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The Next Victim of the Real Estate Crisis: As the economy stalls, state and local governments will see less tax revenue roll in. Get ready for cuts in services

By Prashant Gopal

State and local governments were flush with tax revenue during the five-year housing boom. They pulled from bulging pools of property, income, and sales tax to expand education, law enforcement, health care, and infrastructure programs without needing to burden residents and corporations with tax hikes.

Those days are over. Home prices are falling, and foreclosures, gas prices, unemployment, and inflation are on the rise. At least 29 states, plus the District of Columbia, reported budget shortfalls that total about \$48 billion as they finalized their 2009 fiscal budgets, which typically begin July 1, according to the Center on Budget & Policy Priorities.

States are facing flat or even declining revenues even as costs for salaries, fuel, and construction increase. And revenues will only plunge further as the housing slump and credit crunch begin to reflect more in lower property assessments and sales and income taxes. With fewer homes being sold, homeowners are spending less on new furniture, carpets, bathroom and kitchen fixtures, and other household costs. Americans struggling just to make mortgage payments and fill fuel tanks have less to spend on discretionary purchases. Income tax is down as a result of job losses and shrinking profits for corporations, including those in the construction business.

“The downturn in the housing market is a big factor as to why this has happened,” says state representative David Lujan (D-Ariz.). “When one segment of the economy is going down, all other aspects are impacted as well.”

An Abundance of Shortfalls

Arizona topped the BusinessWeek.com list of the 10 states that took the biggest tax revenue hits, compiled using data from the Nelson A. Rockefeller Institute of Government, the public policy research arm of the State University of New York. Arizona’s tax revenue dropped 13.6% in the quarter ending March compared with the same period last year. On Thursday the Arizona legislature approved a budget plan for the coming year that eliminated a \$2 billion shortfall by cutting spending for college construction projects and expanding revenue by beefing up photo enforcement and the state lottery.

Many of the states with the worst housing markets, including Florida, Nevada, Rhode Island, and California, also topped the revenue shortfall list.

Despite the revenue shortfalls, it could be some time before average taxpayers notice their garbage isn’t being picked up as often or that their children are sharing a teacher with too many students.

“Governments have ways of muting and stretching out the effects of these things,” Donald Boyd, a senior fellow at the Rockefeller Institute, says of the declining state and local tax money. “They take the easiest actions first. They will draw down reserve funds first. They came into this with historically good reserves... You will see spending restraint. But for outright cuts, prisoners released, and teachers laid off, you would have to see something truly significant.”

Governments Affected Too

Many states are freezing new hires, borrowing for necessary expenditures and dipping into “rainy day” funds to fill budget gaps and avoid tax increases. But in many cases they’re tapping out the reserve funds for the coming budgets and might need to make tougher choices when they put together their

2010 spending plans, especially if the economy worsens.

The troubles are already serious in California, which is facing a wave of foreclosures and tumbling home prices that have sapped equity from millions of homeowners. Governor Arnold Schwarzenegger has few good options to plug a \$17 billion budget hole and has already angered teachers' unions and health-care advocates with his proposed cuts. Those proposals include big reductions in the state's health insurance program for the poor.

"That's the conundrum of all of this," says Nick Johnson, director of the state fiscal project at the non-profit Center on Budget & Policy Priorities. "When people are facing economic hard times they turn to state governments for assistance, and that's also the time when governments are under pressure to cut the exact same services."

Finances are also tight at the local level. In California's Stanislaus County, which has one of the nation's highest foreclosure rates, the just-released property assessment roll for Jan. 1, 2008, showed a drop of \$3 billion, or about 6.87%, which eclipsed the county's worst year in recent decades, a 1% drop in the 1990s, says county assessor Doug Harms.

Revenues will likely shrink further next January. There's an inherent lag between the time home prices fall and property tax revenues decline because of the time it takes for homes to be reassessed. (In California, counties calculate their property assessment rolls once a year.)

Busted School Budgets

Even school budgets, which politicians fight hard to protect, have been feeling the pinch. Public schools are generally funded through a combination of local property taxes, sales taxes, and state aid.

The Palm Beach County school district in South Florida is also having to make do with less as it searches for tens of million of dollars in possible operating cuts. Joseph Sanches, chief of facilities management for the district, says the county needs to cut nearly \$653 million from its \$1.9 billion five-year capital budget.

But the county no longer has to deal with a growing student population as it did during most of the boom. The county's population began falling by a few hundred people per year after the hurricanes of 2004.

"The timing could have been worse," Sanches says of the revenue slump.