Underfunded Retirement Promises Create Risks for Future Budgets
- 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 to fiscal sustainability create risks to essential state functions such as investments in education and infrastructure, and they affect the ways in which states are likely to issue debt. Addressing these threats will not be easy. States must address these threats through the budget process, which reflects each state's own culture, institutions, and politics. The effort to achieve an annual or biennial balanced budget is a major political and governing event in the states, made by elected officials in an environment that breeds caution, encourages short-term budget-balancing contrivances, and discourages investment for the future.

We examine each of these threats and risks after an introductory section on the ways in which the 2008 financial collapse impacted state finances and exposed pre-existing structural budget problems. Separate appendices provide reviews of the politics of budgeting and of the structure of the federal-state-local fiscal system.

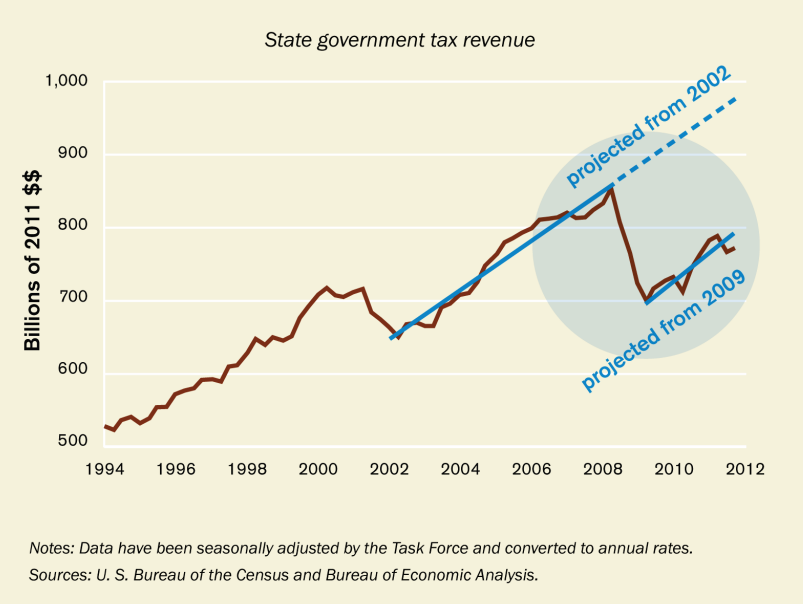
State Structural Deficits Worsened by the Recession and Financial Crisis

Slow Recovery Expected

The sharp deterioration in state finances as a result of the 2008 financial collapse and associated recession is well known. State government tax revenues were hit 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.[2] Many economists believe that 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.[3]

State tax revenues are recovering slowly and remain below their pre-crisis levels: The weak economy is generating less revenue than it did before. (See Figure 1.) Some states have not brought spending in line with this new reality, nor have they raised taxes to support current levels of spending. Instead, their budgets remain based partly on nonrecurring resources.

Figure 1 | States are limping up from the bottom of a cliff



Notes: Data have been seasonally adjusted by the Task Force and converted to annual rates.
Sources: U. S. Bureau of the Census and Bureau of Economic Analysis.

The six study states all suffered considerably after the 2008 financial collapse. Employment is an important broad-based measure of the economy, and state employment figures are available on a relatively timely basis. California employment fell by nine percent from its peak, the largest decline among states in the Task Force study. This drop was followed by the declines in Illinois and New Jersey, at 6.9 percent and 6.4 percent, respectively. The declines in New York, Texas, and Virginia were less sharp but still in the range of four to five percent.

Tax revenues fell much further than employment, reflecting the significant declines in the stock market gains, retail sales, and corporate profits. In New York, overall adjusted gross income fell by 18 percent between 2007 and 2009, and capital gains subject to income tax fell by 75 percent.[4] Texas does not have an income tax, but its sales tax revenue fell by nine percent between 2008 and 2010; and other revenue sources fell substantially as well.[5]

Table 1 shows, for the United States as a whole and for each study state, the peak-to-trough decline in tax revenues, the increase from the trough to its 2011 level, and the net change from the prior peak to 2011, all adjusted for inflation. Because of data limitations, the numbers have not been adjusted for legislative changes. Both California and New York enacted significant tax increases early in the crisis; if tax revenues were adjusted to remove the impact of these increases, the peak-to-trough declines would be larger than those shown in the table.[6]

Table 1 | In most study states, tax revenue fell sharply, is now recovering, but remains below the prior peak

Percent change in inflation-adjusted state tax revenue			
	Peak to trough	Trough to 2011	Peak to 2011
United States	**-12.0%**	**5.7%**	**-7.0%**
California	-14.9	11.9	-4.8
Illinois	-18.7	12.9	-8.2
New Jersey	-17.2	2.7	-15.0
New York	-4.3	4.3	-0.2
Texas	-15.4	7.4	-9.2
Virginia	-15.9	3.9	-12.6

***Notes**: Data are not adjusted for legislative changes.*

***Source**: Task Force analysis of data from the U.S. Bureau of the Census.*

Revenues have resumed growing in the six states, but in 2011 they remained below their prior inflation-adjusted peaks. Illinois, which increased its income tax rate by two-thirds late in fiscal year 2011, will show considerable revenue growth in 2012.

States also have been hit by rising entitlement costs, as unemployed workers and their families exhaust health insurance health benefits and resort to safety net services. According to the National Association of State Budget Officers, Medicaid enrollment rose by 8.1 percent in fiscal year 2010 and by an estimated 5.4 percent in fiscal year 2011; states project a further increase of 3.8 percent in fiscal year 2012.[7] These and other types of required expenditures cause further stress in the day-to-day operations of state and local governments.

In addition, states are contending with the loss of temporary federal stimulus aid provided under the American Recovery and Reinvestment Act (ARRA), as well as losses from expiration of temporary revenue increases adopted in response to the recession.

States' cyclical adjustments in spending and revenue are not yet complete. Three years after the recession ended, they faced gaps for fiscal year 2012-13 that their state budget and legislative offices estimated at approximately $55 billion.[8] The longer-term challenges that states face are larger than these numbers suggest, because the reported gaps do not reflect the underfunding of pensions and retiree health care liabilities and because the reported gaps have sometimes been reduced temporarily by nonrecurring resources.

Governments Have Used Reserves, Federal Aid, and Gimmicks and Have Cut Spending and Employment Significantly

Nonrecurring Resources

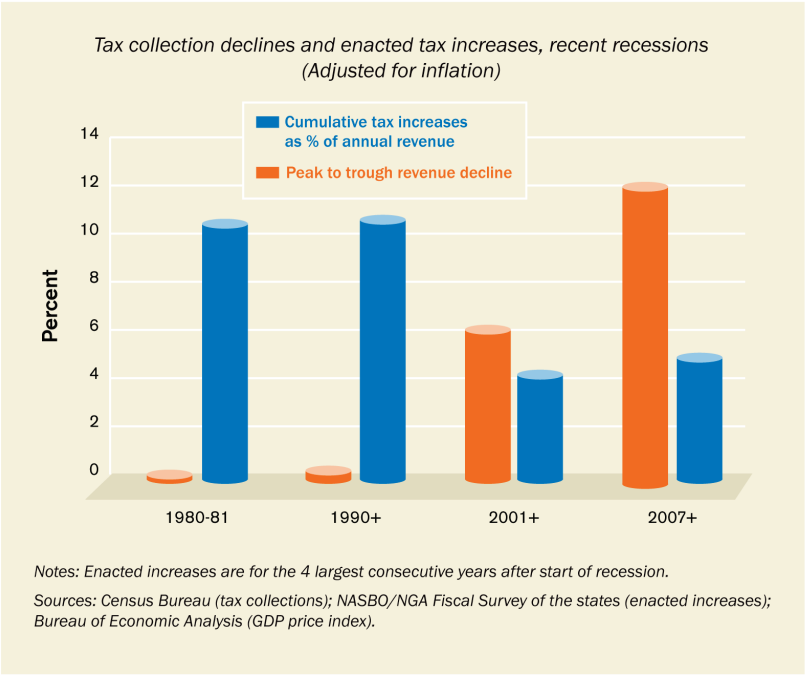
States responded rapidly to severe revenue declines by drawing on reserves, decreasing their aggregate reserve balances from 11.5 percent of general fund expenditures in 2006 to five percent in 2010. Balances have begun rising again but remain low, at an estimated 6.5 percent of general fund expenditures in fiscal year 2012 (and only 3.8 percent, excluding balances in Texas and Alaska, which account for more than half of all state fund balances).[9] In addition, states received more than $150 billion of nonrecurring budgetary relief from the federal stimulus package, primarily in the form of higher Medicaid reimbursement rates and a State Fiscal Stabilization Fund that provided funding for education.[10] (The stimulus package also included substantial aid for infrastructure spending and other activities that did not provide direct budget relief.) States, including those in this study, also employed many other nonrecurring resources and gimmicks, such as shifts in the timing of revenues and expenditures and borrowing to fund current spending, many of which were in use before the recession.

Tax Increases

States enacted $23.9 billion in tax increases for fiscal year 2010, but these increases were small when compared with the decline in tax collections and the tax increases enacted in the recessions of 1980-82 and 1991. (See Figure 2.) Furthermore, many tax increases in this recession were temporary and had expired by 2012.[11]

In addition to tax rate increases, states reduced tax deductions and credits, accelerated collections through tax amnesty programs, and increased compliance efforts. A total of 40 states raised taxes or fees between fiscal years 2009 and 2011. California and New York enacted the largest increases,

Figure 2 | Enacted tax increases were small compared to revenue declines and to 1980s and 1990s recessions



Notes: Enacted increases are for the 4 largest consecutive years after start of recession.

Sources: Census Bureau (tax collections); NASBO/NGA Fiscal Survey of the states (enacted increases); Bureau of Economic Analysis (GDP price index).

accounting for about half of the national total. However, Wisconsin, Rhode Island, Illinois, and Delaware also raised revenues considerably.

State and Local Government Employment

States have relied more heavily on expenditure cuts than in past recessions. It is difficult to measure the impact of spending cuts on state and local programs, but one proxy - changes in state and local government employment - can be tracked quite well.

Historically, state and local governments have cut employment in recessions later than, and by much less than, the private sector.[12] When the private sector economy declines, state tax revenue usually falls as well; but the revenue decline can take several months to be felt, depending on the revenue's source and the way it is collected. It takes time for government officials to come to grips with the size of a fiscal problem and develop proposed solutions.

State and local government officials welcomed substantial temporary relief under the federal stimulus program, one purpose of which was to "stabilize State and local government budgets, in order to minimize and avoid reductions in essential services and counterproductive state and local tax increases."[13] This relief allowed states to delay decisions that they must make now, in light of the slow economic recovery.

Although private sector employment fell sharply from the beginning of the recession, state and local government employment continued to rise modestly for about a year, then plateaued for another half-year before cuts began. After June, 2009, the month the recession ended, state and local government employment began to decline in earnest.[14] Since then, states and localities have cut employment aggressively. Local government employment is now about three percent below its peak; state government employment is just over two percent below its peak. All of the study states except Virginia have reduced state and local government employment substantially, as Table 2 shows.[15]

Table 2 | Employment change since start of the 2007-2009 recession

	Change in number of jobs (000)		Percentage change	
	Dec 2007 to June 2009	June 2009 to May 2012	Dec 2007 to June 2009(%)	June 2009 to May 2012 (%)
United States				
Private employment	(7,673.0)	3,107.0	-6.6%	2.9%
State & local government	135.0	(605.0)	0.7	-3.1
California				
Private employment	(1,094.3)	314.4	-8.6	2.7
State & local government	(9.8)	(125.8)	-0.4	-5.6
Illinois				
Private employment	(353.5)	78.7	-6.9	1.6
State & local government	9.5	(23.3)	1.2	-3.0
New Jersey				
Private employment	(198.1)	44.3	-5.8	1.4
State & local government	5.0	(21.6)	0.8	-3.6
New York				
Private employment	(261.8)	306.8	-3.6	4.4
State & local government	11.4	(23.3)	0.8	-1.7
Texas				
Private employment	(312.5)	529.0	-3.6	6.3
State & local government	54.9	(42.7)	3.5	-2.6
Virginia				
Private employment	(146.6)	71.3	-4.8	2.4
State & local government	8.4	3.5	1.6	0.7

Note: *Employment numbers are seasonally adjusted.*

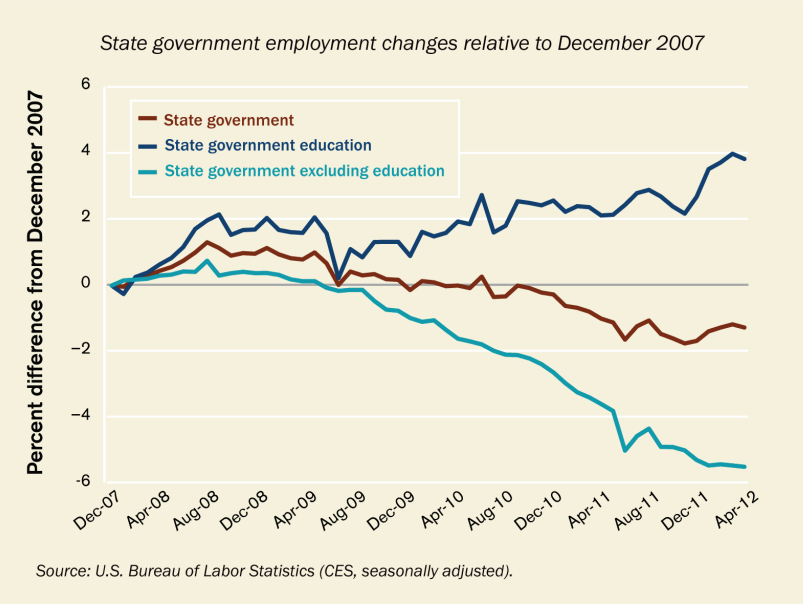
Source: *Task Force analysis of data from Bureau of Labor Statistics.*

State Government Employment

State government employment in the area of education has continued to rise, but states have cut other employment sharply. This "other employment" includes functions like prisons, hospitals, public health, highways, the judicial and legal system, social safety net workers, and administrators in state agencies.

State government education employment in most states is related primarily to public higher education - community colleges, four-year colleges, and universities - where employment has continued to rise significantly throughout the recession and recovery, reflecting in part the increased demand for higher education that usually comes with recessions.[16] (See Figure 3.) Between fall 2007 and fall 2010, community college enrollment rose by 21 percent before leveling off in 2011.[17]Although state government education employment has been rising, states have been shifting the costs of this employment. They have cut back substantially on appropriations for higher education, and public colleges and universities have responded by raising tuition.

Figure 3 | State government employment trends during and after the 2007 recession



Source: U.S. Bureau of Labor Statistics (CES, seasonally adjusted).

By contrast, states have cut non-education employment sharply – in prisons, hospitals, institutions, courts, and state agencies. This employment is now down by more than six percent from its mid-2008 peak.[18] In fact, state government non-education employment is further below its peak than private sector employment is below its own peak.[19] In contrast, in each of the nine previous recessions, state government non-education employment either did not decline at all or declined by much less than private sector employment.

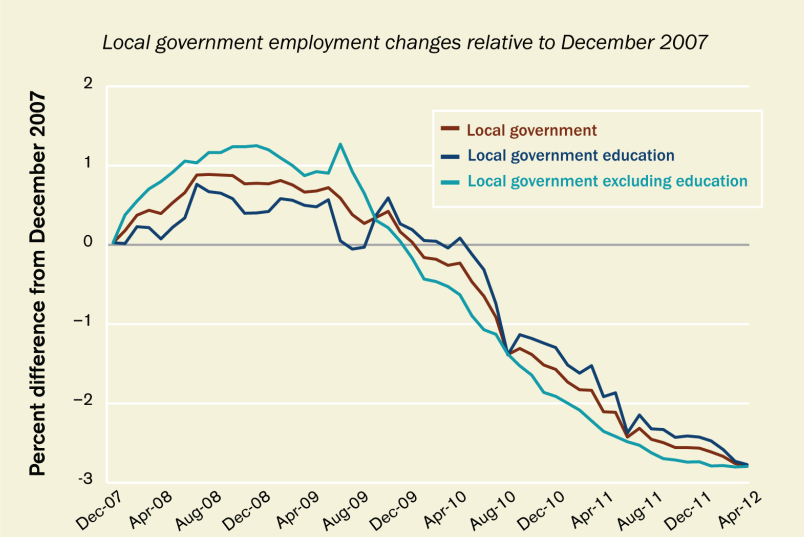
This is a fundamental shift in the way governments have responded to recessions and appears to signal a willingness to "unbuild" state government in a way that has not been done before. Though it is hard to measure the service impact of these cuts, it has clearly been substantial. For example, court systems around the country have been cut severely and are experiencing backlogs and delays. According to the National Center on State Courts, 40 out of 50 states cut court funding in 2010 (the latest year for which data were available). Six states now close their courthouses at least one day a week because of inadequate funding; and 15 states have reduced court operating hours.[20] In California it now takes six months to settle an uncontested divorce.[21] In Georgia, the courts' budget has been cut by 25 percent in the last two years; criminal cases now routinely take more than a year to come to trial.

Local Government Employment

Local governments have cut back significantly: Both education and non-education employment are down more than 3.5 percent from their respective peaks, for a combined loss of 528,000 jobs. (See Figure 4.) As with state government employment cuts, the local cuts are far deeper than those in previous recessions.

Local governments appear to be protecting public safety positions from cuts, particularly police and fire, more than most other activities; nonetheless, the cuts have been broad-based.[22]

Figure 4 | Local governments have been cutting back

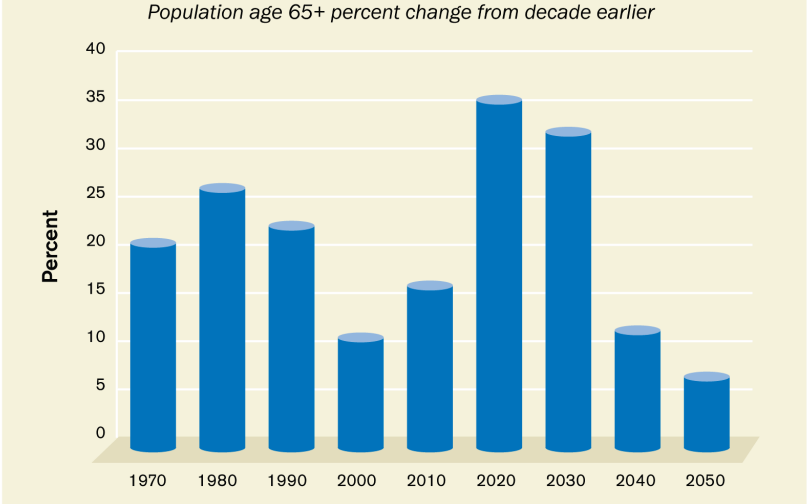


Source: U.S. Bureau of Labor Statistics (CES, seasonally adjusted).

The Recession Has Exposed Longer-Term Structural Gaps

The recession has exposed fiscal problems that states were able to avoid or defer during periods of rapid revenue growth. Even before the recession, Medicaid spending was growing more rapidly than tax revenue; that trend is now exacerbated by the weak economic recovery, which means higher caseloads. Moreover, even after the cyclical effects on the states have disappeared, aging populations and increasing medical costs will put upward pressure on state Medicaid and retiree health care costs, potentially crowding out other spending. Figure 5 shows the growth rates forecast by the Social Security Administration for the age 65+ population for the next four decades: Growth in the current decade and the next will be about 30-35 percent in each decade, up from the approximately 13 percent average for the last two decades.

Figure 5 | As Baby Boomers age, the elderly population will grow more than 30% in both the current decade and the next decade

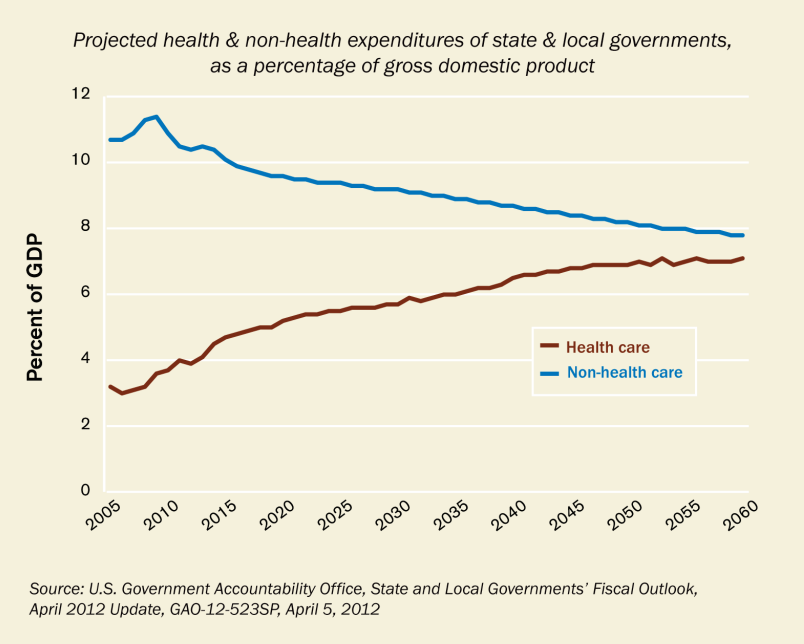


Source: Social Security Administration, 2011 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Federal Disability Insurance Trust Funds.

In addition, states need to raise pension contributions, pay for rising annual costs of retiree health insurance, contend with eroding tax revenue, and make up for years of infrastructure neglect. All these subjects are discussed in more detail below.

The U.S. Governmental Accountability Office (GAO) periodically prepares 50-year projections of expenditures and revenue for the state and local government sector as a whole.[23] They are projections, not forecasts. That is, they reflect what might happen if state and local governments do not change course. The GAO concludes that health-related expenditures will rise much faster than non-health expenditures and will consume a rapidly rising share of state expenditures. According to these projections, state and local government health expenditures will rise from approximately four percent of gross domestic product in 2012 to more than six percent by 2035 and seven percent by 2050.[24] (See Figure 6.)

Figure 6 | Rising health care costs will place increasing pressure on state and local governments



Source: U.S. Government Accountability Office, State and Local Governments' Fiscal Outlook, April 2012 Update, GAO-12-523SP, April 5, 2012

Two percent of GDP – roughly the rise from 2012 to 2035, as shown in Figure 6 – is approximately $300 billion annually, given current GDP of approximately $15 trillion. That is more than the state and local government sector spends on higher education, about half of what it spends on elementary and secondary education, and roughly equivalent to what the sector raises from either the income tax or the general sales tax.

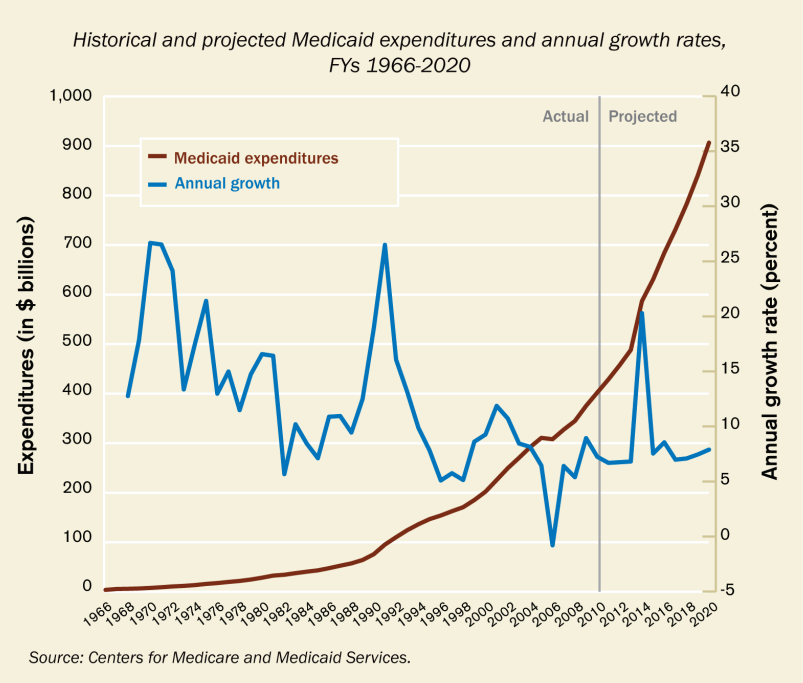
GAO's numbers for the nation as a whole are consistent with the Task Force findings: Many states and localities are on a course that is not sustainable over the longer term.

Six Major Threats to Fiscal Sustainability

Medicaid Spending Growth is Crowding Out Other Needs

Medicaid costs have been growing faster than the economy since the program's inception and generally have grown faster than state revenue as well. (See Figure 7 and Figure 8.) 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 the imbalance (or structural budget gap) can no longer be absorbed without significant cuts to other essential state programs like education or unpopular tax increases or both. This trend is likely to continue, since 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. If state Medicaid spending and state tax revenues continue the trends of the past decade, with a 7.2 percent average annual growth in Medicaid and a 3.9 percent rate for revenues, the gap between Medicaid and state tax revenue growth, expressed in dollars, will increase by at least $23 billion annually within five years and will grow even larger thereafter.

Figure 7 | Medicaid spending has grown dramatically



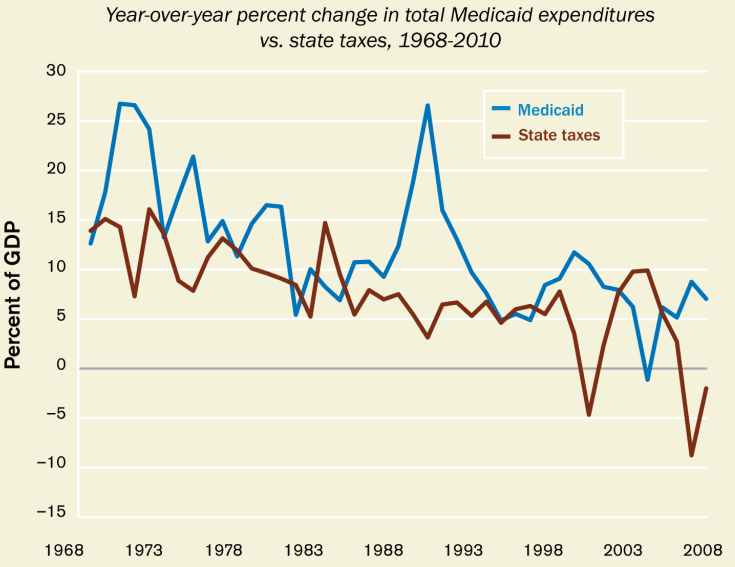
Source: Centers for Medicare and Medicaid Services.

Medicaid recently surpassed K-12 education as the largest area of state spending when all funds, including federal funds, are considered; and Medicaid appears likely to continue to claim a growing share of state resources. (See Figure 9.) During the deepest part of the recent fiscal crisis, states cut education aid, adjusted for inflation and enrollment growth, while Medicaid spending continued to grow.[25] There is budgetary logic behind this: K-12 education is the largest program funded by state taxes, so that a relatively small percentage cut in spending for this purpose can provide enough funds to support a large growth in Medicaid. In contrast, cuts in all other state programs would have to be very large to provide the same budgetary resources.

In the past decade, the problem has been exacerbated in two ways. First, Medicaid cost growth has been driven primarily by growth in enrollment (See Figure 10); other cost drivers, like medical cost inflation and increases in patient benefits, change more slowly. The last two recessions, like other recessions, have increased the numbers of people losing their jobs and their job-related health insurance, thereby increasing Medicaid caseloads. But the past two recessions were also accompanied by increasingly persistent unemployment; therefore, the increases in Medicaid spending were greater than in previous recessions.

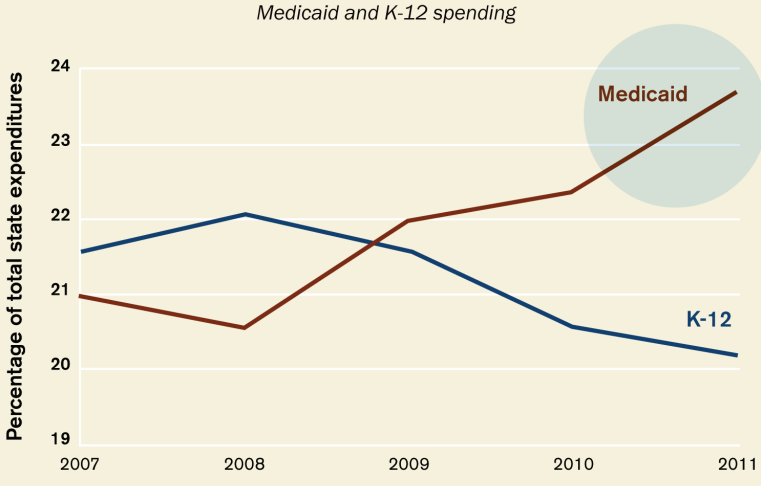
Second, under the American Recovery and Reinvestment Act (ARRA), federal funding, by design, allowed states to reduce their state budget support for the growing Medicaid program in fiscal years 2009, 2010 and in some cases 2011, at the very time when caseloads and resulting costs were growing at an increased rate. This aid kept states from having to raise taxes or cut spending, at least temporarily. However, the expiration of ARRA funding in 2011 forced states both to make up for the lost funding and to absorb three years of high growth in the program, increasing fiscal stress. Medicaid growth is now returning to more normal rates, but tax revenue growth remains slow in most states.[26] So, in most states, the fiscal imbalance between Medicaid growth and state revenue growth remains unusually high and continues to grow, ranging from two

Figure 8 | Medicaid expenditures have grown faster than tax revenue in most years



Sources: Task Force analysis of data from U.S. Bureau of the Census and National Health Expenditure Accounts, Centers for Medicare and Medicaid Services.

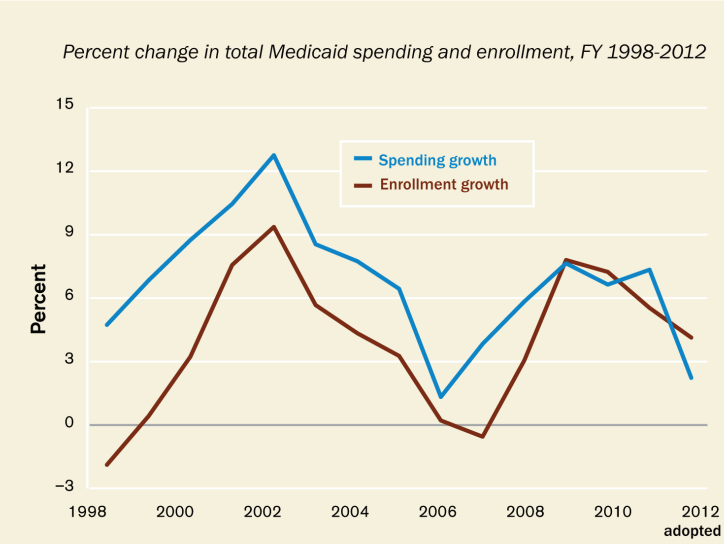
Figure 9 | Total state spending on Medicaid now surpasses K-12 education



Source: National Association of State Budget Officers (NASBO), State Expenditure Report, 2010
Note: Figures are for total state expenditures, including both general fund spending and federal funds

to five percent of Medicaid baseline state spending.

Figure 10 | Enrollment growth is a major driver of Medicaid spending



Note: Enrollment percentage changes from June to June of each year. Spending growth percentages in state fiscal year.

Source: Medicaid Enrollment June 2010 Data Snapshot, KCMU, February 2011. Spending Data from KCMU Analysis of CMS Form 64 Data for Historic Medicaid Growth Rates. FY 2011 and FY 2012 data based on KCMU survey of Medicaid officials in 50 states and DC conducted by Health Management Associates, September 2011.

The Office of the Actuary of the Centers for Medicare and Medicaid Services (CMS) issues annual reports on Medicaid's financial outlook. The most recent report, issued in March, 2012, estimates that total spending for Medicaid in the current decade (2011-2020) will increase by an average of 8.1 percent per year assuming full implementation of the Affordable Care Act as it now exists and by 6.6 percent if ACA is repealed.[27] The 8.1 percent rate of growth could slow if general inflation in health care costs and the number of persons below the poverty level decline or if states refuse to implement enlargement of the Medicaid enrollment base as they are allowed to do under the recent Supreme Court ruling. However, even the 6.6 percent projected growth rate without Medicaid expansion is considerably higher than historical growth rates for recurring state revenue, so the structural Medicaid gap will persist with or without Medicaid expansion.

Impediments to Containing Growth in Medicaid Spending

Since the loss of ARRA funds in fiscal year 2011, states have tried urgently to cut or at least contain the growth in their Medicaid spending. These efforts are described in detail below for the six states studied by the Task Force. While the aggressiveness and inventiveness of savings programs have varied from state to state, all states have been limited by the need to obtain federal approval for virtually any change they want to make that would reduce costs significantly. As a result, states typically end up implementing only a portion of the savings included in their budgets.

Moreover, entrenched provider groups in each state resist reductions in Medicaid provider rates and changes in fee-for-service delivery systems. Thus, even when CMS approves provider payment cuts, provider groups can use litigation to prevent or delay implementation. Finally, because the federal government gets at least half the savings from any cost reduction, states must find roughly two dollars in federally approved cost savings to produce a dollar of benefit to their budgets.

The Maintenance of Effort (MOE) provisions of ACA, which forbid any change that could reduce access to a state program as it existed when ACA was enacted, place an additional limitation on state cost reductions. These MOE restrictions will expire in 2014 for adults and in 2019 for children; but, with or without MOE requirements, the need for

CMS approval and the power of state providers will remain significant impediments to state efforts to implement major reductions in their program costs.

Medicaid In the Study States

California, the most populous state in the country, has the largest number of Medicaid enrollees, 7.5 million. Among the six study states, it also has the highest percentage of its population enrolled in Medicaid, 29 percent. California has been able to roll a number of its state-funded health care programs into Medicaid, thereby gaining federal participation in funding of these programs. Even with the addition of federal funds, however, the state's annual spending per enrollee, $3,364, is the lowest among the six study states and well below the national average of $5,337; its Medicaid spending as a percent of state General Fund spending, 11.8 percent, is also well below the national average of 15.8 percent. The state attributes this low spending level to low provider payment rates, efficient management of medical services, and a very large general fund budget for other services, such as education.

Confronted with severe budget imbalances in the past several years, California has pursued an aggressive program to reduce or at least contain Medicaid costs. Its fiscal year 2012 budget included $2 billion in proposed Medicaid cuts and savings. But most of these cuts and savings required federal approval, and many of the proposals were rejected by CMS. The largest item that was approved, a 10 percent reduction in provider payments, has not been implemented because of a lawsuit brought by providers. Thus, little of the $2 billion in savings has been realized. The Governor's fiscal year 2013 budget proposal includes a smaller Medicaid savings program totaling $842 million--which may stand a better chance of being realized, since it appears to conform more closely to federal policy guidelines.

Illinois has a reasonably generous Medicaid program in terms of optional services, but it covers few individuals that it is not required to cover under federal rules, or "optional enrollees." As with California, Illinois' spending per enrollee is below average, at $4,711; but, in contrast to California, Illinois has an approximately average number of Medicaid enrollees as a percentage of its population–21 percent, which is close to the national average of 20 percent.

After years of underfunding state Medicaid spending and failing to reduce costs significantly, Illinois has accumulated unpaid Medicaid bills from providers that are estimated to total $1.9 billion as of the end of the current fiscal year. The bills will be paid out of funds raised in ensuing fiscal years.

A year ago, Illinois' Governor Quinn proposed significant Medicaid cuts and savings for the fiscal year 2012 budget. They were largely ignored or watered down by the legislature before the budget's enactment. This year the Governor formed a working group, including members from all four legislative caucuses, which developed an ambitious $2.3 billion "saving Medicaid plan." In announcing the plan, the Governor said, "We must act quickly to save the entire Medicaid system in Illinois from collapse." The plan has been endorsed warmly by the business community and the legislature has largely enacted the cost reduction and cigarette tax increases in the plan; but major elements must still be approved by the federal government. If the plan can be implemented, there will be no growth in unpaid Medicaid bills at year's end; but, unless state revenues grow by more than six percent, a structural gap will remain between Medicaid spending and the revenue growth needed to support it.

New Jersey, like Illinois, has a relatively generous Medicaid program in terms of optional benefits but few optional enrollees. Medicaid enrollees constitute only 11 percent of the state population. Spending on optional services, at 65

percent of the whole program, is slightly above the national average of 60 percent; but spending per enrollee, $7,982 per year, is well above the national average of $5,337 and the second highest among the six states studied by the Task Force. The high spending per enrollee in New Jersey reflects spending for the elderly and disabled, who account for 76 percent of total Medicaid spending in the state, and greater-than-average reliance on expensive institutional long term care. The state has a very low provider payment rate - 37 percent of the federal Medicare rate, compared with a national average of 72 percent. The low reimbursement rate is causing a physician shortage in the program: Because of it, according to Dr. Poonan Alaigh, former Commissioner of the New Jersey Department of Health and Senior Citizens, "half the physicians [in New Jersey] don't take Medicaid patients."[28]

Like most other states, New Jersey is trying to cut Medicaid costs and has proposed some 52 Medicaid cost containment initiatives for the four fiscal years 2009-2012 - totaling $1.0 billion in state funds, only a portion of which have been approved by CMS and implemented. However, the state reports that it has contained Medicaid growth over the past six years to an average of four percent annually, primarily by moving clients into managed care, which now covers about 95 percent of enrollment. A new $300 million cost reduction plan submitted early in fiscal year 2012 is, as of now, still waiting for federal approval.

New York has by far the most extensive and expensive Medicaid program in the country. The state spends more of its own funds on Medicaid than Florida, Texas, and Pennsylvania combined. In 2009 its spending per enrollee, $9,056, was 69 percent higher than the national average. New York has had great success in the past at creating a very large Medicaid program through the use of federal dollars, and 72 percent of its Medicaid spending is for optional services.

New York is now tackling the difficult task of reforming its sprawling Medicaid edifice, characterized by former Lieutenant Governor and Task Force co-chair Richard Ravitch as "an unwieldy and overly decentralized structure that serves contradictory goals and provides perverse incentives."[29] Governor Andrew Cuomo has made the job of controlling state spending on Medicaid a major priority in his budget for fiscal years 2012 and 2013. Despite the usual problems in securing quick federal approval for its proposed cost control efforts, the state reports that it has achieved its savings target of $973 million for fiscal year 2012 and is working to achieve its target of $1.1 billion for fiscal year 2013. The state is also in discussions with federal officials about the state's proposal to assume administrative and fiscal responsibility for an integrated managed care program covering the state's 700,000 "dual eligibles," individuals eligible for both Medicare and Medicaid. Under the proposal, the state would assume the risk entailed in its calculation that its costs will be less than the capitated federal payments it will receive from the federal government. If the state's calculation is correct, it will keep the difference – a form of "entrepreneurial federalism."

Texas is widely viewed as a state with a high level of health care need and a low level of health care state spending.[30] The reality is more complicated. On the one hand, Texas Medicaid is not very generous when it comes to either optional enrollment eligibility or optional benefits. Spending for optional services is only 43 percent of total Medicaid spending. The state has very low income limits for eligible parents and no eligibility for childless adults. On the other hand, the state has a large and growing Medicaid enrollment of 4.5 million—which, at 18 percent of the population, is only slightly below the national average and well above New Jersey and Virginia's level of 11 percent. Spending per enrollee is $4,665, about the same as in Illinois and higher than in California. State spending for Medicaid is 17 percent of general fund spending, compared with a national average of 15.8 percent. Because of its lower-than-

average per capita personal income, Texas is the only state among the six states studied by the Task Force that has a higher federal reimbursement rate - 61 percent of total program costs - than the federally provided minimum reimbursement rate of 50 percent.

As in other states across the nation, Texas reduced state Medicaid spending in 2009 and 2010 when ARRA funds increased its federal reimbursement level. But in fiscal year 2011, as ARRA funds vanished and a substantial three-year growth in the program had to be absorbed, Texas was confronted with a large spending increase. The response was a 15 percent across-the-board budget cut and substantial cuts to education. In the 2012-2013 biennial budget, the state openly underfunded Medicaid by an estimated $4.8 billion in order to bring the budget into technical short-term balance. The state will have to make up this shortfall before the end of the budget term in September, 2013.

As in Texas, Virginia's Medicaid program is conservative regarding eligibility, basically limiting coverage to the minimum federal requirements. As a result, the state ranks 48th in Medicaid enrollees as percentage of the state population, at 11 percent. However, optional benefits to enrollees are quite generous; 62 percent of the Medicaid spending in the state is for optional services, above the national average of 60 percent. Also, payment rates to providers are unusually high - 90 percent of Medicare's rates, compared with a national average of 72 percent. As a result, the average cost per enrollee in Virginia, $5,758, is higher than the national average and higher than that of California, Texas, or Illinois though lower than that of New Jersey or New York.

Unlike many other states experiencing fiscal pressures in recent years, Virginia has not attempted to reduce rising costs by eliminating optional benefits and services. However, it has implemented several provider-based cost saving policies, freezing or reducing various components of delivery and expanding managed care. The most recent biennial budget proposed by Virginia Governor Robert McDonnell includes proposed Medicaid savings of $260 million in fiscal year 2013 and $438 million in fiscal year 2014. If achieved, these proposals would reduce Medicaid costs by three percent in 2013 and five percent in 2014.

Implementation of the Affordable Care Act (ACA)

The ACA, as validated in most respects by the Supreme Court, could have a huge impact on state Medicaid programs if states choose to participate in the law's enlargement of eligibility. The federal government initially will pay 100 percent of the costs of newly eligible enrollees, and states may find it difficult to refuse such federal largess benefiting their citizens. States with currently low eligibility levels and high uninsured populations, like Texas, Virginia, and Illinois, could have a substantial increase in their Medicaid caseloads if they participate, putting great pressure on provider capacity - already strained in these states - and increasing pressure for increased rates of payment to providers.

For states that want to increase coverage for the uninsured, ACA is a bargain: The federal government will pay 100 percent of the cost of covering the newly eligible enrollees beginning in 2014, phasing down to 90 percent in 2019. Since ACA's enactment, there has been significant research on the estimated additional cost to states of its implementation. The Kaiser Commission on Medicaid and the Uninsured has projected average additional state spending over the pre-ACA baseline of 1.4 percent by 2019, while a study by the Lewin Group estimated increased state spending of 1.1 percent. The same studies showed federal cost increases of 22.1 percent and 19.1 percent, respectively.

With respect to the six study states, the Kaiser study showed increases above baseline ranging from three percent for Texas to zero percent for New York; Lewin projected a range from a four percent increase for Texas to a net benefit of 5.3 percent for New York. Since Texas has one of the highest percentages of uninsured citizens of any state in the country, at 26 percent, it expects a huge - 51 percent - increase in Medicaid enrollment if it participates in the enlargement under ACA. Although the federal government will pay most of the increased costs of the new enrollees, Texas will have a moderate but greater-than-average increase in state spending over baseline, from three to five percent.

New York expects to be held harmless or actually to gain from ACA implementation, since the state already covers many of the individuals who will be eligible under ACA for the higher reimbursement rate. New York is currently reimbursed by the federal government for the costs of these individuals at a rate of 50 percent. Virginia expects increased Medicaid enrollment under ACA, ranging from 270,000 to 425,000, depending on assumptions about the rate of enrollment by newly and currently eligible individuals. The state estimates increased annual state costs ranging from $1.5 billion to $2.2 billion by 2019.

Above and beyond increased coverage of the uninsured, ACA includes a number of features that will affect the states. The legislation's Health Insurance Exchanges could make private health insurance more affordable and, thereby, could actually result in decreased Medicaid enrollment by those whose incomes place them at the margins of eligibility. Furthermore, the act's restriction on insurance companies' ability to restrict provision of insurance to people with pre-existing medical conditions will, as a budget matter, undoubtedly be welcomed by all states. But at least half of the states have opposed ACA implementation - some on ideological grounds, others because they worry about the federal government's future willingness to fund the increase in federal costs that will result from the newly eligible individuals. If the states greatly increase their Medicaid caseloads under ACA and the federal government later caps or block-grants Medicaid, the states could be left on their own with a very expensive program or could be forced to deal with the political problem of withdrawing benefits from many of their own citizens.

Medicaid Outlook

Federal health care reform, as upheld by the Supreme Court, will not change the fundamental imbalance between rising Medicaid costs and state revenues. The longer term cost pressures resulting from dramatic increases in the elderly population and the inexorable growth in health care costs continue to build. As the CMS Actuary puts it, "The increased Medicaid costs associated with growing caseloads and the pressures on government revenues are likely to add to the financial stress of States' Medicaid programs."[31]

Many state officials desire greater flexibility to design more-affordable Medicaid systems with restricted eligibility and benefits, but there is a wide divergence of opinion on this issue among federal officials. Some plans, such as the block grant plan proposed by Republican Congressman Paul Ryan, would offer states flexibility in exchange for funding caps, while other legislators and the current administration want to maintain and improve Medicaid as a major component of ACA-based health care reform. Most states cannot control Medicaid costs without the cooperation and assistance of the federal government; and the federal government needs to find ways to control its own share of Medicaid funding, which under ACA is far larger than the state share. Reaching agreement on how to control federal and state costs,

while assuring the basic goals of enlarging and improving health care for persons who cannot now afford private insurance, is a major political and economic challenge that should be addressed sooner rather than later.

Federal Deficit Reduction Threatens State Economies and Budgets

Federalism has been at the core of our nation's political system since the ratification of the Constitution in 1788. There have always been tensions between the states and the federal government, and these tensions have manifested themselves in many ways.

The relationships that make up today's federalism are perhaps best described as fractured. Many states resent rules and regulations imposed by the federal government as a condition of federal aid, while many in the federal government fear that without such rules, states will enact laws and initiate programs that run counter to the national interest. The legal and political challenges to ACA present a vivid example of these issues and tensions.

Economist and Task Force Advisory Board Member Alice Rivlin has summarized such challenges this way:[32]

> The American federal system is under extraordinary fiscal pressure as both the national government and the states struggle to recover from the deep recession that followed the Financial Crisis of 2008. Unfortunately, these pressures are not all temporary. Even when the economy returns to stronger growth and unemployment recedes, serious structural funding gaps loom ahead for the federal government and beset most states as well. Both levels of government are stressed by the need to provide services to a rapidly aging population and deal with rising demand for increasingly costly health care.

These tensions are likely to increase as the federal government seeks to lessen its budget deficits, which have existed for the past decade and shot up sharply in recent years. Though the tensions will affect both state and local governments, the states will feel them most directly, through federal spending cuts and tax changes. Expenditure reductions will have two types of effects. First, direct grants to states, under both entitlement programs like Medicaid and discretionary programs like education assistance and infrastructure funding, are likely to be cut back.

In addition, direct federal expenditures on goods and services to support the federal government's own activities - items like salaries and contracts - are likely to shrink. The effect of the decline in direct expenditures will be uneven: Among this study's sample states, Virginia, California, and Texas are likely to feel the most significant effects.

In addition, as discussed below, potential changes in federal tax policy could have positive as well as negative effects on state and local governments. Substantial changes in these areas, even if they do not occur in the next year or two, are virtually inevitable in the longer run; and the federal government currently has very little in place in the way of structures and processes for consulting with states and localities about the likely effects.

Potential Reductions in Grants

Even if Congress and the President do not cut the federal budget drastically this year or next, significant cuts are almost certain over the longer term. We may assume that areas such as defense, Social Security, Medicare, and net interest will not be cut as deeply as other programs. If this is the case, federal grants to state and local governments will be a primary target of federal budget cuts: Although such grants account for only 16 percent of federal outlays as a

whole, they make up more than 40 percent of the discretionary portion of the budget likely to be targeted for deeper cuts. (See Table 3 below.)

Table 3 | Grants are a significant share of federal spending likely to be cut

Federal outlays in FFY 2012 (estimated)	
	Federal Outlays ($ billions)
Total	**$3,795.5**
Subtract: Federal spending that may be cut less deeply	
Defense	709.0
Social Security	772.7
Medicare	484.5
Veterans benefits and services	129.6
Subtotal	**2,320.6**
Remaining federal spending	1,474.9
Grants to state & local governments	612.4
Grant share of total outlays	16.1%
Grant share of remaining spending	41.5%

Sources: *Federal Budget for FFY 2013, Historical Tables 8.1, 8.5, 8.7, & 12.1.*

Of federal grants to the states, Medicaid is the largest category by far: Combined grants for Medicaid and the related Child Health Insurance Program (CHIP), estimated at $265 billion in 2012, account for nearly 45 percent of all grants. Other public and social assistance payments for individuals account for an additional 17 percent, education and training grants make up another 17 percent, and infrastructure and physical capital grants account for 16 percent. (See Table 4.)

Table 4 | Medicaid is by far the single largest category of federal grants to states

Federal outlays in FFY 2012 (estimated)		
	Federal Outlays ($ billions)	Share (%)
Grants to state & local governments	**$612.4**	**100%**
Payments for individuals	**368.5**	**60.2**
Medicaid & Child Health Insurance Program (CHIP)	265.0	43.3
Public assistance, nutrition, & other payments for individuals	103.5	16.9
Grants for education & training	**105.2**	**17.2**
Elementary, secondary, & vocational education	85.1	13.9
Other grants for education & training	20.1	3.3
Grant for physical capital investment	**96.4**	**15.7**
Highway capital grants	41.7	6.8
Transit, airports, & other transportation capital grants	23.8	3.9
Community & regional development capital grants	11.5	1.9
Housing assistance capital grants	6.3	1.0
Pollution control & other capital grants	13.1	2.1
All other grants to state & local governments	**42.2**	**6.9**

Sources: *Federal Budget for FFY 2013, Historical Tables 8.1, 8.5, 8.7, 9.6, 11.3, 12.1 and Public Budget Database outlays spreadsheet.*

Though cuts in federal grants will generally have a larger direct impact on state governments than on local governments, some local governments will suffer acutely from cuts in federal aid. For one thing, 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 largest such grants include education "impact aid" (to local school districts that lose property tax revenues because of tax-exempt federal property, such as military bases), urban transportation aid, and some community development block grants.

Overall, cuts in federal grants, when they come, will have a profound impact. If these grants were cut by 10 percent, the loss to state and local government budgets would be more than $60 billion annually. That is nearly twice the size of the combined tax increases that states enacted for 2008 through 2011 in response to their deepest fiscal crisis in more than 50 years.[33] Cuts this large would certainly cause considerable fiscal stress.

The potential impact on each study state of a 10 percent cut in grants is shown in Table 5, in billions of dollars by major grant category and in dollars per capita for the total.[34] The programs shown below were chosen because they are the largest grant programs that flow to states. Four of them provide services to needy individuals, while Highway Trust funding is a major source of revenue for construction and maintenance of highways.

Table 5 | Potential impact of a 10 percent reduction in Federal grants

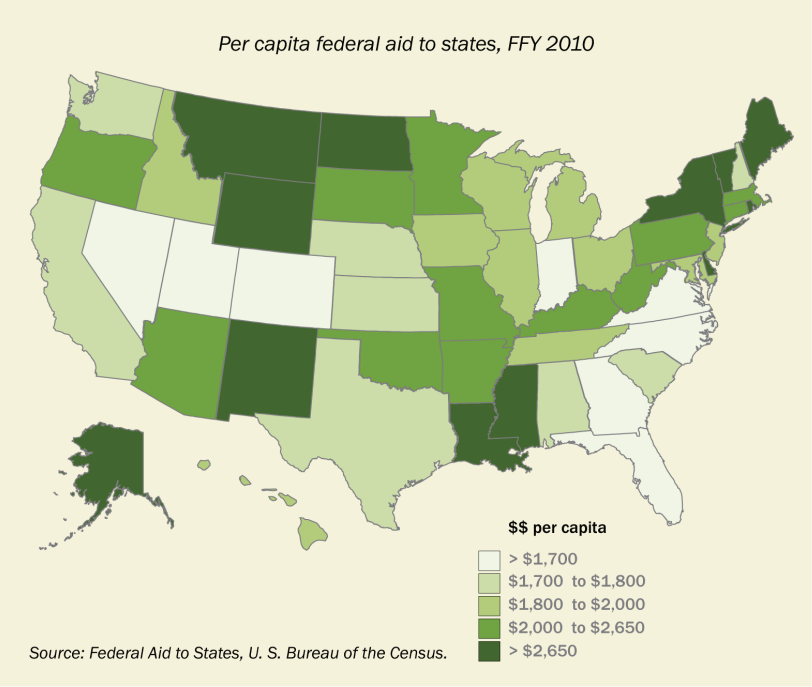
	Potential cuts						
	Total ($ millions)	Medicaid and selected other CMS programs ($ millions)	Highway Trust Fund ($ millions)	Temporary assistance to needy families (TANF) ($ millions)	Title 1 education programs ($ millions)	Child nutrition programs ($ millions)	Potential cuts ($ per capita)
United States	**$62,074**	**$27,804**	**$3,027**	**$1,987**	**$1,811**	**$1,628**	**$201**
California	6,657	2,925	188	425	224	199	179
Illinois	2,319	984	86	73	83	62	181
New Jersey	1,631	684	62	61	35	33	186
New York	6,134	3,274	163	274	152	100	317
Texas	4,373	2,010	161	67	181	191	174
Virginia	1,065	422	85	17	2,824	24	133

***Source**: Task Force analysis of data from U.S. Bureau of the Census, Federal Aid to States 2010.*

California and New York would each lose more than $6 billion, and Texas would lose more than $4 billion. While some adjustments could be made in programs to reduce costs, overall the loss of federal aid would mean increased taxes or less service or fewer dollars to invest in infrastructure.

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.[35] 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,

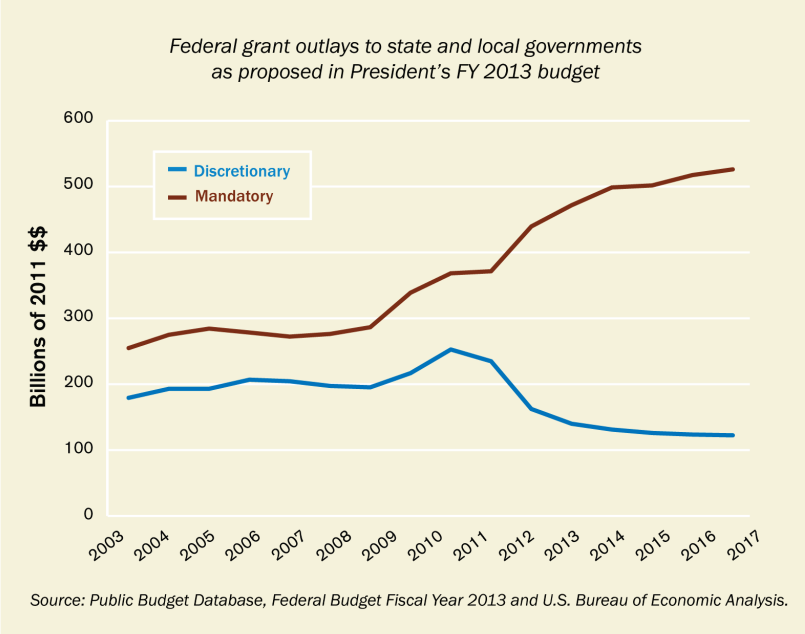
Figure 11 | Per capita federal grants to states vary dramatically across the states



but Medicaid and highway grants are two important factors in making per capita federal grants higher in Northeastern and Mountain states. (See Figure 11.) 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.

The President's Budget for fiscal year 2013, as submitted to Congress, projects a substantial increase in grants to states for what the federal government terms "mandatory" programs - driven primarily by rapid growth in the Medicaid entitlement program, which will, in turn, be influenced by federal health care reform.[36] The same budget projects a decline in inflation-adjusted outlays for discretionary grants and assumes that such grants will stay within the limits established by the Budget Control Act of 2011, or BCA. (See Figure 12.)

Figure 12 | Mandatory grants are projected to rise substantially; discretionary grants are projected to fall



Source: Public Budget Database, Federal Budget Fiscal Year 2013 and U.S. Bureau of Economic Analysis.

Work by the Congressional Budget Office (CBO) describes the general effects on state and local governments of current federal deficit-cutting actions, especially the BCA.[37] CBO projects that, as a result of the BCA, selected discretionary spending for education, transportation, and housing programs benefiting state and local governments will shrink by 35 percent between 2012 and 2022. They project that selected income security programs, primarily those benefiting children, will decline by 35 percent during the same period.

Conversely, CBO expects federal spending for Medicaid and CHIP to increase by 47 percent during the same period:

> Enrollment is expected to rise rapidly over the coming decade as more people become eligible for Medicaid under provisions of the Affordable Care Act (the 2010 health care legislation) and as the number of elderly people rises. By 2022, about 94 million people—more than a quarter of the U.S. population—will be enrolled in Medicaid at some point in the year, CBO estimates. For many of those new enrollees, the federal share of their costs will be significantly larger than the share for individuals enrolled in Medicaid today.

Of course, the actual trajectory of federal grants could vary dramatically from these projections. Medicaid, for instance, was exempted from the "automatic" cuts provided by the BCA; but it is a significant driver of long-term federal budget pressures and, therefore, is unlikely to remain untouched by policymakers over the longer term. In addition to the Ryan plan, the Simpson-Bowles proposal would cap Medicaid's growth rate; either change would substantially reduce future federal grants for Medicaid relative to the CBO projections.

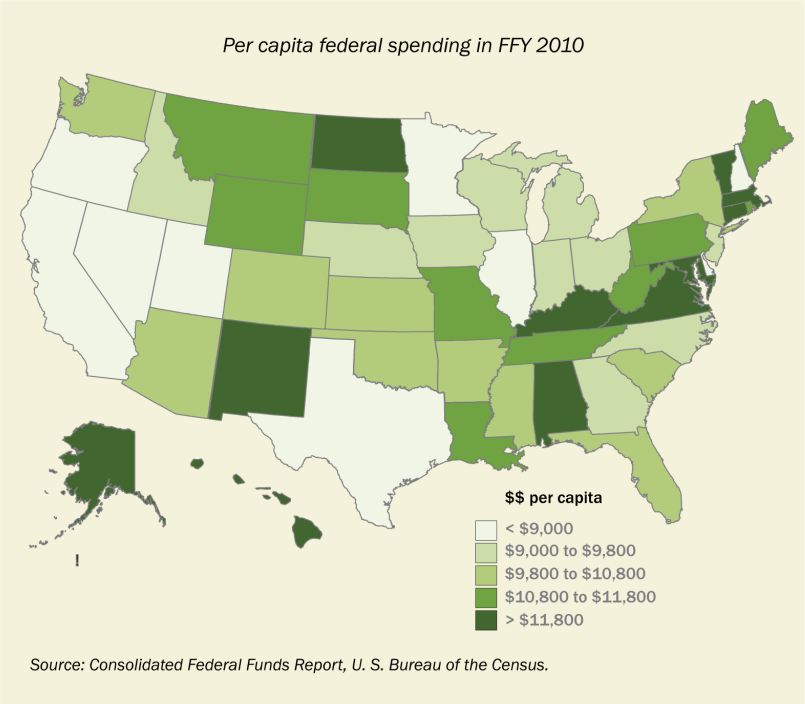
What is more certain is that the opposing views of ACA and Medicaid, reflecting divisions over the proper roles of the federal and state governments in our federal system, are causing increased tensions that make it more difficult to deal with the challenges of fiscal sustainability.

Potential Reductions in Procurement, Contracts, and Other Federal Spending

Reductions in federal spending for procurement, the federal workforce, and other activities will affect state and local economies. This direct spending, like federal aid to states, varies widely (See Figure 13); and direct federal spending is distributed quite differently from federal grant spending.

Thus, cuts in federal procurement, federal workforce, and other items of direct spending will affect some states' economies more profoundly than others. For example, the study state of Virginia, with its dependence on defense procurement and its cadre of federal workers and retirees, is at particular risk. Even though Virginia's per capita federal aid grants rank lowest in the nation, total direct federal spending per capita in Virginia - including procurement, wages, retirement, and other spending - is 60 percent above the national average and accounts for about 32 percent of Virginia's gross state product.[38] Among the study states, Virginia ranks first in federal procurement, which makes up more than 13 percent of its state GDP; federal salaries and wages constitute approximately five percent of state GDP. (See Table 6.)

Figure 13 | Direct per capita federal spending varies widely across states



Source: Consolidated Federal Funds Report, U. S. Bureau of the Census.

Table 6 | Federal procurement, federal salaries and wages, 2010

State	Procurement ($ millions)			Salaries & wages ($ millions)		
	Procurement spending	% of GDP	Rank procurement (based on $)	Salaries & wages ($)	% of GDP	Rank, salaries & wages (based on $)
United States	**$474,204**	**3.3%**	**-**	**$316,368**	**2.2%**	**-**
California	57,537	3.0	2	24,585	1.3	2
Illinois	11,601	1.8	13	7,949	1.2	13
New Jersey	10,236	2.1	16	5,578	1.1	19
New York	13,883	1.2	8	13,936	1.2	7
Texas	40,594	3.4	3	29,926	2.5	1
Virginia	58,338	13.8	1	21,112	5.0	3

***Source**: Task Force analysis from U.S. Bureau of the Census and U.S. Bureau of Economic Analysis.*

In 2011, in fact, Moody's assigned Virginia a negative outlook on grounds that "what we are seeing now is a structural shift, where now a great source of stability (Northern Virginia's economy) is becoming a potential vulnerability, because of federal downsizing."[39]

Potential Impact of Federal Tax Reform

CBO analyzes the potential effects of federal tax policy changes as well as cuts in federal aid. Though no current laws relating to tax policy changes have potential effects as clear as those of the BCA, CBO estimates that under current law, selected tax expenditures affecting state and local governments, such as the deductibility of state and local taxes for federal income tax purposes and the exclusion of interest on state and local bonds from federal income taxation, will grow by 36 percent from 2012 to 2022; thus, they will be attractive targets for federal budget-cutters.

However, the potential effects of federal tax changes are indeterminate. The Federation of Tax Administrators notes that of states that impose an income tax, only five do *not* use a "federal starting point" for calculating state income taxes.[40] Thus, changes to federal tax laws could have significant positive or negative ramifications for states. There will also be significant consequences for localities within each state. For example, limiting the federal deductibility of mortgage interest on primary residences could also increase individual income taxes payable to states. However, the same change could lower the value of these residences for local property tax purposes.

The Congressional Research Service (CRS) recently gave this summary of the role that tax expenditures could play in deficit reduction:[41]

> There are over 200 separate tax expenditures, which are projected to total over $1.1 trillion in FY2014. The revenue loss of all tax expenditures, however, is highly concentrated in a relatively small number—the largest 20 tax expenditures account for 90% of the total revenue loss of all tax expenditures. This amount is

equivalent to 74% of the total FY2014 revenue from individual income taxes. If used for rate reduction alone, eliminating these tax expenditures could allow tax rates to be reduced by around 43%: for example, the top 39.6% tax rate could be reduced to approximately 23%.

Of the $123.8 billion that CRS estimates as tax expenditures directly related to state and local governments for fiscal year 2014, the major items are deductions or exclusions for the following:[42]

- Property taxes, $27.1 billion
- Other state and local taxes, $54.0 billion
- Interest on tax-exempt debt, $42.7 billion

If deductions for state and local taxes are scaled back, different states will be affected differently. Among other things, the impact in a given state will depend on how extensively the state relies upon those taxes that are deductible for federal purposes and on the extent to which the state's taxpayers claim the deduction for federal income tax purposes. The latter is particularly complicated because state and local taxes generally are not deductible for taxpayers who pay the Alternative Minimum Tax (AMT). The AMT rules have changed over time and are likely to change further. However, the available data suggest that changes to state and local tax deductibility could affect California, New Jersey, and New York most heavily, because taxpayers in these states claim the largest deductions for state and local taxes paid and the deductions are a larger share of income than in most states. (See Table 7.)

Table 7 | New York, New Jersey, and California appear to be most at risk if the deduction for state and local taxes is scaled back

The Deduction for State and local Taxes on 2009 Federal Income Tax Returns				
	Average taxes-paid deduction per return claiming deduction		Taxes-paid deduction as % of adjusted gross income	
	Amount ($)	Index to US=100	Percent (%)	Index to US=100
United States	**$6,767**	**100**	**5.4%**	**100**
California	12,486	185	7.6	141
Illinois	9,269	137	5.4	100
New Jersey	14,655	217	9.1	169
New York	16,897	250	9.3	172
Texas	6,704	99	3.0	56
Virginia	9,229	136	5.9	109

Source: *Frank Sammartino. "Federal Support for State and Local Governments Through the Tax Code" presented at the committee on Finance, United States Senate, April 25, 2012.*

A decrease in this deductibility could affect states in two ways. First, the effective "tax cost" of state and local government services to residents of those jurisdictions would rise, placing downward pressure on state and local spending and taxes and increasing incentives for individuals and businesses to move to lower-tax locations. Second, in

the 15 states that allow a federal itemized deduction for state and local taxes in whole or in part, increased taxable income could mean increased taxes unless rates are adjusted.[43]

It is much more difficult to examine the potential impact of scaling back the exclusion for tax-exempt bond interest. The impact will depend on debt issuance patterns in the states, the extent to which their taxpayers invest in tax-exempt bonds, and how taxpayers rearrange their portfolios in response to any changes. The deductions for state and local taxes and the exclusion of interest on tax-exempt debt, for instance, are disproportionately concentrated in high-tax states in the Northeast and some of the coastal states. Generally, however, without a federal subsidy, the cost of borrowing for states will rise.

Moreover, the effects of federal tax changes on state and local governments are not limited to these items alone: Any change in the federal code can have an impact on state and local governments. For example, if the federal government eventually moves toward a consumption or value-added tax, states would be affected enormously, with possible benefits as well as risks.

The Absence of Formal Dialogue Between the Federal Government and the States

There are no standing structures and procedures within the federal government for analyzing the impacts on states and localities of reduced federal spending or federal tax changes, and there is little dialogue about these issues between the federal government and state and local governments. In a recent Senate Finance Committee hearing on the potential implications of federal tax reform on state and local governments, ranking minority member Orrin Hatch emphasized the need for careful analysis of such effects:[44]

> The rush for new tax dollars that too often characterizes the federal legislative process, oftentimes leaves issues involving federal-state tax coordination by the wayside. But we cannot forget that the policies being discussed today touch on fundamental constitutional principles of federalism and separation of powers. And if we are to do no harm it is important to hold hearings such as this one… Issues involving the federal impact on state and local revenues impact both the Constitution's separation of powers between the federal and state governments and the separate identity of the sovereign states.

Senator Hatch's recognition of the relationship between federal tax actions and state and local government finances points to the need for continued formal dialogue among the levels of government. Beginning in 1959, the Advisory Commission on Intergovernmental Relations sought to play this role; but it was criticized for failing to communicate effectively across intergovernmental lines and was disbanded in 1996. At present, there is nothing to take its place.

If the federal government and state groups like the National Governors' Association and the National Conference of State Legislatures do not seek forums for joint modeling, discussion, and planning in this time of retrenchment and realignment, they will miss a critical opportunity to reduce uncertainties and harmful consequences, intended and unintended.

Underfunded Retirement Promises Create Risks for Future Budgets

Public pensions - deferred compensation that state and local governments promise to pay to workers after they retire - should be substantially funded in advance. This helps ensure that funds are available when needed; it also fairly distributes the costs of public services to the taxpayers who benefit from them. To prefund pensions, governments and

most public employees contribute to retirement systems, which invest with the goal of accumulating assets to pay benefits when due. Most retirement systems can pay pension benefits for many years out of existing funds, but this does not mean they are sound. Increased contributions from governments and employees and, in some cases, benefit cuts may be required in order to stave off a crisis. In practice, such prefunding has been dangerously inadequate.

The Legal Nature of the Pension Promise

In the private sector, defined benefit pension plans are disappearing rapidly. The commercial and legal systems accommodate wholesale change to pension regimes through such vehicles as acquisitions, mergers, or buyouts and Chapters 7 and 11 of the U.S. Bankruptcy Code. In the public sector no such structures exist to promote changes to pension laws. Under certain conditions local governments (though not state governments) can apply for Chapter 9 bankruptcy; but the extent to which they can modify pension obligations in these proceedings, if at all, is unsettled. Public pensions are created by legislation and enjoy legal protections that vary widely based on state constitutions, statutes, and court decisions that often restrict subsequent modifications. Nevertheless, there is a steady advocacy for changes in employee benefit programs in just about every state, with increasing awareness by taxpayers of the burdens being placed upon them to fund pension and benefit programs of public employees. Often these taxpayers, as private sector employees, no longer enjoy similar benefits themselves.

The degree of pension protections afforded to public employees varies by state and depends in part on whether proposed modifications are substantial. The degree of protection also depends on the persons affected by proposed modifications: new hires, unvested or vested current employees, or retirees. Legally and politically, legislation directed at new hires is the easiest to achieve because new hires are invisible and, until hired, do not vote in union elections (where unionized); but such modifications produce the smallest immediate savings and do not reduce unfunded liabilities. Legislation directed to retirees, on whom most pension funds are expended, is the hardest to achieve because retirees have fulfilled their employee obligations and earned the entitlements they were promised. Legislation affecting current employees, who can generate the most political resistance, is of varying difficulty. In virtually no state can changes in pension rules and benefits be achieved where rights have been vested or accrued. For rights yet to be accrued, change may be possible.

In 43 states, pension statutes are deemed by constitution, explicit statutory language, or implication to have created a binding legally enforceable contract between employer and employee, vesting either at the time of hire (California, Illinois, New York), at a point during the employee's tenure, or potentially at retirement.[45] The significance of a pension's being deemed a contract is that it thereby enjoys protection under Article One, Section Ten of the U. S. Constitution, which provides that no state may pass any law that diminishes or impairs a contract. Usually state constitutions also provide, in words or substance, a similar non-impairment protection for contracts. Of the non-contract states, which include New Jersey, only two – Texas and Indiana – retain the theory that a pension is a gratuity not entitled to any specific protection. Other non-contract states, such as Minnesota, consider a pension a property right or treat it as subject to promissory estoppel (*i.e.*, as a promise that is relied upon).

Therefore, legal protections for pensions are strong, but they vary among states. Contracts may be modified by proper exercises of a state's police power but proper exercise requires such modification to be the least drastic solution

needed to solve the problem being addressed. In addition, such change may be effected only to solve an important public purpose; this criterion is very narrowly defined and has seldom been found to exist in such cases.

Many states are pursuing pension legislative change - seeking to raise retirement ages, require additional years of service, increase employee contributions, offer section 401(k) options, and reduce or eliminate cost-of-living increases (COLAs). The general effort is to shift both costs and risks from the employer to the employee.

The Structure of Pension Systems

There are more than 3,400 state and local retirement systems in the United States. These retirement systems generally are governed by trustees who are independent of the government and have a fiduciary responsibility to the beneficiaries. Only 222 systems are administered on a statewide basis; but, with a few exceptions the statewide systems are far larger than those administered at the local level, holding 83 percent of investible pension assets.[46] [47] (See Tables 8 and 9.)

Table 8 | States vary greatly in how they organize retirement systems

Number of retirement systems in 2010 by level of administration							
	California	Illinois	New Jersey	New York	Texas	Virginia	United States
State	5	6	7	2	7	1	222
Local	57	451	3	8	68	17	3,196
Total	**62**	**457**	**10**	**10**	**75**	**18**	**3,418**

***Source**: U.S Bureau of the Census, Survey of Public retirement systems.*

Table 9 | State-level retirement systems hold 83 percent of assets

Total investible assets in $ billions in 2010 by level of administration							
	California	Illinois	New Jersey	New York	Texas	Virginia	United States
State	$373.7	$76.4	$66.5	$208.1	$151.5	$46.5	$2,221.3
Local	142.3	36.6	0.1	94.2	23.2	9.7	453.5
Total	**516.1**	**113.0**	**66.5**	**302.3**	**174.7**	**56.3**	**2,674.8**
State %	72.4	67.6	99.9	68.9	86.7	82.7	83

***Source**: U.S Bureau of the Census, Survey of Public retirement systems.*

The six study states vary greatly in the ways they organize their pension systems. Essentially all the assets in public systems in New Jersey are administered at the state level, while California and Illinois have a few large state-level systems plus many local systems; several of these local systems are very large, but many are small. New York is unusual in having just two large state-level systems – a system for general state and local government employees and the state Teachers Retirement System, to which teachers outside New York City belong. New York City administers its own retirement systems, which are larger than most state retirement systems.

The government that employs a worker is not necessarily the government that contributes to his or her pension plan. For example, in Illinois the state government is responsible for funding the Illinois Teachers Retirement System on behalf of school districts outside of Chicago, although Governor Quinn has proposed shifting costs to school districts. In New York, local governments and school districts contribute to statewide plans. (In the case of school districts, the state withholds the districts' contributions from the state aid otherwise payable to the districts.) Both California and Illinois have many locally administered systems that are essentially on their own; in both states, many of these systems are severely underfunded. Illinois has hundreds of small municipal police and fire retirement systems that in the aggregate were only 51 percent funded in 2009.[48] In many states, a statewide retirement system includes some or many local government employees.[49] Depending on the state and the system, the state government may contribute on behalf of local employees or local governments may contribute.

Understanding which governments contribute to which systems is important to understanding the likely fiscal stress if required contributions rise significantly. Often there is pressure to shift fiscal stress to other governments. For example, the California State Teachers Retirement System (CalSTRS, the second-largest system in the country) is underfunded by $64 billion because of investment income shortfalls and statutory contribution rates that are lower than annual required contributions.[50] Contribution rates are set by the state legislature. If and when the legislature approves higher rates, this could create stress for school districts. But because much school funding comes from the state and because the state could bear ultimate legal responsibility for benefit payments, California will face pressure to increase aid to school districts—either by explicitly helping districts make pension contributions or otherwise relieving their fiscal stress. According to its latest actuarial valuation, the legislature would need to approve contribution increase to CalSTRS of approximately $3.5 billion annually to get onto a path toward eventual full funding.[51]

Valuing Pension Liabilities

One of the actuary's critical jobs is estimating the liability that a pension system has to its beneficiaries. This requires projecting benefits that will be paid in the future and "discounting" those benefits to the present. The choice of discount rate is critical. For example, the estimated liability today for a single-year's pension benefit of $31,700, payable 15 years hence, is approximately $10,000 using an 8 percent discount rate, but more than $15,000 using a 5 percent rate.[52] Put differently, using a 5 percent rate increases the estimated liability by about 50 percent relative to an 8 percent rate.[53]

The impact on unfunded liabilities can be dramatic. In the example above, if a pension plan had $8,000 in assets set aside for the future benefit it would have unfunded liabilities of $2,000 at an 8 percent discount rate (given the liability of $10,000). But with a 5 percent rate the plan would have $7,000 in unfunded liabilities (given the liability of $15,000) – the unfunded liability would be more than three times as large.

Under standard actuarial practice and accounting guidance from GASB, actuaries use a discount rate based on the expected return on assets held in the pension fund.[54] That is, the rate they use to discount liabilities is by definition the same as their investment earnings assumption, even though in concept they need not be the same. The vast majority of pension plans currently assume they will earn 8 percent. Economists and others have noted that the size of the liability has nothing to do with how much the funds will earn. As researchers Jeffrey Brown and David Wilcox noted,

"This practice contrasts sharply with finance theory, which is unambiguous that the appropriate discount rate is one that reflects the riskiness of the liabilities, not the assets."[55] The economics profession is virtually unanimous in this view.[56]

There is no unanimity on what discount rate (or rates) would reflect the riskiness of pension liabilities, but given strong legal protections most researchers believe the risk of nonpayment is low, and some even believe benefits should be treated as risk free. This means that in current market conditions the discount rate would be far lower than 8 percent. The Center for Retirement Research at Boston College frequently uses 5 percent in its analyses.[57] Other researchers have used lower rates, which lead to even higher estimates of liabilities.[58] There is no definitive answer, and discount rates will vary with market conditions. There have been periods, particularly during the early 1980s, when risk-free or low-risk interests rates actually were higher than pension fund earnings assumptions.

Using a higher-than-appropriate discount rate can have at least three effects. First, pension plans will appear healthier than they otherwise would, potentially creating incentives to reduce contributions to plans or to enhance benefits. Second, it can create pressures for pension systems to invest in risky assets in an effort to achieve higher investment returns. A recent research paper on this topic concluded, "In the past two decades, U.S. public funds uniquely increased their allocation to riskier investment strategies in order to maintain high discount rates and present lower liabilities…"[59] Third, it can keep employer contributions artificially low, until and unless pension systems suffer investment shortfalls. Because these shortfalls often are associated with economic downturns and contribution increases follow shortly thereafter, the contribution increases can occur at the times governments are least able to afford them. Many governments in the six study states have not kept up with annual required contributions in recent years.

After several years of research and deliberation reflecting on these and other concerns and after hearing comments from stakeholders, in June 2012 GASB adopted new rules governing reporting of public pension liabilities and expenses.[60] Among other things, the rules would require pension systems to calculate liabilities using a two-pronged approach. The portion of benefits that can be supported by existing assets, investment income, and contributions would be discounted using an interest earnings assumption, and the remaining "unfunded" portion would be discounted using a high-grade municipal bond yield, which would typically be much lower. In determining expected contributions, the plan would have to look to the history of governments making contribution and assess likely future contributions, which would not be easy to do given the history some governments have of contributing less than the annual required contribution. The effect generally would be to drive estimated liabilities upward for significantly underfunded plans, although the extent to which this would occur is not easy to estimate because it will depend on market interest rates, the details of each plan's cash flow, and the extent to which retirement plans adjust their behavior in response. Many analysts have argued that this two-pronged approach has no theoretical basis and is subject to potential gaming; others have welcomed it as an imperfect improvement.[61]

The Center for Retirement Research estimated that funded ratios for the plans in their database, which account for roughly 85 percent of assets, would fall from 76 percent to 57 percent if the then-proposed rules had been in place in 2010. The impact would vary dramatically from plan to plan, depending on its specific circumstances and contribution behavior. For example, the funded ratio of the main CalPERS fund was estimated to be unchanged at 65.4 percent,

while the funded ratio of CalSTRS was estimated to drop from 59.7 percent to 41.2 percent. (CalSTRS may be the exception in California. According to the CalPERS actuary, the '"vast majority" of California public pension systems will not reach the crossover point' at which they would have to use a lower discount rate.[62]) The Illinois Municipal Retirement Fund's funded ratio was estimated to stay unchanged at 86.3 percent, while the Illinois State Teachers Retirement System's funded ratio was estimated to drop from 40.5 percent to 18.8 percent. [63]

While declines in funded ratios could be quite significant, they pale in comparison to what would be reported if risk-free or low-risk discounting were used. For example, one recent analysis estimated that CalPERS's funded ratio would be 45.1 percent at a 4.5 percent discount rate.[64]

The use of lower-risk discount rates does not mean that pension funds should or will use earnings assumptions as low as the discount rate, or that they will eliminate risky assets from their portfolios. For several reasons, pension funds will continue to have investments in risky assets. Expected returns from those assets typically will be higher than the rate used to value liabilities.

The new GASB standards make many important changes in addition to those relating to discount rates. Among other things, they would make pension liabilities and expenses more visible and displayed on government statements of net assets and in operating statements, particularly in cases of "multi-employer cost-sharing" plans – plans where more than one employer participates and risks are pooled, so that there is not a separate account for each employer. Under previous standards the liabilities related to these plans were not well disclosed.

How, precisely, the new rules will affect government and pension system reporting and, ultimately, whether and how they will affect their behavior remains to be seen. The discount rate rules fall far short of what finance experts argue is appropriate and reported unfunded liabilities will not increase anywhere near as much as they would under a pure finance approach. On the other hand, in many ways, pension liabilities and expenses are likely to be far more visible than before.

Pension System Underfunding

A pension system is underfunded if assets are less than estimated liabilities. Under current assumptions used by actuaries to value liabilities, state and local government pensions are underfunded by approximately $1 trillion.[65] Economists and financial analysts generally believe that liabilities should be valued using "low risk" discount rates, which would lead to much higher liability estimates. Under this approach, estimated unfunded pension liabilities are $3 trillion or more.[66]

Table 10 shows the aggregate percentage-funded status of 126 major state and local retirement plans for the most recent available year. These plans account for approximately 85 to 90 percent of the assets of the nation's 3,400 systems. The table also shows the percentage-funded status of the major plans summarized for each of the six study states. The 126 major plans were underfunded by $892 billion, for a 74.1 percent-funded ratio, based on a comparison of the market value of assets to actuarial liabilities.[67]

Table 10 | Major retirement systems funded status

State and local government retirement system funded status Major state plans and local plans ($ billions except where indicated otherwise)					
	Actuarial liabilities	Market value of assets	Unfunded liability (surplus) using market value of assets	Funded ratio using market value of assets (%)	Unfunded liability per capita
United States totals, 126 plans	**$3,442.8**	**$2,551.2**	**$891.5**	**74.1%**	**$2,882.1**
Totals for 6 study states	**1,542.2**	**1,156.0**	**386.2**	**75.0**	**3,459.2**
California	597.4	461.6	135.8	77.3	3,635.9
Illinois	187.6	95.0	92.5	50.7	7,205.7
New Jersey	120.2	77.6	42.6	64.6	4,838.6
New York	348.0	301.2	46.8	86.6	2,411.8
Texas	214.0	167.7	46.3	78.3	1,835.2
Virginia	75.1	52.9	22.2	70.4	2,770.1

***Source**: Public Fund Survey (www.publicfundsurvey.org) for actuarial liabilities, accessed June 19, 2012; market value of assets provided by National Association of State Retirement Administrators, June 19, 2012; Unfunded liabilities and funded ratios calculated by Task Force.*

As the table shows, retirement systems in all of the study states are underfunded, with those in Illinois the most poorly funded by far, followed by those of New Jersey, then California. The only state that could be called well-funded on average is New York, where the state-level plans are very well funded and the New York City plans are not. The New York state-level plans use a different actuarial cost method than most plans, known as aggregate cost.[68] In one sense, the state's high level of funding is an artifact of that choice; but the state plans are truly well funded because this method tends to produce annual required contributions (ARCs) that, when compared with other methods tend to produce higher contributions early in employees' careers. In addition, the method as implemented in New York responds sharply to investment income shortfalls, so that ARCs rise quickly in response. Finally, New York law requires state and local governments to pay the full ARC. This combination leads to a high level of funding—and rapidly changing contribution requirements, which provide strong protections to beneficiaries and also cause fiscal stress for the governments required to contribute.

The most significant reason for pension underfunding is that investment earnings have fallen far short of previous assumptions. Many view the vagaries of the markets as being both outside the control of these pension systems and a short term event which, over the longer term, will be offset by gains. Most state and local government retirement

systems use an earnings assumption that is at or near eight percent. A retirement system's earnings may be reasonable by some standards but if it falls short of its assumptions – if it earns less than what it assumes it will earn — unfunded liabilities accumulate relentlessly and down markets may occur for a decade. Further, the looming retirements of baby-boomers makes many argue for a shorter term focus on earnings. During the 2008 financial market collapse, state and local government retirement funds lost nearly $1 trillion of market value. For example, the funded status of the California Public Employees Retirement System (CalPERS), the largest system in the nation, fell from 100.1 percent in 2007 to 60.1 percent in 2009 on a market-value-of-assets basis, reflecting investment losses of 4.9 percent and 23.4 percent in 2008 and 2009, respectively.[69]

It does not take a dramatic downturn to create underfunding: if a retirement system earns five percent a year but assumes eight percent, unfunded liabilities will grow. If the system adjusts its earnings assumption to a new, lower outlook, its estimate of total liabilities will increase, and unfunded liabilities can increase significantly. Systems that appeared well-funded prior to the 2008 collapse would not have appeared well-funded if they had used lower earnings assumptions.

A very serious, non-market related, cause of pension underfunding is that some states and localities habitually have skipped or underpaid their annual required contributions. These governments willfully underpaid and now find it difficult to afford the contributions required to move toward full funding.

Underpayment of Annual Required Contributions

The actuarial funding system is designed to be self-correcting. It relies on assumptions about investment earnings, longevity of workers and retirees, inflation, and other hard-to-predict factors. Most of those assumptions will prove wrong to some degree. System actuaries or their outside consultants conduct periodic actuarial valuations in which they evaluate assumptions and determine whether the system is under (or over) funded by actuarial rules. (The retirement system board or, sometimes, the state legislature, sets assumptions, informed by actuarial analysis.) Typically actuaries produce estimates known as annual required contributions, or ARCs, the actuary's estimates of amounts that must be paid to the system to fund benefits properly. If an employer's ARC is 17 percent, it means the actuary has estimated that paying 17 percent of payroll into the pension fund each year would put the employer on a path to full funding.[70]

Many governments pay their ARC routinely, either by law or custom, but others do not. Despite the name, there is nothing "required" about the ARC unless a government's own laws or rules require payment. In New York, a court decision requires that the state pay the ARC to the New York State and Local Employees Retirement System, and it does so; but, as described below, it has found other ways to achieve temporary cash savings. In California, CalPERS has a guaranteed draw on state funds for state agency employees; in other words, it simply submits a bill that the state must pay.[71] CalSTRS, on the other hand, does not have an automatic draw; and contributions set by statute have been well below the ARC for the last decade. Illinois, Texas, Virginia, and New Jersey (subject to changes described below) set contributions by statute and have underpaid their ARCs.

Over the five years from 2007 through 2011, state and local governments underpaid their ARCs by more than $50 billion. California, Illinois, and New Jersey, with 19 percent of the nation's population, accounted for more than half

(58 percent) of the contribution shortfall during the sub-period for which we have comprehensive data, 2007 through 2010.[72] Governments in these states underpaid pension contributions before the recession began, during the recession, and after the recession officially ended.

In California over the past six years, the shortfalls in CalSTRS and in the Judges Retirement Fund component of CalPERS—which, like CalSTRS, does not have an automatic draw—have amounted to approximately $15 billion. (See Table 11.)

Table 11 | Governments in California underpaid ARCs by $15 billion from 2006 through 2011

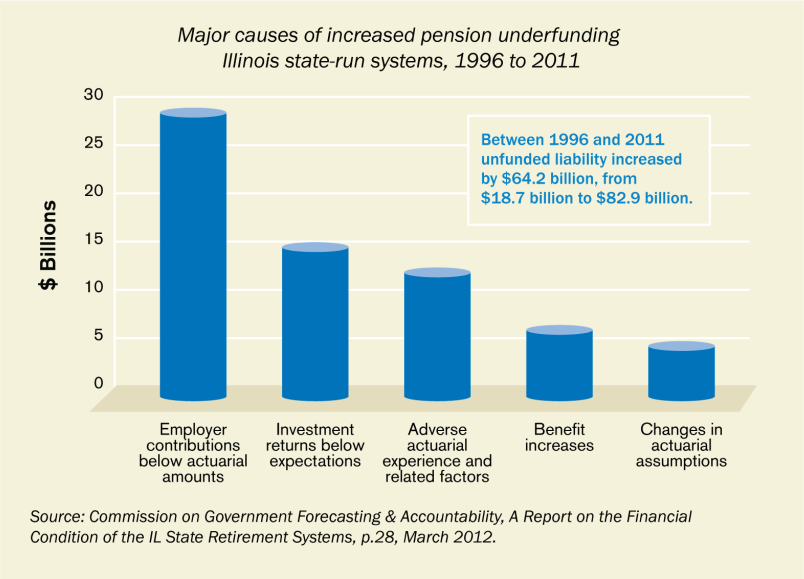
Underpayment of ARCs in California Amount in $ millions				
Fiscal Year	Annual Required Contribution (ARC)	Actual employer contribution	Overpayment or (underpayment)	Percent of ARC paid (%)
	Judges Retirement Fund (within CalPERS)			
2006	$195	$121	($74)	61.9 %
2007	561	131	(430)	23.4
2008	624	163	(460)	26.2
2009	791	191	(600)	24.1
2010	1,167	186	(981)	15.9
2011	1,262	168	(1,095)	13.3
Six-year total	**4,600**	**959**	**(3,640)**	**20.9**
	California State Teachers Retirement System (CalSTRS)			
2006	3,821	2,440	(1,381)	63.9
2007	3,980	2,649	(1,331)	66.6
2008	4,362	2,864	(1,498)	65.7
2009	4,547	2,867	(1,680)	63.1
2010	4,924	2,693	(2,231)	54.7
2011	5,985	2,796	(3,189)	46.7
Six-year total	**27,619**	**16,309**	**(11,310)**	**59.0**
Six-year total, combined funds	**$32,219**	**$17,268**	($14,950)	**53.6**

Source: *2011 CAFRs for CalPERS and CalSTRS.*

Illinois has underpaid its contributions for at least 15 years. Between 1996 and 2011, Illinois underpaid contributions by $28 billion.[73] (See Figure 14.) Now, several Illinois pension plans are extremely underfunded; Governor Quinn has proposed changes that would scale back benefits substantially.

New Jersey, too, has habitually underpaid its pension contributions. Over the last six years, contribution shortfalls have totaled about $14.5 billion. (See Table 12.) In 2011, New Jersey made major changes to scale back pension benefits, suspending COLAs for existing workers and retirees and requiring increased employee contributions. As a result of these changes, the state's unfunded liability was reduced by 30 percent from $37.1 billion to $25.6 billion, increasing the system's funded ratio from 56.4 percent to 65.2 percent. New Jersey also established a seven-year "ramp" under which it would increase contributions each year until, by 2018, it would be paying its full ARC.[74] In 2012, the first year of the ramp, the state paid $484 million, which was one-seventh of the annual required contribution of $3.4 billion – an underpayment of $2.9 billion. In 2013, the state is budgeting a payment of $1.1 billion. While the actual ARC for 2018 will depend on investment performance and other factors, the annual employer contribution probably will have to increase by at least several billion dollars between 2013 and 2018 if New Jersey is to meet the requirements of this new legislation. This will force the state to make difficult choices about spending priorities and taxes.

Figure 14 | Illinois' underpayment of pension contributions is a major cause of underfunding



Source: Commission on Government Forecasting & Accountability, A Report on the Financial Condition of the IL State Retirement Systems, p.28, March 2012.

Table 12 | New Jersey underpaid pension contributions for years, even before the recession started

Aggregate state & local employer contributions to New Jersey pension plans For Fiscal Years 2006 through 2012 ($ millions)				
Fiscal Year	Annual Required Contribution (ARC)	Actual/expected employer contribution	Overpayment or (underpayment)	Percent of ARC paid (%)
State				
2006	$1,451	$164	($1,286)	11.3%
2007	1,779	1,023	(755)	57.5
2008	2,090	1,046	(1,044)	50.1
2009	2,231	106	(2,124)	4.8
2010	2,519	-	(2,519)	-
2011	3,061	-	(3,061)	-
2012	3,389	484	(2,905)	14.3
State subtotal	**16,518**	**2,824**	**(13,694)**	**17.1**
Local				
2006	678	354	(324)	52.2
2007	843	606	(237)	71.9
2008	1,089	993	(96)	91.2
2009	1,169	1,044	(125)	89.3
2010	1,281	1,281	-	100.0
2011	1,611	1,611	-	100.0
2012	1,737	1,737	-	100.0
Local Subtotal	**8,408**	**7,626**	**(782)**	**90.7**
State & local total	**$24,926**	**$10,450**	**($14,475)**	**41.9**

Source: *New Jersey Tax and Revenue Anticipation Notes Official Statement, December 2011, p.I-61.*

New Jersey's 2011 pension reforms also included a provision that could make it more difficult to underpay pension contributions in the future, as described in a bond disclosure document:

> Although no assurance can be given that the State Legislature will make such appropriations in accordance with this law, the 2011 Pension and Health Benefit Reform Legislation contains a provision stating that members of the Pension Plans now have a contractual right to the annual required contribution being made by the State and local participating employers and failure by the State and local employers to make annual required contributions is deemed an impairment of the contractual right of each member. This contractual right could limit the State's ability to reduce or limit pension contributions in response to future budgetary constraints.[75]

Whether this provision will achieve the intended effect remains to be seen.

In New York, the state government and local governments outside New York City are required to pay the ARC.[76] However, over many decades the state periodically has used "amortization" to delay a portion of annual payments to state-run systems – in effect, borrowing from the pension fund itself while being credited for paying the ARC. The state's first use of the practice came during the Great Depression. [77]

Under a new incarnation of amortization developed in the recent fiscal crisis, the state and its local governments can amortize payments over 10 years, at an interest rate set by the state comptroller, who is the sole trustee of the pension fund. Participating jurisdictions must establish reserve accounts, which will be used to reduce the budgetary impact of future employer contribution rate increases. In fiscal year 2012, the state's payments to its retirement systems (including amortization payments) will total $1.5 billion, compared to the $2.1 billion that would have been required without amortization.[78] While the amortization scheme in New York effectively is borrowing, a gimmick, it is small in size compared to many of the techniques other governments have used.

In Texas, contribution requirements for the main retirement systems are set by legislation, except for one plan of the Judicial Retirement System under which the state contribution rate is actuarially determined every even-numbered year for the next two-year budget period.[79] Thus, contribution rates are subject, within limits set in the state constitution, to the vagaries of the budgeting process. As of the August 31, 2010 actuarial valuations, contributions are insufficient to amortize the current unfunded accrued liabilities of the employees retirement, law enforcement, and teachers retirement systems over any period of time. As a result, unless the funds experience a resurgence of investment returns, Texas will need to restructure benefits or increase contributions, or both.[80]

In Virginia, the legislature in very recent years has overridden recommendations from the actuary of the Virginia Retirement System, substituting its own assumptions to calculate a statutory contribution rate. As noted in a bond disclosure document in fiscal year 2012, "The General Assembly is again funding less than the rate determined by the actuary by extending the funding period for these groups from 20 years to 30 years, increasing the investment return assumption from 7.50% to 8.00% and increasing the inflation assumption from 2.50% to 3.00%."[81] Further, in some cases reductions in contributions that would have benefited funds outside the general fund have instead been diverted to the general fund.[82] During the recent fiscal crisis, such moves provided Virginia with cash savings of more than $1 billion – savings that will come at the expense of future budgets.

Pension Benefit Enhancements

When a pension system appears well funded, governments face pressure from workers and retirees, and sometimes from agencies recruiting workers with specialized skills to enhance benefits – benefits that, once granted, have strong legal protections. After the rapid stock market growth of the 1990s, many funds reported actuarial surpluses and increased benefits.[83] If liabilities had been discounted using low-risk discount rates, systems would not have appeared as well funded.

California is an extraordinary example. The state and local governments expanded employee benefits substantially in 1999 and in 2001. Senate Bill 400, sponsored and supported strongly by CalPERS and signed into law by Governor Gray Davis, increased retirement benefits for state workers by lowering the full retirement age, increasing the benefit

formula, or both. It also defined final compensation as the highest 12 months of salary, provided up to a six percent increase in compensation *to those who had already retired*, and increased survivor benefits.

CalPERS stated that "no increase over current employer contributions is needed for these benefit improvements" and that the state's annual pension costs would remain below $766 million for "at least the next decade."[84] However, since then, the pension system has earned an average annual rate of only 4.7% per year, far less than what was assumed.[85] The state has made up the difference, contributing $27 billion—which was $20 billion more than projected.

The scale of the California increase appears extraordinary. Many other retroactive benefit increases appear to have been less costly, applying to fewer retirees who receive relatively small pensions.[86]

Contribution Increases or Other Changes are Needed

The six states in this study need to increase contributions, in some cases quite significantly, to eliminate existing unfunded liabilities. The amount varies from system to system, depending on how underfunded the system is, the extent to which governments currently are paying their ARCs, and the actuarial methods and assumptions the systems use.

For example, by 2015 contributions to CalSTRS would need to increase by more than $3 billion annually to amortize unfunded liabilities, assuming that the fund earns 7.5 percent on its investments, or a further $7 billion annually if a five percent earnings assumption were used.[87]

New York's main pension fund increased employer contribution rates by 158 percent from 2010 to its scheduled 2013 payments, protecting pensions but rapidly stressing local governments. As a result of these changes, pension contributions for this one plan are increasing by more than $3 billion annually; and other plans are raising contributions as well.[88] New Jersey is on the ramp described above and will face sharply increasing contributions for the next seven years. Deeply stressed California and Illinois face hard trade-offs between funding pensions and undoing promised benefits. If the current proposed tax increase in California were used to fund pensions, there would be little left over for other needs. Texas and Virginia also face increases in employer contributions, but compared to other study states these are not as large relative to the budget.

The extent of underfunding and required contribution increases varies dramatically around the country – there is no easy generalization. However, in places where contribution increases are large, as with many of the California pension systems and the Illinois systems, governments are under pressure to cut core services or raise taxes substantially.

Faced with hard choices as a result of contribution increases, governments have been making changes. Between 2009 and 2011, 43 states either increased employee contributions or cut benefits or both.[89] Additional changes will be needed.

Analysis conducted by the Center for Retirement Research for the Task Force indicates that, for most systems in the study states, contribution increases related to the stock market declines in 2008 and 2009 will generally work their

way through the system by about 2015 - for governments that pay their ARCs. In other words, if systems meet their assumptions, particularly their investment earnings assumptions, there will be a new equilibrium.

If systems do not achieve currently assumed returns or increase contribution levels, the next generation of taxpayers may bear the cost, in the form of still higher contributions while workers and retirees could suffer cuts in the pensions that were promised to them.

Unfunded Retiree Health Care Promises

Most state and local governments have promised, in addition to pensions, substantial retirement health care benefits to their workforces. These benefits have barely any funding. In addition to health care, sometimes there are other benefits provided in retirement, such as life insurance; in combination all of these are known as "Other Post-Employment Benefits" (OPEB). Until the Governmental Accounting Standards Board in 2004 issued standards requiring disclosure, governments did not regularly make these liabilities public.[90]

Governments are not always eager to adopt accounting standards that highlight previously undisclosed liabilities. Texas initially protested the new standards, arguing, correctly, that under state law it can eliminate post-retirement benefits any time it chooses. The state even enacted legislation allowing governments to follow alternative rules. Eventually, most governments and plans adopted the new standards although a few local governments remain holdouts.[91]

State-administered OPEB plans have unfunded liabilities of more than $600 billion.[92] Similar liabilities for locally administered plans are likely even larger, since local workforces are almost three times as large as state workforces.[93] The combined state and local government liabilities are likely to be well above $1 trillion. If the federal government increases the eligibility age for Medicare, OPEB liabilities could increase further, because state and local government retiree health plans generally provide substantial benefits for the transition period between retirement (usually under age 65) and eligibility for Medicare.

Most governments fund these benefits on a pay-as-you-go basis rather than contributing to a funded plan. They compute an ARC and report it in their financial statements but generally ignore it for budget purposes, simply paying actual benefits for current retirees. Virginia is an important exception: It has a partially funded plan and until recently contributed the ARC.

In the six study states, unfunded retiree health care promises in state-administered plans, including university plans, exceed $300 billion; there are at least $200 billion of additional liabilities in these states' locally administered plans.[94] (See Table 13.) Annual costs are being driven rapidly upward by two of the same forces influencing Medicaid growth: rising health care costs and a population quickly approaching retirement age. Funding these past promises and current benefits on an actuarial basis in the six states would require an increase in spending by state and local governments of at least $25 billion annually.[95]

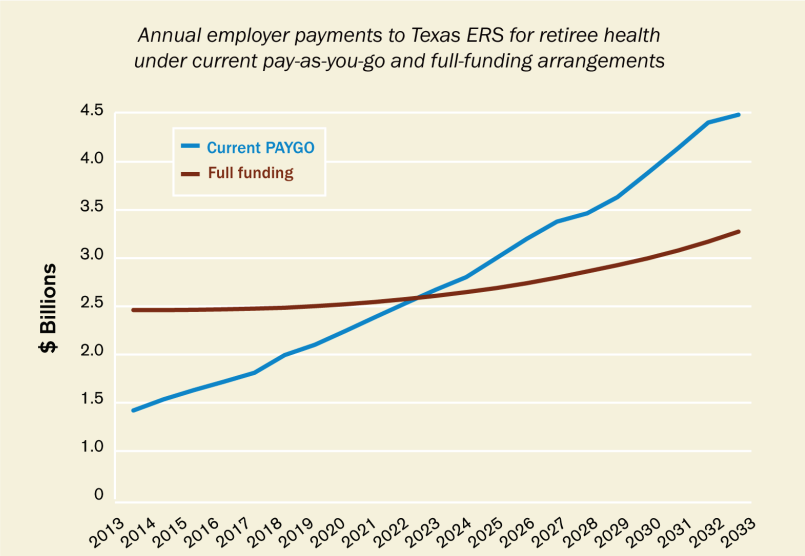
Table 13 | OPEB Unfunded liabilities in the six study states

OPEB plan liabilities ($ Billions)							
	California	Illinois	New Jersey	New York	Texas	Virginia	Six-state sum
Unfunded Actuarial Accrued Liability (UAAL) of OPEB plans administered or participated in by:							
State government-administered plans	$62.14	$54.22	$59.28	$61.99	$58.21	$5.02	$300.86
State university (if not included in state number)	15.98	-	-	12.35	-	-	28.33
Available local government data	58.75	10.73	12.09	122.13	6.21	-	209.89
Minimum statewide total	$136.87	$64.95	$71.37	$196.47	$64.41	$5.02	$539.08

***Sources**: State CAFRs, plan CAFRs and valuations, and published reports in individual states. Liabilities generally are as of 2011.*

Most governments are unlikely to do this, and they have little incentive to do so. Pay-as-you-go costs are currently much lower than ARCs: In the table above, the pay-as-you-go amounts all are less than one-third of actuarially computed contributions. Pay-as-you-go amounts will tend to rise rapidly as more and more workers retire and health care costs rise. In contrast, ARCs will be much more stable. But for the typical plan, it will be many years before pay-as-you-go amounts will exceed ARCs. Figure 15 illustrates this fact for the Texas ERS retiree health plan: If employers were to fund the plan on an actuarial basis, annual contributions would rise almost immediately by more than $1 billion.[96] If they continue on a pay-as-you-go basis, it will be 10 years before payments rise to the level of the ARC. For governments focused on short-term planning, there is little incentive to prefund OPEB obligations.

Figure 15 | It will be many years before PAYGO spending for retiree health benefits exceeds ARC payments under a full-funding approach



Source: Analysis prepared for Task Force by Center for Retirement Research, Boston College.

Unlike pensions, which in most states have constitutional protections of varying degrees, post-employment benefits such as those for retiree health care tend to be covered by the terms of collective bargaining agreements. While an agreement is in place, none of the benefits provided pursuant to the agreement can be changed without mutual consent and in exchange for valuable consideration. Nevertheless, the law of OPEB is not firmly settled.[97] The prospect of large cost increases would create considerable pressure to reduce benefits. Many states, including those in this study, have scaled these benefits back. The most notable recent change occurred in West Virginia, which required increased contributions by retirees, cutting its OPEB liability in half.[98] Still, until economy-wide increases in health care costs slow, these benefits will exert stress on governments and their workforces.

The Combined Impact of Pension and OPEB Underfunding is Large

Pension and OPEB liabilities place different types of potential claims on taxpayers, but it is useful to combine the two in order to gain a sense of the total potential liability. Data are not yet available for this purpose for all six states, but one analysis in Illinois recently estimated total unfunded liabilities of $203 billion, including liabilities associated with pension obligation bonds. That works out to more than $15,800 per capita for the state as a whole.[99]

Building Incentives for Responsible Management and Funding of Retirement Liabilities

It is human nature to prefer the present to the future. Governments display that time preference by promising now and paying later: if they can, they will underestimate liabilities, underfund annual costs, and take on substantial investment risks to make it look like promises will be kept. Improved transparency and a greater understanding of the assumptions underpinning the numbers would help to provide more responsible funding and management of state and local government retirement liabilities.

There is a need for mechanisms to enforce payment of future liabilities. Interestingly, such a requirement to pay debt service has an obvious enforcement mechanism – the threat of losing market access. Because that threat is seen as major, there are prepayment mechanisms, sinking funds, state aid intercepts, and other techniques to minimize the risks. There is no analogue in the pension funding sphere. But there are examples of effective rules. In California, the state pays its ARC when legally required and does not where a legal requirement is absent. New York State, and its local governments outside New York City, legally are required to pay the ARC and do so; and the state comptroller's ability to withhold school district funds provides a mechanism to enforce school district pension contributions. New Jersey's new mechanism, which gives pension plan members a contractual right to the ARC, has not been tested legally but holds promise.

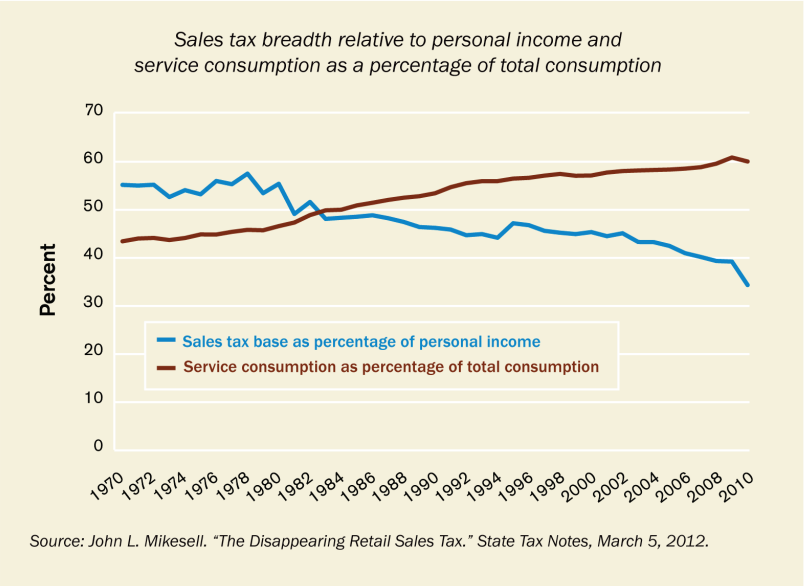
Mechanisms such as these could avert future crises for systems that are not already too far gone. For some systems, such as several in Illinois, underfunding may be so severe that paying the full ARC now might require untenable cuts to education and human services, as well as large tax increases. As a result, benefits cuts are more likely.

While the standards for recognizing pension and OPEB costs in financial statements evolve, states should pay at least their annual required contributions for pensions and develop methods for funding the amounts they expect to need in order to pay other post-employment benefits.

Narrow, Eroding Tax Bases and Volatile Tax Revenues Undermine State Finances

One main goal of tax policy - adequacy - is to raise enough revenue to fund services the population requires.[100] 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.

Figure 16 | The sales tax base has been eroding, driven in part by rising consumption of lightly taxed services



Source: John L. Mikesell. "The Disappearing Retail Sales Tax." State Tax Notes, March 5, 2012.

State Tax Revenue Has Been Eroding

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 (see Box: The Sales Tax and Goods Sold Over the Internet), and state choices that narrow their tax bases.[101] (See Figure 16.)

All six study states had double-digit declines in the breadth of their sales tax bases. (See Table 14.)[102] 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.

Table 14 | Sales tax base erosion in study states

	Reliance on sales tax as % of tax revenue, 2009		Sales tax breadth (tax base as percent of personal income)		
	State government	Local government	Average breadth during 1970-2010	Breadth in 2010	Percentage decline in sales tax breadth
United States	**32.0**	**11.2**	**46.7**	**34.5**	**(26.2)**
California	28.7	12.2	43.0	26.8	(37.6)
Illinois	31.9	5.2	32.8	25.6	(22.0)
New Jersey	30.1	-	28.6	25.3	(11.7)
New York	17.1	16.2	34.3	26.2	(23.7)
Texas	50.4	12.4	48.4	35.9	(25.8)
Virginia	20.3	6.9	40.5	26.9	(33.7)

***Source**: U.S. Bureau of the Census for sales tax as percent of tax revenue. Mikesell (2012) for breadth estimates.*

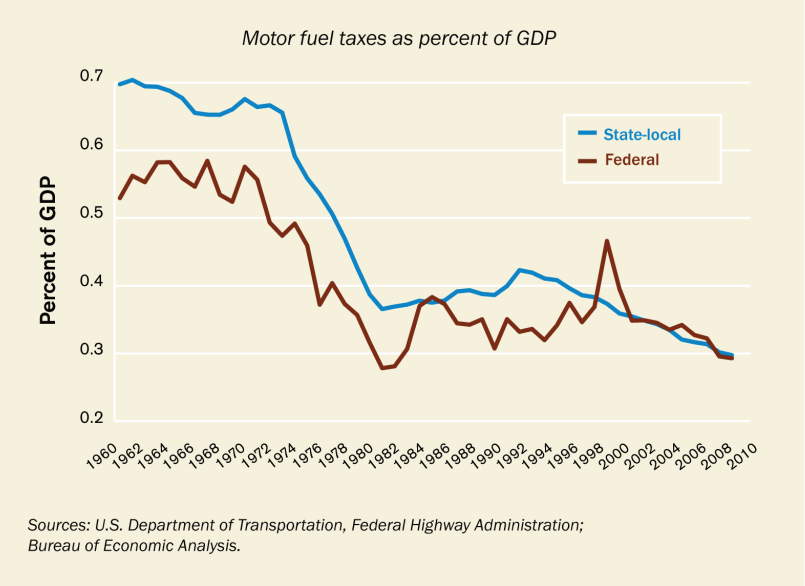
Motor fuel taxes--like other excise taxes on specific goods, such as alcohol and tobacco have also eroded significantly. These taxes are usually levied in fixed amounts on the quantity of goods sold (*e.g.*, 10 cents per gallon) rather than as a percentage of value; thus, they don't keep pace with inflation as closely as sales taxes do. Motor fuel tax revenues, in particular, have also declined in part because automobile gas mileage has improved.[103] Between 1960 and 2010, state and local motor fuel taxes declined relative to the economy by 60 percent.[104] While motor fuel taxes make up only five percent of state tax revenues, they are often dedicated to funding roads, highways, bridges, and transit; thus, their decline has increased the challenges that states face in these areas. Increasing even this small portion of state taxes – or linking it to inflation—has proved politically difficult in many states.

The federal excise tax on motor fuel tax has eroded, too, as Figure 17 shows. The decline has increased the challenges the nation faces in funding transportation infrastructure, particularly highways and bridges.

The Sales Tax and Goods Sold Over the Internet

States have limited authority to require collection of taxes owed on purchases made through the mail and, increasingly, over the internet. As these sales grow, the size of the revenue deprivation will grow. States are unlikely to capture a significant portion of the tax owed under current law unless Congress gives them greater authority to require collection of sales taxes on online purchases, in exchange for tax simplification.

Figure 17 | Motor fuel taxes have fallen as a share of the economy, exacerbating challenges in funding transportation infrastructure



Sources: U.S. Department of Transportation, Federal Highway Administration; Bureau of Economic Analysis.

State and local governments are losing in excess of an estimated $11 billion annually from their inability to collect taxes on online transactions, according to estimates by Donald Bruce, William Fox, and LeAnn Luna of the University of Tennessee.[105] They would not ever be able to collect all of that; but even if states and localities could collect annually only half of the *taxes owed under existing laws* on online sales, that amount would be considerable.[106]

Likely current losses for the individual states in this study appear to be substantial.[107] California estimated that revenue losses in 2012 from online and mail order sales approximate $800 million for the state and $400 million for localities. [108] Illinois estimated that state revenue losses in 2010 approximated $163 million. The New Jersey Treasury Department spokesman cited an estimate of $200 million annually, which is consistent with the Tennessee researchers' estimate.[109] New York's state government does not appear to have released estimates of losses; the Tennessee researchers' estimate for state and local losses in 2012 in New York is $865 million, although the state is reported to believe revenue losses are lower. [110] Texas estimated that state revenue losses from remote sellers approximate $600 million annually. [111] The Tennessee group estimated that state and local governments in Virginia will lose $207 million of sales tax revenue in 2012.

The Issue

In general, if a good or service is taxable when bought in a retail store it is taxable when bought online or by mail order. The problem is how to *collect* that tax. Merchants are responsible for collecting the taxes on store sales and passing it on to state revenue departments. Collecting for goods sold online or by mail order is trickier. Federal law requires that states can only compel an out-of-state seller to collect a tax due on sales into their state if the seller has a physical presence in the state.[112] This issue remains the domain of Congress, which could loosen the rules to permit states to require sellers to collect taxes, even without a physical presence in the state, but it has not done so.[113] As a result, the

issue of equity (or equal treatment) among sellers of goods is obvious. Retail stores are at a competitive disadvantage compared to online sellers with no physical presence in the state, with important differences in burdens depending on the types of goods sold. In addition, state and local governments lose revenue as more and more transactions are conducted over the Internet. Although most states impose a "use tax" on mail order and internet sales, it is virtually never enforced and rarely paid.[114]

How States Are Reacting

States are attempting to address the issue in two ways. One is through interstate cooperation. The other is as lone agents probing and pushing at the edges of the rules.

Twenty-four states (representing a third of the nation's population) have conformed their sales taxes under the Streamlined Sales and Use Tax Agreement (SSUTA).[115] Co-ordinated efforts among sovereign states on tax matters are not unprecedented, but they are rare and this effort is a serious one that is aimed at the Congress. According to the governing board, "Now that these states have made tax collection simple and easy for retailers, Congress can adopt legislation that applies to the products and services sold by remote sellers." The effort has spawned three federal proposals to grant states, under certain conditions, the authority to require online sellers to collect sales tax even if they do not meet a physical presence test. None of the bills has had sufficient support to pass both houses.[116]

The states not participating either will not give up control over their tax policy, believe they are unable to, or believe they have relatively little to gain owing to their own size and market power with vendors.[117] Among the study states, only New Jersey has conformed.

New York's "Amazon law" demonstrates the other approach. The law deems an out-of-state seller to have physical presence if it relies upon third parties with in-state presence to help "establish and maintain a market" in the state.[118] Once a remote seller has sufficient connection to these in-state parties (often called associates), the seller is required to collect sales tax on all its sales in the state, not only from those made through the in-state associates.[119] Arkansas, California, Connecticut, Illinois, North Carolina, and Rhode Island have since adopted such "Amazon laws."[120]

A different go-it-alone approach that appears to require less-aggressive policy is when a state asserts that an online seller must collect taxes because related businesses (as opposed to unrelated associates) have a physical presence in the state. This often occurs when a seller has subsidiaries that own warehouses or distribution centers in the state. Texas and Amazon recently reached an agreement on this basis, under which Amazon will begin to collect sales tax in the state.[121] This terrain remains in dispute; the policy arena is unsettled.

Outlook

The SSUTA and "Amazon" laws are partial approaches to stem the potential hemorrhaging of sales tax revenues that technology has foisted on states and localities. It is neither practical nor wise for every state to negotiate agreements with every major online vendor. Congress could solve this issue for all states by allowing states to require online sellers to collect tax even if they do not meet a physical presence test, and it should set the conditions that states must satisfy if they wish to do so. This issue belongs on the table as part of any grand bargain on federal deficit reduction.

State Tax Revenue has Become Increasingly Volatile

Some tax collections tend to be more volatile than others, changing more erratically from year to year, usually due to changes in the economy. Volatile revenues are by their nature hard for states to predict and collect in a timely way and generate their own set of headaches in trying to achieve *annual* budget balance.

The personal income, sales, and corporate income taxes are states' most economically sensitive and volatile revenues and they have grown in importance in recent years. Together they accounted for only 38 percent of state tax revenues in 1950, but had grown to 72 percent by 1990, contributing to increased overall volatility.[122] (See Table 15.) Since 1990, states' reliance on income taxes has continued to increase and the tax itself has become more volatile.[123] 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."[124]

Table 15 | States now rely on highly economically sensitive taxes for more than 70% of their tax revenue

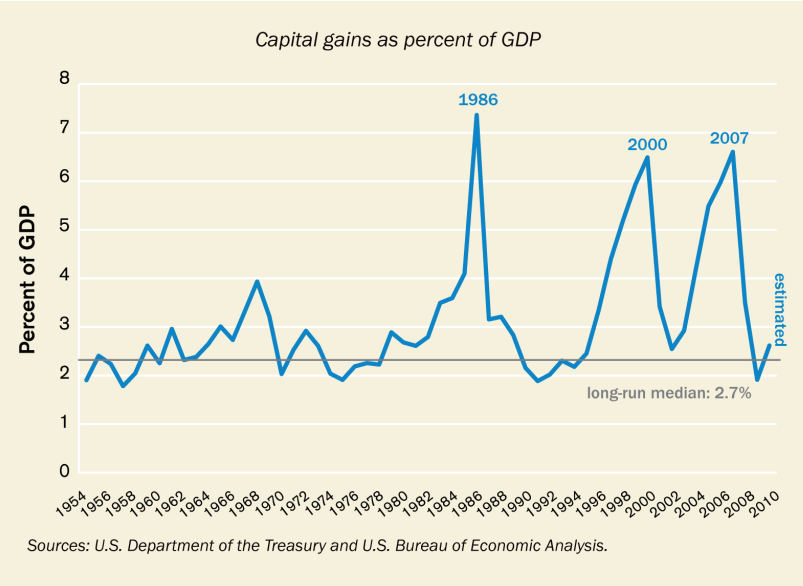
Percentage of total state government tax revenue (%)						
	Highly economically sensitive taxes					
	Personal income tax	General sales tax	Corporate income tax	Sum	Other taxes	Total
1950	9.1	21.1	7.4	37.6	62.4	100.0
1960	12.3	23.9	6.5	42.6	57.4	100.0
1970	19.2	29.6	7.8	56.5	43.5	100.0
1980	27.1	31.5	9.7	68.3	31.7	100.0
1990	32.0	33.2	7.2	72.4	27.6	100.0
2000	36.1	32.3	6.0	74.4	25.6	100.0
2005	34.1	32.7	5.9	72.7	27.3	100.0
2010	33.6	31.9	5.2	70.8	29.2	100.0

***Source**: Holcombe & Sobel (1950-1990); Census Bureau (2000-2010).*

Sales tax revenues are volatile for several reasons. First, they are based on spending, which fluctuates with income, the economy and expectations of the future. Second, sales taxes often are based on a narrower mix of goods and services than overall spending. For example, most states exclude grocery food purchases from the sales tax but tax restaurant meals. Third, tax revenue volatility is not constant over time. It depends on what kind of recession or growth period the economy is experiencing. For example, in the 2001 recession, consumer spending did not fall and the sales tax held up quite well, but in the 2007 recession consumption plummeted and, along with it, state sales taxes. The income tax clearly has been more volatile in the last two recessions.[125]

Income taxes are volatile for several reasons. When the economy declines, fewer people are working; often those working have fewer hours, so earnings decline. [126] If income taxes have progressive rates, then in a downturn, people who lose income tend to fall through the brackets. Not only do they have less income, but it is taxed at lower rates and in the upturn, climbing up through the brackets is a powerful force driving tax revenue up faster than income. Further, some forms of income fall and rise more sharply than the broader economy. Bonuses paid to investment bankers, security brokers, hedge fund managers, and many executives are an important part of their compensation and mirror the fluctuations in individual company profits. Interest rates and the earnings derived from them as well as dividends too, go up and down with the economy and with the markets, which often experience even more dramatic swings. Adding to the volatility is the fact that income taxes have become increasingly dependent on financial markets and on the highest earners. Capital gains are the most erratic as they depend not only on stock market performance but also on taxpayers' choices about whether and when to sell assets. In the 1950s, capital gains were less than two percent of gross domestic product; in 2007 they peaked at around 6.5 percent of GDP. However, over the next two years they fell 72 percent.[127] Figure 18 shows the increasing volatility of capital gains.

Figure 18 | Capital gains have become exceedingly volatile

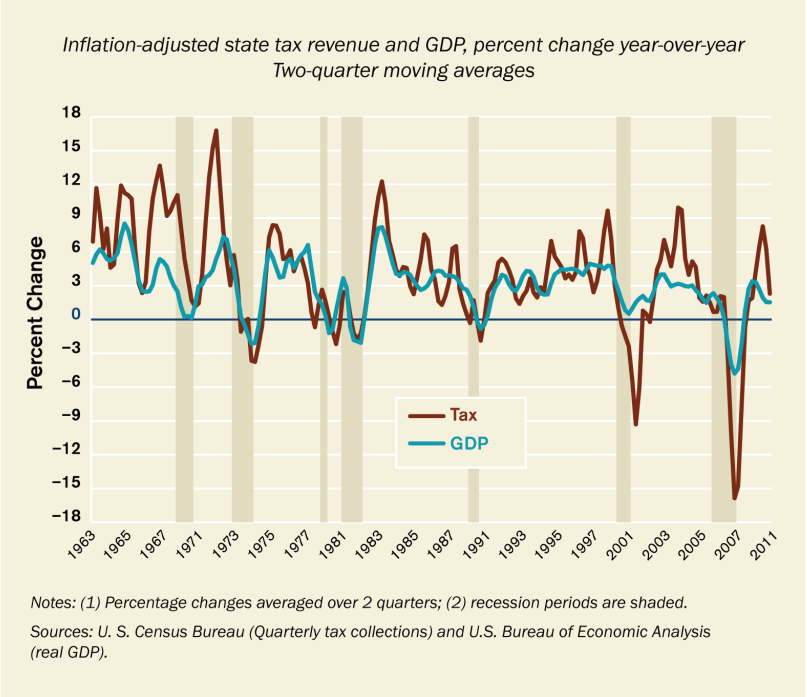


Sources: U.S. Department of the Treasury and U.S. Bureau of Economic Analysis.

Corporate income taxes are extremely variable for similar reasons. They have also been eroding, and are increasingly volatile, because of tax preferences granted in pursuit of policy goals and factors such as legal tax avoidance.[128]

Increased reliance on economically sensitive taxes and the rising volatility of revenues produced by those taxes has caused state tax revenues to plunge in the last two recessions. The fluctuation in these tax revenues is now enormous. Between the 2008 and 2010 fiscal years, state tax revenues declined by more than 12 percent in inflation-adjusted terms, a far greater decline than in any past recession.[129] (See Figure 19.) Such severe fluctuations can open up sudden budget gaps that exceed gaps projected to accumulate over the next 15 years due to rising health care costs and other structural factors.[130]

Figure 19 | State tax revenue is more volatile than the economy



Notes: (1) Percentage changes averaged over 2 quarters; (2) recession periods are shaded.

Sources: U. S. Census Bureau (Quarterly tax collections) and U.S. Bureau of Economic Analysis (real GDP).

Revenue Erosion and Volatility In the Study States[131]

All of the study states have felt the effects of revenue erosion or volatility in one important way or another.

California's personal income tax provides more than 60 percent of general fund revenues. A significant amount of this tax comes from high-income earners, heavily reliant on capital gains and taxed at the highest tax rates. Since capital gains are not included in measures of the economy - such as personal income - state revenues, by definition, are more volatile than personal income; according to the state's Legislative Analyst's Office, they are also more volatile than in the average state.[132] The California sales tax base, like 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. Since 1991, no new permanent tax revenue has been approved by the legislature, or by the voters' initiative measures, to bolster the general financing capability of the state.

The Illinois income tax is a flat tax, as required by the state constitution, likely making its revenue less volatile than in most states; but all pension income is exempted from the tax, so that the base is quite narrow. Like other states' sales tax bases, there has been a narrowing. Food and drug purchases carry a tax rate of only one percent, which is distributed to local governments; there are also significant exemptions, which have increased over time. The state taxes few services and, in national studies, is shown to have a narrow sales tax base relative to other states.

In New Jersey, all income tax receipts must be used for property tax relief (in essence, state aid to municipalities, counties, and school districts). The income tax represents the largest source of volatility in the New Jersey tax

structure and is concentrated on a small number of high income residents. Income tax revenue grew 32 percent from fiscal year 2005 to 2008, and then declined by 16 percent from 2008 to 2011. In tax year 2007, the last year before the Wall Street crisis, almost $72 billion in wage, business, and capital gains income (22 percent of the total) was concentrated in the 1.2 percent of returns in the top bracket. In tax year 2009, total wages, business income, and capital gains income declined by three percent, 18 percent, and 75 percent, respectively, from 2007 levels; but among taxpayers in the highest New Jersey bracket, the declines were 26 percent, 28 percent, and 78 percent, respectively.

New York's largest budget revenue – the personal income tax – illustrates the trade-off between tax equity and revenue volatility. In December, 2011, the governor and legislature created a longer and thinner "tail" to the top of the state income tax. A new top rate of 8.82 percent now applies to individuals with taxable income above $1 million and married couples above $2 million and does so in a more concentrated way than before.[133] This "millionaires" bracket brings increased dependence on a relatively small number of taxpayers (estimated at 31,000) -- roughly half of whom, according to the state's Budget Division, live outside the state and, therefore, pay only the state's nonresident income tax.[134]

Texas does not impose a personal income tax. And, the sales tax performance relative to the overall economy is diminishing over time, as the base (essentially created before 1990) resembles the current state economy less and less. Following national trends, the growth of service consumption relative to goods consumption has reduced the revenue-generating potential of the tax. Since the sales tax is so central to the state revenue system, this erosion generates an underperformance in the overall revenue system. Base erosion has meant that the estimated effect of a one percent increase in personal income produces only an estimated 0.7 - 0.8 percent increase in sales tax revenue. As a result, over time the revenue from this crucial tax is a decreasing share of income.[135]

Virginia depends on the individual income tax for two-thirds of general fund revenue and is subject to the volatility of that tax. The state's sales tax (producing 20 percent of general fund revenue) has not kept pace with changes in consumer spending - from goods to services and, among goods, to purchases made over the Internet. Estimates place Virginia's revenue loss during the current fiscal year from untaxed Internet sales at $207 million, roughly one-quarter of all of the state's estimated retail sales and use taxes due on Internet sales.[136] The state taxes only 18 of 168 potentially-taxable services, well below the average (48 services), across all states.[137] Importantly, Virginia's main revenue source for transportation is the gas tax, levied at 17.5 cents per gallon, which has not changed for 24 years. The buying power of Virginia's gas tax revenue has declined 45 percent in this period; it would take a 14.5 cent increase to restore the real value of gas tax revenue – $580.3 million annually in current dollars.[138]

Local Government Fiscal Stress Poses Challenges for States

Local governments - cities, towns, counties, school districts, and special-purpose districts - are enormously diverse. Yet, they are all creatures of states, deriving their legal existence and powers from state laws and constitutions. States determine the taxes that local governments may impose and mandate many spending responsibilities. States have often and increasingly imposed limits on the single largest local tax, the property tax. The ability of local governments to respond to stress is constrained by state rules and may be eased by state legislatures.

While fiscal stress in cities will not "bankrupt" a state, this fiscal stress is an indicator that action is needed to prevent further damage to the overall condition of the state. Generally speaking, local governments suffer from many of the same economic difficulties as are state governments - a gap between the rate of growth in revenues and the rate of growth in spending required to maintain traditional services expected by the public. Local governments' current fiscal problems are caused primarily by slower-than-normal growth in their main sources of tax revenue - property taxes and sales taxes - as well as continuing cuts in state aid and growth in employee related costs, particularly pensions and employee health care.

One of the biggest uncertainties for some, though not all, local governments is the future of property tax revenues, which make up more than two-thirds of total tax revenue for local governments as a whole and 100 percent of tax revenue for many school districts and counties. Property tax collections typically lag declines in property values by several years.[139] Many local governments are able to increase property tax rates to offset declines in full value assessments, turning potential stress for local governments into actual stress for property owners. But many states place limits on property taxes. The type of limit influences how revenue will respond to the housing bust and will affect overall fiscal stress. In some of these states, like California and Texas, local governments are severely limited by state laws capping effective property tax rates throughout the state. Property tax revenue declines have been widespread and significant in California. Both New Jersey and New York recently have adopted caps on the amount that may be raised by the property tax levy. These caps generally limit annual growth in the tax levy to two percent, with certain adjustments. The New Jersey cap allows more exclusions than the New York cap and generally appears more liberal. Levy caps do not prevent local governments from raising rates to offset declines in property values: What is capped is the levy, not tax rates. This is very different from the California limit. However, they can cause difficulties for local governments nonetheless if levies cannot grow to keep pace with difficult-to-control spending, such as pension contributions.

Where local governments are on the hook for a substantial share of unfunded pension promises, as in New York, California, Illinois, and many large cities and counties throughout the nation, the resulting pressure is hitting them hard.

Another important uncertainty is the extent to which state governments will continue to cut state aid to local governments responsible for delivering K-12 education, as most states have done in the last two years, or whether states will gradually restore the amounts of these cuts as their revenues improve. One recent analysis found that at least 30 states reduced inflation-adjusted education aid between fiscal years 2008 and 2012.[140] To the extent that states restrict the ability of local governments to raise taxes, one can expect increasing pressure on states to increase or at least stop cutting aid to local governments; and there were some efforts to restore aid in 2012.[141]

Like states, many local governments have used up or significantly reduced their fund balances and other temporary budget solutions in the last three years. Most continuing budget gaps will have to be closed primarily with some combination of reductions in traditional public services, privatization of services, and tax increases. Many local governments have already made these difficult decisions and are adjusting to a "new normal" with a less-than-historical growth in revenues and spending. Others have kicked the can down the road by delaying unpopular budget

adjustments and are now experiencing severe fiscal distress as they run out of temporary solutions and are forced to confront hard fiscal realities.

Table 16 | States with well-established local government oversight mechanisms

State Financial Oversight Systems								
			Data Source					
State	Staff size	Number of units reviewed	Budget	Annual financial report	Budget & annual financial report	Budget & interim financial report	Early assistance to local units	Intervention power
Florida	12	1,000		X			No	Weak
Kentucky	6	120				X	Yes	Strong
Maryland	2	179		X			No	None
New Hampshire	5	784	X				No	None
New Jersey	23	587			X		Yes	Strong
New Mexico	9	137				X	Yes	Strong
North Carolina	25	1,100		X			Yes	Strong
Ohio	23	1,325		X			No	Weak
Pennsylvania	30	2,631		X			Yes	Weak

Source: *Coe, C.K. (2008), Preventing Local Government Fiscal Crises Emerging Best Practices Public Administrative Review, 68 (4): 759-767.*

States cannot file for bankruptcy, but their political subdivisions can file for debt restructuring under Chapter 9 of the U.S. Bankruptcy Code as long as states authorize it. Currently, 28 states have statutes authorizing Chapter 9 filings. Some of these authorizations are conditioned on the fulfillment of intervening steps, like California's new 60-day mediation requirement; but any state can enact a statute or otherwise grant permission on a one-off basis. A Chapter 9 filing requires proof of insolvency - *i.e.*, the inability of a local government or political subdivision to pay its debts as they come due, a test that is strictly construed. So far, Chapter 9 cases have been very rare. But there have been a few notable filings since 2009, some of which reflected deep local government fiscal distress as a result of the recent recession, and others that reflected deeper management problems.

Because the law of municipal restructuring in Chapter 9 is not developed, a filing can be an expensive venture into the unknown. In addition to defaults due to unwise debt incurrence for failed, uneconomic projects, the most worrisome reasons for a municipality's considering Chapter 9 are unfunded pension obligations and collective bargaining agreements that require the unwelcome choice between paying for benefits and dramatically reducing services.

There has been only one case in which a bankruptcy court has impaired a pension obligation and very few instances in which executory collective bargaining agreements have been abrogated.

The law is very unclear and uncertain. Nevertheless, some local governments may employ the threat of filing as a means of creating bargaining leverage with their creditors, including general obligation bond holders, employees and retirees: Because of fear of contagion with respect to other debt issuers in a state, including the state itself, and possible political repercussions as a result of a filing, which could include labor upheaval, states may be forced to address local government failures directly by imposing such measures as receiverships, fiscal management oversight boards, provision of liquidity, and debt assumptions or guarantees.

Recently, the number of municipal bond downgrades for governments has outnumbered upgrades.[142] States are finding it difficult to ignore their local governments' increasing fiscal distress. A few states, including North Carolina, New Jersey, and Pennsylvania, have well-established, effective procedures for monitoring and assisting local governments before they encounter acute fiscal distress (see Table 16 for a more complete list).[143] More recently, Michigan has established significantly expanded oversight procedures. But most states wait until local governments approach fiscal insolvency or seek aid from the state before intervening. There appears to be growing recognition in the financial community and the states themselves that state monitoring, supervision, and early state involvement in solving local government fiscal problems is sound policy for both levels of government. But it will require skilled political leadership at the state level to overcome local government resistance to what localities often regard as intrusions on their right to self-government.

State Budget Laws and Practices Hinder Fiscal Stability and Mask Imbalances

Greater volatility in revenues and increased spending on entitlements and other hard-to-control items have made states more vulnerable to business cycles. When recessions hit, state revenues plunge; soon thereafter, pressures increase for spending on Medicaid, the social safety net, and higher education. Just when the federal government's automatic counter-cyclical stabilizers, such as unemployment compensation, kick in against recession, state budgets become pro-cyclical. In the last recession, even with the grants in aid from the federal stimulus law, states cut their spending significantly; some also raised taxes. In effect, state budgets act as a headwind against the national push toward economic recovery.

This outcome is undesirable as politics and as policy.

States Lack Adequate Fiscal Stabilization Funds

States can dampen these effects through well-designed and well-stocked reserve funds (commonly called rainy day funds), intended to help stabilize finances. States have increased their reserve funds over the last three decades; but these funds remain too small and inflexible to cushion state budgets against outsized fiscal crises. At the beginning of each of the last two recessions, state fund balances were larger than in previous recessions; but severe revenue declines led most states to reduce these balances sharply and quickly.[144] The funds' effectiveness as a stabilizing tool proved limited in the past two economic downturns.

While it is difficult to specify how large and how flexible rainy day funds should be, two of the study states, Texas and Virginia, have reasonably effective rainy day funds. Both have automatic contributions to the fund - Texas from 75

percent of oil and gas revenues when oil prices exceed 1987 levels and Virginia from general revenues when such revenues exceed the past six-year trend. The Texas rainy day fund has a cap of 10 percent of general revenues in the previous biennium, and Virginia raised its cap to 15 percent in 2010. Excluding the Texas and Alaska funds, which account for almost half of total state rainy day funds, for the nation as a whole the average state fund in fiscal year 2012 is only 3.8 percent of general fund spending, well below the target adopted by Virginia. In mid-2012, California has a negative fund balance of two percent, Illinois a one percent balance, New Jersey a zero balance, New York a 2.3 percent balance, Texas a 14 percent balance (which is expected to be used to balance the second year of the biennial budget in fiscal year 2013), and Virginia a 1.8 percent balance.

Richard Mattoon, an economist at the Federal Reserve Bank of Chicago, has proposed an interstate compact establishing a national rainy day fund for states, modeled on the federal unemployment insurance fund.[145] States would be governed by uniform rules regarding required contributions and withdrawals, thus removing individual state judgments about required contributions and eliminating the raiding of funds for purposes other than stabilization.[146] In return, the states would be able to borrow from the national stabilization fund in fiscal emergencies subject to later repayment with interest, as they do now with the unemployment insurance fund.

Alternatively, the federal government could encourage all states to have well-funded and well-managed rainy day funds. If the federal government were to establish or facilitate a national rainy day fund, it might require states to adopt model financial planning procedures as a condition of participation.

States Often Use Budget Gimmicks and Nonrecurring Resources

In the absence of rainy day funds big and flexible enough to make a difference, states have tried to fill in budget gaps with nonrecurring or temporary resources like asset sales and raids on dedicated funds. The states in this study all have used such temporary and one-time actions to achieve their legally required budget balance in extraordinary fiscal circumstances. In light of the spending cuts or tax increases that states might otherwise be forced to undertake, this use of nonrecurring resources is understandable. The problem occurs when states continue to use such temporary resources without a plan to phase out their use. None of the study states, unfortunately, has an effective multi-year planning process that puts it on a path to longer-term balance as the economy recovers. Some states that used gap-filling techniques in the 2001 fiscal crisis had not yet returned their budgets to a sound position by the time the 2008 crisis hit.

Worse, some states rely on nonrecurring items as an ongoing budget strategy. The just-enacted fiscal year 2013 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. Chronic dependence on nonrecurring actions, in good times as well as bad, can mask a growing mismatch between ongoing spending commitments and ongoing revenues, which allows voters to believe that they can continue to have desired services without higher taxes. Further, it may breed cynicism about purportedly “temporary” actions.

As shown in Table 17 the six states in our study have used a wide variety of temporary mechanisms to balance budgets in the past decade.[147] Some mechanisms, such as using rainy day funds, represent prudent attempts to

stabilize government finances over the economic cycle. Others, such as shifts in the timing of expenditures to future years, or borrowing to fund current spending, simply postpone problems to the future.

One notorious gimmick is "securitizing" future revenues – issuing bonds secured by a revenue source that otherwise would have provided annual revenue to the state. By doing this, a state borrows cash not just from the year ahead but from many years into the future, causing future budget gaps to grow. Many states have securitized revenue they would have received from tobacco companies under a settlement intended to compensate states for health care costs resulting from smoking. Four of the six study states used this to help "balance" their budgets in the past 10 years.

States also have issued taxable "pension obligation bonds" – borrowing in financial markets and using the proceeds to pay pension contributions. If the pension fund earns a higher return on the money than the state pays in borrowing costs, this can generate a net financial gain. And if the pension fund earns less – as has been true for the majority of pension obligation bonds – it generates a net financial loss.[148]

Table 17 | Study states have used a wide variety of nonrecurring actions

		California	Illinois	New Jersey	New York	Texas	Virginia
I.	**Rainy Day Funds**			**(Emptied FY2009)**		**Yes**	**Yes**
IIa.	**Temporary Federal Stimulus**	Yes	Yes	Yes	Yes	Yes	Yes
IIb.	**Temporary Taxes**	Yes	Yes	Yes	Yes		
III.	**Borrowing (bonds) – includes refinancing**	Yes	Yes	Yes	Yes		Yes (v. PAYGO)
	Tobacco securitization	Yes	Yes	Yes	Yes		
IV.	**Disguised borrowing (aka "dependable")**						
	Transfer to GF out of dedicated funds: raids, sweeps, etc.	Yes (K-12)	Yes	Yes	Yes	Yes	Yes
	Payment deferrals contractors/local govts, including carry-overs	Yes	Yes	Yes	Yes	Yes	Yes (& int. delayed)
	Employee benefit & pension contributions shifts & delays temporary cuts, furloughs, layoffs	Yes		Yes	Yes		Yes
	Timing shifts: tax receipts, audits, amnesties	Yes	Yes	Yes	Yes	Yes	Yes
V.	**Rosy Scenarios – Revenues or Spending**	Yes	Yes	Yes	Yes	Yes	Yes
VI.	**Asset Sales**			Yes	Yes		Yes (both)
	Franchise fees, licenses, etc.		Yes		Yes		

***Note**: "Both" means both recessions.*

***Source**: Task Force analysis of state budget documents and associated reports.*

Over the last decade each study state has used significant nonrecurring resources, well beyond those available from rainy day funds and the federal stimulus program. For example:[149]

- California has used voter-approved bond issues and debt restructuring to generate budget cash. In fiscal year 2003, in addition to $4.5 billion from securitizing tobacco revenue, it restructured debt to generate $1 billion for the budget. One deficit bond sale accounted for $10.7 billion in revenue in fiscal year 2004 and $2 billion in fiscal year 2005; another generated $3.3 billion in fiscal year 2009. These and other borrowings have led to a "wall of debt" to fund current expenditures that following the passage of the state's 2012-2013 budget is estimated at $28 billion.

- Illinois sold a record-breaking $10 billion in pension obligation bonds in June, 2003, using the proceeds to pay part of its fiscal year 2003 pension contribution and all of its fiscal year 2004 contribution. Illinois has about 860 budget funds, and from fiscal year 2003 through 2010 it "swept" $2.2 billion of what it termed "surplus" dollars from 455 dedicated special funds to pay general state bills. The dedicated revenues have been lost to their intended uses.

- New Jersey securitized tobacco settlement revenue in fiscal year 2003 and again in 2004. In fiscal year 2005 it issued bonds supported by new revenues from motor vehicle surcharges for $1.9 billion. The New Jersey Supreme Court found the transaction unconstitutional, prospectively, but allowed it to stand for 2005.[150]

- New York securitized tobacco settlement revenue, generating approximately $4.2 billion in gap-closing relief during the years after the September 11, 2001 attack. New York has hundreds of dedicated funds and accounts and over the last decade has transferred balances from funds legally dedicated to support environmental protection programs ($264 million), wireless network improvements ($50 million), the state lottery ($76 million), home care ($82 million), and welfare purposes ($261 million), robbing them of their intended uses.

- Texas frequently times receipts and payments to result in cash budget balance. In the early 1990s the state moved the monthly pay date for public employees from the last day of the month to the first day of the following month, "saving" one month's salary in the biennium in which the strategy was first adopted. More recently, it delayed a school aid payment by a few days from the end of August (the last month of its fiscal year) to the beginning of September, moving more than $2 billion in spending out of one budget period and into the next.

- Virginia used nonrecurring resources over the last two biennia in response to the fiscal crisis. Among other things, it accelerated sales tax collections from July into June, moving $242 million across fiscal years. It also underpaid contributions to the state pension fund and the teachers' pension fund and transferred money to the general fund from other funds.

Four Major Shortcomings in State Budget Rules and Practices

Beyond the use of nonrecurring revenues and gimmicks that disguise both temporary and structural deficits in state budgets, we found four major shortcomings in state budget rules and practices that have contributed to inadequate fiscal management.

Cash-Based Budgeting Facilitates Gimmicks and Obscures Fiscal Condition

Cash budgeting, which recognizes revenues as soon as they are received and expenditures only when cash is disbursed, is a major enabler of budget gimmickry.[151] "Revenue" is a flexible term in a cash system and can cover the never-to-be-repeated receipts from selling assets or pulling income streams forward. Similarly, "expenditures" often are defined in practice to be cash outlays, and can change from one fiscal year to the next if a payment date is adjusted by a few days. The immediate cash from an asset sale (a loose revenue definition) and the one-day delayed

payment into the next fiscal year (a loose expenditure definition) are only two examples of the porous definitions allowing cash budgets to appear balanced.

While seemingly benign and easy to understand, cash budgeting allows states to postpone payments to their contractors and suppliers, aid to local governments, and paychecks to employees. A state may treat a budget as balanced even, as New York has done in holding back income tax refunds, when it relies on what are properly next year's resources to pay this year's bills. Illinois regularly delays payments due to vendors and others; the state has accumulated a backlog of approximately $9 billion.

State governments, at a minimum, should use a modified accrual basis of accounting for state budgeting so that legislators and the public can more nearly see how revenues *earned* in the budget year from taxes, fees and intergovernmental transfers match up with spending *obligated* in the year, and so that real deficits and surpluses are more clearly revealed.[152] A simple translation can reconcile accounts between the cash-basis balance required by most state laws and constitutions and the modified accrual basis more appropriate to budget accounts. The state's Comprehensive Annual Financial Report (CAFR), an audited report on its financial condition, includes a reconciliation between modified accrual and the budgetary basis after the year ends; but budget documents should include a reconciliation for the budget period if the state's budget does not reflect modified accrual accounting.

States Lack Meaningful Multi-year Financial Plans

It is rare to find programs, policies, projects, revenues and investments that are limited to a single year. Yet, the typical budget – and its cycle of planning, passage and execution - is focused on just 12 months. Clearly, budgets should be focused on a longer time horizon. To produce such a focus, states should manage the planning, execution and balancing of budgets over the longer term by having a multi-year financial and capital plan linked to the budget process.[153] This approach has been successful in jurisdictions that have experienced severe financial emergencies, such as New York City and Washington, D.C.. It has helped them avoid continual fiscal crises and restore their financial reputations. See, below, the GFOA Statement on Best Practices in Public Budgeting.

GFOA Statement on Best Practices in Public Budgeting

A financial plan and budget that moves toward achievement of goals, within the constraints of available resources, should be prepared and adopted.

This principle provides for the preparation of a financial plan, a capital improvement plan, and budget options. Development of a long-range financial plan is essential to ensure that the programs, services, and capital assets are affordable over the long run. Through the financial planning process, decision makers are able to better understand the long- term financial implications of current and proposed policies, programs, and assumptions and decide on a course of action to achieve its goals. These strategies are reflected in the development of a capital improvement plan and options for the budget. The planning process results in the preparation of a financial plan consisting of various components such as an analysis of financial trends; an assessment of problems or opportunities facing the jurisdiction and actions needed to address these issues; and a long-term forecast of revenues and expenditures that uses alternative economic, planning, and policy

assumptions. The financial plan identifies key assumptions and choices related to achievement of goals. The plan may be summarized in the budget document or in a separate report. It should be available to decision makers for their review in making choices and decisions related to the budget process. It should also be shared with stakeholders for their input.

A process should exist for evaluating proposed capital projects and financing options, and developing a long-range capital improvement plan that integrates projects, time frames, and financing mechanisms. The plan, including both capital and operating costs, should project at least five years into the future and should be fully integrated into the government's overall financial plan. The process for developing the plan should allow ample opportunity for stakeholder involvement in prioritizing projects and review. The capital improvement plan should be included in a budget document, either in a single document describing both the operating and capital budgets or in a separate document describing the capital improvement plan and capital budget. The plan should be approved by the governing body.[154]

State multi-year planning practices are mixed and inadequate. Among the six study states, four - California, Illinois, New York, and Virginia - produce partial multi-year forecasts; but they are not always treated as serious efforts to project realistic future revenue and spending trends and generally are not used as guides to future annual budgets. There is no multi-year planning process in place in either New Jersey or Texas.

There is no easy way to require states to prepare multi-year financial projections or consider those projections in budget decisions. Although states sometimes require local governments to prepare multi-year financial projections, the federal government cannot require the same of states because states are, to a limited but real extent, sovereign. (The federal government could, conceivably, require improvements in financial procedures as a condition of participating in grant programs.) The Securities and Exchange Commission regulates municipal bond disclosure; but under the Tower Amendment to the Securities and Exchange Act of 1934, the SEC cannot regulate government borrowers directly and cannot require them to include multi-year projections in disclosure documents. The Governmental Accounting Standards Board (GASB) prescribes standards that must be followed in order to make Comprehensive Annual Financial Reports (CAFRs) compliant with Generally Accepted Accounting Principles (GAAP); but their rules apply only to CAFRs, not to budgeting or planning.

GASB recently proposed that governments include five-year projections in their CAFRs - and set off a firestorm of protest and opposition among governments and their associations. Many of the opponents extolled the virtues of multi-year planning and projections while opposing a requirement that they be included in CAFRs.[155]

It would seem obvious that capital projects, which often take years to build and may last generations, would require multi-year planning and execution; and many states, including Virginia, have excellent capital planning and budgets. However, even this practice is not universal. In California, for example, the last formal government-wide capital plan was prepared in 2008. Illinois went almost 10 years without a capital budget before enacting one in fiscal year 2010.

State and Local Budgets and Financial Reports Fail to Reveal the Future Costs of Promises Already Made

In both financial reporting and budgeting, future obligations to repay debt are routinely revealed. However, as discussed above, future obligations for workers' pensions and other benefits are inadequately and confusingly disclosed. Despite improvements, *liabilities* for pensions and retiree health care are generally understated on financial statements, although considerable amounts of important data are reported in notes and required supplemental information. Furthermore, *expenses* on the financial statements are often understated, while the numbers disclosed in footnotes are measured in ways that can underestimate liabilities very substantially in comparison to liabilities estimated in accordance with principles of financial economics. Current accounting, actuarial and disclosure rules make it difficult for non-experts to understand the extent of state and local governments' liabilities for pensions and employee retirement health care and their likely effects on future budgets. Uniform reporting rules for these employee based obligations should be required so that the public has a clear view of the size of these obligations and the risks involved in the failure to fund them in advance. Non-transparent reporting does not excuse failure to fund obligations, but transparency can increase the incentives for funding.

State and Local Government Financial Reports Fail to Illuminate Budget Reality

Ideally, the future obligations and budget gimmicks discussed above would be highlighted in the state's CAFRs. Over the past two decades GASB has significantly broadened and improved the information included in CAFRs: For example, new information provides a much broader view of the state government than the traditional fund-based statements and presents information on previously unreported liabilities and expenses.[156] But, while much needed information can be found (sometimes in notes, sometimes in reconciliation statements, and sometimes in required supplemental information), CAFRs are far from user-friendly. The shortest CAFR in the study states was more than 200 pages long, and Illinois' 2010 CAFR topped out at 367 pages. CAFRs contain extraordinary amounts of information (and some of it goes far beyond what is required for compliance with GASB standards); unfortunately, all but the most knowledgeable users often find themselves mired in data, unsure of how to find the information they want and need.

States, unfortunately, cannot be required to issue timely CAFRs. In a recent research brief, GASB noted that "the largest local and county governments and independent school districts issued their financial reports approximately 6 months after fiscal year-end on average during fiscal years 2006–2008. State governments averaged closer to 7 months (199 days), whereas special districts averaged about 4 months. Overall, 73 percent of the largest governments issued their reports within 6 months; 2 percent took longer than one year."[157] Illinois is particularly slow: It did not issue its CAFR for the fiscal year ended in June 2011 until June 2012. By contrast, the SEC requires large corporations to issue their annual reports within 60 days of the end of the fiscal year, and even the smallest corporations must issue within 90 days.[158] The federal government requires its agencies to publish their financial statements in 45 days.

States can do several things to improve the usefulness of financial reports in the budget process. First and foremost, CAFRs should be issued in time to be useful in the budget decision-making cycle. Legislators and governors can be forgiven for ignoring CAFRs that are nearly two years old when budget decisions are being made. Second, state budgets should be required to link more tightly to the CAFR – which presents the latest financial results - by providing a forecast at budget time of the expected financial results as they would appear in the CAFR for the year then ending and the budget year ahead, and a reconciliation between that and the budget. Third, recognizing that CAFRs may

always be unwieldy for the public, most elected officials, and the press, states should present simplified state balance sheets along with the proposed operating budget showing total state assets, liquid assets and all present and future obligations. In many places, "citizen reports" partially fill the need for simpler and more accessible financial reports; states should be encouraged to produce them and insist their localities and authorities produce them. A model document is the *State of New York Financial Conditions Report*, prepared annually by the state comptroller.

Threats to Fiscal Sustainability Create Risks to Essential State Functions

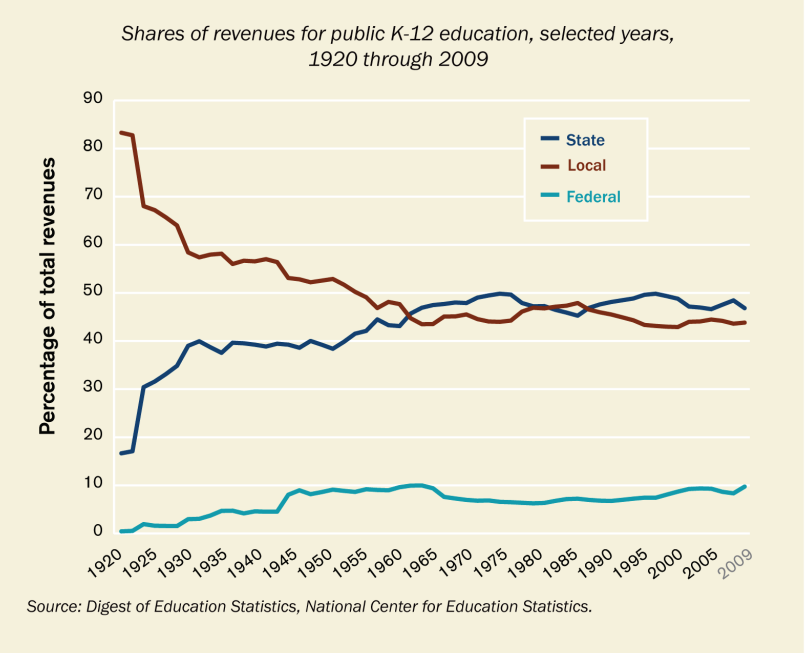
Educating Our Nation for the Future

From colonial times until well into the 20th century, public elementary and secondary education was financed almost entirely by local governments largely from local property taxes. In 1920, local governments and local school districts provided 83 percent of K-12 education funding with state governments providing the remainder. However, in the next 60 years, the share of K-12 funding by states steadily increased while the share from local governments declined. Since 1980 state and local shares of K-12 funding have stabilized, on average, at about 48 percent state funding, 44 percent local funding and eight percent federal funding. (See Figure 20.)

Education has almost always been the largest single category of state spending of general funds and until recently was the largest category of total state spending. Medicaid, which is heavily supported by Federal matching grants, now slightly exceeds education in total state spending.

The U.S. Department of Education projects the growth in pre-K-12 enrollment at 6.9 percent nationwide for the period 2009-2021. Projections for the six states in the Task Force study are shown in Figure 21. Other things being equal, Texas, California, and Virginia will have greater pressures to increase state K-12 spending than Illinois, New Jersey, and New York.

Figure 20 | Education funding: Now stable after decades of increasing state responsibility

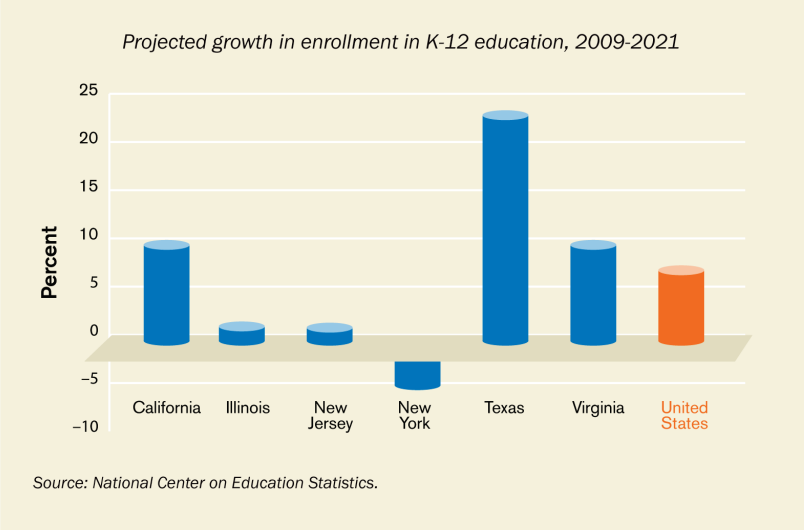


Source: Digest of Education Statistics, National Center for Education Statistics.

K-12 Education Funding as the Balance Wheel of State Budgets

The reasons for the secular growth in state funding and control of education have been to assure a minimal level of educational spending for all school districts in the state, reduce the huge disparities in spending on a per student basis from one district to another that would otherwise result from differences in the size of their property tax bases, and provide additional revenue for education in states that have limited the ability of localities to increase property taxes to support education.

Figure 21 | Texas, California, and Virginia face enrollment pressures



Source: National Center on Education Statistics.

State government spending for public elementary and secondary (K-12) education is driven by two primary factors: (1) enrollment, largely a function of population growth in the 5-17 age group, and (2) state formulas governing the total amount and distribution of state aid to education. These formulas are usually tied to some combination of needs assessments, levels of state and district revenue, and economic indicators associated with growth in state and district wealth. State formulas governing aid to K-12 education tend to be complicated and highly variable. The process generally works as follows: The state or a state educational policy institution determines the "foundation level" for each year's appropriation, based on its determination of educational needs and requirements. In some states there are minimum or guaranteed levels of state education aid; for example, California's Proposition 98 formula tied aid to growth in average state personal income. There is plenty of room for political negotiation and value judgments in this process, but it does provide a degree of stability and predictability to state education funding under normal budgetary circumstances.

In normal budgetary times, when state revenues and property values are growing and school budgets are more or less balanced, financing education has not been a big fiscal problem for most states. In fact, there is considerable evidence that prior to the last recession many states were able to increase education aid on a per-student basis. (See Table 19 below for growth in per student spending in the six study states); and some have been able to reduce teacher/student ratios and increase special education for disadvantaged students - because in most states revenues and property values were growing while the K-12 student population in most states, though not in the study states of Texas and California, was flat, slightly declining, or only slightly increasing.

Most state fiscal officials believe that as soon as state revenues and economies resume normal growth, states will replace the amounts of the education aid cuts that have been necessary during the current hard fiscal times, as they have done in the past. However, there is also recognition that continued growth in state Medicaid spending and increasing pressure on states to increase funding for pensions and OPEB may well continue to crowd out even modest growth in state K-12 education spending in the near term.

Reliance of Localities on Property Taxes for Education Funding

Another concern about future state education spending is the property tax, the primary source of local revenue supporting public education in most states. Current quarterly Census data on property tax collection show that the four-quarter average of property tax revenues, which lag reductions in property market values by three to five years, began to decline on a year over year basis in the fourth quarter of 2010, and declined in each of the next five quarters.[159,160] This is the first overall decline since housing values began to tumble after 2006.

In the past, shortfalls in local property revenues have been largely offset by increases in property tax rates. But such rate increases are not only increasingly being prohibited or limited by state law but, in general, strongly resisted by most state legislatures. Many independent school districts wholly dependent on the property tax funding and unable to increase rates are already in severe fiscal difficulty and are reducing staff, increasing class sizes and reducing the number of school days. If there is a long term decline or a no-growth period in property tax revenue available to local governments and school districts, this fact could well increase pressure on states to increase their traditional levels of funding for K-12 education.

Inflation in Education Costs

Like other government costs driven primarily by personnel expenditures, public education costs have been growing somewhat faster than general inflation. Teachers are well organized in most states; their salaries and benefits have been steadily increased in good times, and only in times of severe financial distress have their salaries been capped or slightly reduced. In addition, in states experiencing a combination of little or no enrollment growth and substantial revenue growth, there has been a tendency to grant substantial increases in personnel benefits. These increases, in addition to the funding of deferred pension and OPEB costs, could well require substantial increases in state and local spending attributed to education-related employees.

Outlook for State Funding of K-12 Education, near term and long term

With the ending of ARRA grants in 2011 and the continued slow growth in state revenues, state aid for K-12 education in most states is being either reduced or held flat as other state spending priorities, such as uncontrollable Medicaid costs and underfunded pensions crowd out any increases in spending for education. Nonetheless, state aid for K-12 education generally has not yet been reduced to levels below those existing a decade ago on a per-pupil basis.

In the longer term, if states get relief from Medicaid cost pressures and pension and employee health care underfunding, education aid is likely to remain the biggest category of state general fund spending; but its growth will remain related to growth in enrollment levels, state economic and revenue growth, and inflation in education costs, and it will remain the primary target of state budget cutters during periods of fiscal distress - not just because the large size of education budgets makes them a tempting “cash cow” but because there is no clear, measureable relationship between levels of education spending and educational attainment.

School Funding Lawsuits

Since the 1960s, educational interest groups and local school districts have challenged states’ school funding levels and systems in some 45 states. In the early years of these challenges, most of the lawsuits were based on claims of a lack of equity in public school funding between rich and poor districts. These suits were largely unsuccessful; and the U.S. Supreme Court ended them in the 1973 *San Antonio Independent School District v. Rodriquez* decision, ruling

that education was not a fundamental right and property wealth per pupil was not a suspect class, so that school funding disparities did not violate the Equal Protection Clause of the U.S. Constitution.

In recent years, however, there have been a number of successful lawsuits brought against states, based on the argument, supported by provisions in many state constitutions, that states have an obligation to provide all their children with the opportunity to receive an adequate education and that states are not meeting this obligation, as evidenced by disparities in educational performance.

Federal courts have in some cases required states to make changes including increases in financing for poor districts with low educational outcomes. A recent study found that between 1972 and 2002, in states facing court-mandated school financing reforms, state aid to schools increased by 9.2 percent in real terms and in-state inequality between districts fell by 15-19 percent.[161] Such lawsuits are continuing and are increasing in states that have recently suffered severe cuts in state education aid.

Diversity Among States in Financing K-12 Education

States vary tremendously in the extent to which they finance K-12 education - not only in the proportion of education costs financed by the state, but in state education spending as a percentage of state budgets. In Texas, state spending for K-12 education is more than 29 percent of total state spending, while in Illinois it is only 18 percent. The variations in state spending for higher education are even greater among our six states, ranging from four percent of total spending in Illinois to more than 15 percent in Virginia.[162] (See Table 18 and Table 19.)

Table 18 | Revenue per elementary and secondary pupil

Per student total revenues for public elementary & secondary education, 1999-2009								2009 shares (including ARRA)		
State	1998-1999	2000-2001	2002-2003	2004-2005	2006-2007	2008-2009	Percentage Change, 1999-2009	State Share	Local Share	Federal Share
United States	**$7,464**	**$8,503**	**$9,134**	**$9,996**	**$11,261**	**$12,038**	**61%**	**47%**	**44%**	**10%**
California	6,750	8,306	8,975	9,234	10,857	11,180	66	57	30	13
Illinois	7,625	8,892	9,190	10,146	11,342	12,508	64	28	61	12
New Jersey	11,178	12,157	13,825	15,602	17,418	18,302	64	42	54	4
New York	10,383	11,889	13,120	15,389	17,707	20,272	95	46	49	6
Texas	6,501	7,506	8,124	8,353	9,410	9,882	52	43	47	11
Virginia	7,436	8,135	8,735	9,952	11,440	12,109	63	42	52	6

Source: *U.S. Department of Education, National Center on Education Statistics, "National Public Education Financial Survey (State Fiscal)", 1987-2009.*

Table 19 | Education spending as percentage of total state general fund spending

Education spending as share of total state & general fund spending							
	Share of total funds		Share of general funds			Share of total funds, FY 2010	
	K-12	Higher Ed	K-12	Higher Ed	State	K-12	Higher Ed
FY 1998	22.0	10.3	35.2	13.1	CA	19.6	8.1
FY 2002	21.3	10.9	35.1	12.4	IL	18.2	4.5
FY 2008	22.0	10.7	35.0	11.7	NJ	24.6	7.9
FY 2009	21.5	10.5	35.2	11.5	NY	20.4	7.5
FY 2010	20.5	10.2	35.3	11.6	TX	29.3	10.0
FY 2011	20.1	10.1	35.0	11.5	VA	16.7	15.6

Source: *NASBO, State Expenditure Report, 2010.*

The reasons for these variations are rooted in the history and politics of each state. States like Texas and California, which have experienced high levels of enrollment growth, cannot afford to increase spending per student simultaneously, while states like New York and Illinois, with little or no enrollment growth, have significantly increased spending per student in the past decade.

Federal Role in Financing K-12 Education in the States

The federal role in funding K-12 education was negligible until the enactment of the Elementary and Secondary Education Act of 1965 (ESEA), when such spending jumped to almost 10 percent of total funding; despite many subsequent federal initiatives, federal spending has remained around 10 percent. The purpose of ESEA was to target funds to school districts whose student performance levels were inadequate. However, the federal government soon discovered that states were substituting ESEA funds for state and local funding aimed at these same districts; so, the program has not been enlarged but has been more closely targeted to the achievement of objectives that the states alone cannot achieve. In recent years federal funding has been used to stimulate and enforce compliance with new federal reform initiatives like No Child Left Behind and Race to the Top and to encourage states to spend more on early childhood education.

State Funding of Public Higher Education

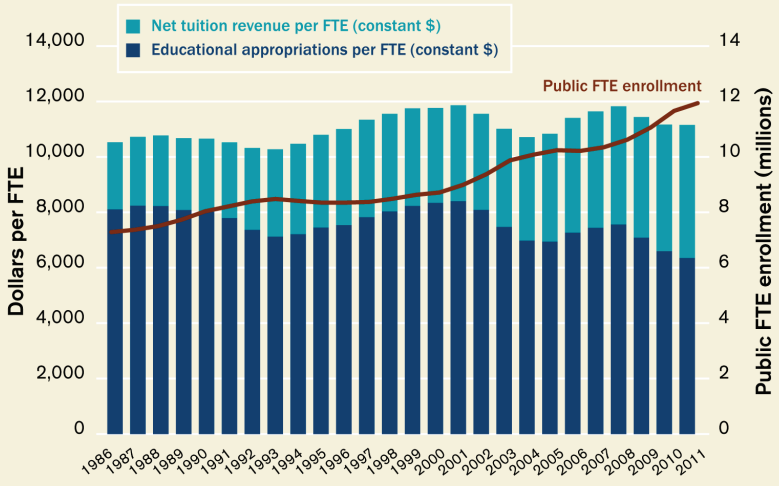
State aid to higher education has been a relatively stable portion of state support for education for many years - about 10 percent of total state spending, compared to the 20 percent of total state spending made up of K-12 education. Like support for K-12 education, state aid to higher education has grown moderately in good times and has been cut in bad fiscal times, with restoration of the cuts when state revenue growth resumes. However, unlike K-12, public higher education has experienced significant enrollment increases since the late 1990s, growing by about one-third in the last decade and 16.9 percent since the onset of the last recession.[163] State appropriations for public higher education declined by 12.6 percent in constant dollars between fiscal year 2006 and fiscal year 2011. On a per-full-time-enrolled-student basis, state support has declined since its peak of $8,316 in 2001 to $6,290 in 2011 (in constant dollars), the lowest level in the last 25 years. And in fiscal year 2012, there was another reduction of 7.6

percent in constant dollars. Net tuition revenue per FTE has increased from $3,450 to $4,774 in that same period (in constant dollars) as states have relaxed limitations on tuition and public universities have struggled to replace reductions in state support.[164] (See Figure 22 for longer-term trends.)

This trend toward less dependence on state funding for public universities and more dependence on tuition, student fees, and gifts and bequests is not likely to be reversed in the foreseeable future, even though public support for higher education remains strong and enrollment growth continues to exceed population growth in the 18-24 age group. (See Figure 23.) This development is causing a funding crisis in public higher education, as resistance to further tuition increases grows and some states resort to enrollment caps to control costs. Enrollment in California public higher education, which accounts for one seventh of the nation's enrollees, grew by only eight percent between fiscal years 2006 and 2011, compared to the national average of 17 percent, while Illinois enrollment grew by only nine percent in the same period. New York and Texas had enrollment growth slightly below the national average, while New Jersey and Virginia had rates a little above average.

Figure 22 | Trends in public higher education enrollment, appropriations, and revenue

Public FTE enrollment, educational appropriations and total educational revenue per FTE, United States, fiscal 1986-2011

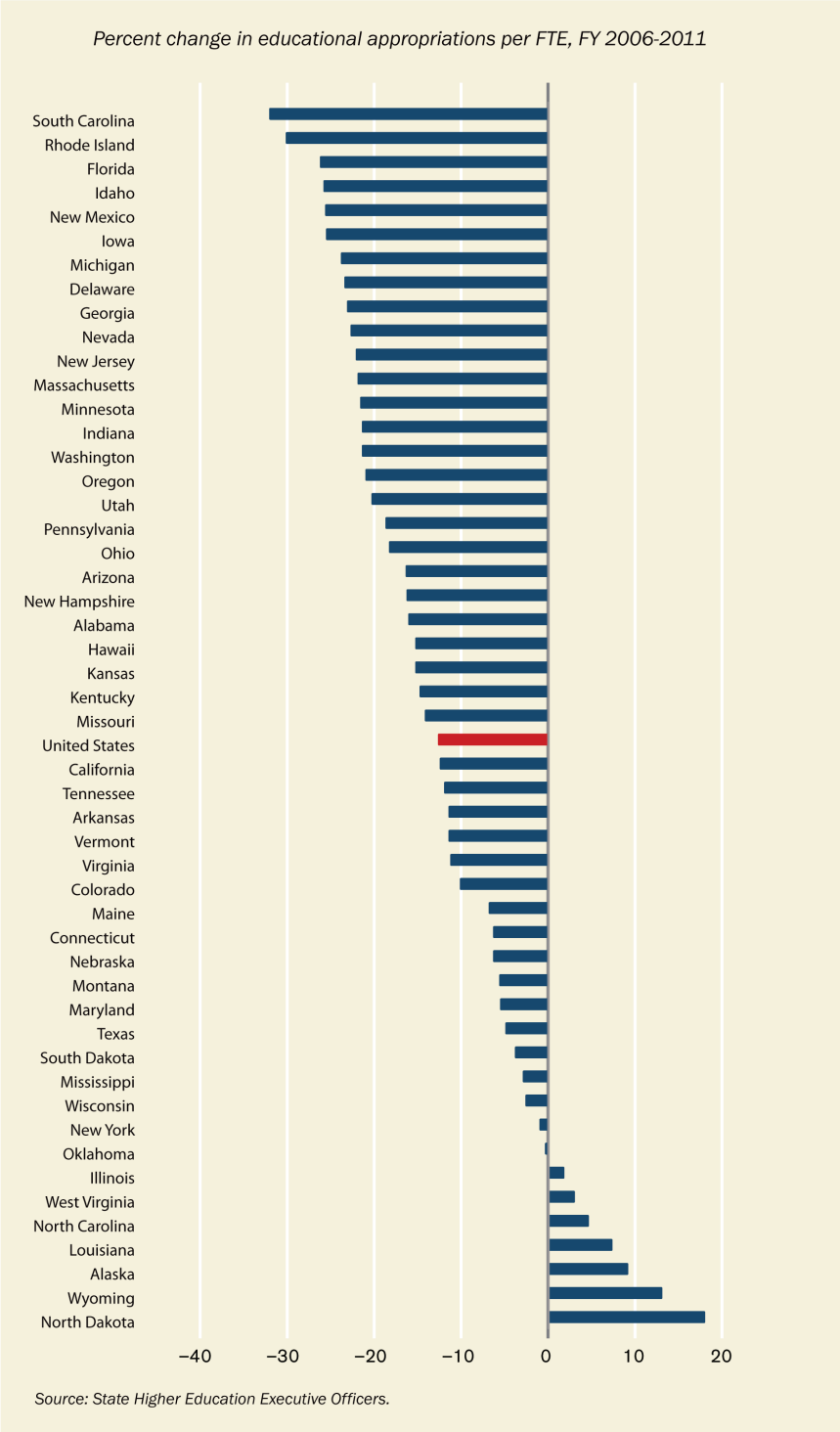


Notes: Constant 2011 dollars adjusted by SHEEO Higher Education Cost Adjustment. Educational Appropriations include ARRA funds. (HECA).

Source: State Higher Education Executive Officers.

States have cut their support for higher education despite rising enrollment and widespread recognition that higher education is key to both state and national competiveness and growth in employment. Confronted with persistent budget crunches, state legislatures assume that college and universities, especially flagship institutions, have more flexibility than K-12 in shifting costs to students, increasing class sizes, changing the curriculum, attracting private funding and managing more efficiently. While there are wide differences within and among states in how much state support has been cut, a typical current trend is to hold state aid to higher education relatively flat and let inflation chip away at the base level of support, as is the case in Illinois. Individual states like Virginia are giving a higher priority to restoring higher education cuts; and some, like Texas, can draw on substantial assets and investment funds supporting higher education. In contrast, California has cut state support by 12.5 percent, the national average, since fiscal year 2006 and has seen tuition increases of 175 percent in constant dollars. (See Figure 24 for California trends.)

Figure 23 | Most states have been cutting support for higher education

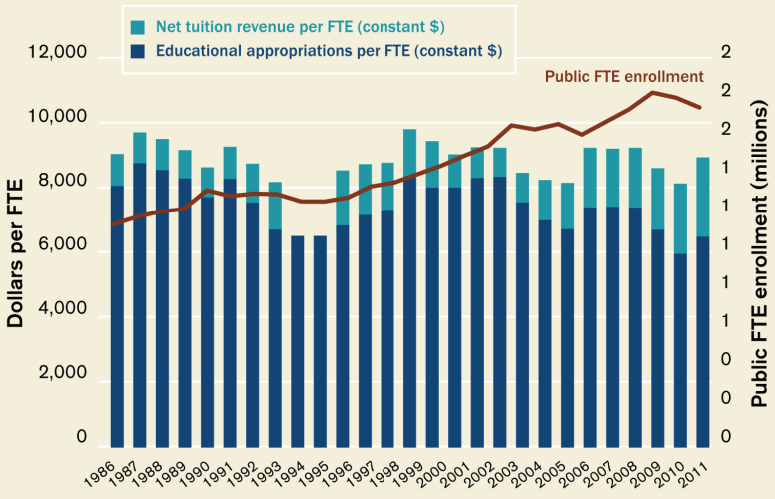


While higher education is not likely to be a rapidly growing spending category that will threaten state government fiscal sustainability, there is growing concern that many flagship public universities, like Berkeley, Michigan, and the University of Virginia, are moving toward de facto privatization with high fees that effectively exclude many highly qualified lower income

students. In response, states are beginning to focus more on student aid for the needy than on direct support to colleges and universities. And universities are beginning to experiment with ways to increase instructional efficiency in order to lower per student costs.

Figure 24 | Tuition has been rising as a share of education costs in California

Public FTE enrollment, educational appropriations and total educational revenue per FTE, California, fiscal 1986-2011



Notes: Constant 2011 dollars adjusted by SHEEO. Educational Appropriations include ARRA funds. (HECA).

Source: State Higher Education Executive Officers.

Technology and Efficiency in Education

A recurring theme among some educators is that while most of today's students have grown up in a society in which communications are more digital than verbal, education systems have not learned to use inexpensive digital techniques to replace traditional labor-intensive, expensive teaching methods. Few suggest that teachers can be wholly replaced by computers, but the potential for more effective and less expensive learning is tantalizing. Virginia's Governor McDonnell, in his budget for fiscal year 2012-2014, proposed legislation requiring that every student in Virginia public schools pass at least one course utilizing computer-based instruction to qualify for graduation. Digital instruction may hold out hope for long-term relief from the huge burden of costly benefits for instructional staff, particularly in higher education, and has potential for improving some elements of educational performance as well.

Education Conclusion

State aid to public education, particularly K-12 education, will continue to be an important role of state government in the foreseeable future. However, any large and sustained reduction in property tax revenues could put pressure on states to replace the localities' lost revenues supporting K-12 education; and continued growth in relatively uncontrollable spending items such as Medicaid, pension contributions, and OPEB payments could well continue to crowd out "normal" state funding for both K-12 and higher education.

Spending for public higher education institutions probably will not be a significant growth area in state education budgets. States will increasingly look for ways to increase aid to superior in-state students who cannot afford increasingly expensive public universities, but this item will not be large enough to threaten state fiscal solvency. Elite flagship public universities are already on the road to de facto privatization, while junior colleges and local universities will continue to depend heavily on state and local support. California has already moved from a K-12 system of education to a K-14 system, and other states have been doing so as well.

Digital instruction offers hope for long-term efficiencies in instructional costs and more effective learning. It will require continuous experimentation and public support over many years to achieve these results, but the capital investment involved appears to be modest and affordable. This digital revolution in education will probably be led by universities that have less need than elementary and secondary schools for intensive teacher-student interaction.

Underinvestment in Infrastructure

The status of the nation's physical infrastructure may be characterized as anywhere from discouraging to alarming, based on surveys of infrastructure condition and needs. Infrastructure has been "crumbling" for so long, according to the American Society of Civil Engineers (ASCE), that its condition deserves a grade of "D."[165] The nation, in the early 1960s, spent three percent of gross domestic product on our transportation and water infrastructure alone; this figure had fallen to 2.4 percent of GDP by 2007.[166]

In its analysis of the six study states, the Task Force focused on the three major types of infrastructure spending by state and local governments: transportation (roads, bridges, mass transit), water (drinking and waste water, dams) and buildings (general public buildings, K-12 schools, and higher education).

Improving the situation in any of these areas will not come cheap. In 2009, ASCE's report card highlighted an estimated five-year transportation investment shortfall (including only bridges, roads, and transit) of $739.6 billion. The National Surface Transportation Infrastructure Financing Commission estimated a federal investment gap for surface transportation (including only highways and transit) of $2.3 trillion from 2010-2035.[167] With water systems, the U.S. Environmental Protection Agency estimates that $623 billion will be needed over the next 20 years (the six study states account for about $250 billion).[168] Producing a state of good repair in the nation's most critical dams, which usually gain attention only after natural disasters, would require an estimated $16 billion over the next 12 years.[169] There are few national estimates of capital needs for public buildings; but states often prepare their own estimates, using definitions and methods that vary from state to state. Virginia alone has an estimated $2 billion in capital needs; Texas's estimate of its needs is $350 million.[170] School districts, nationwide, have an estimated $271 billion of deferred building and grounds maintenance.[171] In higher education, recent estimates prepared in individual states show needs of more than $2.2 billion in California, $3.6 billion in Illinois, $5.8 billion in New Jersey, about $5 billion in New York and $740 million in Texas.[172]

There are important limitations to these estimates.[173] State governments, while they fund and regulate infrastructure, do not always collect information on the assets of their local governments, which are responsible for crucial elements such as waste water systems. While some local governments may keep inventories of assets and their condition, often best estimates and expert guesses are required. Definitions may vary; numbers may not be standardized. Thus, comparisons should be viewed with caution.[174]

The Value of Infrastructure

The information required to estimate the value of infrastructure often is not publicly available, but state CAFRs tell how states measure the value of their capital assets. The most recently available state CAFRs show capital assets, net of depreciation, valued at $109 billion in California, $20.2 billion in Illinois, $22.8 billion in New Jersey, $93.2 billion in New York, $98.9 billion in Texas, and $22.5 billion in Virginia. As with other infrastructure numbers, cross-state

comparisons may not be very useful; the underlying data vary, as states include different agencies and authorities in the counting. Some states may and some may not exclude assets held by local governments.

Infrastructure Condition

Transportation

The Federal Highway Administration estimates that less than half of American highways are in better than fair, mediocre, or poor condition.[175] The average age of a bridge in this country is 43 years; 25 percent of bridges are rated as structurally deficient or functionally obsolete, with an existing or emerging need for maintenance, rehabilitation, or replacement.[176] The Federal Transit Administration estimates that only 30 percent of the nation's transit assets are in excellent or good condition.[177] Conditions vary widely across states. (See Table 20.)

Table 20 | Inventory and condition: roads and bridges in US and selected states

		FHWA Road Conditions, 2008				Bridge Conditions, 2011	
	Total Highway Mileage 2009	% Very Good/ Good	% Mediocre/ Poor	Total number of bridges, 2011	% of bridges older than 50 years, 2011	% Structurally deficient	% Functionally obsolete
United States	**4,050,717**	**40%**	**16%**	**602,880**	**34%**	**11%**	**13%**
California	171,874	16%	41%	24,609	36%	12%	16%
Illinois	139,577	44%	15%	26,436	27%	9%	7%
New Jersey	38,835	7%	55%	6,514	47%	10%	25%
New York	114,546	29%	25%	17,384	42%	12%	25%
Texas	310,850	29%	9%	51,878	33%	3%	15%
Virginia	74,182	34%	5%	13,524	31%	9%	16%

***Notes**: Road conditions classified as Very Good /Good are based on the International Roughness Index (IRI) of less than 95 and road conditions classified as Mediocre/Poor are based on IRI of over 170.*

***Source**: Task Force analysis of data from U.S. Bureau of the Census (highway mileage); Bureau of Transportation Statistics (road conditions); Federal Highway Administration (bridge conditions).*

Table 21 provides each state's own assessment of future transportation capital needs (roads, highways, transit and, with the exception of New Jersey, bridges). It should not be used for comparisons, as the estimates cover different timeframes, definitions of needs and state-local responsibilities or data.[178] Even so, the table illustrates the importance of population and size in the study states and the fact that all have made forward-looking assessments of basic needs.

Table 21 | Estimated Transportation Capital Needs Forecast by State

State	Capital Need ($ billions)	Time Frame
California	469	2011-2021
Illinois	238	2007-2027
New Jersey	32	2013-2022
New York	81	2008-2028
Texas	413	2010-2035
Virginia*	7.7 to 23.9	2005-2025

**Capital need estimates vary by anticipated future market share.*

Source: *Estimates from individual states.*

Water Systems

Generally, water infrastructure (drinking and waste water) is a matter for localities. States do not maintain inventories of assets, but localities sometimes have detailed inventories of their water infrastructure; and a 2007 U.S. Conference of Mayors survey found that cities have a general understanding of the condition of their drinking water distribution systems, including water pipes.[179] The EPA estimates that $323 billion is needed over the next 20 years for drinking water (nearly $200 billion for buried network of transmission and distribution pipelines alone) and $298 billion for waste water infrastructure. The six states in this study account for around $250 billion of combined drinking and waste water need.

Dams and levees are another essential component of water infrastructure. No comprehensive direct measure of their condition currently exists, but engineers consider age to be an important factor. The country's dams — 884,134, according to the Army Corps of Engineers in 2010 — were built mainly between 1950 and 1979; their average age is 53 years.[180] In the study states, dam ages for Illinois and Texas are somewhat below the average, at 48 and 49 years, respectively. But the figures are 60 years in Virginia, 65 years in California, 75 years in New York, and 80 years in New Jersey. Until 2007, there was no official inventory of the estimated 100,000 to 300,000 miles of U.S. levees; in that year the Army Corps of Engineers began compiling what is still a partial inventory.[181] Most dams are privately owned and state-regulated; with levees, the roles are not so clearly demarcated.

Buildings and Structures

States have made efforts to inventory public buildings and their needs; but some inventories are deficient, and not all are complete. New Jersey has a commission to ensure comprehensive reviews of capital needs. California has a web-based inventory of buildings but does not include information on their condition. Illinois has ceased its inventory efforts in recent years. Future needs and cost estimates are rarely reported in the aggregate.

Elementary and Secondary Schools: Data on educational structures, especially at the elementary and secondary levels, is far more robust than for other public buildings, mainly because of regulations mandating condition and needs assessments. In 2008-2009 there were 98,706 pre-kindergarten through 12th-grade public schools in the United States, including 4,694 charter schools. According to the 21st Century School Fund and Building Educational

Success Together (BEST), school districts have approximately $271 billion of deferred building and grounds maintenance in their schools, excluding administrative facilities, averaging $4,883 per student.[182]

Higher Education: The evidence points to a pattern of deferred maintenance. The states themselves have recognized this. California dedicated 10 percent of the state's total infrastructure spending to higher education between 2005 and 2010.[183] Illinois released nearly $800 million in capital funds for such purposes in 2012.[184] Texas plans to spend $16.1 million over five years for new construction, renovations, and infrastructure projects for higher education facilities.[185] Virginia is proposing $412 million in spending on 19 capital projects at higher educational institutions for 2012 through 2014, although funding is committed only on an annual basis.[186]

Infrastructure Funding

Federal Funding

While the majority of spending for infrastructure does not occur at the federal level, federal efforts and involvement in the nation's transportation system and other federally-owned assets are well known. The federal government provides a mix of formula grants, revolving loan programs, specific appropriations, and competitive grants to further national infrastructure goals.[187] It funds state and local infrastructure projects through both direct spending or grants and loan subsidies. About 80 percent of surface transportation funds distributed to states are transferred in the form of grants allocated by formula for road construction, rehabilitation, and safety programs. The remaining 20 percent are distributed for specific projects or purposes.[188] User fees, tax credits, and legislative earmarks also fund projects.

As the Congressional Budget Office (CBO) found in 2007, the respective shares of spending by the federal government and the states and localities on water and transportation infrastructure have remained reasonably stable since the mid-1980s.[189] Funding for drinking and waste water projects comes primarily from local sources, a pattern that is likely to continue.[190] Local governments and utilities use mainly debt financing for such purposes, issuing bonds to be repaid through tax revenues and, increasingly, water and sewer user charges.

After the 2008 economic decline and the failure to enact a new surface transportation act to replace the one that expired in 2009, the American Recovery and Reinvestment Act of 2009 (ARRA) awarded $86.6 billion in federal funds to state and local transportation, energy, environment, and other infrastructure projects. ARRA provided incremental help but did not significantly reduce short-term needs. Furthermore, ARRA funds were non-recurring; and the program's size, when compared with total long-term infrastructure needs, was marginal.[191]

Dedicated Federal and State Government Funding for Transportation

While federal spending for transportation is significant, more than half the capital funding for such purposes comes from other levels of government. They often rely on dedicated revenues, including state gas and diesel taxes; but these revenues are in decline.

All six study states employ fixed-rate gas taxes, with California, Illinois, and New York levying additional variable-rate taxes. The average effective state gas tax rate for the nation as a whole has fallen by 20 percent since such rates were last increased.[192] Federal gasoline tax revenues are also stagnating, with dramatic effect on the availability of federal Highway Trust Fund (HTF) revenues. Under current policy, 88 percent of HTF revenues are devoted to highways and 12

percent to mass transit.[193] In recent years, the gap between program costs in these areas and the federal gas tax revenue supporting them has increased. In 2008 through 2010, the federal government was forced to go beyond the HTF, tapping into its general fund for a total of approximately $35 billion to meet federal highway program obligations.[194]

The condition of the HTF is expected to worsen: The CBO forecasts that the average rate of annual revenue growth will be only about one percent from 2013 through 2022 and estimates that by 2013 the highway account, and by 2014 the transit account, will be unable to meet obligations in a timely manner. The total HTF deficit is expected to reach $67 billion between 2013 and 2017 and increase by another $69 billion by 2022.[195]

Unless the federal and state governments are willing to raise gas taxes or find alternative sources to pay debt service on bonds, there will be insufficient revenue to meet the nation's transportation infrastructure needs.

State and Local Government Spending on Infrastructure

Spending for infrastructure capital, operations, and maintenance is symbiotic. Proper operation and maintenance can prolong infrastructure life and affect capital needs in both the short and long term. For example, when bridges deteriorate, the cost of keeping them in a safe condition can skyrocket. When infrastructure is well-maintained, that fact may sometimes lower future needs; sometimes, by increasing the life of existing infrastructure, it may raise ultimate capital replacement costs by making way for newer, more advanced technology, systems and design.

Infrastructure spending by state and local governments, adjusted for inflation and population growth, has generally risen over the last three decades. However, it has not kept up with overall growth in the economy. Numerous studies have concluded that the condition of the nation's infrastructure is inadequate, despite increased spending. There may be several reasons for this gap. The number of motor vehicles is increasing faster than the population, thus increasing the intensity of road use and rate of wear and causing congestion. In addition, during part of this period, prices for asphalt and other road construction materials and services have risen more rapidly than overall economy-wide prices. Meanwhile, the need for investment in water infrastructure has been driven by regulatory standards that did not exist several generations ago and are getting tighter year by year: Businesses, governments, and the public are required to treat or eliminate contaminants that just a few years ago they were allowed to dump or ignore. Finally, even well-maintained infrastructure can become functionally obsolete, requiring new, often expensive investment such as electronic scanning for tolls or other new technologies that reduce waiting times, speed travel, and make the economy more efficient.

Transportation

Real per-capita spending on transportation by state and local governments, both capital outlays and spending on operations and maintenance, is dominated by highways; the next largest category of spending is public transit. Per-capita transportation spending, adjusted for inflation, has grown in the past 30 years, nationally and in all study states and their localities, with two exceptions: New Jersey local governments' operations and maintenance spending remained virtually flat, while Virginia's state government capital outlays declined by 35 percent.

New Jersey state government is an outlier both nationally and among the six study states: From 1977 through 2008, the most recent year for which data were available, its real per-capita outlays on transportation grew at seven times

the national average for capital spending and five times the national average for operations and maintenance. The U.S. average for state government spending on capital outlays and operations and maintenance did not even double during this time period.[196]

Water Systems

Spending on water utilities is done chiefly by local governments, often through independent municipal or regional utilities rather than city or county governments. These utilities generally finance infrastructure through water and sewer charges and property taxes. Except in California and New Jersey, there is very little state government spending in this area in the six study states; but many states, including states in this study, have revolving loan funds capitalized by federal and state appropriations that help make lower-cost loans possible for local water utilities.

Nationally, localities' real per-capita capital outlays on water systems have doubled over the past 31 years; the growth in operations and maintenance spending has more than doubled. But Virginia's localities cut capital spending in this area by almost 37 percent while increasing their operations and maintenance spending slightly more than the national average.

The report *The Cost of Rehabilitating Our Nation's Dams* by the Association of State Dam Safety Officials, updated as of 2009, calculated that it would take approximately $16 billion to rehabilitate the nation's most critical dams to a state of good repair over the next 12 years, $8.7 billion for publicly owned dams and $7.3 billion for privately owned dams.[197] There are no available federal funding sources and few state funding sources for dam repairs.

Buildings and Structures

Responsibility for building, rehabilitating, and maintaining primary and secondary education facilities typically falls to local school districts; capital outlay funding is generally provided through state and local taxes, with a small federal contribution.[198] Nationally, between 2005 and 2008, state contributions for school capital costs averaged 30 percent but ranged from 100 percent (in three states) to zero percent (in 11 states). From 1977 through 2008, on average, real per-capita K-12 capital spending by localities and school districts grew by 216 percent, while operations and maintenance spending grew by 88 percent.[199]

Public institutions of higher education are largely controlled by states, and infrastructure funding for higher education is overwhelmingly provided by states.[200] From 1977 through 2008, on average, national real per-capita spending by states on capital projects for higher education grew by 146 percent, while state government operations and maintenance spending grew by 118 percent. The six states in this study displayed highly diverse behavior over this period, depending on their baselines in 1977 and the policies they subsequently chose. Virginia was the extreme outlier: It went from capital spending on higher education of half the real per-capita national average to more than twice that amount, a ten-fold increase.

Infrastructure In the Future

The Coming Federal Budget Crunch: Pressure on State Aid, Cutbacks in Procurement, and the Question of State and Local Tax Deductibility

Though politics is inherently uncertain, it is reasonable to assume that the future will bring restraints on federal government spending, pressure to cut grants-in-aid to states, cuts in federal procurement, and uncertainty about federal tax changes. Such developments would hit the states in this study particularly hard. For one thing, they are among the top recipients of federal aid.[201] In addition, their businesses and economies have strong links to the federal government. In 2010, Virginia, California, and Texas ranked first, second and third, with New York ninth, in receipts from federal procurement spending.[202] Finally, according to the CBO, four of the study states (though not Texas, without a state income tax, or Illinois, with a flat state income tax) benefit more from the deduction than the nation as a whole.[203] State treasuries will be hard-pressed to meet budget needs if the federal subsidy for state and local taxpayers disappears.

The Coming Rise in User Charges and the Resulting Pressure on the Ability to Raise Taxes

Reports by government, research, and advocacy groups describe a bleak future if America does not address the neglect of transportation infrastructure soon; and the failure of the present Congress to extend existing federal transportation spending legislation does not inspire confidence in the federal commitment to raising and distributing national revenues to fund transportation infrastructure.

Transportation costs the average American family more than $8,600 a year, second only to housing expenditures and a third more than food.[204] The policy response long promoted by economists and now made possible through efficient technology is to price the use of transportation infrastructure so as to spread the traffic more efficiently and produce from users the revenue needed to build and repair roads and bridges.[205] The Federal Highway Administration considers four types of congestion pricing an option: variable-priced lanes, variable tolls, cordon fees, and area-wide pricing.[206] Each of the states in this study has adopted, in selected ways, one or more of these approaches; some have failed to do so in other instances. For none of them has this model proved, yet, to be the total solution for funding transportation needs.

Failing Grades and Future Needs

The nation's infrastructure presents a picture of failing report cards, visibly aged facilities, deferred maintenance, and mounting backlogs. The nation needs capital investment: the funding gaps are large. The gap between federal spending and investment needs for highways and transit, alone, is an estimated $400 billion for 2010-2015 or $2.3 trillion for 2010-2035.[207] The inability of elected officials – both in Washington DC and at the individual state level – to address the consequences of the diminishing revenues from a crucial revenue source, the gasoline tax, stands out as a prominent public policy failure in recent years.

Uses and Misuses of State Borrowing

States issue debt for three fundamental purposes. The first is to finance needed capital improvements. The second is to finance short term imbalances between revenues and expenditures during a fiscal year and the third is to plug

budget gaps or finance deficits. Financing deficits, particularly using debt as if it were an element of revenue, generally is bad financial and budgetary practice.

Many states have used borrowing to balance budgets. Some states, like California, have borrowed from external credit markets to eliminate potential deficits or to finance prior ones. Other states have borrowed to meet pension obligations. Still others, like California and Illinois, have used long term debt to finance short term obligations thereby burdening a succeeding generation without providing a new asset. The Supreme Court of New Jersey held that proceeds of certain borrowings cannot be considered revenue under the New Jersey constitution.

Each state in this study has both constitutional and statutory provisions that on their face authorize, control and limit the amounts and type of debt that the states can issue. These provisions all have evolved and adherence to them, either strict or nominal, is a reflection of the governmental and spending cultures of the particular states.

An examination of their laws and the contexts in which those laws are construed indicates that debt limitations and other obstacles to the issuance of debt may be circumvented if there is a compelling need that political leaders identify and choose to address. Similarly, if the electorate opposes incurring additional debt, statutory and constitutional limitations provide to elected officials rationales to determine that borrowing is not the most appropriate vehicle with which to implement policy.

A common, limiting provision in nearly all state constitutions is that general obligation ("GO") debt in excess of a nominal amount such as $250,000 only can be issued if it is approved by the general electorate. General obligation debt is backed by the full faith and credit of the state. Such referendum provisions have been viewed as cumbersome since there can be no assurance that voters will approve additional, long term debt. In New York, for example, a proposed issuance must be for a single purpose and only one bond proposition can be considered per election. These elections are statewide. As a practical matter, to gain electoral approval a bond proposition must contain widespread benefits throughout the state, regardless of where the greatest capital needs are. This makes proposed issues bloated and unfocused. New York has not attempted a GO proposition since 2005.

Illinois and California require a super majority of each house of the legislature (three-fifths and two-thirds respectively) to authorize GO debt and California also requires electoral approval. Virginia requires both legislative and electorate majorities for GO debt and a two-thirds majority of each house of the legislature for revenue debt. New Jersey, pursuant to a 2008 constitutional revision in response to the perception that its debt load was overwhelming, now requires voter approval for all debt other than savings-producing refinancings and revenue bonds.

A prevalent means whereby referenda are avoided is the increasing use of public benefit corporations or state created authorities that are authorized to issue long term debt in support of government initiatives.[208] Many authorities issue revenue bonds the proceeds of which are used to build or maintain capital revenue producing facilities that impose tolls or user fees which produce a revenue stream sufficient to service the bonds. Such revenue debt is not state debt.

Other instrumentalities, however, serve only as conduits or vehicles for the purposes of issuing debt to finance state assets or operations. Debt service for such bonds ultimately is backed by tax revenues which either requires an annual

appropriation or the use of irrevocable and continuous transfers of state funds as may be necessary to meet debt service. Appropriation debt is not GO debt but it implicates state credit.

Expanded use of appropriation backed debt has allowed states to have reliable means of financing infrastructure and, occasionally and inappropriately, operations, while gaining the benefit of the federal tax exemption for interest on the debt. However, such debt carries the potential for abuse and reduces the transparency of government finance. Authority debt reduces transparency because it does not require electoral approval and, therefore, voter scrutiny, and it often is not shown as balance sheet indebtedness or is not easily discernible on state financial statements.[209]

States have many ways of supporting authority debt: they have employed leases, installment purchase agreements, service contracts and moral obligation, as well as specific taxes such as personal income and sales taxes. Three states in our study rely heavily on non-GO debt: it constitutes more than 90 percent of net state tax-supported debt in New York and New Jersey, and approximately 80 percent in Virginia.[210]

The lack of transparency creates the possibility of bad debt management and the inappropriate issuance of debt with insufficient regard for the ability to repay. Tax and appropriation backed debt can crowd out other legitimate budget expenditures and place unnecessary stress on a state's fiscal and governance condition. Despite debt proliferation, each of the states under analysis is creditworthy and there are currently no state government debt crises.

States historically have been among the most credit worthy entities in the municipal bond markets. As Moody's Investors Service reports, "The rating distribution for states has historically been higher and more compressed than that of local governments, reflecting states' generally greater financial and economic strengths. State financial strength is derived from economic bases that are larger and more diverse than those of most local governments. In addition, states are sovereign, and their power to tax is generally not limited by the U.S. Constitution, outside of interstate commerce or international trade constraints."[211]

The creditworthiness of the states, as measured by the rating agencies, is partly a function of the fact that states are not legally able to avail themselves of bankruptcy protection. States can, of course, become temporarily insolvent and be forced to retrench or raise taxes often harming their most vulnerable citizens and their long term economic prospects.

This relatively sanguine view of state debt is challenged from time to time by the difficulties of individual states particularly in regard to swings in economic cycles. When states borrow to balance their budgets, they are violating the principles of budgeting and financial management on which the relatively high credit ratings rest.

Growth of State Debt

The debt of state and local governments has grown dramatically in the past four decades. This is true both in absolute terms and relative to state's capacity to pay as measured by state gross domestic product as shown in Figure 25. We compare debt to the economy, as do most analysts, rather than to tax revenue because we are examining long-term debt. In the long run, state governments (and to a lesser extent local governments) have the ability to change their tax structures. Therefore, the underlying economic base that could generate tax revenue is particularly important.

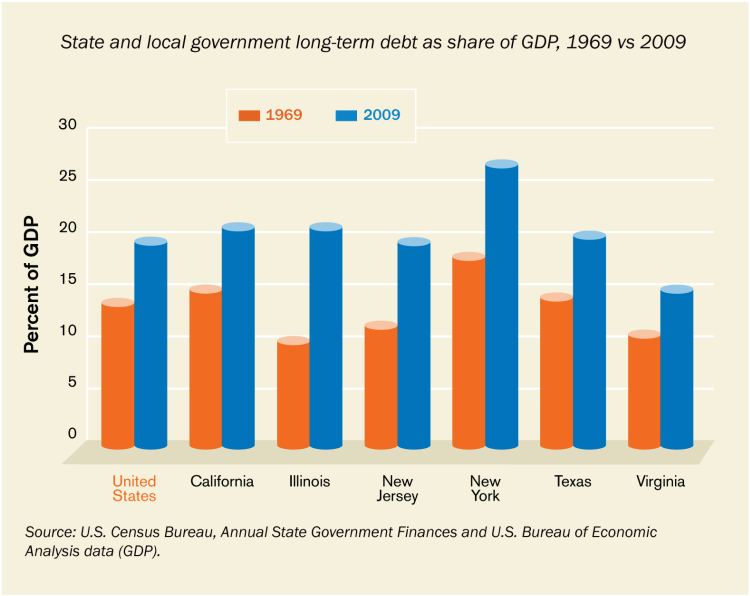
A look at the purposes of the debt shows that most of the growth has been in debt for infrastructure purposes rather than for the budgetary borrowing that can be so dangerous to state finances.

The growth in debt was fueled by population growth, new purposes such as housing, and expansion of traditional infrastructure purposes such as water and wastewater. We measure debt across all governments in a state because different states assign functions to different levels of government. For example, California finances much school construction at the state level while all of it is financed locally in Texas.

State Net Tax Supported Debt

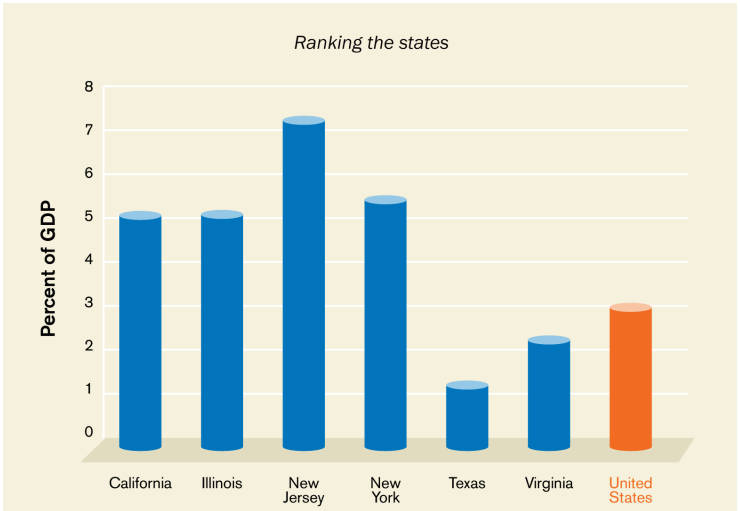
Moody's Investors Service annually publishes a report called "State Debt Medians." This report focuses on debt supported by state government tax revenue that could be used for other purposes if it were not assigned to service debt. Moody's makes judgments about what is and what is not tax supported. These judgments do not always agree with the views of the states but Net Tax Supported (NTS) debt gives us a common measure across states. For all states, NTS debt is relatively small as a percentage of state GDP as shown in Figure 26. Four of our study states are above the national average and rank in the top ten. The level of state NTS debt is much lower than the levels of debt usually associated with government debt crises, as occurred with New York City in the 1970s and as currently is a problem for several European Union countries. As noted above

Figure 25 | State and local government long-term debt has risen substantially



Source: U.S. Census Bureau, Annual State Government Finances and U.S. Bureau of Economic Analysis data (GDP).

Figure 26 | Net tax supported debt as a percentage of state GDP, 2011



Source: Moody's Investor Service, 2012 State Debt Medians Report and U.S. Bureau of Economic Analysis data (GDP).

the NTS debt data reflect choices about which level of government will finance different public expenditures so comparisons across states must be made carefully. The long -term general obligation bond ratings of each of our study states is investment grade as shown in Table 22.

Table 22 | State net tax-supported debt

Total and Per Capita NTS Debt and State Ratings, 2011					
State	Total NTS Debt ($ Billions)	Rank	Per Capita NTS Debt	Rank	Rating
California	$96.436	1	$2,559	9	A1
Illinois	32.999	4	2,564	8	A2
New Jersey	34.971	3	3,964	3	Aa3
New York	62.441	2	3,208	5	Aa2
Texas	15.104	9	588	39	Aaa
Virginia	9.466	15	1,169	21	Aaa
United States	**$509.500**		**$1,408**		

***Source**: Moody's Investors Service State Debt Medians Report 2012.*

Security for State Long Term Debt

The growth of so called "appropriations debt," for which payment of debt service is subject to appropriation by state legislatures, has been called a weakness in state credit structures. As a practical matter, however, all debt service is subject to appropriations except in cases in which a specific revenue stream, such as a dedicated tax, has been pledged without need of further appropriations. In some states — New York is a prime example — it is not permissible to bind future legislatures by pledging specific tax revenues in this non-discretionary manner. New York is required to make annual appropriations of debt service even where revenues are dedicated.[212]

While the need for periodic appropriations of dedicated revenues makes appropriation debt pledges less robust, in theory, than a non-discretionary dedication, Standard & Poor's (S&P) does not criticize the use of this debt if the pledge of revenue is extremely secure.[213] S&P ranks priority of payment as more important than the overall nature (such as general obligation versus other type of obligation) of the pledge.

Short Term Debt and Use of Derivatives

Many governments have mismatches between revenues and expenditures at various times within a single fiscal year. To deal with negative cash flow produced by mismatches, states borrow internally or externally—internally under state statutes by using balances in one fund to provide temporary assistance to another fund or externally from credit markets or financial institutions. In either case, such borrowing is designed to be repaid within the current fiscal year. Some states borrow at multiple times during the year, while others borrow near the beginning of a fiscal year and repay near the end.

Sometimes the need for cash-flow borrowing simply reflects the timing of revenues and expenditures. For example, states with a fiscal year ending on June 30 often have "backloaded" revenue because income tax collections tend to be highest in the April-June quarter, when income tax returns typically are due. In other cases, the need for cash flow

borrowing can build up over time if a government is delaying payments from one fiscal year into the start of the next, or is manipulating cash flow in other ways. This can be a sign of fiscal danger.

External borrowing for short-term purposes varies dramatically across the states in our study; furthermore, it may vary from year to year, depending on prior-year fund and cash balances and current-year revenue and expense requirements. For example, on June 30, 2011, California had more than $18 billion in internal funds available to provide resources to the general fund for intra-year borrowing. Despite the availability of these internal funds, the state dramatically increased its short-term external borrowings in fiscal years 2009 and 2010 because of the large fund balance deficits it was experiencing.

In New York State, negative cash flows and the need for "spring borrowing" were eliminated with the creation of the Local Government Assistance Corporation (LGAC), which borrowed long term to finance payments to local governments that otherwise would have been paid from the general fund, thereby freeing up general fund resources. This strategy, while more expensive than short-term borrowing, eliminated the need to conduct a large cash flow borrowing at the start of each fiscal year.

Texas recently has increased its short-term borrowing, largely as a result of school finance reforms enacted in 2006 that significantly increased state levels of school funding and, thus, magnified timing imbalances. The increased spending was not fully paid for with new taxes or spending cuts; so, with the recession, there also arose a structural gap in state funding. This gap, along with the decline in state revenues during the downturn, has produced a larger spending imbalance that requires heavier short-term borrowing.

Illinois has historically relied on short-term borrowing for cash flow purposes. The state has also delayed payment to creditors, especially in the health care area, as a means of managing cash through increasing deficits. In December, 2010, the state issued $1.5 billion in long-term debt under the Master Tobacco Settlement Agreement; the bond proceeds were used to settle unpaid bills and, so far, have eliminated the need for short-term borrowing in fiscal year 2012.

For each state in the study, we reviewed the use of variable rate debt and derivatives. We found very little use of variable rate debt for long term purposes. Derivatives were used almost exclusively in commercial functions to offset risk of interest rate or commodity price fluctuations.

Use of Debt as a Budget Gimmick

States have used two major types of borrowing as budget gimmicks. The first is direct borrowing from external sources especially where the debt service puts a claim on revenue over many future years. For example California still had outstanding more than $6 billion in "Economic Recovery Bonds" at the time of the submission of the Governor's 2012-13 budget in January. These bonds were first issued in 2004 to finance a gap in the state budget. While the state is committed to repaying these bonds relatively quickly, the funds used for debt service payments could have been used for other purposes.

Another example of external borrowing is securitization of the tobacco settlement to balance budgets. This was done by Illinois, New Jersey, and New York. Yet another example of external borrowing for budget relief was pension obligation bonds of the state of Illinois.

The second type of borrowing gimmick is borrowing from funds of the state or from payees due state expenditures. California had cumulative borrowing from other funds, additional borrowing from payees including local governments and school districts of $23 billion and external borrowings estimated at a total of $28 billion at the time of passage of the state's 2012-2013 budget. Governor Brown refers to this as a "wall of debt" and is committed to seeking repayment. Similarly, Illinois has delayed payments to vendors approximating $9 billion.

Both internal and external borrowings can put a state at risk of serious financial emergencies if it has a budget gap and loses market access at the same time. Also these borrowings are among the factors that rating agencies use in assessing the credit worthiness of a jurisdiction and can lead to downgrades.[214]

Debt Conclusions

Debt is essential if states are to invest in the infrastructure they need and smooth out cash flows within fiscal years. While debt has grown substantially in recent decades, most states remain highly creditworthy; the primary restraint on debt for infrastructure has been an unwillingness to provide revenue streams to support the debt, such as taxes or tolls, rather than excessive debt levels. Debt can be misused, however, and financing deficits, particularly using debt as if it were an element of revenue, generally is bad financial and budgetary practice.

Conclusions and Recommendations

The recent recession and financial crisis have exposed both structural problems in state budgets and the increasingly pro-cyclical nature of these budgets. States and their localities face major challenges due to the aging of the population, rising health care costs, unfunded promises, increasingly volatile and eroding revenues, and impending federal budget cuts.

If these problems are not addressed soon, they are likely to worsen. The problems affect the national interest and require the attention of national policymakers. In addition, each state can sharpen its fiscal tools to improve its own decision-making process.

- The public needs transparent, accountable state government finances. States and standards-setting and advisory bodies should develop and adopt best practices to improve the quality of planning, budgeting, and reporting.
    - States should replace cash-based budgeting, with modified accrual budgets so the public and legislators can easily discern how revenues earned in the fiscal year relate to obligations incurred in the same year. This change won't eliminate budget gimmickry but will be a step in the right direction, particularly if accounting standards continue to be strengthened. In addition, states should publish information,

together with their budgets, on the extent to which these budgets rely on temporary resources and underfund annual required contributions for pension and retiree health plans.

  - States should enact multi-year forecasts and plans that extend at least four years beyond the current budget year, in order to increase their ability to make better short-term decisions and improve long-term outcomes. States should encourage independent review of their budget forecasts. Above all, states need rules that encourage them to adhere to these plans, so that the longer-term consequences of budgetary decisions become apparent.

  - State Comprehensive Annual Financial Reports should be supplemented with easily accessible summaries of financial information and should be issued more quickly after the end of the fiscal year, so that they are available before the next year's budget is proposed; the private sector accomplishes this task regularly.

- States should strengthen and make better use of their main tool for counter-cyclical policy, their rainy day funds. They need to save larger amounts automatically. Also, to avoid discouraging the use of these funds, states should allow enough time to replenish them once a fiscal emergency is over. Successful state models of rainy day funds, like those in Virginia and Texas, should be promoted, disseminated, and replicated. It is in the national interest that states have effective rainy day funds so that state balanced-budget imperatives do not counteract efforts to spur national economic recovery and so that states can maintain more-stable tax and spending policies, particularly for the programs implemented by states under federal oversight.

- Pension systems and states need to account clearly for the risks they assume and more fully disclose the potential shortfalls they face. States and retirement systems should develop and adopt rules for responsible management of these systems and mechanisms to ensure that required contributions are paid. States should begin to use dedicated systems of reserves to save for the ongoing health benefits they expect to provide to retirees and should monitor the ability of their local jurisdictions to do the same.

- State tax bases have eroded and become more volatile; these developments are undermining fiscal sustainability. States should mitigate these trends by seeking reforms that would make their tax structures more broad-based, stable and productive. The federal government should exercise its authority to make it easier for states to collect existing sales taxes on goods and services sold over the internet. Federal tax reform needs to take account of the significant effects of such change on state and local tax systems.

- Federal deficit reduction and budget balancing actions pose serious potential threats to state and local government economies and budgets. There is a "disconnect" between the federal government and the states, with no formal mechanism for evaluating the impact of proposed federal policies on the states. There should be a permanent national-level body to consider the ways in which federal deficit reduction or major changes in the federal tax system will affect states and localities. Such a body, with purposes similar to those of the former Advisory Commission on Intergovernmental Relations, should conduct careful, ongoing examination of the relationship between federal and state governments. Even before such a body is established, Congress should require the Congressional Budget Office to prepare analyses of the ways in which major legislative proposals,

whether relating to mandated programs, discretionary programs, or tax revenue, are likely to affect the fiscal situation of state and local governments.

- Federal and state governments should work together to control health care costs and Medicaid costs. State costs for existing Medicaid programs are likely to continue to grow faster than state revenues; many states already consider these costs unaffordable unless they scale back other essential functions or substantially raise taxes. Now that the Supreme Court has validated most of the Affordable Care Act, states that implement eligibility expansions will incur additional annual costs over the next eight years that could range from zero to five percent of baseline Medicaid spending.

- Few state governments have effective procedures for monitoring the fiscal condition of their local governments in a timely manner or taking early action to help local governments resolve their fiscal problems before they threaten insolvency or bankruptcy. Most states either ignore such problems altogether or wait until local governments actively seek state help because they are on the brink of insolvency. Fortunately, a few states have well-established monitoring and early intervention procedures that can serve as models for other states. North Carolina, New Jersey, Kentucky, Pennsylvania and Michigan are examples worth careful study.

- Essential state and local infrastructure is starved of funding and necessary maintenance. This underfunding threatens the nation's competitiveness; the longer it is ignored, the larger the problem it will pose. An essential first step toward mitigating the problem will be the adoption and funding by states of realistic annual capital budgets based on multi-year capital plans.

Report of the State Budget Crisis Task Force | FULL REPORT

Appendices

The Politics of Budget Decision-Making

The effort to achieve an annual or biennial balanced budget is a major political and governing event in the states. This effort is made by elected officials in an environment that breeds caution, encourages short-term budget-balancing contrivances, and discourages investment for the future.

Forty-nine states legally require a balanced budget, but these requirements are seldom legally enforceable. Constitutions and statutes do not contain definitions of "revenue" and other key terms, and malleable cash or "checkbook" accounting is often the measure of balance. The greater significance of a balanced budget requirement is political. Balanced budgets are expected, and their pursuit is an aspirational goal by which political performance can be assessed. Therefore, there is often a resort to "one-shots" that use nonrecurring revenues to fund recurring expenditures, an approach that can work in the short term but makes true balancing of resources and commitments illusory.

A balanced budget requirement shapes the political dialogue for state elected and appointed officials and the many citizens with stakes in the way the government taxes, spends, borrows, and invests. Politics is the struggle for power, and budget-making epitomizes such struggle. Political nature, like human nature, does not change. Budgets allocate political power as much as revenues, and the political budget contest reflects a state's political as much as its economic circumstances.

Budget-making is characterized by predictable political impulses filtered through the legal structure and traditions in a state. For example, when there is a division of power, either between the legislature and the governor or between the two houses of the legislature, compromise becomes essential to achieve balance; contrivances that mask true distortive future costs, such as sale-leasebacks, often lubricate budget agreements. Another prevalent tendency is the effort to blame political rivals for choices that cause pain to favored constituencies. This "lay-it-off" politics occurs more frequently when political control is divided. Moreover, politicians seek to avoid blame as much as they like to lay it off; so, they make the least politically difficult choices.

In most states the budget process is driven by the governor. Some states have strong gubernatorial models, but the efficacy of legal and institutional power depends on political power. For most politicians, power is maintained by caution. Strong-willed governors who have great political acumen can achieve remarkable reforms, but political behavior usually returns to the mean.

In stressed times, the legislative denial reflex becomes an especially rigid barrier to fiscally sound budgets. There is a natural tendency to ignore difficult facts and the need for decisive action. It is assumed that next year will be better - so that muddling through is acceptable for the current year, especially since legislators know that the governor is constitutionally obligated to present a balanced budget in the ensuing period. He or she will take the initial blame for hard choices proposed.

Significantly, no state is required to enact a spending plan beyond its annual or biennial budget. When balance has only short-term importance, the natural tendency is to have a short term spending focus. This tendency is reinforced by the political tendency to focus on the short term: Elected officials do not govern in the long term. This combination makes it more difficult to invest in education, infrastructure and other needs that require spending commitments in the present budget period but deliver returns only in future periods. Similarly, it can be unattractive to set aside funds in the current budget period for long-term promises such as pensions and health care benefits.

How State and Local Government Finances Are Structured

To understand threats to state fiscal sustainability, it is important to understand how state finances are structured and how states fit into the federal-state-local fiscal system.

The Federal-State-Local Fiscal System

The federal government is generally responsible for financing and delivering virtually all national defense and most services relating to economic security, particularly Social Security and programs that redistribute income. In addition, it finances Medicare, which provides health insurance for the elderly. State and local governments have little involvement in these areas but play major roles in financing and delivering education, health care and other safety net services for the needy, as well as public safety and the vast majority of planning, financing, building, operation, and maintenance of infrastructure. The federal government provides significant financing for some programs that states administer, particularly Medicaid, (the federal-state program that finances health care for the poor and medically needy), other social safety net programs, and highway infrastructure.

State and local governments around the country vary enormously in the ways they finance and deliver services. For example, Hawaii has the nation's only statewide public education system; the state pays more than 80 percent of the cost. Near the other extreme, state aid in Illinois covers only 29 percent of the direct cost of elementary and secondary education; but, unlike many other states, Illinois is responsible for pension contributions for locally employed teachers.[215]

State tax systems also exhibit extreme differences. On average, the personal income tax is the largest state revenue source; but nine states - including Texas, one of the study states - have no broad-based income tax. The sales tax is the second-largest revenue source overall, but five states have no broad-based sales tax. Two states – Alaska and New Hampshire – have no broad-based sales or income tax.

Local governments vary even more than states. Some localities, like New York City, finance and deliver virtually all local services, including elementary and secondary education, public safety, local roads, and water and sewer services. Others finance and deliver only a single service, such as education or fire protection. Unlike states, most local governments depend heavily on property taxes. Most do not rely on broad-based income taxes - although a few large cities have them, and local income taxes are common in several states.[216] Local governments in a few states rely greatly on sales taxes.

There are a few broad patterns, with many exceptions and variations. State and local governments jointly finance most elementary and secondary education spending, and local school districts tend to deliver education; the federal role has traditionally been minor. The largest expenditure items in the typical state budget are Medicaid, elementary and

secondary education, higher education, transportation, and corrections. Most state government spending on elementary and secondary education is aid to local school districts.

In addition to delivering elementary and secondary education, local governments are primarily responsible for public order, delivering firefighting services and the vast majority of police services as well as garbage collection and water and sewer utilities - services that generally benefit local residents and vary from place to place according to local needs and preferences.

States receive roughly a third of their revenue from the federal government, and about 60 percent of that is for Medicaid. Local governments receive only about four percent of their revenue directly from the federal government, although they benefit from federal grants that flow to them through state governments. Local governments receive about a third of their revenue from state governments, with school aid accounting for the largest share.

States play a large role in defining, overseeing, and financing the work of government – creating many of the rules and mandates, raising money through taxes, and providing financial assistance. They also define, oversee, and finance much work done by the private sector, particularly in the delivery of health care. Local governments are the workhorses of service delivery: They employ approximately 14 million workers, compared with the five million workers employed by state governments.

Table 23 shows state and local expenditures in 2009, the latest year for which comprehensive data are available, divided between direct payments for goods and services and payments to other governments, such as aid to local schools.[217]

Table 23 | Expenditures of state and local governments

Composition of state and local government expenditures in fiscal year 2009				
	State	Local	State	Local
	($ Billions)		*(% Share)*	
General expenditures	**$1,556**	**$1,426**	**100.0%**	**100.0%**
Intergovernmental payments to local schools	310	-	19.9%	0.0%
Intergovernmental expenditures other than aid to local schools	182	15	11.7%	1.1%
Direct expenditures (not including payments to other governments)	**1,065**	**1,410**	**68.4%**	**98.9%**
K-12 education	8	569	0.5%	39.9%
Higher education	196	39	12.6%	2.7%
Public welfare	**379**	**52**	**24.4%**	**3.6%**
Vendor payments (includes most Medicaid)	317	6	20.4%	0.4%
Other public welfare	62	46	4.0%	3.2%
Public health, and hospitals	97	121	6.2%	8.5%
Highways	91	61	5.8%	4.3%
Police	12	81	0.8%	5.7%
Corrections	48	27	3.1%	1.9%
All other	234	460	15.0%	32.3%

***Note**: Intergovernmental expenditures between state and local governments must be excluded to obtain total state and local government expenditures without double counting.*

***Source**: Task Force analysis of data from U.S. Bureau of the Census.*

As Table 23 shows, school aid (intergovernmental payments to schools) and Medicaid-related spending (vendor payments) are the two largest state government spending items. When state finances are in trouble, these functions are invariably targeted for cuts.

Table 24 shows the revenue structures of state governments in the nation as a whole.[218] Most states rely heavily on economically sensitive taxes such as the income tax and the general sales tax. Local governments rely more on the traditionally stable property tax. When the economy weakens, state taxes tend to fall further and faster than local government taxes.

Table 24 | Revenue structures of state and local governments

Composition of state and local government revenue in fiscal year 2009				
	State	Local	State	Local
	($ Billions)		*(% Share)*	
General revenue	**$1,496**	**$1,408**	**100.0%**	**100.0%**
Intergovernmental revenue from federal (Medicaid is largest component)	476	61	31.8%	4.3%
Intergovernmental revenue from state (predominantly school aid)	-	471	0.0%	33.4%
Intergovernmental revenue from local	20	-	1.3%	0.0%
Own-Source revenue	**1,000**	**877**	**66.9%**	**62.3%**
Taxes	**715**	**556**	**47.8%**	**39.5%**
Property tax	13	411	0.9%	29.2%
Individual income tax	246	25	16.4%	1.7%
General sales tax	229	62	15.3%	4.4%
Selective Sales taxes	116	27	7.7%	1.9%
Corporate income taxes	39	7	2.6%	0.5%
All other taxes	73	24	4.9%	1.7%
Charges	161	228	10.8%	16.2%
Miscellaneous	123	93	8.2%	6.6%

***Note**: (1) Intergovernmental revenue between state and local governments must be subtracted to obtain total state and local government revenue without double counting; (2) Intergovernmental revenue from federal government includes some revenue received under the federal stimulus program.*

***Source**: Task Force analysis of data from U.S. Bureau of the Census.*

States vary enormously in their levels of spending and taxation, reflecting cultural, political, economic, and demographic differences. Per capita expenditures in the six study states range from 42 percent above the U.S. average (New York) to 14 percent below the average (Texas). The states also differ in the ways they split responsibilities between state and local governments (See Table 25.)

Table 25 | Expenditures vary enormously in the study states

Expenditures per-capita in study states, 2009							
	California	Illinois	New Jersey	New York	Texas	Virginia	United States
	Per-capita expenditures						
State & local government spending	**$9,168**	**$7,861**	**$9,185**	**$11,399**	**$6,854**	**$7,224**	**$8,017**
State government spending	5,666	4,464	5,483	6,912	3,909	4,733	5,039
State government direct-spending	3,118	3,277	4,217	4,068	2,746	3,257	3,448
State aid to local governments	2,548	1,187	1,267	2,844	1,163	1,476	1,591
Local government spending (including funds received from state)	6,050	4,584	4,969	7,331	4,108	3,967	4,568
	Per-capita expenditures compared to average for all states (US=100)						
State & local government spending	**114.4**	**98.1**	**114.6**	**142.2**	**85.5**	**90.1**	**100.0**
State government spending	112.4	88.6	108.8	137.2	77.6	93.9	100.0
State government direct spending	90.4	95.0	122.3	118.0	79.6	94.5	100.0
State aid to local governments	160.1	79.6	79.6	178.7	73.1	92.8	100.0
Local government spending (including funds received from state)	132.4	100.3	108.8	160.5	89.9	86.8	100.0

***Note**: Spending measure is "general expenditures" as defined by the Census Bureau. It is a broad measure of spending from all funds, including federal funds.*

***Source**: Task Force analysis of data from U.S. Bureau of the Census.*

State taxation levels vary enormously relative to personal income, a broad measure of the economy. States with higher per capita spending generally raise more tax revenue relative to their economies. In New York, local governments (dominated by New York City) raise more tax revenue than the state government, while in California the state government raises almost half again as much as local governments (See Table 26.)

Table 26 | Tax revenues vary enormously in the study states

Taxes as percent of personal income in study states, 2009							
	California	Illinois	New Jersey	New York	Texas	Virginia	United States
	Tax revenue as % of personal income						
State & local government tax revenue	11.1	10.8	11.7	15.0	9.5	9.2	10.7
State government tax revenue	6.6	5.6	6.3	7.2	4.6	4.9	6.0
Local government tax revenue	4.5	5.2	5.5	7.8	4.9	4.3	4.7
	Tax revenue as % of personal income, compared to average for all states (US=100)						
State & local government tax revenue	104.1	101.3	110.0	140.5	89.3	86.1	100.0
State government tax revenue	110.2	93.1	104.4	119.3	76.9	80.8	100.0
Local government tax revenue	96.3	111.9	117.3	167.8	105.3	93.0	100.0

Source: *Task Force analysis of data from U.S. Bureau of the Census and U.S. Bureau of Economic Analysis.*

Implications for Fiscal Sustainability

The composition of revenue and expenditures, and how it varies across states, is crucial to the fiscal sustainability issues discussed in this report. For example, Medicaid expenditures are growing rapidly and make up a large share of virtually every state budget. Federal grants and reimbursements, a likely target of federal deficit reduction efforts, are more important to state governments than to local governments. Income tax revenue, which is increasingly volatile, is more important to states than to local governments and more important in some states than others. Sales tax revenue, which has been eroding, is important to both state and local governments and more important in some states than others. State education aid is a large share of both state spending and local revenue; thus, it is a target of state budget-cutting efforts, which will have significant impacts on school districts. Local governments rely heavily on property taxes, placing them at special risk when housing prices turn down.

How Big Is a State Budget?

States are complicated financial entities with many activities conducted through far-flung organizations, some of which are legally separate from the main government. Traditional state agencies, reporting directly to a governor, do much of the work of government; but states conduct other activities through quasi-independent organizations such as lotteries, bridge authorities, power authorities, state universities, and workers compensation and mortgage insurance funds. Some states even run liquor stores. States' elected leaders have varying degrees of legal, financial, and political responsibility for these organizations; but the entities often fall outside the normal state budgetary process.

States prepare their budgets using separate funds designed to isolate activities and their financing, in part to create legal and financial accountability. For example, many states have road or transportation funds that receive motor fuel tax revenue and make payments for transportation projects. The biggest fund in most states is the general fund, which receives most state tax revenue and finances services that do not have a dedicated revenue source. The general fund is both the focus of budget debates and the fund that under state law must ordinarily be balanced to the extent that balance is defined. Sometimes the general fund consists of many sub-funds and accounts.

Table 27 shows several measures of state spending in the study states in 2010. The first row shows spending from the general fund, as reported in the state's Comprehensive Annual Financial Report (CAFR). Every state issues a CAFR – an audited report on the state's financial condition, prepared under guidelines developed by the Governmental Accounting Standards Board, a non-profit standards-setting body. The general fund is the narrowest measure of state finances and the primary focus of budget-balancing debates. The second row shows a much broader measure, also from the CAFR – "all governmental funds." This category includes the general fund, dedicated funds like highway funds, funds used to account for money received from the federal government, and funds that account for debt and capital. This is a much broader measure, more than twice as large as the general fund in four of the study states. Often, some or all of this larger measure is also a part of the budget process, even though it is not subject to the same budget-balancing requirement as the general fund.

The third row shows expenses of the "primary government." It generally includes the same activities as governmental funds but throws a still broader net in capturing the costs of delivering services, including some costs incurred within the fiscal year that will be paid only in future years with future resources.[219] This measure is anywhere from eight to 33 percent larger than governmental funds spending, depending on the state.

For comparison, the fourth row shows state "general expenditures" as defined by the Census Bureau, accounted for largely in the same manner as governmental funds. It is similar in definition and size to governmental funds expenditures. Finally, the table shows the budgetary basis general fund as a percent of governmental funds and as a percent of the primary government.

Table 27 | The state general fund budget is only about 30 to 65 percent of the state's total finances

State government finances in fiscal year 2010 by different measures						
	California	Illinois	New Jersey	New York	Texas	Virginia
	Billions of dollars					
General fund expenditures, budgetary basis (CAFR)	$87.55	$26.30	$31.89	$46.42	$77.99	$15.52
Governmental funds expenditures per statement of revenues, expenditures, and changes in fund balances (CAFR)	190.74	58.22	50.13	128.57	90.41	31.33
Primary government expenses, per state of activities (CAFR)	230.02	69.85	62.99	154.52	120.14	33.83
General expenditures (Census Bureau)	210.36	59.25	49.25	138.00	102.37	38.15
	Relationships among measures					
General fund as percent of governmental funds	45.9%	45.2%	63.6%	36.1%	86.3%	49.6%
General fund as percent of primary government	38.1%	37.7%	50.6%	30.0%	64.9%	45.9%

Source: *Task Force analysis of data from U.S. Bureau of the Census and 2010 State Comprehensive Annual Financial Reports (CAFRs).*

States have additional legally separate entities that fall outside the primary government. They are usually outside the day-to-day operating control of elected officials, though they may have boards appointed by governors or legislators. Expenditures by these "discretely presented component units" (not shown in the table) range from 1.7 percent of primary government spending in Texas to 37 percent in Virginia. An example of a discretely presented component unit is the Thruway Authority in New York, which built and operates the state Thruway and conducts many additional government-related functions. It is legally separate from the state, but its board is appointed by the governor with the advice and consent of the state Senate. It is not included in the primary government in Table 28 but is presented separately in the state's CAFR.

As the table makes clear, the general fund is much smaller than the state government broadly defined; and the relationship of the general fund to the rest of government varies greatly across states, ranging from 30 percent of the size of the primary government in New York to 65 percent in Texas. The decision about how to define a state's budgeting entity is complicated and is driven by legal, technical, and political factors. The task of consolidating funds

into a coherent entity can be quite complex. For example, the Fiscal Futures Project in Illinois, for purposes of the models it has developed to forecast the Illinois budget, had to consolidate 380 out of 650 state funds.[220]

This does not mean that all of the myriad operations of government should necessarily be brought into the budget process. Rather, the point is that state finances are complicated and vary significantly from one state to the next. Without a clear understanding of a state's fund structure and how it relates to the budget and broader measures of state finances, it is easy to reach erroneous conclusions.

Endnotes

[1] Previous analyses of state structural gaps include: GAO. State and Local Governments' Fiscal Outlook: April 2012 Update (Washington, D.C.: GAO-12-523SP, April 2012) and Matthew Murray et al. Structurally Unbalanced: Cyclical and Structural Deficits in California and the Intermountain West (Brookings Mountain West; Morrison Institute for Public Policy, Arizona State University, January 2011).
[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.
[3] See, for example, Carmen M. Reinhart and Kenneth S. Rogoff. *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press, September 2009) Charles P. Kindleberger. *Manias, Panics, and Crashes: History of Financial Crises* (New York: Wiley Investment Classics, 2000); James H. Stock and Mark W. Watson, "Disentangling the Channels of the 2007-2009 Recession" (NBER Working Paper No. 18094, May 2012).
[4] New York State. 2012-13 Executive Budget Economic and Revenue Outlook (Albany, NY: New York State Division of Budget, January 2012).
[5] Based on data from the U.S. Census Bureau, Annual Survey of State Government Tax Collections.
[6] In addition, New York has an April 1 fiscal year, while the other income-tax states in the table (those other than Texas) have a July 1 fiscal year. Because income tax returns are due on April 15, shortfalls on tax returns filed in 2009 (on 2008 income) occurred in the final quarter of the 2008-09 fiscal year for July 1 states, but in the first quarter of New York's 2009-10 fiscal year – a year in which tax increases were well in effect. As a result, New York's tax revenue decline as recorded in public data does not look as bad as the underlying tax liability data would suggest.
[7] National Governors Association and National Association of State Budget Officers. The Fiscal Survey of States, Fall 2011. (Washington, D.C.: NGA/NASBO, November 2011).
[8] As reported in Phil Oliff, Chris Mai, and Vincent Palacios. States Continue to Feel Recession's Impact (Washington, D.C.: Center on Budget and Policy Priorities, June 27, 2012).
[9] National Governors Association and National Association of State Budget Officers. The Fiscal Survey of States, Spring 2012. (Washington, D.C.: NGA/NASBO, Spring 2012).
[10] Phil Oliff, Chris Mai, and Vincent Palacios. States Continue to Feel Recession's Impact (Washington, D.C.: Center on Budget and Policy Priorities, June 27, 2012).
[11] Tracy M. Gordon. What States Can, and Can't, Teach the Federal Government about Budgets (Washington, D.C.: The Brookings Institution, March 2012).
[12] Donald J. Boyd. State/Local Employment Up Slightly Since Start of Recession, But Cuts Are Now Underway (Albany, NY: Nelson A. Rockefeller Institute of Government, August 20, 2009).
[13] The American Recovery and Reinvestment Act (ARRA) of 2009, 111th Congress Public Law 5, Section (3)(a)(5).
[14]According to the official recession arbiter, the National Bureau of Economic Research, the recession ended in June 2009.
[15] Although not discernible from the table, Virginia cut state and local government employment between late 2008 and mid-2010, but it has been rising since then and has recovered its losses.
[16] Julian R. Betts and Laurel L. McFarland, "Safe Port in a Storm: The Impact of Labor Market Conditions on Community College Enrollments," *The Journal of Human Resources* 30 (1995): 741-765.
[17] Christopher M. Mullin and Kent Phillippe. Fall 2011: Estimated Headcount Enrollment and Pell Grant Trends (Washington, D.C.: American Association of Community Colleges, December 2011).
[18] Based on employment data for May 2012 from U.S. Bureau of Labor Statistics, Current Employment Statistics.
[19] Private sector employment has recovered somewhat from its trough.
[20] William T. Robinson III, "Rising to Historic Challenge Funding for State Courts, Preserving Justice," *The Judges' Journal* 51 (Winter 2012): 8-12.
[21] "The Judicial System: The Feeblest Branch," *The Economist*, October 1, 2011.
[22] Based on an examination of detailed data from U.S. Bureau of Labor Statistics, Quarterly Census of Employment and Wages.
[23] GAO does not conduct the analysis for individual states, nor does it separate state from local governments.
[24] GAO. State and Local Governments' Fiscal Outlook: April 2012 Update (Washington, D.C.: GAO-12-523SP, April 2012).
[25] For analysis of cuts in real spending per pupil, see: Phil Oliff and Michael Leachman. New School Year Brings Steep Cuts in State Funding for Schools (Washington, D.C.: Center on Budget and Policy Priorities, October 7, 2011).
[26] Lucy Dadayan. Tax Revenues Surpass Previous Peak But Growth Softens Once Again (Albany, NY: Nelson A. Rockefeller Institute of Government, April 2012).
[27] Office of the Actuary, Centers for Medicare & Medicaid Services, 2011 Actuarial Report on the Financial Outlook for Medicaid (Washington, D.C.: Centers for Medicare & Medicaid Services, March 16, 2012).

[28] Beth Fitzgerald, "Think Tank Cautions NJ Needs to Do More to Prepare for Medicaid Surge," *NJ Spotlight*, February 15, 2012.
[29] Richard Ravitch, Lieutenant Governor's Report on Controlling Increases in the Cost of New York Medicaid, Letter to Governor David Patterson, September 20, 2010.
[30] For example, it has the highest percentage of its population uninsured in 2010 according to data from U.S. Census Bureau, Current Population Survey (http://www.census.gov/hhes/www/cpstables/032011/health/toc.htm, Table HI06) and it ranked 45th among the states in total per capita health care expenditures in 2009, according to data from the Kaiser Family Foundation (http://www.statehealthfacts.org/comparemaptable.jsp?cat=5&ind=596).
[31] For example Texas has the highest percentage of its population uninsured in 2010 (Bureau of Labor Statistics and the U.S. Census Bureau. "Table HI06: Health Insurance Coverage Status by State for All People: 2010." Last modified September 13, 2011. http://www.census.gov/hhes/www/cpstables/032011/health/toc.htm) and it ranked 45th among the states in total health care expenditures per capita in 2009 (The Henry J. Kaiser Family Foundation. "Health Care Expenditures per Capita by State of Residence, 2009." Last modified December 2011. http://www.statehealthfacts.org/comparemaptable.jsp?cat=5&ind=596.)
[32] Alice M. Rivlin, "Rethinking Federalism for More Effective Governance," *Publius* 42 (June 2012).
[33] See Tables 2-4 in National Governors Association and National Association of State Budget Officers. The Fiscal Survey of States, Fall 2011. (Washington, D.C.: NGA/NASBO, November 2011).
[34] The table is for federal fiscal year 2010, and thus includes grant spending under the stimulus program, which has since waned, but total grants nonetheless are greater now than in 2010.
[35] Per capita aid to the District of Columbia was $16,436.
[36] These programs are "mandatory" in federal budget parlance because of their entitlement nature. They are not mandatory from the perspective of states – states can choose not to implement Medicaid and thereby not receive associated federal reimbursement.
[37]Jeffrey R. Kling, "The Federal Budget Outlook and Aid to States," (Presentation to the National Lieutenant Governors Association, March 21, 2012).
[38] Commonwealth of Virginia, Senate Finance Committee. Revenue and Budget Outlook (Richmond, VA: Virginia Senate Finance Committee, November 17, 2011).
[39] Peter J. Smith, "Negative: Moody's Says Northern Virginia Powerhouse Now a Liability," *Virginia Statehouse News,* December 8, 2011.
[40] See: Federation of Tax Administrators, State Personal Income Taxes: Federal Starting Points (Washington, D.C.: Federation of Tax Administrators, January 2012).
[41] Jane G. Gravelle and Thomas L. Hungerford. The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening (Congressional Research Service, March 22, 2012).
[42] *Ibid*., page 6, Table 2 (based on Joint Committee on Taxation data).
[43] See Table 4, Rick Olin and Sandy Swain. Individual Income Tax Provisions in the States (Madison, WI: Wisconsin Legislative Fiscal Bureau, January 2011).
[44] Statement by U.S. Senator Orrin Hatch. Hatch Statement at Finance Committee Hearing Examining the Impact of Tax Reform on State & Local Governments (Washington D.C.: The United States Senate, Committee on Finance, April 25, 2012).
[45] The Code of Virginia provides for vesting after five years of creditable service; case law with respect to alternative time frames for vesting is not as clear in the Commonwealth as it is in other states.
[46] This table is based on the U.S. Census Bureau's Annual Survey of State and Local Retirement systems. The survey uses uniform definitions, making the data reasonably comparable across states. However, sometimes the definitions are different from those used by individual states. For example, the table shows five state-administered systems in California, whereas those familiar with California data typically think of three. The difference is attributable to two small systems that the Census Bureau breaks out separately, but are typically combined with CalPERS in California data. Furthermore, the table shows the level of government that administers the systems, not the level that funds it. For example, Illinois has six state-administered systems but funds only five; it administers but does not fund the Illinois Municipal Retirement Fund.
[47] Usually the Census Bureau data match quite closely to numbers from other sources. In the case of New Jersey, a recent bond disclosure document indicated that the market value of assets was $70.5 billion, in comparison to $66.5 billion shown in Table 14. A detailed examination of system-by-system details in the Census Bureau data shows that the difference is primarily in the Police and Fire Retirement System and the Public Employees Retirement System.
[48] State of Illinois, Department of Insurance Public Pension Division. 2011 Public Pension Report (2009-2010) (Springfield, IL: Illinois Department of Insurance Public Pension Division, 2011).
[49] Sometimes the system will maintain separate accounts for each local government employer (multi-employer agent systems) and sometimes they are pooled ("multi-employer cost-sharing plans).
[50] Based on the 2011 actuarial valuation, using the actuarial value of assets.
[51] Based on the 2011 actuarial valuation, assuming the system earns an average return of 7.5 percent per year.
[52] The calculations are straightforward: with an 8 percent discount rate the liability is $31,700/(1.08^15), or $9,993. With a 5 percent rate, the liability is $31,700/(1.05^15), or $15,248.

[53] The precise relationship depends on the duration of the liabilities – when they will be paid. Evidence from several pension plans suggests that an average duration of 15 years is not uncommon. The longer the duration, the greater the difference between liability estimates computed using different discount rates. There are important additional details that enter into debates about valuing liabilities, particularly regarding what should be taken into account in determining future benefits. These details are beyond the scope of this analysis.
[54] GASB Statements 25 and 27 have prescribed the accounting treatment for public pensions.
[55] Jeffrey R. Brown and David W. Wilcox, "Discounting State and Local Pension Liabilities," *American Economic Review* 99 (May 2009): 538-542.
[56] For example, see:
George Pennacchi and Mahdi Rastad, "Portfolio Allocation for Public Pension Funds," *Journal of Pension Economics and Finance* 10 (2011): 221–245;
Donald Kohn. The Economic Outlook*: Speech at the National Conference on Public Employee Retirement Systems Annual Conference* (Federal Reserve Board, May 20, 2008);
Alicia H. Munnell et al., Valuing Liabilities in State and Local Pensions (Chestnut Hill, MA: Center for Retirement Research at Boston College, June 2010); and
Frank Russek, The Underfunding of State and Local Pension Plans (Congressional Budget Office, May 2011).
[57] See, for example, Alicia H. Munnell et al., Valuing Liabilities in State and Local Pensions (Chestnut Hill, MA: Center for Retirement Research at Boston College, June 2010)
[58] See, for example, Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *The Journal of Economic Perspectives* 23 (Fall 2009): 191-210.
[59] Aleksandar Andonov et al. Pension Fund Asset Allocation and Liability Discount Rates: Camouflage and Reckless Risk Taking by U.S. Public Plans? (May 1, 2012).
[60] See GASB Statements 67 and 68, adopted June 25, 2012.
[61] See comment letters at www.gasb.org, particularly from Girard Miller, Alicia Munnell, and Joshua Rauh.
[62] Ed Mendel, "GASB Pension Rules: Sticker Shock Less Likely," *Calpensions*, May 29, 2012.
[63] Alicia H. Munnell et al., How Would Gasb Proposals Affect State and Local Pension Reporting? (Chestnut Hill, MA: Center for Retirement Research at Boston College, June 2012).
[64] Joe Nation, Pension Math: How California's Retirement Spending is Squeezing The State Budget (Stanford, CA: Stanford Institute for Economic Policy Research, December 13, 2011).
[65] As shown in Table 15, major plans are underfunded by approximately $892 billion, using actuarial liabilities largely for 2010 and the market value of assets for a mix of periods including 2010 and 2011. Historically the assets of plans in the Public Fund Survey have averaged about 85 percent of the assets of the universe. If the plans not included in the Public Fund Survey had a similar degree of underfunding, then total underfunding, based on actuarial liabilities, would be approximately $1.048 trillion.
[66] The Task Force examined unfunded liabilities in several different ways, and these numbers are consistent with other published reports. See, for example, Alicia H. Munnell et al., The Funding of State and Local Pensions: 2011-2015 (Chestnut Hill, MA: Center for Retirement Research at Boston College, May 2012). This report examines a sample of plans representing about 85 percent of the assets of the universe of public pension systems. Unfunded liabilities in 2011 for these plans were reported to be approximately $900 billion based on actuaries' estimates (quite similar to the underfunding shown in Table 15), and $2.7 trillion when liabilities were discounted at five percent.
[67] Comparing the market value of assets to actuarial liabilities is imperfect because the timing is not always precisely aligned. The market value of assets is as of the last date of the fiscal year shown in parentheses in the first column. The actuarial liabilities are based on the latest actuarial valuation, which could be a year or more earlier. But the advantage of using the market value of assets, rather than actuarial assets, is that it is a truer measure of funds actually available to pay benefits. So the imperfect market funded ratio generally is a more up-to-date measure of capacity to pay benefits than the more-official ratios often reported on the basis of actuarial assets. A second issue is that the liabilities are based on the plan's assumed interest earnings rather than on a low-risk discount rate. Liabilities valued with a low-risk discount rate easily can be 70 percent or more above those shown here.
[68] New York's state-level plans use the aggregate cost method.
[69] Based on analysis provided by Joe Nation, Stanford Institute for Economic and Policy Research. Investment return data from CalPERS, *General Facts at a Glance*, June 20, 2012, available at https://www.calpers.ca.gov/eip-docs/about/facts/general.pdf.
[70] An ARC usually has two main components: an estimate of what must be contributed to cover the newly accruing benefits of the workforce for a year ahead, known as the normal cost, and an estimate of how much extra money should be contributed to amortize any unfunded liability over a period of years – often 30 years. The normal cost, the amortization component, and their sum, the ARC, usually are expressed as a percentage of payroll. In some circumstances additional adjustments are part of the ARC calculation, but in the typical situation it is the sum of the normal cost plus amortization.
[71] Employer contributions for public agency employers come from local governments, i.e., there is no state contribution.
[72] Task Force analysis of data in Chris Mier, Ann Kibler, and Robert Haidari. 2011 State Pension Funding Review (Loop Capital Markets, December 19, 2011). Additional analysis based on data provided to the Task Force by the Loop Capital Markets.

[73] Commission on Government Forecasting and Accountability, *A Report on the Financial Condition of the Illinois State Retirement Systems*, March 2012.
[74] Chapter 78, P.L. 2011, State of New Jersey, 214th Legislature, approved June 28, 2011.
[75] "Official Statement of the State of New Jersey, Tax and Revenue Anticipation Notes, Series Fiscal 2012C" December 6, 2011, p. I-53.
[76] The New York City plans are outside the scope of this analysis.
[77] Staff Report to the New York State Senate, Select Committee on Budget and Tax Reform. Pension Amortization: Smoothing The Way or Stretching the Limits? (New York State Senate Select Committee on Budget and Tax Reform, December 2010).
[78] Robert Ward. *Pensions and OPEB in New York, Prepared for the Task Force on the State Budget Crisis* (Albany, NY: Nelson A. Rockefeller Institute of Government, March 2012).
[79] Texas State Constitution, Article XVI §67 states: "Financing of benefits must be based on sound actuarial principles. ...The amount contributed by a person participating in the Employees Retirement System of Texas or the Teacher Retirement System of Texas shall be established by the legislature but may not be less than six percent of current compensation. The amount contributed by the state may not be less than six percent nor more than 10 percent of the aggregate compensation paid to individuals participating in the system. In an emergency, as determined by the governor, the legislature may appropriate such additional sums as are actuarially determined to be required to fund benefits authorized by law."
[80] This paragraph paraphrases and quotes partially from Billy Hamilton, "*Pensions and OPEB in Texas,*" Prepared for the Task Force on the State Budget Crisis, January 17, 2012.
[81] Official Statement of the Commonwealth of Virginia, General Obligation Refunding Bonds Series 2012a" February 16, 2012, p. B-34.
[82] Commonwealth of Virginia, Office of the Comptroller. A Comprehensive Annual Financial Report For the Fiscal Year Ended June 30, 2011 (Richmond, VA: Virginia Office of the Comptroller, December 2011), p. 35.
[83] Cory Koedel, Shawn Ni, and Michael Podgursky, Who Benefits from Pension Enhancements? (Washington, D.C.: CALDER Working Paper 76, June 2012).
[84] CalPERS. Addressing Benefit Equity: The CalPERS Proposal (Sacramento, CA: CalPERS, 1999).
[85] Analysis of CalPERS reported investment returns, provided to Task Force by Joe Nation, Stanford Institute for Economic and Policy Research.
[86] See, for example, increases in Missouri (chapter 169 of 1995), and increases in Arizona in 1991, 1992, and 1994.
[87] Results from preliminary analysis conducted for the Task Force by the Center for Retirement Research at Boston College.
[88] Michael R. Dutcher, Annual Report to the Comptroller on Actuarial Assumptions (Albany, NY: Retirement Systems Actuary, August 2011).
[89] Ron Snell. State Pension Reform, 2009-2011 (National Conference of State Legislatures, March 2012).
[90] These standards, issued by the Governmental Accounting Standards Board, are known as GASB Statement 43 and Statement 45. They are not technically requirements, but must be followed for government financial statements to be considered prepared in accordance with generally accepted accounting principles.
[91] Billy Hamilton, "*Pensions and OPEB in Texas,*" Prepared for the Task Force on the State Budget Crisis, January 17, 2012.
[92] We use the term "retiree health care liabilities" interchangeably with Other Post-Employment Benefit liabilities, of which they are the major part. There is no authoritative tally. The most complete tally appears to us to be $607 billion from the 2011 Pew *Widening Gap* report, based on data available for 2007-2010. In 2012, Franzel and Brown estimated unfunded liabilities of state-administered plans were $451 billion based on latest data available as of midyear 2011. Earlier estimates include $441 billion by Clark and Morrill (2010) and $405 billion by GAO (2009). See:
The Pew Center on the States. The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs (Washington, D.C.: The Pew Center on the States, April 2011);
Joshua Franzel and Alexander Brown, "Understanding Finances and Changes in Retiree Health Care," *Government Finance Review* 28 (February 2012): 59-64;
Robert L. Clark and Melinda S. Morrill, *Retiree Health Plans in the Public Sector: Is There a Funding Crisis* (Cheltenham, UK: Edward Elgar, 2010); and
GAO. State and Local Government Retiree Health Benefits: Liabilities Are Largely Unfunded, but Some Governments Are Taking Action (Washington, D.C.: GAO-10-61, November 2009).
[93] There is no comprehensive summation of liabilities in locally administered plans. The Government Accountability Office estimated that liabilities for 39 of the largest local governments were $129 billion in 2009. (See: GAO. State and Local Government Retiree Health Benefits: Liabilities Are Largely Unfunded, but Some Governments Are Taking Action (Washington, D.C.: GAO-10-61, November 2009)). Those governments represented approximately one fifth of local government expenditures in the United States, suggesting that total liabilities in locally administered plans could easily exceed $600 billion. New York City alone reported unfunded OPEB liabilities of $82 billion in 2011.
[94] Based on a review of state CAFRs, CAFRs from OPEB plans, actuarial valuation reports for those plans, and conversations with state and local government officials. This includes plans administered by a state university. Taxpayers need not be liable for this. Future and current students, employees, professors, and other university stakeholders may bear the costs of this. Local

governments participate in some state-administered plans. We do not attempt to distinguish state government liability from local government liability because of the considerable difficulty in making these distinctions. For an effort to distinguish state government liabilities from local government liabilities, see: Sheila Weinberg. The Financial State of the States: 2010 (Northbrook, IL: Institute for Truth in Accounting, May 25, 2012).

[95] Based on a review of current contributions and annual required contributions (ARCs) as reported in government CAFRs and OPEB plan actuarial valuations.

[96] This is based on the ARC as computed for the plan. In what may seem an odd quirk of accounting, most OPEB ARCs are computed using a low-risk discount rate. If a government actually funds an OPEB plan, then under certain conditions GASB guidelines permit discounting of liabilities using an assumed rate of investment return, as is the case with funded pension plans. So if Texas were to fund the Texas ERS OPEB plan, it might calculate liabilities and ARCs using a higher discount rate, in which case the ARC would be lower than that shown in the graph. This may create a small incentive for governments to fund OPEB plans, but as of yet very few governments do so.

[97] For example, in a recent decision pertaining to Orange County employees, the California Supreme Court held that under California law a vested right to health benefits for retired employees possibly could be implied under certain circumstances from a county ordinance or resolution. The case was remanded for closer scrutiny of the subject ordinance.

[98] "West Virginia earns its place as national leader in handling OPEB," *Times West Virginian,* February 22, 2012.

[99] *$203 Billion and Counting: Total Debt for State and Local Retirement Benefits in Illinois*. Illinois Policy Institute, June 20, 2012. Illinois recently passed legislation eliminating free health care for state retirees. It will be on a sliding scale factoring in need and years of service. This will reduce unfunded liabilities but details are not yet available.

[100] For a commonly cited set of principles for tax policy, see National Council of State Legislatures. Principles of a High-Quality State Revenue System (NCSL, June 2007).

[101] 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.

[102] The table shows that the Virginia sales tax base is not as broad as the national average. A Task Force partner in Virginia notes that the sales tax may not be as narrow as it appears because in some cases Virginia excludes goods or services from the sales tax on which it has separate taxes; other states may include these goods or services in their sales taxes. The data in the table have been adjusted by Professor Mikesell to reflect these items as much as practical. For example, they do include the separate motor vehicles tax in Virginia. (Personal correspondence with John Mikesell, May 14, 2012.)

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

[104] They declined from 0.65 percent of GDP to 0.26 percent. Task Force analysis of motor fuel tax receipts data from the Federal Highway Administration (http://www.fhwa.dot.gov/policyinformation/statistics/2010/xls/mf201.xls), and GDP from the U.S. Bureau of Economic Analysis.

[105] Donald Bruce, William F. Fox and LeAnn Luna, "State and Local Sales Tax Revenue Losses from Electronic Commerce," *Center for Business and Economic Research, The University of Tennessee,* April 13, 2009.

[106] Small vendors likely would be excluded under de minimis rules, reducing potential gains to $7 to 8 billion, and leakages due to less-than-full compliance would reduce gains further. But the potential revenue is likely double if catalog sales and others were included. Ibid.

[107] Estimates prepared in some states are lower than those of Bruce, Fox, and Luna. For example, the state of Illinois estimated a potential revenue gain of $153 million in fiscal year 2009 if taxes on internet sales were fully collected. (See: Andy Chupick and Natalie Davila, "A New Method for Estimating Illinois's E-Commerce Losses," Illinois Department of Revenue, February 2009). The comparable number from the Bruce, Fox, and Luna 2009 analysis appears to be about $247 million, after adjusting for the fact that the Illinois estimate was based on a state sales tax rate of 5 percent, whereas the Bruce, Fox, and Luna estimate of $309 million was based on a combined state-local tax rate of 6.25 percent. Both estimates are before accounting for *de minimis* exclusions or allowances for noncompliance. Earlier estimates from Bruce and Fox (see: Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-commerce: Estimates as of July 2004," *Center for Business and Economic Research, The University of Tennessee,* July 2004), cited in the Illinois report, were considerably higher. California estimated total state and local government revenue losses of $1.2 billion in fiscal year 2012 from internet and mail order sales (See: State of California, Board of Equalization. Revenue Estimate: Electronic Commerce and Mail Order Sales, Sacramento, CA: California Board of Equalization, December 6, 2010), compared with the Bruce, Fox, and Luna estimates of $1.9 billion for internet only. So there are considerable differences among estimates, which is not surprising given that direct data on associated tax revenue are not available, but in any event the revenue loss appears substantial.

[108] State of California, Board of Equalization. Revenue Estimate: Electronic Commerce and Mail Order Sales (Sacramento, CA: California Board of Equalization, December 6, 2010).

[109] See: Megan DeMarco, "N.J. Lost $171M in Tax Revenue as a Result of Online Merchandise Sales 2 Years Ago, Study Finds," *NJ.com,* September 29, 2011. A report prepared by Rutgers University provide estimates ranging from $52 million to $608 million

depending on methodology used (see: Nancy Mantell et al., "Estimates of New Jersey Sales and Use Tax Losses Resulting from E-Commerce," *Edward J. Bloustein School of Planning and Public Policy, Rutgers University*, May 2011).

[110] See: New York State Senate. *Enhancing New York State's Fiscal Stability Through a More Rational and Streamlined Sales Tax System* (Albany, NY: New York State Senate Select Committee on Budget and Tax Reform, July 2010); and Robert D. Plattner, Daniel Smirlock, and Mary Ellen Ladouceur, "A New Way Forward for Remote Vendor Sales Tax Collection," *State Tax Notes* 55 (January 18, 2010): 187-197. Also, estimates prepared by the New York City Independent Budget Office for state and local losses in New York City appear to be much lower. See: Eldar Beiseitov. E-Commerce: Eroding City's Sales Tax Revenue (New York City, NY: New York City Independent Budget Office, August 2008).

[111] Billy Hamilton, "*Revenue Volatility and Erosion in Texas,*" Prepared for the Task Force on the State Budget Crisis, November 9, 2011.

[112] The U.S. Supreme Court ruled in the 1992 Quill decision that under current federal law, North Dakota could not compel collection on a remote seller because it would pose an unconstitutional burden on interstate commerce. Quill Corp. v. North Dakota, 504 U.S. 298 (1992). The burden arises in large part because sales tax bases, rates, and other rules vary from state to state and across jurisdictions within states; with 9,600 sales tax jurisdictions nationwide, determining and remitting tax owed can be quite complex, particularly for a business that has minimal contact with a state. Modern software can ease this task, particularly if sales taxes are simplified and made more uniform.

[113] The Court in *Quill* noted that "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve.... Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes."

[114] Nina Manzi. Use Tax Collection on Income Tax Returns in Other States (St. Paul, MN: Minnesota House of Representatives, June 2010 Updated April 2012).

[115] See http://www.streamlinedsalestax.org.

[116] Introduced in 2011 are the Main Street Fairness Act, the Marketplace Equity Act, and the Marketplace Fairness Act. They differ in many ways, including the conditions states would have to meet to gain this authority. See: Sylvia F. Dion, "From Main Street to Marketplace Fairness Acts – Sales Tax 2011," *SalesTaxSupport.com*, November 28, 2011;
Sylvia F. Dion, "Main Street Fairness Act. Is SST the Silver Bullet?," *SalesTaxSupport.com*, August 10, 2011; and
Sylvia F. Dion, "The Marketplace Equity Act: The New Competition on the Block," *SalesTaxSupport.com*, October 25, 2011.

[117] See: Robert D. Plattner, Daniel Smirlock, and Mary Ellen Ladouceur, "A New Way Forward for Remote Vendor Sales Tax Collection," *State Tax Notes* 55 (January 18, 2010): 187-197 and Eldar Beiseitov. E-Commerce: Eroding City's Sales Tax Revenue (New York City, NY: New York City Independent Budget Office, August 2008) for discussions of these issues as they pertain to New York.

[118] These third-party associates or affiliates typically are businesses or nonprofit organizations that link to an online seller's web site from their own site and receive a commission when people click through and buy from the linked site. While the laws are known as "Amazon laws," they apply equally to all similarly situated sellers. See: Michael Mazerov. New York's "Amazon Law": An Important Tool for Collecting Taxes Owed on Internet Purchases (Washington, D.C.: Center on Budget and Policy Priorities, July 23, 2009).

[119] Amazon and other affected sellers opposed the laws aggressively. Overstock.com initially terminated its affiliate programs in New York. Amazon has since taken a more conciliatory stance, arguing that there should be uniform sales tax collection rules for online vendors and beginning to carve out a method by which it would handle collection of sales taxes on behalf of affiliates and has reached agreements with California and New Jersey to collect sales taxes in those states.

[120] Joseph Henchman. California Becomes Seventh State to Adopt "Amazon" Tax on Out-of-State Online Sellers (Washington, D.C.: Tax Foundation, July 1, 2011).

[121] See: Kirk Victor, "Who's Winning the Amazon Tax Battles?" *Governing.com*, November 1, 2011; and
Stu Woo, "Amazon Softens Stance on Taxes," *The Wall Street Journal,* April 27, 2012.

[122] Randall G. Holcombe and Russell S. Sobel, *Growth and Variability in State Tax Revenue: An Anatomy of State Fiscal Crises* (Westport, CT: Greenwood Press, 1997).

[123] 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.

[124] Rick Mattoon and Leslie McGranahan, "Revenue Bubbles and Structural Deficits: What's a State to Do?" (Federal Reserve Bank of Chicago, Working Paper 2008-15, April 2012).

[125] Some studies have examined the question of whether the income tax or the sales tax is more volatile, and there is no clear winner or loser over the long run. See, for example, W. Mark Crain, *Volatile States: Institutions, Policy, and the Performance of American State Economies* (Ann Arbor, MI: University of Michigan Press, 2003) and
Randall G. Holcombe and Russell S. Sobel, *Growth and Variability in State Tax Revenue: An Anatomy of State Fiscal Crises* (Praeger, 1997).

[126] In real terms. Price inflation can keep nominal wages growing.

[127] See CBO. The Budget and Economic Outlook: Fiscal Years 2012 to 2022 (Washington, D.C.: CBO, January 2012) and supplemental tables available at http://www.cbo.gov/publication/42905.

[128] William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," *National Tax Journal* 55 (September 2002): 491-508.
[129] Task Force analysis of U.S. Census Bureau data.
[130] The gap caused by the two-year cyclical decline from 2008 to 2010 exceeded the structural gap that the Government Accountability Office estimates would accumulate over the next 15 years if state and local governments were to stay on their current fiscal path, according to Task Force analysis of estimates underlying GAO. State and Local Governments' Fiscal Outlook: April 2012 Update (Washington, D.C.: GAO-12-523SP, April 2012).
[131] This section draws upon work conducted by the Task Force's partners in the six study states.
[132] Jon D. Vasché and Brad Williams, "Revenue Volatility in California," *State Tax Notes* 36 (April 4 2005).
[133] For example, the tax rates in effect for 2009 through 2011 included a top rate of 8.97 for individuals at $250,000 and above, or couples reporting $500,000 in taxable income. A 7.85 percent rate extended down the income scale, further expanding the number of taxpayers above the permanent-law top rate of 6.85 percent. When the Legislature imposed a similar "surcharge" on high-income taxpayers from 2003 to 2005, the top rate was lower than that just enacted at 7.7 percent and applied to more taxpayers than the new law (the 2003 tax increase applied to all those with incomes of $500,000 or above). Before 2003, the top rates were imposed starting at relatively modest levels of income (in the range of $20,000 to $30,000 from 1961 through 1987, and rising to $40,000 for married couples from 1997 through 2002). While these rates limited the progressivity, they also limited volatility to some extent. From 1919 to 1933, only taxpayers with income above $50,000 paid the state income tax. In 2011, such an amount would represent roughly $871,000 in 1933 dollars. However, in 1934 the threshold was reduced to $9,000, the equivalent of $152,000 today. Until 2003, the top rate consistently applied to middle-income taxpayers. Historical data are from the Department of Taxation and Finance's New York State Tax Sourcebook.
[134] The State's Budget Division has shown concern over the state's dependence in recent years on revenues from the top 1 percent of PIT payers. (Based on email correspondence from Morris Peters to Robert Ward, December 12, 2011.)
[135] *Ibid.*
[136] Donald Bruce, William F. Fox and LeAnn Luna, "State and Local Sales Tax Revenue Losses from Electronic Commerce," *Center for Business and Economic Research, The University of Tennessee,* April 13, 2009.
[137] See: Federation of Tax Administrators, Number of Services Taxed by Category and State (Washington, D.C.: Federation of Tax Administrators, July 2007).
[138] Institute on Taxation and Economic Policy. Building a Better Gas Tax: How to Fix One of State Government's Least Sustainable Revenue Sources (Washington, D.C.: Institute on Taxation and Economic Policy, December 2011).
[139] Byron F. Lutz. The Connection Between House Price Appreciation and Property Tax Revenues (Washington, D.C.: Federal Reserve Board of Governors, September 12, 2008).
[140] Phil Oliff and Michael Leachman. New School Year Brings Steep Cuts in State Funding for Schools (Washington, D.C.: Center on Budget and Policy Priorities, October 7, 2011).
[141] Sean Cavanagh, "States Seek to Boost K-12 Aid as Revenue Recovers," *Education Week*, February 22, 2012.
[142] Alan Schankel. *Core Municipal Sector Has Been Slowed by Recession Induced Revenue Declines. Most Issuers Remain Resilient* (2012 Muni Credit Outlook, Janney Capital Markets, December 8, 2011).
[143] Charles K. Coe, "Preventing Local Government Fiscal Crises: Emerging Best Practices," *Public Administration Review* 68 (2008): 759-767.
[144]By "fund balances" we mean balances as reported in The Fiscal Survey of States, Fall 2011 (Washington, D.C.: NGA/NASBO, November 2011) and comparable documents for earlier years. This includes ending balances as well as rainy day funds. Beginning in 2010 the Fiscal Survey has been reporting on rainy day funds, there is not a time series for rainy day funds for years before 2009.
[145] Rick Mattoon, "Creating a National State Rainy Day Fund: A Modest Proposal to Improve Future State Fiscal Performance" (Federal Reserve Bank of Chicago, Working Paper 2003-20, November 2003).
[146] The Governmental Accounting Standards Board, in its Statement 54, lays out criteria that would allow a government to treat stabilization as a purpose for which fund balance could be restricted or committed. One is that the circumstances for withdrawal need to be sufficiently specific, and the other is that those circumstances should not be the kind that occur routinely.
[147] Not all of these uses were major. For example, the "asset sales" category includes large-scale sales such as highways, as well as sales of smaller real property assets.
[148] Alicia Munnell of the Center for Retirement Research at Boston College examined the universe of pension obligation bonds issued between 1992, when the federal tax exemption for POB interest was eliminated, and 2009. (Munnell, Alicia, Untitled book on state and local pension systems, forthcoming.) She calculated the internal rate of return on each such bond, assuming proceeds were invested in portfolios similar to those of state and local retirement systems. Only bonds issued in 6 years (1992 through 1996, and 2009) out of the 18 analyzed had a positive internal rate of return.
[149] These examples are drawn from work conducted by consultants in the study states and by the central Task Force team.
[150] *Lance v. McGreevey*, 180 N.J. 590.
[151] Some states budget on a basis that is closer to modified accrual, but even that can be subject to substantial manipulation.

[152] Modified accrual accounting, as the name implies, does not fully accrual revenues and expenditures. It comes closer than cash-basis accounting to showing revenues when earned and spending when obligated, but still differs from full accrual in important ways.
[153] For one approach to linking budgets and longer term projections, see: Iris J. Lav, Paygo: Improving State Budget Discipline While Retaining Flexibility (Washington, D.C.: Center on Budget and Policy Priorities, September 22, 2011).
[154] Government Finance Officers Association. Recommended Budget Practices: A Framework For Improved State and Local Government Budgeting (Chicago, IL: National Advisory Council on State and Local Budgeting, Government Finance Officers Association, 1998).
[155] Among others, the proposal was opposed by the National Governors Association; the National Association of State Budget Officers; the National Association of State Auditors, Comptrollers, and Treasurers; the Government Finance Officers Association and many of their state affiliates; the National Association of Counties; the National League of Cities; and the International City/County Management Association. In addition, dozens of individual governments, large and small, including New York City, New York State, Colorado, Vermont, and Wisconsin opposed the proposal. The National Governors Association commented, "NGA strongly believes this project is outside the purview of GASB because it attempts to provide guidance on budgetary information rather than GASB's traditional focus on accounting standards…The recent recession underscores the inherent uncertainty in making fiscal projections; uncertainties that are best dealt with in the context of policy making…". The National Association of State Budget Officers said that "the goals of fiscal sustainability are desirable, but they can be better addressed through other public financial management tools… such as the budget document, the budget process, legislative appropriations process, elections, and public referendums…". See Dan Crippen's Letter to Mr. Robert H. Attmore, Chair of GASB, April 16, 2012.
[156] This is a result, primarily, of GASB Statement 34, which required government-wide financial statements prepare on a nearly full-accrual basis, and Statement 45, which required disclosure of OPEB liabilities, although other pronouncements also have expanded and improved information available in CAFRs.
[157] Dean Mead, The Timeliness of Financial Reporting by State and Local Governments Compared with the Needs of Users (Norwalk, CT: GASB, March 2011).
[158] "Form 10-K," *U.S. Securities and Exchange Commission*, June 26, 2009.
[159] Byron F. Lutz. The Connection Between House Price Appreciation and Property Tax Revenues (Washington, D.C.: Federal Reserve Board of Governors, September 12, 2008).
[160] Property tax growth patterns can be erratic because of changes in payment dates and payment patterns. It is more useful to examine year-over-year growth of revenue averaged over four quarters than to examine growth for individual quarters.
[161] Sean P. Corcoran and William N. Evans, "Equity, Adequacy and the Evolving State Role in Education Finance," in *The Handbook of Research in Education, Finance and Public Policy*, ed. Helen Ladd and Edward Fiske (Routledge, 2007).
[162] It can be difficult to compare higher education spending in California to other states because community colleges are protected under Proposition 98 but the University of California and California State University are not. Figures for total higher education, with community colleges included, can mask some of the deeper cuts to the portion of higher education that is not protected by Proposition 98.
[163] State Higher Education Finance, FY2011 (Boulder, CO: State Higher Education Executive Officers (SHEEO), 2012).
[164] *Ibid*.
[165] 2009 Report Card for America's Infrastructure (American Society of Civil Engineers, March 25, 2009).
[166] Congressional Budget Office. Public Spending on Transportation and Water Infrastructure (Washington, D.C.: Congressional Budget Office, November 2010).
[167] See: 2009 Report Card for America's Infrastructure (American Society of Civil Engineers, March 25, 2009); and
Paying Our Way: A New Framework for Transportation Finance (National Surface Transportation Infrastructure Financing Commission, February 2009).
[168] See: Drinking Water Infrastructure Needs Survey and Assessment 2007: Fourth Report to Congress (Washington, D.C.: U.S. Environmental Protection Agency, February 2009); and
Clean Watershed Needs Survey 2008: Report to Congress (Washington, D.C.: U.S. Environmental Protection Agency, 2008).
[169] The Cost of Rehabilitating Our Nation's Dams. A Methodology, Estimate & Proposed Funding Mechanism (Lexington, KY: Association of State Dam Safety Officials, January 2009).
[170] See: Follow up on Deferred Maintenance in the Commonwealth (Richmond, VA: Commonwealth of Virginia, Auditor of Public Accounts, December 2009); and
Texas Facilities Commission Maintenance Program Review (Austin, TX: Council on Competitive Government, August 2008).
[171] Repair for Success: An Analysis of the Need and Possibilities for a Federal Investment in PK-12 School Maintenance and Repair (Washington, D.C.: 21st Century School Fund, November 16, 2009).
[172] For California, see: Deferred Maintenance Needs of California Public Higher Education (Sacramento, CA: California Postsecondary Education Commission, June 2005). More recent estimates indicate a backlog of about $3 billion, close to $700 million each for UCLA and UC Berkeley. See, for example, Mihir Zaveri "State School's Maintenance Backlog in the Billions," *San Francisco Chronicle*, May 9, 2011.

For Illinois, see: Fiscal Year 2013 Higher Education Budget Recommendations: Operations, Grants, and Capital Improvements (Springfield, IL: State of Illinois, Board of Higher Education, February 2012).
For New Jersey, see: New Jersey's Long-Range Plan for Higher Education (Trenton, NJ: New Jersey Commission on Higher Education, October 2005).
For New York, see: System-Wide Academic, Residential and Hospital Facilities Profile (State University of New York, 2009); and Testimony submitted to the New York State Senate Finance and Assembly Ways and Means Committees on the 2010-11 State Executive Budget Proposal (statement by Matthew Goldstein, CUNY Chancellor, January 27, 2012).
For Texas, see: Testimony submitted to Texas Higher Education Coordinating Board House Appropriations (statement by Fred Heldenfels IV, Chairman, May 8, 2012).

[173] This report focuses on the major types of infrastructure spending by state and local governments in the study states: transportation (roads, bridges, and mass transit), water (drinking water, waste water, and dams), and buildings (general public buildings, elementary and secondary schools, and higher education facilities). It will describe the condition of these assets and, where possible, the estimated funding needs.

[174] Evaluating the exact level of funding needed in each category to address the states' infrastructure needs adequately would require better data collection. However, consistently, the state and national data available indicates the presence of significant gaps between estimated need and actual funding levels. This report highlights current conditions to its best abilities. Additional documentation about the infrastructure in the six study states is available at www.statebudgetcrisis.org along with an extensive analysis of Census Bureau data covering additional categories.

[175] U.S. Department of Transportation, Research and Innovative Technology Administration (RITA). State Transportation Statistics 2010 (Washington, D.C.: U.S. Department of Transportation, 2011).

[176] Bridges are evaluated using the National Bridge Inspection Standards. It utilizes a scale system and categorizes bridges as structurally deficient, functionally obsolete, or deficient. A bridge in the structurally deficient or functionally obsolete category generally will be considered for the Federal Bridge Program for rehabilitation or replacement. See: U.S. Department of Transportation, Research and Innovative Technology Administration. State Transportation Statistics 2010 (Washington, D.C.: U.S. Department of Transportation, 2011).

[177] U.S. Department of Transportation, Federal Transit Administration. National State of Good Repair Assessment, 2010 (Washington, D.C.: U.S. Department of Transportation, June 2010).

[178]Estimates of capital needs were obtained from reports prepared by government or transportation planning organizations. In some cases they prepared estimates that were in constant dollars, in some cases the estimates of future costs were in nominal dollars for those future years, and in some cases the reports do not appear to state what was done. Even when estimates were prepared in constant dollars, the base year would differ from state to state. Cross-state comparison is not recommended as needs may only apply to single parts of transportation while other estimates include various ones such as roads, highways, and mass transit. This report highlights needs to its best abilities. Additional documentation about infrastructure need in the six study states is available at www.statebudgetcrisis.org

[179]U.S. Conference of Mayors. National City Water Survey 2007: The Status of Asset Management Programs in Public Water and Sewer Infrastructure in America's Major Cities (Washington, D.C.: U.S. Conference of Mayors, September 2007).

[180] See: U.S. Army Corp of Engineers. *2010 National Inventory of Dams* (Washington, D.C.: U.S. Army Corp of Engineers, 2012)

[181] U.S. Army Corp of Engineers. Levee Safety Program (Washington, D.C.: U.S. Army Corp of Engineers, 2012)

[182] 21st Century School Fund. PK-12 Public School Facility Infrastructure Fact Sheet (Washington, D.C.: 21st Century School Fund, February 2011).

[183] Mac Taylor. 2011 Cal Facts: California's Economy and Budget in Perspective (Sacramento, CA: Legislative Analyst's Office, January 5, 2011).

[184] Illinois Board of Higher Education. Fiscal Year 2013 Higher Education Budget Recommendations: Operations, Grants, and Capital Improvements (Springfield, IL: State of Illinois, Board of Higher Education, February 2012).

[185] Texas Higher Education Coordinating Board. Capital Expenditure Plans: FY 2012 to FY 2016 (Austin, TX: Texas Higher Education Coordinating Board, July 2011).

[186] Virginia Department of Planning and Budget. Six Year Capital Outlay Plan 2008-2014 (Richmond, VA: Virginia Department of Planning and Budget, January 2008).

[187] Sheldon Edner and Bruce D. McDowell, "Surface-Transportation Funding in a New Century: Assessing One Slice of the Federal Marble Cake," *Federalism and Surface Transportation* 32 (Winter 2002): 7-24.

[188] Joseph Kile. The Highway Trust Fund and Paying for Highways (Testimony before the Committee on Finance, United States Senate) (Washington, D.C.: Congressional Budget Office, May 17, 2011).

[189] Congressional Budget Office. Trends in Public Spending on Transportation and Water Infrastructure, 1956 to 2004 (Washington, D.C.: Congressional Budget Office, August 2007).

[190] U.S. Conference of Mayors. Who Pays for the Water Pipes, Pumps and Treatment Works? - Local Government Expenditures on Sewer and Water - 1991-2005 (Washington, D.C.: U.S. Conference of Mayors, 2007).

[191] These funds accelerated new construction and improvements to highways, bridges, mass transit, and water and energy systems, nationwide. However, because the primary purpose of ARRA was to create immediate jobs, funds went only to projects that were ready for implementation; these projects had been in the pipeline for construction for some time, perhaps because the states themselves considered them to be of lower priority. See: Recovery Act Spending, Breakdown of Funds Paid Out available at: www.recovery.gov.
[192] Institute on Taxation and Economic Policy. Building a Better Gas Tax: How to Fix One of State Government's Least Sustainable Revenue Sources (Washington, D.C.: Institute on Taxation and Economic Policy, December 2011).
[193] U.S. Government Accountability Office. Highway Trust Fund: Nearly All States Received More Funding Than They Contributed in Highway Taxes Since 2005http://www.gao.gov/assets/590/589908.pdf (Washington, D.C.: GAO-10-780, June 2010)
[194] Congressional Budget Office. The Budget and Economic Outlook: Fiscal Years 2012 to 2022 (Washington, D.C.: Congressional Budget Office, January 2012).
[195] *Ibid.*
[196] Supplemental data analysis is available at www.statebudgetcrisis.org.
[197] See: Strategic Plan 2012-2016 (Lexington, KY: Association of State Dam Safety Officials, December 6, 2011); and State and Federal Oversight of Dam Safety Must Be Improved (Lexington, KY: Association of State Dam Safety Officials, October 2011).
[198] The 2011 fact sheet created by the 21st Century School Fund affirms that "the federal share [is] less than 86 cents per 1,000 dollars of state and local spending." See: 21st Century School Fund. PK-12 Public School Facility Infrastructure Fact Sheet (Washington, D.C.: 21st Century School Fund, February 2011).
[199] Of the six states in this study, growth in capital spending in New York and New Jersey was significantly greater than average; growth in California and Texas was above average, and Illinois and Virginia had below-average capital spending growth. Local spending on O&M in all of the study states exceeded the national average growth of 82%, with the exception of Illinois, which was only marginally lower, and California, the lowest-spending study state in this area, at 16 percent below the national average. The only study state with a large amount of state government K-12 capital spending was New Jersey, which also spent more than any other study state government on O&M; in both cases the amount was far greater than the national average. Illinois showed minimal state government real per capita spending from the late 1970s throughout the early 1990s. Most years the spending ranged from less than $1 to about $4, peak was in 1979/80 at around $8. In regard to O&M, Texas and California show consistent spending throughout the years but most recently showed about $11 per capita, while New Jersey spent $236 in 2008.
[200] In some states localities are responsible for community or county colleges.
[201] This study demonstrated the importance of Medicaid receipts to their budgets and health systems.
[202] Stephen S. Fuller "The Impact of Potential Federal Spending Reductions on the Commonwealth of Virginia Economy," (Presentation to the Virginia House of Delegates House Appropriations Committee Annual Retreat, November 15, 2011).
[203] The top state by their measure is Maryland at a 1.39 ratio (to the US average), of deduction share to AGI share. California is 1.3; New Jersey 1.19; New York 1.14; Virginia 1.1; Illinois 0.92, and Texas 0.70. See: Frank Sammartino. Federal Support for State and Local Governments Through the Tax Code (Testimony before the Committee on Finance, United State Senate) (Washington, D.C.: Congressional Budget Office, April 25, 2012).
The states in which taxpayers claim the largest shares of the deduction are states with large populations and, particularly, large populations of high-income itemizing taxpayers. California and New York are heavy weights, with almost one third of all national deductions are located in these two states. Percent of amount claimed for the other four states (2009): New Jersey (5.8%), Illinois (4.0%), Texas (3.6%), and Virginia (3.0%). See: Tax Policy Center, Urban Institute and Brookings Institution. State and Local Tax Deduction by State, 2002-2009 (Washington, D.C.: Urban Institute and Brookings Institution, July 29, 2011).
[204] U.S. Department of the Treasury with the Council of Economic Advisors. An Economic Analysis of Infrastructure Investment (Washington, D.C.: U.S. Department of Treasury, October 11, 2010).
[205] For example, advances in GPS technology, highway cameras, and transponder tags, such as EZ Pass play key roles in systems of pricing.
[206] U.S. Department of Transportation, Federal Highway Administration. Congestion Pricing: A Primer (Washington, D.C.: U.S. Department of Transportation, December 2006).
[207] National Surface Transportation Infrastructure Financing Commission. Paying Our Way: A New Framework for Transportation Finance (National Surface Transportation Infrastructure Financing Commission, February 2009).
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[210] Task Force analysis of detailed debt statements for the six study states provided by Moody's Investors Service.
[211] Moody's. *Moody's State Rating Methodology* (New York City, NY: Moody's, November 2004).
[212] Whether payment could be made in absence of a required appropriation is a different matter, which generally would have to be resolved judicially.
[213] Standard & Poor's. *U.S. State Ratings Methodology* (New York City, NY: Standard & Poor's, January 3, 2011).

[214] Internal borrowings are not included in the tables or graphs in this section, and generally are not reflected in ratios and medians published by the rating agencies.
[215] National Center for Education Statistics. "Table 181. Revenues for public elementary and secondary schools, by source and state or jurisdiction: 2008-09." Digest of Education Statistics. Last modified June 2011. http://nces.ed.gov/programs/digest/d11/tables/dt11_181.asp. Illinois is not responsible for pension contributions for teachers employed in the Chicago Public Schools. Also, as discussed elsewhere, it has not kept up with required contributions.
[216] Local income taxes are particularly common in Maryland, Kentucky, Ohio, Pennsylvania, and Indiana.
[217] Fiscal year 2009 is the first year in which the federal stimulus program, the American Recovery and Reinvestment Act (ARRA), affected state and local finances. The program was enacted in February 2009, which was late in the state fiscal year and funds generally did not begin flowing to states until nearly the end of the year. Still, states were aware of the program and may have adjusted their behavior in light of it. For example, many states had income and sales tax shortfalls late in the 2009 fiscal year. If ARRA funds had not been available early the next year, perhaps they would have cut spending more deeply at the end of 2009. Even so, we do not believe it would have had a material impact on the composition of expenditures, which this table is designed to show.
[218] As with the expenditure table, data shown in the revenue table for fiscal year 2009 may have been affected by ARRA. The U.S. Census Bureau does not identify separately the federal funds received under ARRA, but to the extent funds were received in the final months of 2009 they would have caused the "Intergovernmental revenue from federal" amounts to be higher than in prior years. We do not believe this would make 2009 an unrepresentative year for examining the composition of revenue.
[219] For example, expenses of the primary government include an estimate of retiree health benefits earned by government workers in the current year, even though those benefits may not be paid until many years in the future. For those familiar with governmental accounting, under the rules prescribed by GASB activities shown in governmental funds financial statements are reported on a modified accrual basis, while activities of the primary government reported in the government wide financial statements are more-nearly on a full accrual basis.
[220] Dye, Richard F., Nancy W. Hudspeth, and David F. Merriman. "Why Ignore Over Half of the Illinois State Budget Picture? Consolidation of General and Special Fund Reporting." The Fiscal Futures Project, Institute of Government and Public Affairs, University of Illinois-Chicago. July 2011. http://igpa.uillinois.edu/system/files/FiscalFuturesBudgetTransparencyReport.pdf. The Fiscal Futures Project is housed at the Institute for Government and Public Affairs at the University of Illinois at Chicago. The IGPA served as consultant to the Task Force.

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