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State Budgets Facing Crisis

As revenues shrink, lawmakers must cut programs or raise taxes

By Justin Ewers

SAN FRANCISCO — When Arnold Schwarzenegger was elected California's governor in 2003, he vowed to solve one big problem. The state's nearly $100 billion budget was a mess. After the tech bubble popped, tax revenues had dropped by 17 percent in one year and the state, required by law to balance its budget, was struggling with an $8 billion deficit. Schwarzenegger went into action, borrowing heavily until the economy and tax revenues picked up, and the ship of state seemed to steady. Last year, he declared victory, along with a "zero deficit."

The good times didn't last—in California, or in many other states that struggled out of the dot-com bust only to watch the housing bubble disappear along with much of their revenue. This winter, with the economy slowing again, Schwarzenegger finds himself mired in a budget crisis even bigger than the first. Shrinking tax revenues and housing deflation are creating a $14.5 billion budget hole to fill. Declaring a fiscal emergency, Schwarzenegger is asking for a 10 percent spending cut in all state agencies. In addition to closing 48 state parks and releasing early as many as 22,000 nonviolent prisoners, he has proposed deep cuts in education, trimming $4 billion from next year's K-12 budget, which would require suspending a law that guarantees a minimum level of school funding. Experts say this is no ideological, small-government crusade. "He's trying to get people's attention," says Daniel Mitchell, a professor of management and public policy at the University of California-Los Angeles. "This is a train wreck, where California is heading."

The Golden State isn't the only one teetering on the brink of budgetary disaster. The economic slowdown has depleted sales and income tax revenues, the lifeblood of state governments, for the first time in four years, causing budget shortfalls in 20 states. According to the National Governors Association, 35 to 40 states could face cuts in 2009. "Most folks did forecast some tempering of the economy; they just weren't conservative enough," says Corina Eckl, director of fiscal affairs at the National Conference of State Legislatures. "They didn't think [revenues] were going to decline as much as they have."

Congress's proposed stimulus package is not expected to present much aid to the states. Which gives state lawmakers three hard choices: Raise taxes, cut spending, or both. Maryland and Michigan opted for both last year, but election season may put an end to the tax hikes. "We're still in an era when tax increases are highly unpopular," says Robert Ward, deputy director of SUNY's Rockefeller Institute of Government. They can also be politically impossible; California and Arizona, for example, require a two-thirds majority in the Legislature to raise taxes.

Heartbreaking. So where to swing the ax? Around two thirds of many general funds are devoted to education, healthcare, and corrections systems. In North Carolina, which so far isn't experiencing a shortfall, those three services make up 93 percent of the state budget. When the state faced a $2 billion shortfall on a $14 billion budget during the last recession, it had to make some heartbreaking choices. "You can cut out the rest of state government and still not be [balanced]," says David Crotts, an economist for the North Carolina General Assembly. "Unless you get into the core areas, it's difficult to cut that much."

A few leaders, like Schwarzenegger, have begun to bite the bullet. New Hampshire's governor has asked for cuts of at least 5.7 percent. In Kentucky, which faces a shortfall of nearly $900 million, state agencies, including colleges, are trimming spending by 3 percent. Experts say tuition hikes and staff cuts will surely follow.

To ease the pain, gambling revenues are being dangled in front of some voters. Measures on the ballot in California this week would allow four Indian tribes to massively expand their casino operations, bringing the state up to $430 million. Kentucky's governor is pushing for a constitutional amendment to legalize gambling, and a ballot measure in Maryland would legalize slot machines. Some 56 percent of likely voters support the measure.

More subtle money-raising schemes are also beginning to appear. Gov. Eliot Spitzer of New York, which is facing a $4.4 billion deficit, proposed $738 million in new "fees" in his budget, including tax increases on malt liquor and small cigars, a new "tax" on illegal drugs ($3.50 per gram of marijuana and $200 per gram of other drugs), and larger closing fees for home purchases over $175,000. "There are creative ways of raising revenue and not calling it a broad tax increase," says Eckl.

Budgetary gimmicks are also gaining popularity. In Arizona, which faces a $1.2 billion shortfall, legislators are considering a proposal to transfer some of the state's transportation funds—devoted to road upkeep—to pay police officers. Another proposal would bump nearly $300 million in school funding expenditures into next year's budget. There are more painful cuts on the table, too, including eliminating over 19,000 children from a children's healthcare program by raising income minimums for eligibility. "We're going to have to do a number of things we'd have preferred not to do," says Robert Burns, chairman of the appropriations committee in the state Senate. State economic experts have told him it will be two or three years before revenue growth returns to normal.

More state lawmakers, as the year progresses, will face similar choices. "They're not the federal government; they can't print money," says Mitchell of UCLA. "They're more like individual consumers: If you take away their revenue, they can borrow against their credit card for a little bit, but eventually you have to cut." Many states, it appears, will soon be forced to do just that.