



*The US State Fiscal Crisis:
Recession, Structural Imbalance
or Political Disconnect?*

Elizabeth Keating
Eli Goldston Lecturer on Law
Harvard Law School

Overview

The fiscal situation in many states can be characterized as:

- Taxes – sensitive to economic fluctuations
- Federal grants growing slower than GDP
- Non-discretionary expenses increasing steadily and faster than economic growth and revenues
- Increasing debt per-capita
- Substantial unfunded liabilities:
 - Infrastructure
 - Pensions
 - OPEB

The Revenue Outlook

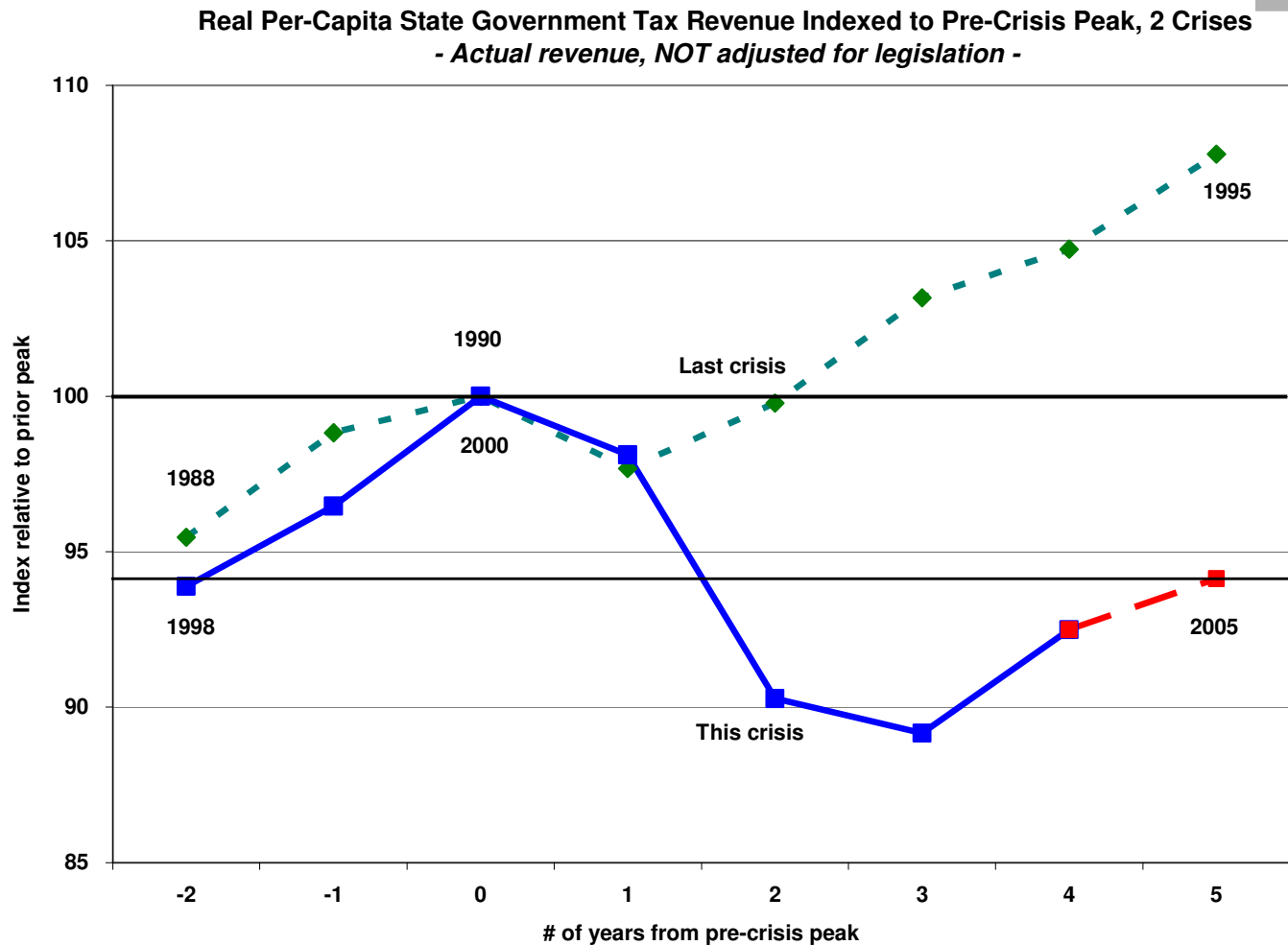
- Historical reliance on a mix of sales and income taxes
- Sales tax base decline
 - Shift from goods to service consumption
 - E-commerce, mail order, cross-border losses
 - Exemption creep
- During late 1990 economic upswing, state income and sales tax **rates** were lowered – “NO NEW TAXES”

This revenue decline partially offset by:

- Decoupling the historical ties of state income taxes to federal tax policies
- Increased use of excise taxes, lotteries, and user fees
- Increased reliance on intergovernmental transfers

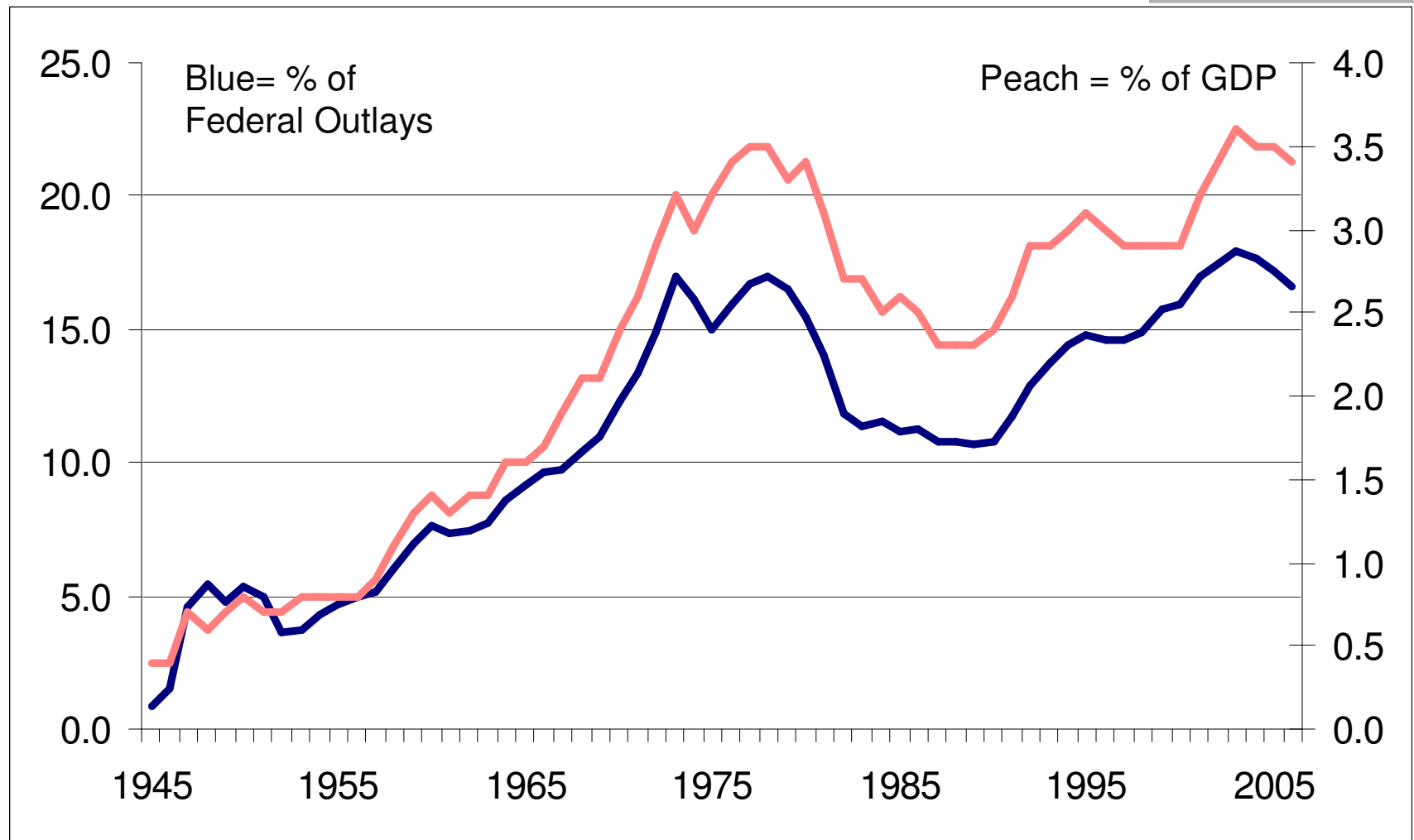


Tax Revenue Is Still Well Below Prior Peak



Sources: "State Finances: Improvement, But Pressures and Risks" presentation by Donald Boyd, Rockefeller Institute, January 13, 2005 to National Federation of Municipal Analysts. Data from Census Bureau, Rockefeller Institute, National Association of State Budget Officers, and Bureau of Economic Analysis.

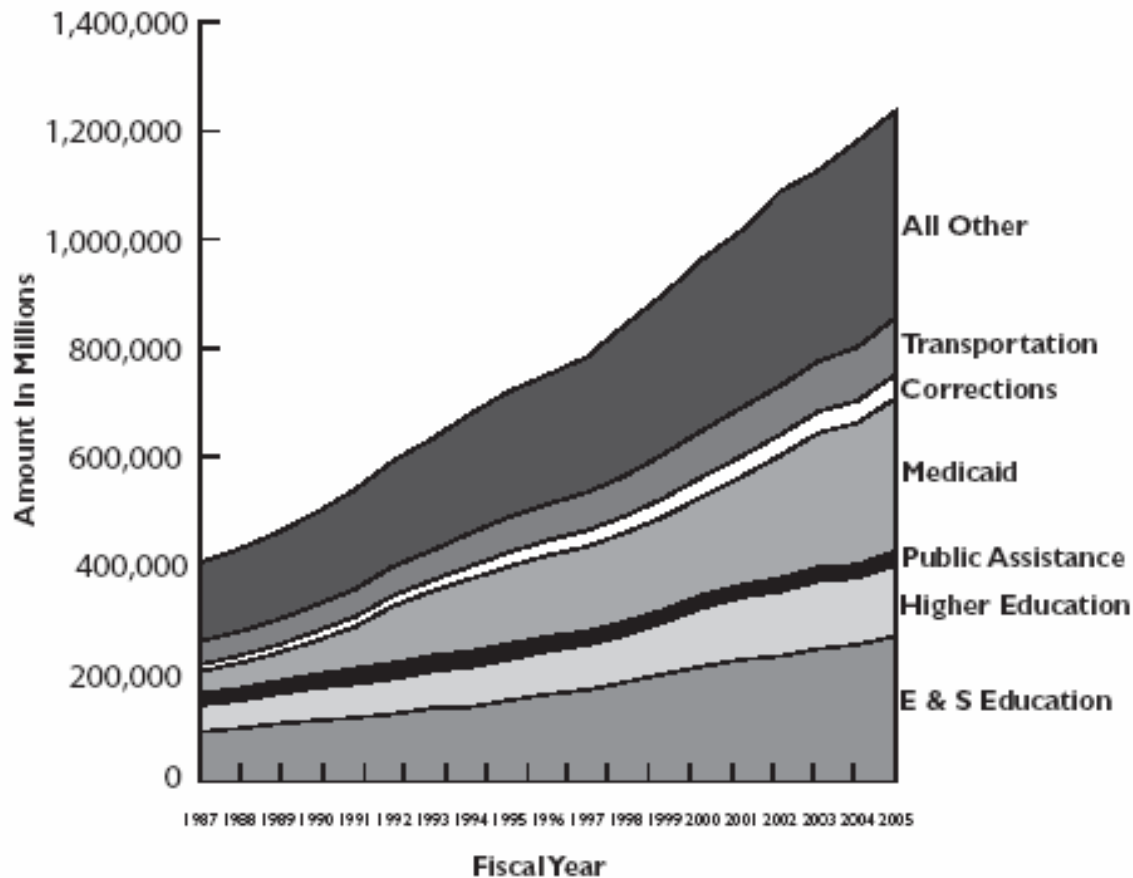
Federal Grants to State & Local Governments



Source: Budget of the United States Government



Expenditure Mix



- Medicaid and education are the fastest growing portions
- These are driven by demographics, federal unfunded mandates, insurance coverage and income levels

Source: 2005 State Expenditure Report, National Association of State Budget Officers

Significant Variation in State Spending Practices

STATE SPENDING BY FUNCTION AS A PERCENT OF TOTAL STATE EXPENDITURES, FISCAL 2005

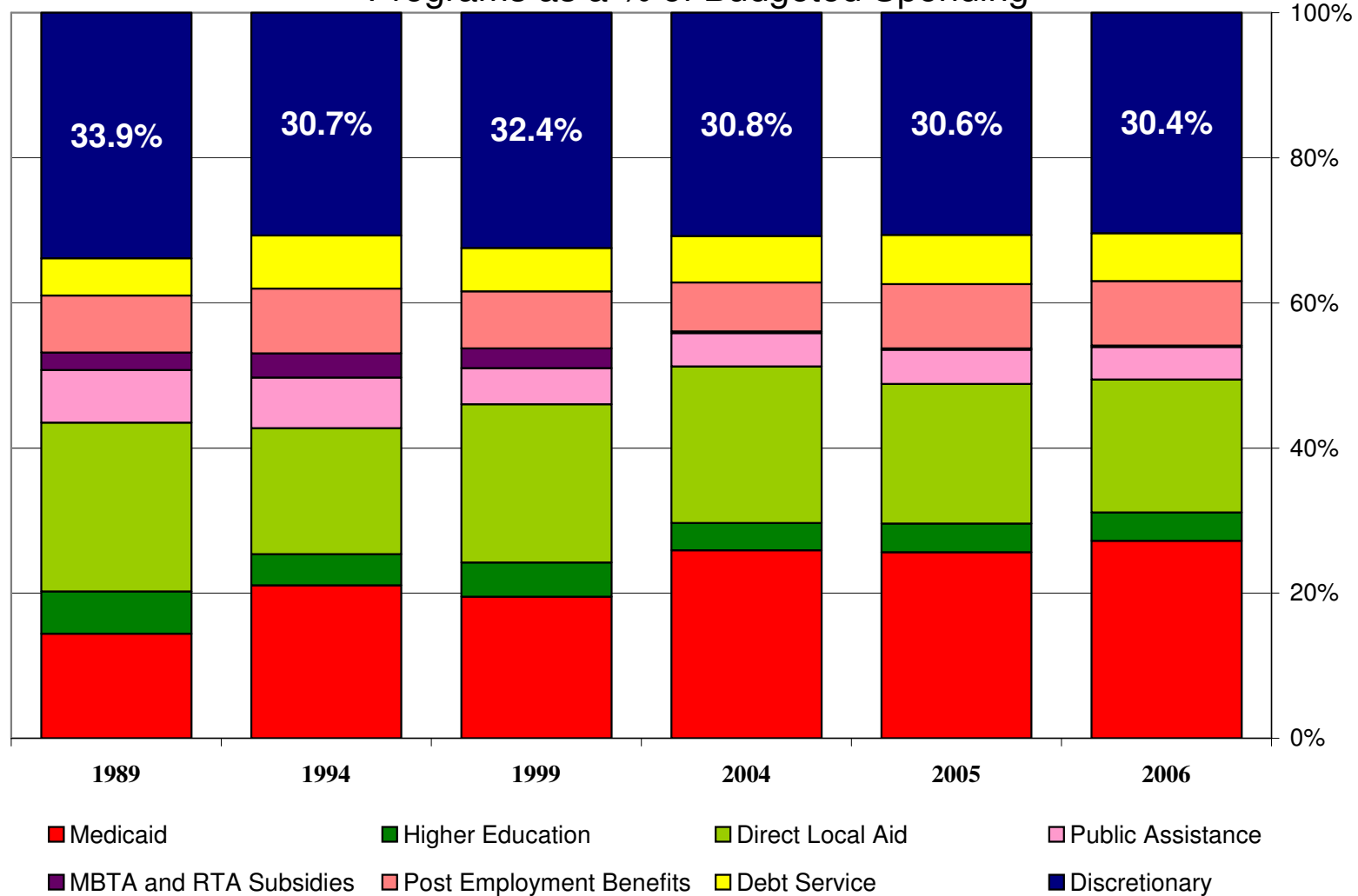
Region/State	Elementary & Secondary Education	Higher Education	Public Assistance	Medicaid	Corrections	Transportation	All Other	Total
NEW ENGLAND								
Connecticut	14.6 %	11.6 %	2.3 %	17.6 %	2.9 %	7.1 %	44.0 %	100.0 %
Maine	17.4	3.6	2.4	31.1	2.0	7.7	35.9	100.0
Massachusetts	20.3	3.7	3.9	22.8	3.9	5.5	39.9	100.0
New Hampshire	21.9	4.5	1.7	27.6	1.8	10.3	32.2	100.0
Rhode Island	16.2	10.6	4.3	27.5	6.1	6.0	29.2	100.0
Vermont	35.5	3.3	2.1	23.1	2.8	8.9	24.3	100.0
MID-ATLANTIC								
Delaware	26.6	5.1	0.4	14.8	3.3	11.5	38.3	100.0
Maryland	18.4	14.5	1.9	20.9	4.3	13.4	26.5	100.0
New Jersey	23.6	7.5	1.0	18.2	3.5	9.3	36.9	100.0
New York	19.7	6.8	3.4	29.2	2.9	5.0	33.0	100.0
Pennsylvania	18.7	4.0	2.2	32.4	3.4	9.1	30.2	100.0

Source: 2005 State Expenditure Report, National Association of State Budget Officers



Discretionary Spending is Shrinking: The Massachusetts Example

Programs as a % of Budgeted Spending

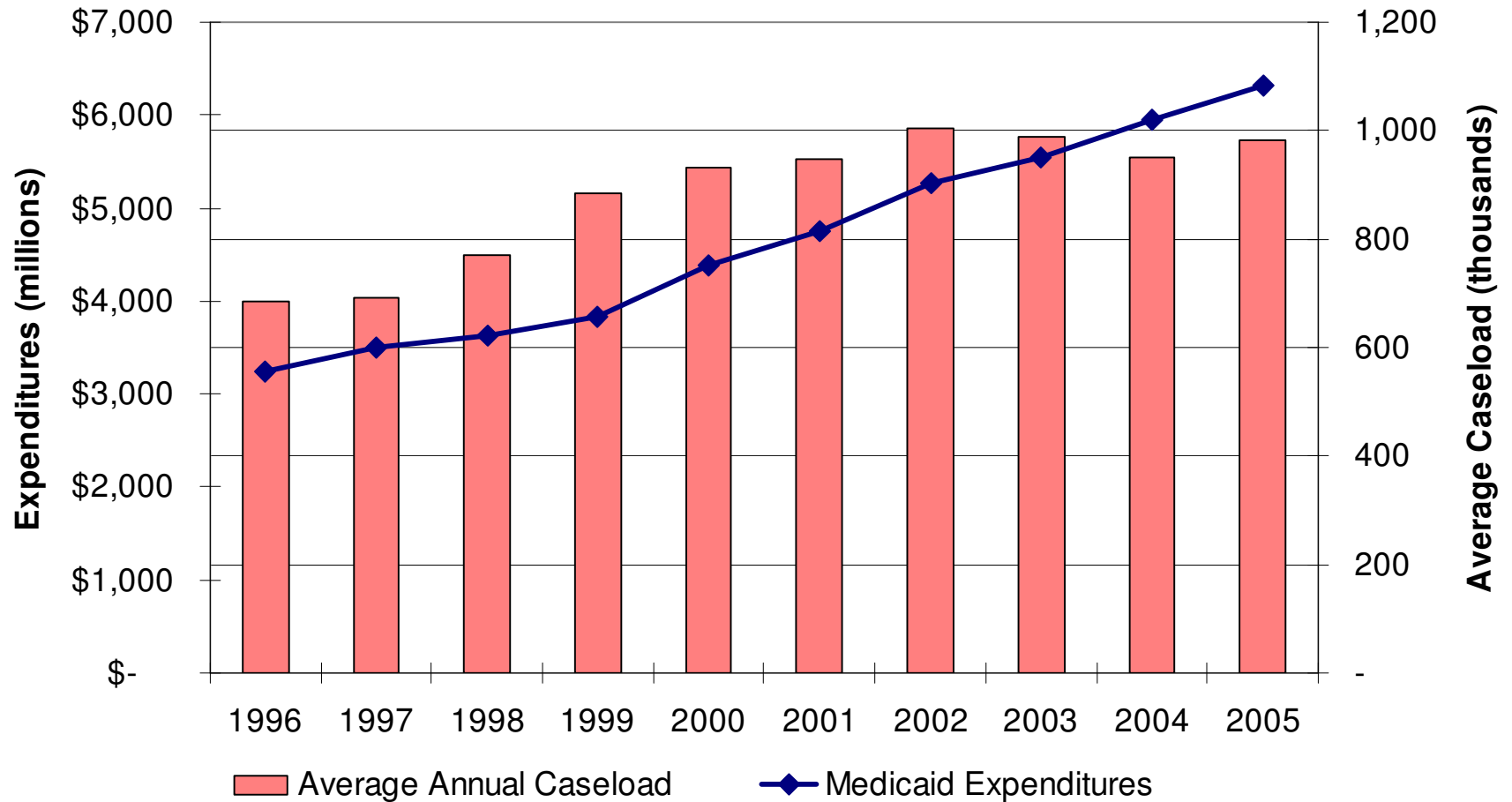


Source: Statutory Basis Financial Reports,
Commonwealth of Massachusetts



Medicaid continues to grow

Massachusetts' Medicaid Program

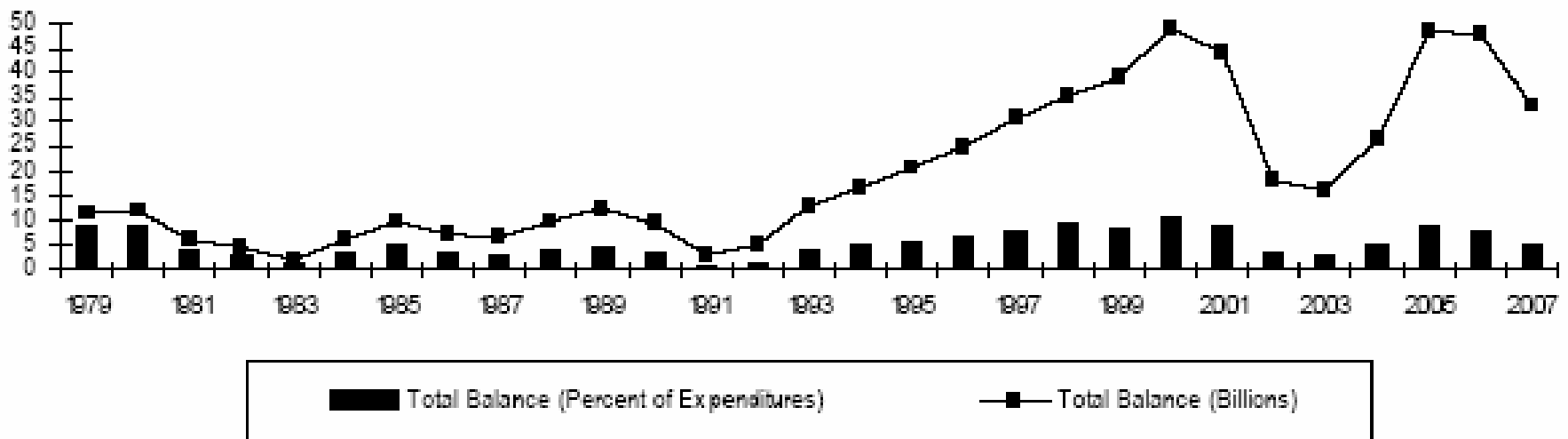


Source: Massachusetts 2005 CAFR



Silver Lining: Fund Balances Have Been Rebuilt

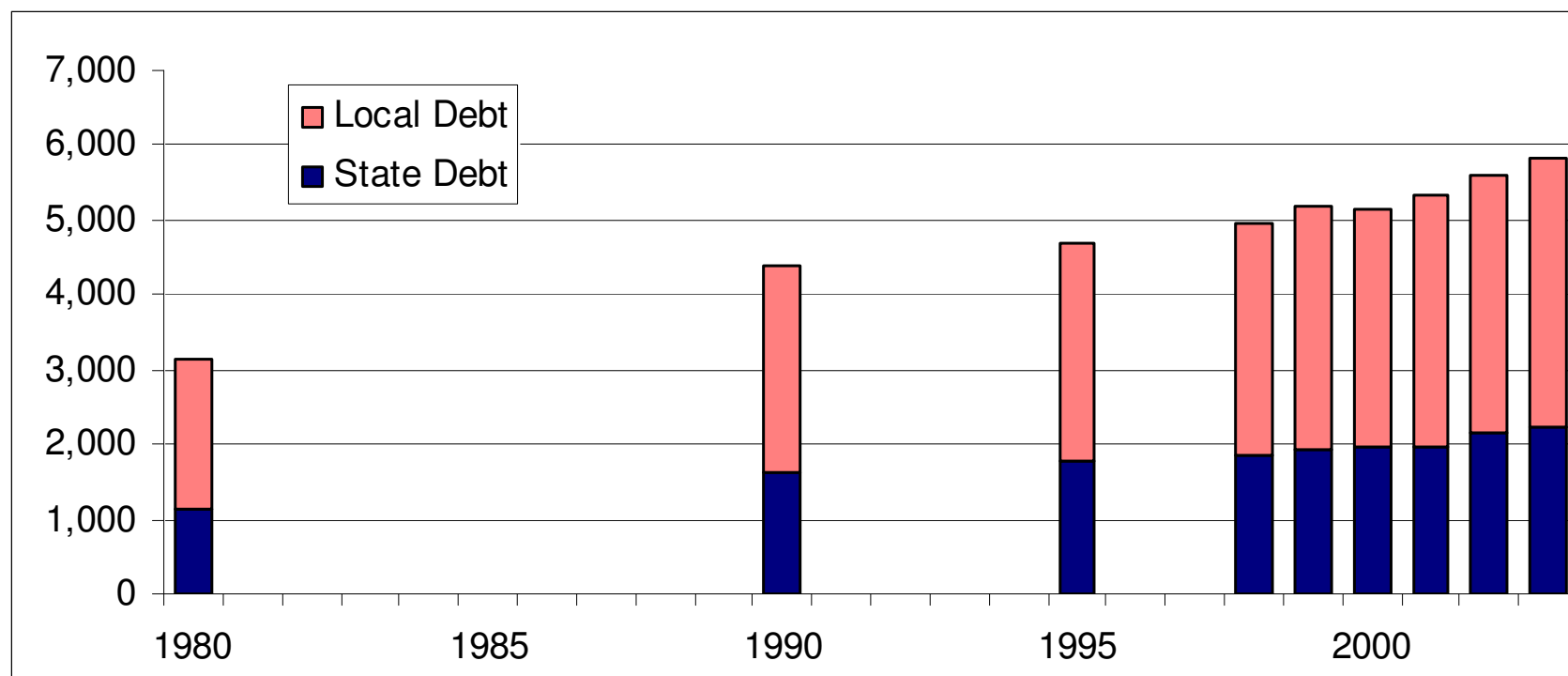
**Total Year-End Balances and Total Year-End Balances as a Percentage of Expenditures,
Fiscal 1979 to Fiscal 2007**



Source: Fiscal Survey of States, June 2006 National Association of State Budget Officers

The Problem Is More Than Cash Flow

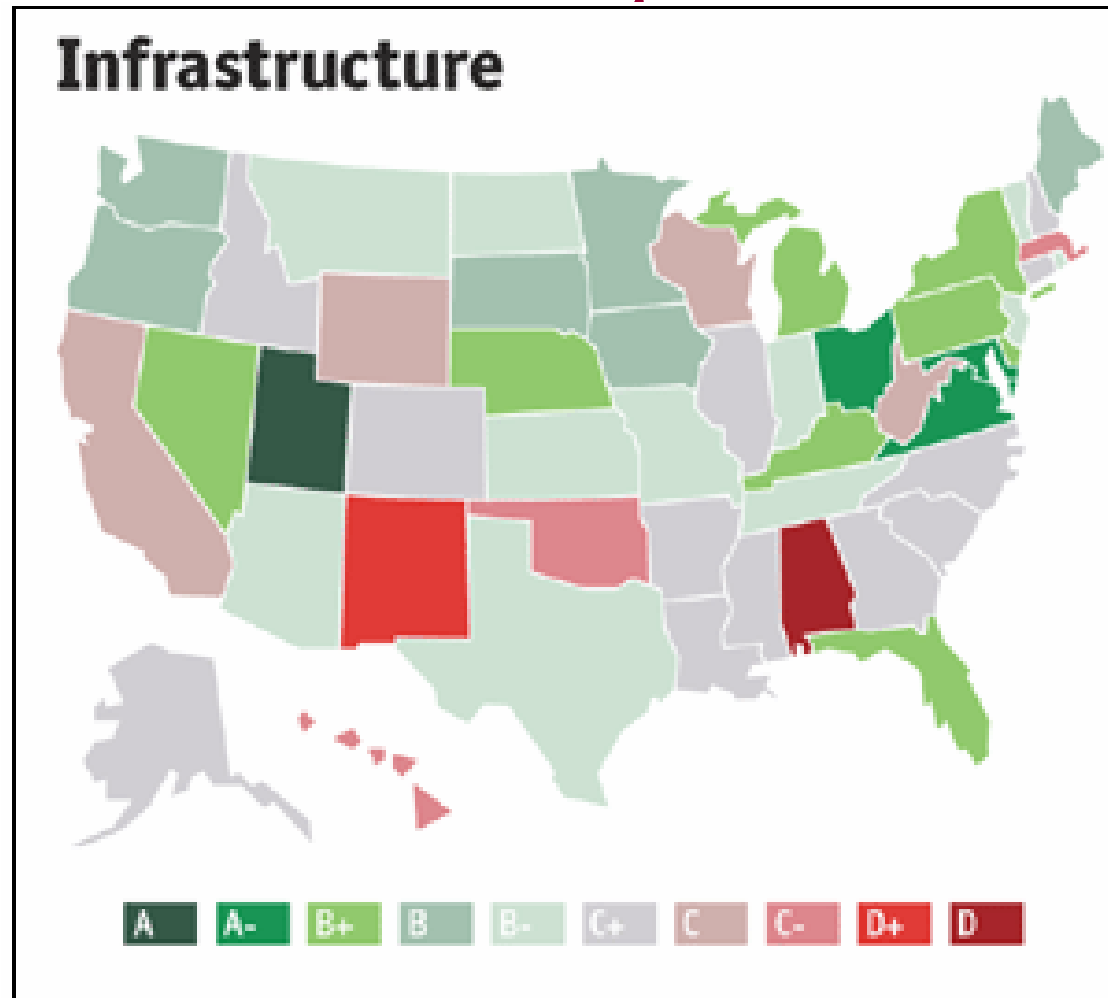
- Deferred Infrastructure Maintenance
- Unfunded SLG Employee Retirements
- Increased Per-Capita SLG Debt (in constant 2000 dollars)



Source: Statistical Abstract of the United States,
Census Bureau



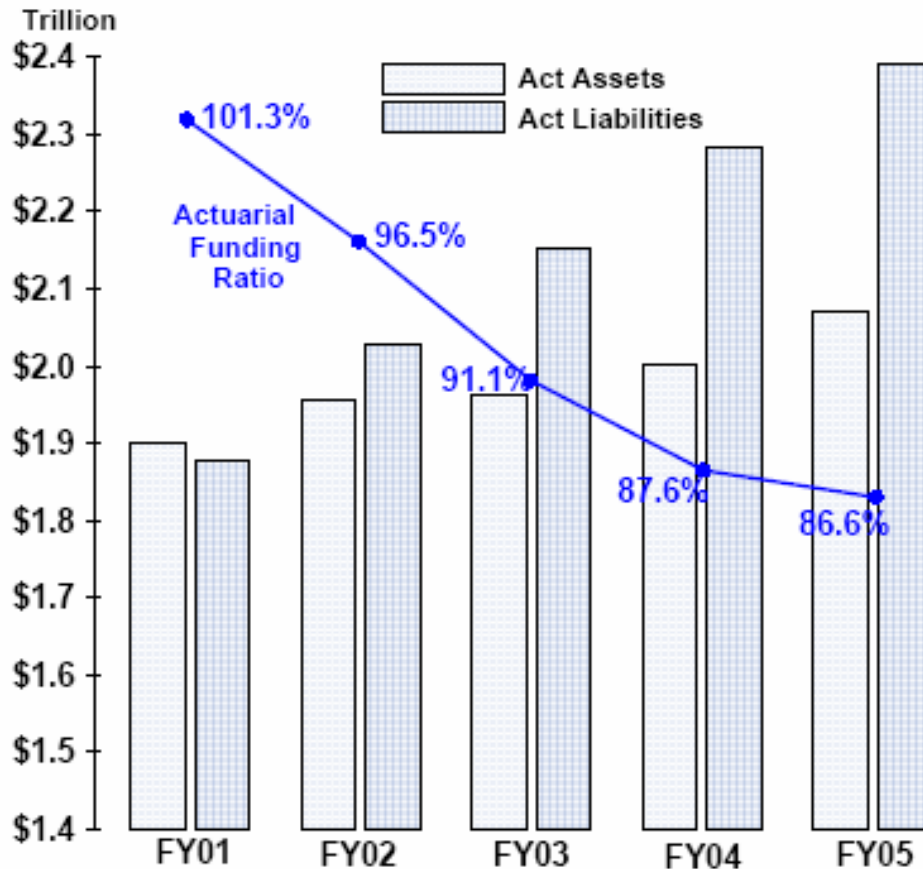
Infrastructure is Increasingly in Disrepair



Source: Grading the States, Government Performance Project, 2005

Pensions Are Increasingly Underfunded

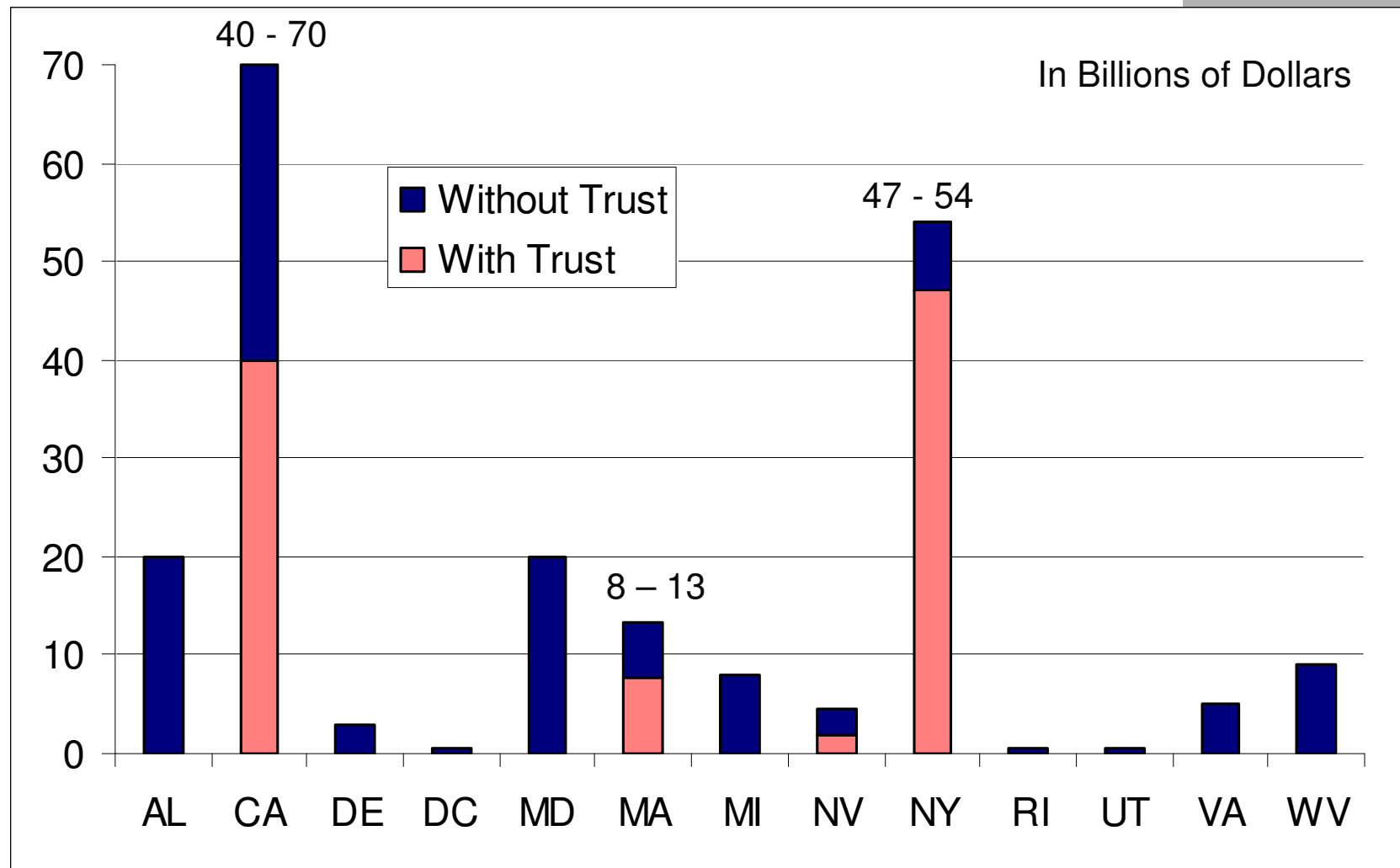
Figure A: Change in aggregate actuarial assets, liabilities, and funding levels, FY 01 to FY 05



- Stats represent the largest public pension plans
- Unlike corporate DB plans, these plans are not covered by pension insurance
- 25% of plan members do not have Social Security

Source: "Public Fund Survey, Summary of Findings, FY 2005." Keith Brainard, National Association of State Retirement Administrators, September 2006.

OPEB Liabilities Largely Unfunded



Sources: State Press Releases and Disclosures



Strategies for Dealing with OPEB

- Create an irrevocable trust
- Consolidate management of OPEB
- Amortize unfunded OPEB obligations over a long time – up to 30 years
- Change the health benefit structure
- Increase cost sharing
- Think outside the box –
 - Contributions of unused sick and vacation time from employees
 - Voluntary employee benefit associations
 - OPEB Bonds
 - Insurance vehicles

Tough Decisions Ahead

- Revenues are not well-matched to expenditures
- Non-discretionary spending will continue to grow at a faster pace than inflation
- Efforts need to be taken to cap costs, cost share and reduce fraud
- Tax collections will be inadequate based on current systems
- Current political unwillingness to raise tax rates broadly or to expand tax base to include services and internet sales
- Federal government deficits place pressure to decrease rather than increase intergovernmental grants