

*Report of the  
State Budget Crisis Task Force*

SUMMARY REPORT



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### **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](http://www.statebudgetcrisis.org)



## State Budget Crisis Task Force

### A Statement From the Task Force Co-Chairs

July 17, 2012

**CHAIRS:**

Richard Ravitch  
Paul A. Volcker

**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

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.

## **State Budget Crisis Task Force**

- 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



## *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:

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

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 are grappling with unprecedented fiscal crises. Even before the 2008 financial collapse, many states faced long-term structural problems. Many economists believe that in the aftermath of the crisis, 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. Tax revenues are recovering slowly and remain well below their pre-crisis trends.

Large fiscal pressures loom. The most important demographic force of the next two decades, the aging of our society, is upon us. The first wave of baby boomers is at retirement age. The medically expensive elderly population that is eligible for Medicaid will swell, as will the number of state and local government retirees to whom health benefits were promised. In addition, pension costs will rise as a result of earlier pension underfunding and failure to recognize liabilities, and investment earnings that have fallen below assumed rates of return. Internet shopping is eroding the states' already-narrow sales tax bases. Some states face significant cost pressures for prisons and other spending areas. Extremely volatile income tax revenues bring seesaw swings in state revenues overall. States will suffer greatly if federal budget cuts eventually come their way. In some states, especially where the consequences of a collapsed real estate market persist and residents and businesses are still in trouble, local governments face especially severe fiscal challenges.

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 variations 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.

The study states all suffered considerably after the 2008 financial collapse. One measure of this damage is employment, an important broad-based measure of the economy. Employment in California fell by nine percent from its peak, the largest decline among states in our study. California was followed by Illinois and New Jersey, at 6.9 percent and 6.4 percent employment drops respectively. The declines in New York, Texas, and Virginia were less acute but still in the range of 4 to 5 percent. Tax revenues generally fell much further than employment, reflecting, among other things, significant declines in stock market gains, retail sales, and corporate profits, which drove income, sales, and corporate taxes down sharply. In New York between 2007 and 2009, for example, overall adjusted gross income fell by 18 percent; but capital gains subject to income tax fell by 75 percent. Tax revenues would have fallen sharply but for tax rate increases that the state enacted. Texas does not have an income tax, but its sales tax revenues fell by 9 percent between 2008 and 2010; other tax revenues fell substantially as well. 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, will show considerable revenue growth in 2012.

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 Imbalance**

These problems threaten the states' investments in education and infrastructure and affect the ways in which the states are likely to issue debt. More broadly, these problems threaten states' abilities to provide other essential services, such as their justice systems, welfare, and environmental protection.



## *Six Major Threats to Fiscal Sustainability*

### **Medicaid Spending Growth Is Crowding Out Other Needs**

Medicaid, the single largest spending category in most state budgets, is growing faster than the economy and faster than state tax revenues. This trend will continue as long as health care costs grow faster than the overall economy and Medicaid caseloads continue to increase. According to the federal Centers for Medicare and Medicaid Services (CMS), total Medicaid costs are likely to grow at an average annual rate of 8.1 percent between 2012 and 2020 if the health care reforms in the Affordable Care Act (ACA) are implemented and at a rate of 6.6 percent if they are not. If state Medicaid spending and state tax revenues continue their trends of the past decade, with a 7.2 percent average annual growth for Medicaid and a 3.9 percent growth rate for revenues, the gap between Medicaid and state tax revenue growth will increase by at least \$22 billion annually within five years and will grow even larger thereafter.

Medicaid will face further pressure with the growth of its medically expensive elderly population. The elderly population in the nation increased by an annual average of 1.3 percent in each of the last two decades but is projected by the Social Security Administration to increase by 30 to 35 percent in this decade and the next.

The recent slowing in health care inflation could mitigate this trend, but there can be no assurance that the slowing will continue over the next decade. Most states are trying to find ways to contain or reduce rising Medicaid costs. The states' ability to save is dependent upon federal approval of state Medicaid changes that may restrict access to Medicaid, increase patients' cost-sharing, or reduce payments to health care providers. Further, when the federal government approves state plans to reduce Medicaid costs, the same federal government—because it shares Medicaid costs with the states—will reap half the cost savings. States must therefore find roughly two dollars in federally approved cost savings to produce a dollar of benefit to their budgets.

The rapid growth in Medicaid spending has pushed aside other types of state spending. Medicaid recently surpassed K-12 education as the largest area of state spending when all funds, including federal funds, are considered; Medicaid appears likely to continue to claim a growing share of state resources.

**(See Figure 1.)**

All six states have been struggling to reduce or contain Medicaid costs. California's fiscal year 2012 budget included \$2 billion in proposed Medicaid savings, most of which required federal waivers or other forms of approval. Many items were rejected by CMS and the largest item approved, a 10 percent reduction in

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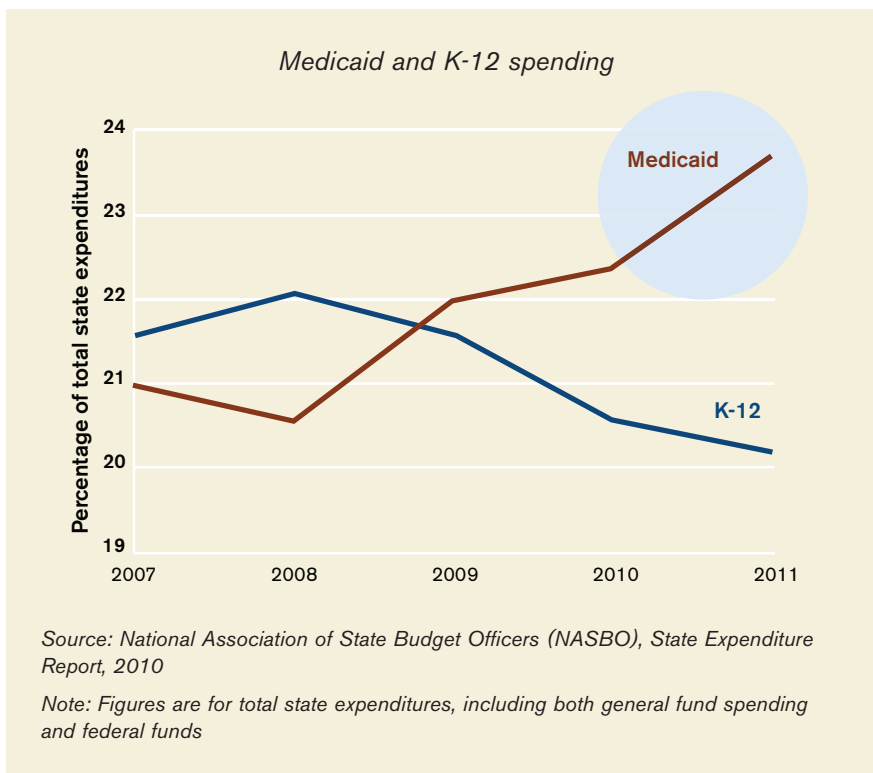
physician payments, has not been implemented due to a lawsuit brought by medical providers. A new \$842 million Medicaid cost saving plan has been included in the fiscal year 2013 budget.

Illinois has accumulated unpaid Medicaid bills estimated to total \$1.9 billion by the end of the current fiscal year which it will roll into the next year. Governor Pat Quinn introduced a \$2.3 billion “saving Medicaid plan” saying “We must act quickly to save the entire Medicaid system in Illinois from collapse.” The legislature has largely enacted the cost reductions in the plan but many parts await federal approval.

New Jersey reports that it has contained Medicaid cost growth over the past six years to an average of 4 percent per year, primarily by moving clients to managed care. A new \$300 million cost reduction plan submitted early in fiscal year 2012 at year-end is pending federal approval. An additional \$400 million in initiatives were rejected or are still pending.

New York Governor Andrew Cuomo has made controlling state spending on Medicaid a major priority. Despite problems in securing timely federal approval, the state has achieved \$973 million in savings for fiscal year 2012 and has a target of \$1.1 billion for fiscal year 2013.

**Figure 1** | Medicaid has surpassed K-12 education as the largest expenditure item in state budgets



Confronted with a large increase in Medicaid spending in fiscal year 2011, Texas slashed overall spending by 15 percent and openly underfunded Medicaid in fiscal years 2012-2013 by appropriating funds for only 18 months of the biennium, creating an estimated shortfall of \$4.8 billion, which will have to be made up before the end of the budget term in September 2013.

Virginia has not tried to eliminate optional benefits and services but has implemented several provider cost saving policies. Governor Robert McDonnell has proposed Medicaid savings of \$260 million in fiscal year 2013 and \$438 million in 2014, for possible savings of 3 to 5 percent of Medicaid spending.

Federal health care reform as recently validated by the Supreme Court will probably increase state Medicaid costs moderately and make the projected imbalance between spending and revenue somewhat worse.

Most research by Medicaid experts predict cumulative annual increases in state costs resulting from ACA implementation ranging from zero to 5 percent over the next eight years. Some states may choose not to expand existing Medicaid coverage under ACA, a choice effectively provided by the recent Supreme Court ruling; but states will continue to be bound by federal maintenance of effort provisions until 2014 for adults and 2019 for children. States are also expected to experience increases in Medicaid enrollment of existing eligible persons who are not currently enrolled, since the universal mandate validated by the Court may provide an additional incentive for them to enroll. The cost of this caseload growth under existing state programs will vary from state to state depending on the size of their eligible but unenrolled population. Other elements of the ACA, however, provide potential savings to states.

Medicaid will continue to place stress on state budgets and possibly crowd out other needed expenditures whether or not states choose to enlarge their programs under ACA. 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.” Both the states and the federal government need to find ways to contain and control Medicaid costs. They should work together to reach mutually acceptable solutions.

### **Federal Deficit Reduction Threatens State Economies and Budgets**

When the federal government takes significant action to reduce its budget deficit, such action could wreak havoc on the states. U.S. states depended on federal grants for 32 percent of their revenue in 2009—though the degree of this dependence varies widely, from 47 percent in Mississippi to 21 percent in Alaska. Federal spending for procurement, salaries, and other items plays a huge role in state economies, particularly in the study states of Virginia, California, and Texas. Reductions in mandatory or discretionary federal grants, federal military and civilian procurement, and federal employment could adversely affect states.

The federal government will also undoubtedly examine the federal tax code for deficit-reducing options, including tax preference items like the deductibility of state and local taxes and interest on tax-exempt bonds. Such deductions tend to benefit higher-income individuals; moreover, the deductibility of tax-exempt interest is a highly inefficient subsidy to state and local governments because they receive only a portion of the tax revenues lost to the federal government, yet scaling back these deductions would raise the states’ cost of capital projects and other services. Scaling back deductibility of state and local taxes would also raise the effective burden of state and local taxes, especially in states, including four of the study states, that base their own tax systems on the federal system.

Because of the same linkage, if the federal government were to expand the income tax base by restricting other types of deductions or exclusions, such action could broaden state tax bases, potentially increasing state tax revenues, but attempts to do so have rarely succeeded in recent years, and no state wants to get too far out of line with its neighbors.

Replacing the annual \$60 billion that states would lose from, for example, a 10 percent cut in federal grants would be hard—equivalent to more than doubling the corporate income tax, cutting police and fire spending almost in half, or eliminating all spending on libraries, parks, and recreation. States that are unwilling to replace the lost federal monies would try to cut the particular programs from which the federal government has withdrawn support, but because the federal government requires states to maintain their current levels of service in some of these programs, it will not be easy for states to make such cuts unless the federal government provides flexibility along with its decreases in aid. The largest federal aid programs—and, thus, the program areas most vulnerable to this potential combination of federal cuts and required maintenance of state spending—are in the areas of Medicaid, education and training, and infrastructure. (See Table 1.)

**Table 1** | Medicaid, education & training, and infrastructure are the largest components of federal grants

Federal outlays in FFY 2012 (estimated)		
	Federal outlays (\$ billions)	Share (percent)
<b>Grants to state &amp; local governments</b>	<b>612.4</b>	<b>100</b>
<b>Payments for individuals</b>	<b>368.5</b>	<b>60.2</b>
Medicaid & Child Health Insurance Program (CHIP)	265.0	43.3
Public assistance, nutrition, & other payments for individuals	103.5	16.9
<b>Grants for education &amp; training</b>	<b>105.2</b>	<b>17.2</b>
Elementary, secondary, & vocational education	85.1	13.9
Other grants for education & training	20.1	3.3
<b>Grants for physical capital investment</b>	<b>96.4</b>	<b>15.7</b>
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
<b>All other grants to state &amp; local governments</b>	<b>42.2</b>	<b>6.9</b>

Sources: Federal Budget for FFY 2013, Historical Tables 8.1, 8.5, 8.7, 9.6, 9.9, 11.3, 12.1 and Public Budget Database outlays spreadsheet.

**Table 2** shows the potential impact of a 10 percent across-the-board cut in all federal grants, in total and for selected large program areas. California and New York would each lose more than \$6 billion. In the case of California, such a cut would increase its already-large budget gap by more than a third.

Federal spending on procurement and salaries also varies widely among states, and its reduction could be devastating to some state economies. For example, a five percent cut in procurement, salaries, and other federal spending, which is 65 percent higher in Virginia than in the average state, would reduce federal spending in the Virginia economy by more than \$850 per capita. Secondary effects would reverberate throughout the state's economy.

Therefore, states' interests should be on the table when federal reductions are being debated. There is no standing arrangement in the federal government for analyzing the overall impacts of federal actions on states. The 1996 demise of the Advisory Commission on Intergovernmental Relations, whose mission was to examine such issues, has created a void in this area. The federal government needs a mechanism for consulting with states about the upcoming federal changes and their impact on state and local governments.

**Table 2** | Potential impact of a 10 percent reduction in federal grants

State	Potential cuts (\$millions)							2010 decennial census pop
	Total	Medicaid and selected other CMS programs	Highway Trust Fund	Temporary Assistance to Needy Families (TANF)	Title 1 education programs	Child nutrition programs	Potential cuts (\$ per capita)	
<b>United States</b>	<b>62,074</b>	<b>27,804</b>	<b>3,027</b>	<b>1,987</b>	<b>1,811</b>	<b>1,628</b>	<b>201.1</b>	<b>308,745,538</b>
California	6,657	2,925	188	425	224	199	178.7	37,253,956
Illinois	2,319	984	86	73	83	62	180.8	12,830,632
New Jersey	1,631	684	62	61	35	33	185.5	8,791,894
New York	6,134	3,274	163	274	152	100	316.5	19,378,102
Texas	4,373	2,010	161	67	181	191	173.9	25,145,561
Virginia	1,065	422	85	17	28	24	133.1	8,001,024

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

## 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, both to help ensure that funds are available when needed and to require that the taxpayers who receive employees' services incur the costs of those services. To prefund pensions, governments and their employees contribute to retirement systems, which invest the contributed funds in order to accumulate assets to pay benefits when due. Actuaries project the amounts of the future benefit payments, then discount them to their present value in order to estimate pension liabilities. Actuaries also estimate contributions that will be required to accumulate the necessary assets. The system is based on a large number of assumptions. Many will prove wrong, but the system is designed to be self-correcting. For example, if investment returns fall short of assumptions, actuaries will raise their

estimates of required contributions. In practice, however, things do not always work so neatly; governments sometimes override actuaries' assumptions or pay less than what the actuaries estimate is required.

A pension system is underfunded if its assets are less than its estimated liabilities. Under current actuarial assumptions, state and local government pensions are underfunded by approximately \$1 trillion. Economists, in contrast to actuaries, generally believe that liabilities should be valued using "low risk" discount rates; using these rates leads to much higher liability estimates. Under this approach,

estimated unfunded pension liabilities are \$3 trillion or more. **Table 3** shows a summary of funded status of major plans accounting for approximately 85-90 percent of the universe.

The most significant reason for pension underfunding is that investment earnings have fallen far short of what was assumed. Many pension plans with the greatest need for increased contributions have an additional burden in the fact that their states and localities habitually have skipped or underpaid their actuarially required contributions: That is, these governments have willfully underpaid and now find it difficult to afford the contributions required. Over the last five years, state and local governments have underpaid contributions by more than \$50 billion. California, Illinois, and New Jersey, with 19 percent of the nation's population, accounted for more than half of the contribution shortfall. Between 1996 and 2011, Illinois underpaid contributions by \$28 billion.

On top of that, California and certain other states have enriched pension benefits, some retroactively, on the basis of assumptions that made their systems appear well funded but, in retrospect, were far too optimistic. And, pension benefits, once granted, have strong legal protections.

*The most significant reason for pension underfunding is that investment earnings have fallen far short of previous assumptions.*

Most retirement systems can pay pension benefits for many years out of existing funds, but this does not mean they are sound. Increased contributions will be required—or, in some cases, benefit cuts may be needed—in order to stave off a crisis.

The six states in this study need to increase contributions, in some cases quite significantly, to eliminate existing unfunded liabilities. For example, contributions to the California State Teachers Retirement System (CalSTRS) would need to increase by more than \$3 billion annually to amortize unfunded liabilities, assuming that the system earns 7.5 percent on its investments. Assuming lower rates of return would require larger contributions still. For example, annual contributions to CalSTRS would need to increase by a further \$7 billion if a five percent earnings assumption were used. If systems do not achieve currently assumed returns or contribution levels, the next generation may bear the cost, in the form of higher future contributions, of deferred compensation promised to workers whose services benefited this generation. Failure to achieve these returns or contribution levels also may be borne by workers and retirees, who could suffer cuts in the pensions that were promised to them.

**Table 3** | Major retirement systems funded status

<b>State and local government retirement system funded status</b>					
Major state plans and local plans (\$ billions except where indicated otherwise)					
	<b>Actuarial liabilities</b>	<b>Market value of assets</b>	<b>Unfunded liability (surplus) using market value of assets</b>	<b>Funded ratio using market value of assets (percent)</b>	<b>Unfunded liability per capita</b>
<b>United States totals, 126 plans</b>	<b>\$3,442.8</b>	<b>\$2,551.2</b>	<b>\$891.5</b>	<b>74.1</b>	<b>\$2,882.1</b>
<b>Totals for 6 study states</b>	<b>1,542.2</b>	<b>1,156.0</b>	<b>386.2</b>	<b>75.0</b>	<b>3,459.2</b>
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](http://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.

While pension benefits are at least partially funded through significant assets protected by trustees, most state and local governments have also promised substantial retirement health care benefits to their workforces with barely any funding. These are known as Other Post-Employment Benefits (OPEB).

***While pension payments are partly funded in advance, states and localities have also promised retiree health benefits with hardly any advance funding.***

State-administered OPEB plans have unfunded liabilities of more than \$600 billion. Similar liabilities for locally administered plans are likely even larger, since local workforces are almost three times as large as state workforces. 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, thus lengthening the period during which retirees rely exclusively on state promises, OPEB liabilities could increase still more.

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. (See Table 4.) Annual costs are being rapidly driven 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.

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 determined by collective bargaining agreements

**Table 4** | Conservatively estimated OPEB liabilities in the six study states

OPEB plan liabilities (\$ billions)							
	California	Illinois	New Jersey	New York	Texas	Virginia	SIX-STATE SUM
<b>Unfunded Actuarial Accrued Liability (UAAL) of OPEB plans administered or participated in by:</b>							
State government	\$62.14	\$54.22	\$59.28	\$56.92	\$58.21	\$5.02	\$295.79
State university <i>(if not included in state number)</i>	15.98	–	–	–	–	–	15.98
Selected large local governments	58.75	5.52	12.09	122.13	6.21	–	204.69
<b>Statewide Total</b>	<b>\$136.87</b>	<b>\$59.74</b>	<b>\$71.37</b>	<b>\$179.04</b>	<b>\$64.41</b>	<b>\$5.02</b>	<b>\$516.46</b>

Sources: CAFRs of individual plans, generally for 2011, as described in text.



and, therefore, are governed by the terms of those agreements, which are time-limited. While an agreement is in place, the benefits provided by the agreement cannot be changed without mutual consent and in exchange for valuable consideration. Laws relating to pensions and OPEB are subject to continuing litigation, with some legal opinions conflicting with others. Many states, including those in this study, have scaled back these benefits. The most notable recent change occurred in West Virginia, which cut its OPEB liabilities in half by requiring increased contributions by retirees. Still, until economy-wide health care cost increases slow, these benefits will exert stress on governments and their workforces.

There are many incentives to provide compensation that is not paid currently, incentives to underestimate liabilities, incentives to underfund annual costs, and incentives to take on substantial investment risks. States and localities need more transparency in undertaking and assessing these obligations and they need rules for more responsible management and funding of their retirement obligations.

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

The tax revenues needed to fund state and local government services have been eroding for decades and are increasingly volatile, making budgeting and planning more difficult.

In 1950 the states' personal income, sales, and corporate income taxes—their most economically sensitive and volatile large taxes—together accounted for only 38 percent of state tax revenues; taxes on motor fuel, alcohol, and tobacco accounted for half of the remainder. Today, in contrast, personal income, sales, and corporate income taxes account for 71 percent of state tax revenues.

These revenues have become more volatile in large part because income taxes have become increasingly dependent on financial markets and on the states' highest earners. In the 1950s, capital gains, whose fluctuations are a major cause of income tax volatility, made up less than two percent of gross domestic product (GDP). In 2007 capital gains peaked at about 6.5 percent of GDP; they then fell 72 percent over the next two years.

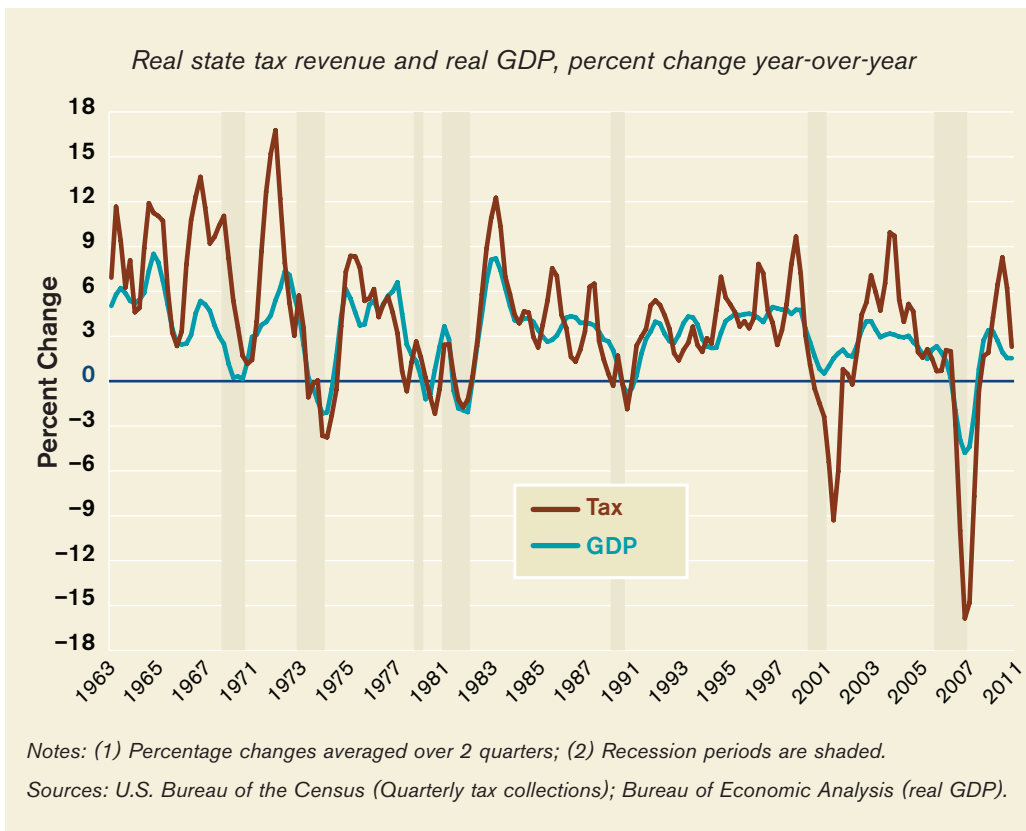
The capital gains that are recognized for tax purposes depend heavily not just on stock market performance but on taxpayers' choices about whether and when to sell assets; this feature adds to their variability. Other forms of highly variable income, particularly bonuses paid to high-income individuals, also have increased in importance. Recent research by Professor John Mikesell concludes 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."

*Revenues have become more volatile in large part because income taxes have become increasingly dependent on financial markets and on the states' highest earners.*

Sales taxes were particularly volatile in the recent recession because of sharp declines in the consumption on which such taxes depend. Corporate taxes have been eroding and are increasingly volatile as well, partly because of tax preferences granted in pursuit of policy goals and partly because of factors such as legal tax avoidance.

The states' increasing reliance on economically sensitive taxes and the rising volatility of revenues produced by those taxes have 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. (See Figure 2.) Such severe fluctuations can open up budget gaps that are large even in comparison to longer-term structural gaps. 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.

**Figure 2** | State tax revenue is more volatile than the economy



Sales tax revenues are volatile and eroding. The sales tax base—that is, the value of taxed goods and services—has declined by 37 percent over the last 40 years as a share of the economy in the typical state because of consumer spending shifts toward lightly taxed services, the difficulty of collecting taxes on Internet-related transactions, and state choices that narrow their tax bases. In response to this erosion of the tax base, many states have raised tax rates substantially.

Motor fuel taxes, like other excise taxes on specific goods such as alcohol and tobacco, also have 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. They therefore don't keep pace with inflation as closely as sales taxes do. Motor fuel tax revenues, in particular, have also declined because automobile gas mileage has improved: Cars use less taxable fuel. Between 1960 and 2010, state and local motor fuel taxes declined relative to the economy by 60 percent. While motor fuel taxes are not a particularly large part of state 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.

All of the study states have had difficulty managing revenue volatility, tax base erosion, or both. California's revenue structure is dominated by the personal income tax, which provides more than 60 percent of general fund revenue. A significant amount comes from high-income earners. As a result, California's revenues are more volatile than personal income and more volatile than revenues in the average state. Illinois has seen a narrowing of its sales tax base; it taxes relatively few services and has increased exemptions over time. New Jersey's income tax revenue grew 32 percent from fiscal year 2005 to 2008 but by 2011 had declined by 16 percent, contributing to severe fiscal stress. New York's income tax is its largest revenue source, and its new top rate of 8.82 percent on individuals with taxable income above \$1 million will heighten the already-substantial volatility of the revenue produced by the tax. Texas does not have an income tax and relies far more heavily on the sales tax than most states. The sales tax has been diminishing relative to the economy, and a one percent change in personal income now produces only about an estimated 0.7-0.8 percent increase in sales tax revenue.

*Motor fuel taxes are often dedicated to funding roads, highways, bridges, and transit; thus, their decline has increased the challenges that states face in these areas.*

## 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 often, and increasingly, have imposed limits on the single largest locally imposed 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.

Fiscal stress rolls downhill. States have passed and will continue to pass some of their own problems down to local governments, as many have done in the present downturn by cutting aid to primary and secondary education. In addition, many local governments face their own severe fiscal difficulties. 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. The housing bust is causing declines in property tax revenues in California, where local

governments also face laws that prevent them from raising rates to offset these declines. In contrast, local governments in other states, such as New Jersey, Illinois and Virginia, can raise tax rates to offset declining property values, and many are doing so, but this kind of compensating mechanism only turns potential stress for local governments into actual stress for property owners.

The nature of the limit, if any, that a state imposes on local property taxes will influence the way in which the housing bust affects property tax revenues. New Jersey and New York have new caps that limit annual growth in property taxes: Local governments may raise rates to offset declines in property values,

as long as resulting growth in revenues does not exceed the limit. In California, by contrast, the overall amount of property tax revenue that is allowed—not just its growth—is limited by the value of the underlying property. Even the less stringent limits, those that restrict revenue growth alone, can cause difficulties for local governments if such growth is not allowed to keep pace with difficult-to-control spending such as pension contributions.

As a result of these fiscal pressures, increasing numbers of local governments are encountering fiscal stress. While local government bankruptcies and insolvencies remain rare, municipal bond downgrades for governments greatly outnumber upgrades; and

the threat of outright fiscal crisis among localities is increasing. 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. Michigan recently established significant new oversight procedures. However, while early action can prevent fiscal distress from becoming fiscal crisis, most states wait until there is a full-blown crisis, with a locality on the brink of insolvency, before intervening. Although local home rule traditions vary, states can establish procedures for systematic monitoring of local government fiscal conditions and early-enough intervention so as to avoid local governments' ending up insolvent.

### **State Budget Laws and Practices Hinder Fiscal Stability and Mask Imbalances**

Before the 1970s, state fiscal crises were relatively uncommon, but that has changed. Rising revenue volatility 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, pressures increase for spending on Medicaid, the social safety net, and higher education. Just when the federal government's automatic counter-cyclical stabilizers, like unemployment compensation, kick in against recession, state budgets become pro-cyclical. In the last recession, even with the federal stimulus, states cut their spending significantly; some also raised taxes. In effect, state budgets act as a headwind against the national push toward economic recovery.

*Chronic dependence on nonrecurring actions, in good times as well as bad, can disguise a growing mismatch between long-term spending commitments and long-term resources.*

Falling revenues, rising spending, and budget gimmickry also conspire to destabilize the states' finances. States that act in the full spirit of their balanced budget rules may slash spending, raise taxes dramatically, scale back care for the needy when they are most in need, increase class sizes when recessions hit only to reduce them in recovery, or raise, then lower, tax rates. These outcomes are undesirable as politics and as policy.

States can dampen these effects through well-designed and well-funded reserve funds. States have increased their reserve funds over the last three decades, but these funds remain too small and inflexible to be capable of having much effect 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 states to reduce these balances sharply and quickly. The funds' effectiveness as stabilizing tools was limited.

In the absence of rainy day funds big and flexible enough to make a difference, states tried to minimize the effects of their pro-cyclical actions by filling in budget gaps with nonrecurring or temporary resources like asset sales and hidden borrowings. The states in this study all used such temporary and one-time actions to achieve their legally required budget balance.

In light of the spending cuts or tax increases that states might otherwise be forced to undertake in extraordinary circumstances, this use of nonrecurring resources is quite understandable. The problem occurs when states use such resources without a plan to retreat from their use. None of the study states has an effective multi-year planning process that puts it on a path to longer-term balance as the economy recovers. It is the reliance on substantial nonrecurring resources without a multi-year plan for replacement that is dangerous. Some states that used such 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.

For some states, reliance on nonrecurring items is an ongoing budget strategy. Chronic dependence on nonrecurring actions, in good times as well as bad, can disguise a growing mismatch between long-term spending commitments and long-term resources. It may allow voters to believe that they can continue to have services they find necessary or desirable without higher taxes. It can also fuel a growing cynicism, born of an acceptance of the idea that "temporary" actions will never disappear.

Cash-basis budgeting, which recognizes revenues as soon as they are received and recognizes expenditures only when cash is actually disbursed, is a major enabler of such budget gimmickry. Even budgeting on a partial accrual basis can enable gimmicks. While seemingly benign, cash budgeting and some variants led state governments to postpone payments to their contractors and suppliers, aid to local governments, and paychecks to employees. The state may treat a budget as balanced even if 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 some \$9 billion.

*An effective way to manage the budget over not just a single budget year but the longer economic cycle is to have in place a multi-year financial and capital plan linked to the annual budgeting process.*

There is no painless way to stop such a practice.

One of the most notorious gimmicks is capitalizing future revenues to produce balance in a current year, borrowing cash not just from the year ahead but from many years into the future.

These budget sleights-of-hand should be exposed in the state's Comprehensive Annual Financial Report (CAFR), an audited report on the state's financial condition. Unfortunately, CAFRs are technically difficult to reconcile with state budgets and appear too late in the budget preparation and review cycle to be very useful in the budgeting process. And even CAFRs understate or obscure pension and retiree health benefit (OPEB) liabilities. If states were required to balance their budgets with the inclusion of the true costs of promised pension and OPEB benefits, state and local governments would need to set aside billions of additional dollars each year.

An effective way to manage the budget over not just a single budget year but the longer economic cycle is to have in place a multi-year financial and capital plan linked to the annual budgeting process. This approach has been imposed successfully in cities that have experienced financial emergencies, such as New York City and Washington, D.C. It has helped these governments to avoid continual fiscal crises and restore their financial reputations.

Multi-year planning practices in our study states, however, are mixed. California, Illinois, New York, and Virginia produce some multi-year forecasts; but it is not clear that they are treated seriously or used in budgeting. There is no multi-year process in place in New Jersey or Texas.

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, 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.

## ***Threats to Fiscal Sustainability Create Risks to Essential State Functions***

- Since 2008, as shown in Figure 1 on page 8, state funding of K-12 education has declined as a share of state spending while Medicaid spending has increased in share. There have also been significant cuts in state funding of public higher education. Relatively uncontrollable Medicaid spending and rising obligations to contribute to pension funding crowd out spending for education and will continue to do so until these problems are brought under control. Continuing cuts in state funding have put access to education and the quality of instruction and student performance at serious risk.
- America's aging infrastructure faces growing capital needs, most of which are funded by state and local governments. However, these critical needs suffer from low budgetary priority. Like education spending, essential infrastructure spending is now crowded out by more immediate spending pressures, pushing essential investments off to the future and increasing the risks to public health and safety and economic growth.
- Both state borrowing to finance long-term capital assets like infrastructure and temporary state borrowing to adjust to cash flows within a fiscal year are appropriate reasons to borrow. Borrowing to finance current spending is not an appropriate reason. Yet, confronted with fiscal distress, states have borrowed to finance budget deficits and even have, in effect, borrowed from pension trusts to make current payments to these trusts. Extensive misuse of state borrowing could diminish state credit ratings, increase interest costs, and further limit their ability to borrow for much-needed capital projects.

## 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.

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