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This conference of top state officials and other experts examined potential solutions to the structural budget gaps that loom for states in the years ahead. The conference was supported by a grant from the Carnegie Corporation of New York.

Speakers were:

- **Richard Ravitch**, lieutenant governor of New York State
- **Nancy L. Zimpher**, chancellor, State University of New York
- **Kim Rueben**, Urban Institute-Brookings Institution Tax Policy Center
- **Ronald Snell**, director of state services, National Conference of State Legislatures
- **David M. Walker**, president, Peter G. Peterson Foundation
- **Donald J. Boyd**, senior fellow, Rockefeller Institute of Government
- **Nicholas Johnson**, director, State Fiscal Project, Center on Budget and Policy Priorities
- **E.J. McMahon**, director, Empire Center/Manhattan Institute
- **John Cape**, director, State Strategic Consulting, Public Financial Management, Inc.
- **Richard P. Nathan**, former director, Rockefeller Institute of Government
- **Robert B. Ward** (moderator), Rockefeller Institute of Government

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States' Long-Term Budget Gaps: Are There Any Solutions?

A summary transcript of a Rockefeller Institute conference at the Levin Institute, New York City, November 30, 2009

Introduction: Robert Ward

We're here to talk about the mid-term to long-term fiscal future for the states. And that picture is very troubling.

We don't do a good enough job of explaining why this matters. Most voters and taxpayers don't pay a lot of attention to government. They need to understand why and how these long-term budget gaps affect them if they are to be enticed into paying more attention to, and maybe getting involved in, the painful budgetary choices facing state and local governments.

The budget gaps with which we are all very familiar are great disruptors. They force service reductions and tax increases at the time when you most want to avoid those things. In very simple terms, it comes down to this: There are additional services that state and local governments could provide, and new taxes and other costs that they could avoid, if they could manage their budgetary challenges better.

Right now, across the country, we see many instances where states have lost the ability to manage themselves. And so they're making decisions — or refusing to make decisions — not because it's the right thing to do but because states can't quite figure out the best way to solve these problems, or can't find the way to get there in the context of a given set of economic and political realities.

States need greater ability, more capacity if you will, to find solutions. We hope today's conference will be one source of some solutions.

Lieutenant Governor Richard Ravitch

Governor Paterson has asked Lieutenant Governor Ravitch to lead New York State's response to the current fiscal crisis and to develop a multiyear, structurally balanced financial plan. The lieutenant governor focused his remarks on the current and long-term challenges for New York.

Next year, the deficit will likely be over \$9 billion. And the following year, when the stimulus money ends, the deficit could be in the range of \$18 billion to \$20 billion. These are extraordinarily difficult numbers to fathom.

Despite the inexorability of the numbers, what amazes me is the fact that behavior has not changed in Albany, or on

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– Lieutenant Governor
Richard Ravitch

behalf of all the constituencies that have a dramatic impact on Albany.

In the last 10 years, there have been between \$20 billion and \$24 billion of one-shots, of borrowing, asset sales, or similar non-recurring revenue items that balanced the budgets. In all but two of those years, the recurring revenues were insufficient to maintain the level of spending, which has gone up on a straight-line basis throughout that entire period. The federal stimulus bill was intended to do a lot of things, but from the point of view of the state budget it was two years of one-shots.

As you all know, New York is not unique. We're not as bad as California, but there are very few states that don't have a structural imbalance.

I don't want to see what happened in California happen here. They had great state universities, and the system has been badly hurt, and it is no longer the magnet it was. Our universities in the state of New York are in the long term the most important economic engine for our future.

This is the year in which we have to address the problem. We have to understand the political nature of the spending addiction that has afflicted the state. With the help of the Rockefeller Institute and a number of foundations, I am going to try in these next months to put together a three-or-four-year financial plan for the state that ultimately closes the circle.

Can we actually put into place self-imposed discipline on the budgetary process? And can we change the culture so people will understand that having real balance, having our expenditures bear a straight line relationship with our revenues is a good thing, and not just to avoid more taxes but to ensure an ability to build, an ability to continue to provide the essential services which the State of New York must provide?

Nancy L. Zimpher

A forthcoming strategic plan will leverage resources and position the State University of New York to play a key role in New York's economic resurgence, Chancellor Zimpher told the conference. The strategic plan, to be released in April 2010, will be designed to guide the university's actions and its partnership with state leaders for the coming decade.

How can higher education be part of the solution? Let us step up to our rightful role as anchor institutions. We are an industry sector that is not going anywhere. We are what CEOs for Cities calls sticky capital.



Our strategic plan at SUNY will focus almost exclusively on the economic revitalization and enhanced quality of life of the state of New York.

– Nancy L. Zimpher

We're doing something at SUNY that's very atypical for universities. Typically, universities talk about enrollment management, attracting more high-performing students, investing in research, and increasing the excellence of our programs – we rarely send ourselves to the outside structures and talk about how universities can play a critical role in economic recovery.

If we could only educate to the baccalaureate level one percent more of the population, we could generate in a year's time \$17 billion in personal income for the citizenry of New York. As you look at something like this you can begin to see part of the solution. This talent dividend is important.

With "SUNY Flex," we are asking for flexibility in the lease of land that we think could be lucrative for us; we are asking to drop onerous regulations that slow down our ability to purchase and to acquire services. At a time when the Legislature can offer no money to the solution, regulatory relief is an honest and fair way to proceed and to make universities revenue generators in their own right.

[Presentation available online](#)

Kim Rueben

Even as the economy begins to recover, states should expect to see ongoing budget pressures from health care, employee pensions, prisons, schools and infrastructure, Ms. Rueben said in a wide-ranging review of state/local expenditures.

Education and Medicaid make up about half of state expenditures. When we start talking about making significant cuts, you can't do that through firing state workers. You can't do that through cutting along the edges and actually have things work.

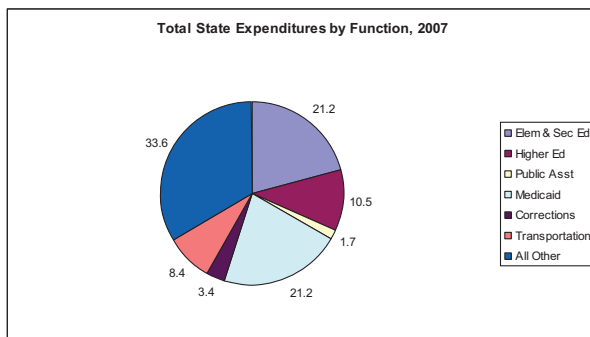
When we talk about where the cuts are, the cuts are basically going to be where the money goes and where the people are.

States increased pension benefits in the 1990s when many systems were overfunded, in part because of the stock market bubble. States should start trying to address this issue during salary discussions, looking at the overall value of salaries and benefits.

Are we going to be able to afford the increase in health-care costs and, if not able to afford it, what do we do about it? We're getting older, with the share of the population that is over 65 increasing.

We are also getting younger, as the number of school-age children

Education and Medicaid Make Up About Half of State Expenditures



Source: National Association of State Budget Officers, State Expenditure Report 2007.

Tax Policy Center
Urban Institute and Brookings Institution

The question about future expenditures for states comes down to what services governments want to provide.

– Kim Rueben

Many states used the federal stimulus money to prop up the status quo and did not make tough choices.... They still need to make tough choices.

– David M. Walker

increases. If you think that education is something that gives you private returns, maybe letting students pay more of the cost of their higher education isn't a terrible idea.

There might be some opportunity for salary negotiations with the public sector unions, acknowledging the fact that they're getting a big retirement benefit and maybe that can be reflected in salary discussions.

[Presentation available online](#)

Ron Snell

There never has been a crisis like this for state governments. It's pointless to compare this to the Great Depression of the 1930s because in the early 1930s, states did very little. It's not even a fair comparison with the 1990-91 crisis for state governments because at that time the overhang of state pension obligations and the overhang of retiree health care obligations weren't out there.

The states probably are not at their low point yet. With less federal stimulus money next year, and with state revenues likely to decline, we're going to see very, very deep budget cuts next year. Those budget cuts are going to have to extend into two sacrosanct areas: health care and education.

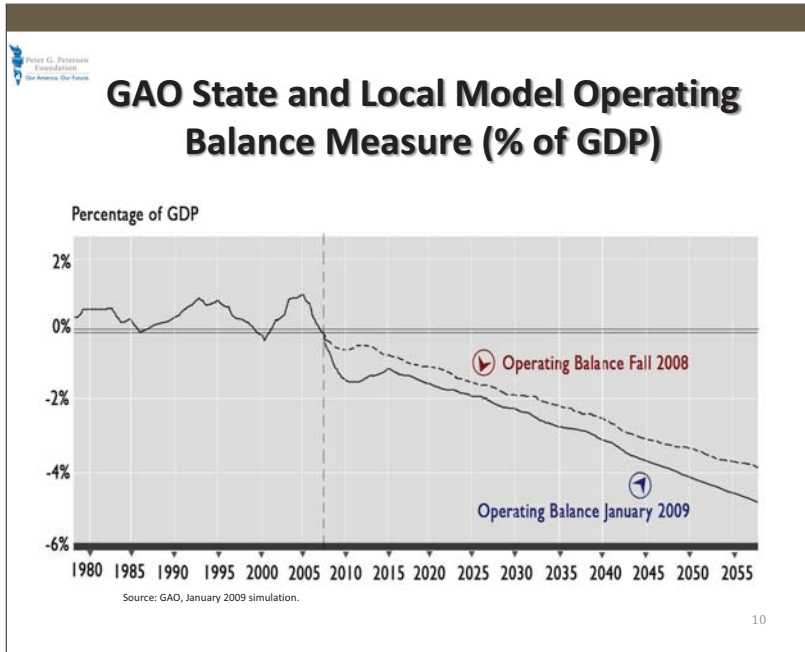
One of the hopeful signs presently is that there are a lot of meetings like this one going on around the country. That's a very good thing. An even better thing is that legislatures are holding budget study groups, tax study groups in places where this would have been thought unlikely in the recent past. Across the country, these groups are aware of the kinds of problems that you have seen laid out for you today.

I think we're going to see a very difficult year next year economically, fiscally, and politically. In the year or two after that we're going to begin to see creative answers to questions about what state priorities should be, how responsibilities should be divided up, and how we can put state revenues on a more stable base.

David M. Walker

In his keynote address, Walker outlined challenges facing both the federal and state governments. He discussed potential solutions including a constitutional limit on federal debt, "fiscally responsible health-care reform," comprehensive tax reform, and a "grand bargain" in which the federal government might assume states' health-care costs.

Bad news flows downhill. There has been relief provided by the federal government this past year to help states, but the federal government faces a large, known, and growing structural imbalance. It has to make tough choices sooner rather than later because our foreign lenders are now speaking publicly about their concern about the value of the dollar, and the long-term creditworthiness of the United States, and whether or not the dollar should remain the dominant global currency. These and other



factors will force the federal government to take tough steps.

The ripple effect will be felt at the state and local level. State and local governments have their own structural challenges that they need to start to deal with. And there are a number of common denominators between those structural challenges.

We're adding debt at record rates. Within 12 years the single largest item in the federal budget could be interest on the federal debt. And what do you get for interest on the federal debt? Shinola. Absolutely nothing. Increasingly, the budget is on auto pilot, driven by entitlement programs, driven by mandatory spending and therefore the squeeze is on so-called discretionary spending.

Forty-eight states had budget shortfalls in 2010. The stimulus covered 30 to 40 percent of the budget shortfalls. My experience has been that many of the states used the stimulus support this year to prop up the status quo and did not make tough choices. Well, just like the federal government is going to have to make tough choices, so are the states and local governments.

Einstein said the most powerful force on earth is not nuclear energy but the power of compounding. The sooner you make tough choices, the quicker the power of compounding can work for you. And that's what we need to do, at all levels of government.

Deteriorating conditions for states and locals are driven primarily by Medicaid, unfunded retiree health care, underfunded pension plans, deferred maintenance, and education costs — those are the primary drivers.

This isn't just about numbers. It's about stewardship — not just generating positive results today, but leaving things better positioned for the future. On the path we're on right now, my grandkids — 8, 6, and soon to be 3 — will pay the price and bear the burden. Their future is being mortgaged. At a time when we're facing increasing global competition that is not a fair deal. That is not what America is all about. We need to do something about it.

[Presentation available online](#)

Donald J. Boyd

Boyd called for state processes that force budget designers to take a longer-term view, abandoning one-year planning periods and paving the way for reduced volatility in revenue and expenditure cycles.

States really need to focus on three- to five-year periods. What you need are fiscal institutions that make it possible to bring the out-year consequences of decisions into near-term decision making.

– Donald J. Boyd

You might not adopt a policy that you can't afford over the longer term if you're actually looking, thinking, and perhaps even have a process that forces you to think about the out-year implications. Right now, policy options that cost money in the short term but might save you money two, three, four, and five years down the road often are kind of politically unfeasible. And gimmicks are very attractive.

Short-term volatility, coupled with balanced budget requirements and myopia when budgets are adopted, can lead to sharp cuts in services when demand is stable or rising.

Among longer-term revenue problems, collection of sales and use tax related to remote sellers, and sales taxation of services, are demonstrably large issues of tax erosion. The former is tractable and, I believe, likely to be solved. The latter is extremely difficult politically.

In addition, states have many options for making existing revenue systems more efficient — meaning broader bases, possibly lower rates in both the income tax and sales tax — if they choose to raise additional revenue. Reducing or eliminating property tax exemptions and abatements is another option. So far, these options have been politically unpalatable.

The wild card — if the feds move toward a consumption-based tax — might be an opportunity at some point to scrap parts of the sales tax and move toward a more rational, uniformly administered tax.

Nicholas Johnson

State leaders wrestling with large budget gaps cannot solve the dilemma entirely by cutting budgets and services, but must start looking at longer-term revenue solutions, Johnson said. He outlined three principles for budget solutions:

The first is obvious. Be revenue positive. The size of the hole most states face is so big that the cuts-only solution is unrealistic and irresponsible.

The second key principle needs to be, to the extent possible, to protect the most vulnerable. State and local taxes are regressive, and the states rely heavily on consumption taxes. States should look at some form of progressive social taxation or, to the extent possible, create offsetting mechanisms that protect low-income families or the newly unemployed.

The third principle is to look at long-term sustainability and stability of tax systems. Continue to fight the erosion of corporate income taxes through combined reporting, which a number of states have yet to do. Look hard at various forms of alternative minimum taxes. A lot of states haven't changed those in decades.

Broadening the sales tax base is a no brainer. Expand it in the areas of services. While we are waiting for the federal government to give states the power to tax Internet sales, there are self-help things states can do, such as New York's approach to level the playing field a bit with the brick and mortar approach. A progressive income tax needs to be accompanied by some other

We need to focus on priorities — on what really what matters.

– E.J. McMahon

mechanisms that assure that when a recession comes along states are protected from the worst fallout.

E.J. McMahon

With state expenditures far outpacing growth in GDP or tax revenues, New York's General Fund spending is projected at \$75 billion in fiscal 2013 while revenues are projected at \$56 billion, McMahon said. He proposed several solutions to "the spending problem":

Point one: Reform and restructure employee compensation. Most states are locked into outmoded civil service systems that increasingly are mismatched with the way the rest of the world operates. They need to look at more flexible work arrangements and this includes incentive-based pay structures that actually offer many employees more upside based on performance.

Next are retirement benefit plans. The situation with the pension benefit is much, much, much worse than it's been portrayed. If you follow the debate in this area, all defined benefit public pension plans are based and calculated on the basis of an accounting fallacy. Their mutual liabilities are discounted on the basis of their *target* rate of return. That is not only a fallacy, it's closer to outright falsehood. This is an immense long-term debt we have created for our grandchildren.

We also need to focus on priorities — on what really matters. One proven approach for meeting this challenge is called Priorities of Government, or POG, which was used in the state of Washington to deal with a fiscal crisis in 2003. POG asks questions like: What services are essential? How will the state measure progress in meeting its goals? What is the most effective way to accomplish the state's goals with the money available?

John Cape

Cape agreed that the expenditure side of the equation represented the biggest part of the fiscal problem for states. He used New York as an example of what is happening throughout the U.S.

If you look at the spending trend line of Medicaid and school aid in New York and then you look at, with a fairly rosy set of glasses, the production of our revenue systems — and that is with revenue growth annually above the rate of personal income, say five to six percent revenue growth — by somewhere between 2020 to 2025 Medicaid and school aid will consume the entire general fund of the state of New York. There won't be any room for transportation, corrections, mental health, general government ... anything else. That leads me to suggest that this is mostly a spending problem.

Schools largely rely upon state transfers and property taxes. Now, especially in the downstate area, property taxes have reached a practical limit. On Long Island, school/property taxes are more than eight percent of median personal household income. Over the next 20 years that number will double or triple.

Health care is the biggest driver behind the problem of government finances. We have to do this now.

– Richard P. Nathan

Now we are finding that schools are up against the practical limit on property taxes and are facing a state government without the resources to meet their revenue growth demands, so they are in crisis. Local governments became more reliant on the sales tax and are now victims of the volatility that comes with that. There isn't another ready source to migrate to in terms of dealing with spending. Maybe that's going to be the catalyst for some innovation that's long overdue.

Richard P. Nathan

Richard P. Nathan, the recently retired director and co-director of the Rockefeller Institute, closed the day with the presentation of a new paper on the long-term budget gaps facing the states. He argued that one of the best ways out of the overall government fiscal crisis would be to pass the proposed federal legislation that would reform the nation's health-insurance system.

We are in a very new time economically – in the world economy and the national economy. Institutions have to adjust to that and they *are* adjusting. Private corporations are behaving differently in fundamental ways. Reforms are happening while we're talking.

The lieutenant governor is saying that what the state needs is a four-year budget. And you'll note that when he got to the end of his remarks, he is suggesting ways of bringing people together ... reaching out to a lot of experts to try find ways to change the state budget ... change its priorities ... change how budget systems operate. We often don't give enough attention to the fact that we change institutions all the time: To bring expertise to bear to close military bases, to close hospitals, to effect change in this mighty fiscal system.

We now have a real chance that we're going to have a very large change in health care. Whatever is passed will depend on state governments, and the irony is that states are being weakened by the great recession, by the Medicaid pressure, and by the technology that makes everybody think we can just have smart people in Washington push buttons and arrange things. The role of states has to be important in health care reform. States *are* innovative. Eight to nine states are already out front on this issue in ways that would be impossible to do from Washington.

Health care is the biggest driver behind the problem of government in the country, national and state. Budgets can't tolerate keeping going this way. We have to figure out how to make hard choices. We have to do this now. This is a very important moral issue too. No country in the world as rich as this one has so many people who can't be served. We have come to the point where the suggestion to wait and work on it some more is not a good idea.

(Nathan's full paper can be found on the Federalism and Intergovernmental Relations section of www.rockinst.org.)