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States to Tighten Belts as Weakness Of Economy Cuts Into Tax Receipts
By Conor Dougherty

Slower growth in tax revenues, the result of a weakening economy, are prompting governors from New Jersey to California to consider an array of belt-tightening measures to balance their budgets for this year and next.

Facing a severe revenue shortfall, Kentucky Gov. Steve Beshear has asked most state agencies to trim their spending by 3% in the current fiscal year, which ends June 30. New Jersey Gov. Jon Corzine has proposed raising tolls and freezing spending to reduce his state's debt. And California Gov. Arnold Schwarzenegger, in a bid to avert a deficit in the coming fiscal year, has proposed closing state parks, eliminating dental care for the poor and cutting $4 billion from the state education budget.

Slimmer Pickings

State tax revenues, adjusted for inflation, change from a year earlier

Source: Nelson A. Rockefeller Institute of Government

"There are going to be very difficult — but very necessary — reductions to close the spending gap," says H.D. Palmer, a deputy budget director for California. "By definition, closing a $14.5 billion budget gap is difficult."

In last year's third quarter, state tax revenues overall were up 4.4% from a year earlier, according to a report scheduled for release today by the Nelson A. Rockefeller Institute of Government at the State University of New York. But, after adjusting for inflation, they were down 0.6%. That was the first year-to-year decline in four years.

Much of the shortfall stemmed from the slowing economy, as well as tax cuts enacted by some states for 2007. While revenues from personal-income taxes have remained healthy, growth in sales-tax revenues has slowed as consumers have reined in their spending, and income taxes collected from corporations have fallen, along with corporate profits.

"This could be a very tough year for states," says Robert Ward, the Rockefeller Institute's deputy director. "The bad news is fairly widespread."

Belt-tightening by the states could further damp the nationwide economy. State and local governments account for about 9% of gross domestic product, and they have been a steady contributor to economic growth in recent years. Their spending grew at a 19.4% pace last year and at a 6.1% pace in the third quarter.

This is the time of year when governors give their "state of the state" speeches, and over the next few weeks they will be presenting budgets to their legislatures. Unlike the federal government, most states are required by law to balance their budgets.

Bracing for Cuts

Most states don't have to pass a budget until the middle of the year, but already, state agencies and their employees are bracing for cuts. In Alabama, the state's teachers lobby has said it probably won't seek a pay increase in 2009, and instead will focus on preserving health benefits. "There's no likelihood of a pay raise because the economy is going south," says Alabama Education Association spokesman David Stout.

The budget picture could be much gloomier than the third-quarter revenue figures indicate. Evidence suggests consumers have continued to pull back on spending. Last week, companies including retailer Kohl's Corp. issued profit warnings, citing slower sales.

In many places, the slump in home prices has reduced revenue from property taxes and taxes levied when houses change hands. In most cases, these taxes are collected by local — not state — governments. But a deteriorating real-estate market also strains state coffers, which depend heavily on sales taxes, by making consumers feel poorer and thus less inclined to spend on things like home furnishings, new cars and dinners out.

Only a few states, including New Hampshire, Ohio and Nevada, saw an overall decline in third-quarter revenue, according to the Rockefeller Institute. Nationally, the weakest link was corporate income taxes, which declined 2.4% from a year earlier. Sales taxes grew at a 3.1% rate, unchanged from the previous quarter. Income taxes increased 6.3%, less than their year-to-year increase of 8.7% in the second quarter.

States that saw some of the highest run-ups in real-estate prices — including California, Nevada and Arizona — have some of the worst of the budget problems. Revenues in California increased just 2.8% in the third quarter from a year earlier, Arizona's take increased 0.8% and Nevada had a 4.1% decline.

In Florida, overall state revenue declined 6.7% in the third quarter from a year earlier, the biggest drop of any state, according to the Rockefeller Institute. The decline was led by corporate-income taxes, which fell 15.4%, while sales taxes were down 3.5%. Florida has no personal income tax. The state recently projected that falling tax revenues would force it to cut as much as $600 million from the budget for the current fiscal year, which ends in June.

Florida's legislative session doesn't begin until March, but politicians already are discussing remedies. House Speaker Marco Rubio has suggested that the state could eliminate or consolidate some state agencies. Other ideas include tapping rainy-day reserves to make ends meet or raising revenue by adding new games to the Florida lottery.

Budget Mess

Many states were in a budget mess in 2001 and 2002, when the bursting of the tech-stock bubble hammered personal incomes, especially among wealthy taxpayers. But consumers quickly regained their footing, and rising real-estate prices and the subsequent home-refinancing boom boosted consumption — and sales-tax revenues — even more. Between 2004 and 2005, the peak of the latest cycle, states enjoyed year-to-year increases of 7% to 12.9% in their quarterly revenues.

One critical difference between today's budget squeeze and the last: the effect on local governments. Property values held steady after the tech bust, so local governments, which rely on property taxes for much of their funding, were shielded from the blow. But the current drop in property values is squeezing local budgets and could force deep spending cuts at the local level as well.

"When state budgets get tight they push programs down to the local level," says Robert Kurtter, managing director in U.S. public finance at Moody's Investors Service.