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Structurally Unbalanced:
Cyclical and Structural Deficits in California and the Intermountain West

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The cyclical and structural budget deficits racking California and the Mountain states challenge leaders to break with past budgeting habits and embrace balance as their watchword.

Though the Great Recession may be officially over, economic recovery is slow and tentative, particularly in California and much of the Intermountain West. Among other challenges, the protracted downturn in these states has exposed and aggravated a huge public-sector fiscal crisis—with disconcerting implications for citizens and states' long-term economic health.

This brief takes a careful look at the fiscal situation in Arizona, California, Colorado, and Nevada, examining both their serious cyclical budget shortfalls—those resulting from the recession and its aftermath—as well as the critical longer-term structural imbalances between revenues and expenditures that have developed in Arizona, California, and, to a lesser extent, Nevada. Along these lines, the study uses a unique methodology to estimate the size of the states' structural deficits (or, in Colorado, the surplus) and explores the mix of forces, particularly the policy choices, that created them. After that, the authors highlight the dramatic impacts these states' fiscal challenges, and government responses to them, are having on service delivery as well as local governments. The brief suggests some of the steps state policymakers must take to close their budget gaps over the short and longer term.

First, it urges better policymaking and prods leaders to broaden, balance, and diversify their revenue bases while looking to ensure a long-haul balance of taxing and spending. And second, the report recommends that the states improve the information sharing and budgeting processes through which fiscal problems are understood—so they may be averted.

I. Introduction

Nationwide, the Great Recession is technically over. Real gross domestic product (GDP) is expanding, modest job growth has begun, and housing prices are stabilizing. A halting and tentative economic recovery is underway.

And yet, all is not well, and especially not in California and the Mountain states. Three years after the collapse of a massive housing "bubble," the deepest economic downturn in memory has exposed and exacerbated a massive public-sector fiscal crisis that is affecting all of the region's states, albeit in varied ways.

To be sure, the crisis in public budgets is not the only problem Western states face: In Arizona, California, Colorado, and Nevada employment levels remain fully 2 million jobs off their pre-recession peak.[1] But it is now the state budget crisis that promises to bring the most painful next round of dislocations to the fore.

A moment of reckoning has arrived, after all. During much of the 1990s and again in the mid-2000s, California and the Mountain states had enjoyed years of strong economic growth that had produced what appeared to be robust budgets. This created a fiscal mirage that allowed several of these states to expand public service provision as well as implement permanent tax cuts—with seemingly little thought as to how they might be sustained over the longer term. But now the illusion has been shattered, as the length and depth of the economic downturn has at once created serious temporary or *cyclical* budget shortfalls in these states (associated with the business cycle) while also exposing the existence of long-term *structural* deficits that have resulted in large part from starry-eyed decisionmaking during better times.[2] Such policy choices have now interacted with the base performance of the states' fiscal systems (i.e. the structure of taxes and expenditures) and broader economic and demographic trends to produce in some cases massive chronic imbalances that have largely been overlooked in discussions of states' current fiscal health.

Hence this primer: Intended to help motivate and inform urgent work to close Western states' fiscal gaps and avoid their reemergence, the present brief explores the nature and scope of the cyclical and structural deficits now confronting Arizona, California, Colorado, and Nevada and suggests some prudent ways policymakers should respond.

Already these states have struggled to close (or nearly close) total budgetary gaps for Fiscal Year (FY) 2011 that were nothing less than monumental.[3] These gaps included: in Arizona, $3.1 billion or 36.6 percent of the final budget; in California, $17.9 billion or 21.6 percent of the final budget; in Colorado, $1.5 billion or 21.6 percent of the final budget; and in Nevada, $1.8 billion or an astonishing 54.0 percent of the final budget. In closing these holes, California has garnered the most attention for its use of a mix of deep spending cuts and a host of one-time maneuvers that balance budgets today but leave unattended the reality of future budget shortfalls.[4] And yet other Western states have themselves deeply slashed aid to public education, state university systems, and social welfare programs while employing their own short-term devices and gimmicks. These include temporary tax increases like the voter-approved sales tax rate hike in Arizona, the sweeping use of idle fund balances across most states, and highly publicized asset sales in Arizona and California.

What is more, now that many of those quick fixes have been exhausted, a starker reality has set in in which deeper-going structural deficits will place continued extreme pressure on annual budgets even as economic health returns—albeit slowly—to the states.

The forecast is bleak: With budgets already slashed but overhangs of hundreds of millions of dollars looming, state governments in the West are now going to be compelled to implement huge new cuts to budgets for education, innovation, economic development, health care, and services for the vulnerable, the old, and the young, all the while foisting greater burdens on local governments whose own budgets are in dire straits.

In short, at a time when state governments need to invest and innovate to create jobs, educate workers, and build the next economy in Western metropolitan areas, they will be grappling with historic, long-developing budget crises that threaten to significantly weaken their ability to act—unless they innovate in resolving them.[5]

This brief attempts to distill these issues. It first examines the nature of cyclical and structural deficits and the forces that create them. It then provides structural deficit estimates for Arizona, California, Colorado and Nevada, discusses the factors that have contributed to their emergence, and highlights the implications these deficits—and the states' response to them—have for their residents and economies. The final major section of the brief points to some recommendations for policymakers, suggesting not so much a full blueprint for erasing the present deficits as a guide for putting in place the right platform for attacking these gargantuan problems. This guide includes two key ideas: First, states need to improve the quality of their fiscal policymaking by steadily working to broaden, balance, and diversify their revenue bases while looking to the long-haul balance of taxing and spending. And second, states need to concurrently improve the information sharing and budgeting processes through which fiscal problems are identified, analyzed, and addressed. Each of these changes will require of leaders substantial self-discipline.

In sum, the choices that need to be made by California and the Mountain states are difficult and they will be unpopular in many circles. Hopefully this short primer will help four states emblematic of hope and ingenuity better understand and ultimately work through their colossal challenges successfully.

II. Framing the Issue: The Nature of State Structural Deficits

How can sizable structural deficits or even unmanageably large cyclical deficits exist when states generally are required to maintain budget balance? There are two basic ways. Cyclical deficits can spike in economic downturns when reduced economic activity diminishes revenue performance and lower incomes and higher unemployment rates put added pressures on spending. At the same time, a weak economy can also help expose longer-term structural (or chronic) imbalances between revenues and expenditures. In this circumstance revenue consistently fails to grow in tandem with expenditure obligations and the cost of government. At any point in time a state's total deficit (surplus) is the sum of its cyclical and structural deficits (surpluses).

While there is growing attention to the problem, most states, analysts, and policymakers fail to distinguish between cyclical and structural deficits. For example, the budget gap figures presented above for California and the Mountain states include cyclical imbalances as well as any underlying structural imbalances between revenues and expenditures. In fact, only a small number of analysts have developed structural deficit estimates for individual states.[6] The absence of good, timely data contribute to a lack of understanding of the scope and breadth of the deficit problems confronting states, and ultimately to the failure of their leaders to take the tough policy actions needed to address structural problems, even as they scrap and scrape to close year-to-year budget gaps.

Hal Hovey is one of the first policy analysts to formalize and estimate the size of structural deficits for all America states.[7] Hovey defined a structural deficit as "…a condition in which the revenues produced by a state's tax system (along with its other revenues) are insufficient to maintain existing levels of services." He notes that "structural deficits arise when government spending and revenues are inconsistent over long time horizons." This inconsistency reflects a permanent imbalance between revenues and expenditures and may come from any of a number of sources that broadly can be placed in three categories: the prevailing fiscal structure, economic and demographic trends, and political decisionmaking. These three factors interact to influence both near-term and long-term fiscal health. Consider each in turn:

- ***Fiscal structure.*** A state's existing fiscal structure defines expenditure obligations and the means of financing them through the tax system, and will influence the degree of growth in revenues and expenditures over time. This fiscal structure will have its roots in both statute and a state's constitution. Some expenditures may be discretionary while others may be mandated by previous choices made by voters and politicians. For example, state constitutions typically require a level of elementary and secondary education spending that is enshrined in the state's legislated schools funding formula. The revenue system structure used to pay for these and other expenditures includes a mix of taxes (e.g. income, sales, property) and fees and their rates and bases, which also vary from state to state. Nevada, for example, is one of only a handful of states nationwide with no personal income tax. Overall fiscal performance is therefore heavily influenced by a state's overall revenue fiscal arrangements, which affect the amount of money coming in and going out of state coffers.

▪ ***The economy and demographics.*** Trends affecting a state's economy and demographic composition can impact how a given fiscal structure stands up across budget cycles. All states with a sales tax, for example, have seen revenue performance weaken as the overall economy has become more service-oriented, since the traditional sales tax falls primarily on tangible goods. Population shifts, too, can impact a state's fiscal health. The effects of strong population growth, for example, depend on the extent to which new residents pay for themselves: A large increase of lower-income residents places more fiscal on pressure on both sides of budgets than does a swelling middle- or upper-income populace. An aging population, moreover, can contribute it own pressures by driving up spending on health and human services and public employee benefit programs. In these ways, then, a state largely without structural deficits today may see them emerge in the future as economic and demographic trends ripple through the budget, even with no changes in policy.

When economic times get rough, policymakers often neglect to make the tough decisions needed to put state budgets back on track, commonly resorting to one-time fixes that resolve the current deficit but do little or nothing to resolve more deeply-seated structural imbalances between revenues and expenditures.

▪ ***Political decisionmaking.*** Political decisions can play a huge role in budget dynamics, as changes made to a state's fiscal structure in one budget cycle can and often do have significant effects on its long-term fiscal health. During periods of strong economic growth, for example, states often enjoy cyclical budget surpluses. Decisionmakers often fail to consider that these surges in revenue are temporary, however. For that reason, state budget surpluses are rarely saved in their entirety, with only a fraction typically committed to rainy day funds. More often, the larger portion of such surpluses is given back to taxpayers through permanent tax cuts or used to support permanent spending increases. As a result, a fiscal shortfall typically emerges during a downturn that includes both the cyclical deficit along with any structural deficit arising from the long-term tax/expenditure mismatch created during previous periods of economic expansion. In this way, policy decisions made by state legislatures or directly by the voting public, as well as by federal mandate, can contribute substantially to the emergence of permanent, recurrent budget imbalances. For example, voter initiatives may be introduced that mandate higher spending or that place restrictions on the effective capacity of states to raise revenues—initiatives that, as noted above, can become fiscally unsustainable as the economy progresses through the classic boom and bust cycle. What is more, when economic times get rough, policymakers often neglect to make the tough decisions needed to put state budgets back on track, commonly resorting to one-time fixes that resolve the current deficit but do little or nothing to resolve more deeply seated structural imbalances between revenues and expenditures. While one-time remedies like base-funding reductions might be necessary as well as politically expedient, they can have ongoing effects even after economic health is restored.

In any event, these three forces each have an independent influence on the budget and also can interact in such a way as to produce or magnify a fiscal crisis. A classic convergence of crisis-spawning events is a growth cycle that produces rising income tax revenues that in turn lead to tax cuts; healthy revenues that convince the public to mandate spending increases; and a growing population that needs to be served by program expansion. The convergence then brings disaster when the economy falls into a recession, exposing the well-intentioned but ultimately faulty decisionmaking that took place during times of better economic and fiscal health.

Though often overlooked, the imbalances created by structural deficits are hugely important because they further complicate the resolution of cyclical fiscal problems. Together, they can produce devastating consequences for state economies and their residents. Critical services ranging from public safety to education may be subjected to larger cuts. Infrastructure spending may suffer from greater reductions and deferral. And tax rates may need to be raised further than would be the case if the state were only addressing a cyclical shortfall. Moreover, there comes a point when spending cuts begin to hit residents, and ultimately the economy, where it hurts. Large tuition hikes in a recession can deny students access to college, for example, and diminish not only their own long-term economic prospects but, over time, the overall quality of a state's workforce. Reduced spending on transportation services and improvements can hinder both worker's ability to get to jobs and the swift movement of goods and services, slowing economic activity.

And health care services cuts can adversely affect physical and mental wellbeing, reducing productivity, and leading to the need for more costly treatment down the road.

Nor does the political climate associated with eliminating deficits during an economic downturn tend to foster the development of sound, long-term policy decisions. Often times, instead, during crisis, policymakers resort to gimmicks or evasion, which can potentially further put the state at risk. Some of the policy choices are more egregious than others—New York, for example, has borrowed from its pension fund in order to make its scheduled contribution back to it. Meanwhile, fiscal pressures on a state ripple through to counties, cities, and school districts via reduced aid, diminished tax sharing, and increased spending requirements that create additional hardship. These policy outcomes can have lasting economic effects and lead to future budget dilemmas necessitating additional spending cuts or tax increases. Most notably, the local government layoffs and service cutbacks that frequently result from state deficit traumas and pass-throughs can depress spending, purchasing, and local contracting and place a serious drag on regional economic performance.[8] In this respect, state-level grappling with cyclical and structural deficits—and its impacts on localities—can become at a time of economic shakiness the equivalent of a massive "anti-stimulus," as *The Washington Post* blogger Ezra Klein puts it.[9]

III. Estimating State Budget Deficits

The analysis of state budget deficits discussed in this brief focuses on three Intermountain states (Arizona, Colorado, and Nevada) and California, and extends from FY 2007 through the current fiscal year. The estimates of cyclical and structural deficits presented for each of these states are derived through a unique and consistent methodology that previously has been applied to Arizona.[10]

A detailed description of the methodology can be found in the Appendix. But three caveats regarding the estimates are worth emphasizing here:

First, the analysis does not account for capital expenditures and revenues/expenditures that do not flow through the general fund (e.g. pension fund contributions from the general fund and long-term pension fund expenditure commitments); these other components of the state budget may also suffer from imbalances that will not be captured here.

Second, the measure of expenditure requirements is based on FY 2008, which may or may not reflect the long-term spending needs for a given state. For Colorado, for example, this takes the long-term influence of the Tax Payer Bill of Rights (TABOR) on the size of state government as a given: The presumption is that the revenue and expenditure patterns induced by TABOR reflect the preferences of the electorate.[11] (TABOR is described in more detail later.) For all four states, at any rate, the analysis assumes stable economic and demographic patterns. That is, there is no accounting for potentially higher (lower) service delivery costs in future years, either due to differences in input costs or the scope of the population benefiting from service delivery. In practice, there are demographic and economic pressures building in each of the states that have the potential to aggravate structural deficits in future years.

Finally, the estimates are sensitive to the fiscal structure and the nature of political decisionmaking in each state. The expenditure policy changes that have transpired since the FY 2008 baseline are assumed to be temporary, since past experience indicates that recent cuts such as these are largely restored when revenues rebound. If post-2008 spending cuts prove to be permanent then the structural deficit estimates reported below would be diminished. Otherwise, no further changes in fiscal policy are built into the analysis. However, future tax cuts or expenditure increases would add to the structural deficit problem confronting the states.

IV. Cyclical and Structural Deficits in California and the Intermountain West

So: How serious are the state budget deficits faced by selected Intermountain West states and California? A careful analysis of cyclical and structural deficits in Arizona, California, Colorado, and Nevada reveals a set of varied—though universally disconcerting—trends that point to the depth and nature of the fiscal crisis facing these states:

All four of the Western states examined are under heavy fiscal stress. The new analysis underscores that Arizona, California, Colorado, and Nevada are all grappling with extraordinary general fund deficits that were revealed and exacerbated by the recent Great Recession. For each state these shortfalls include a substantial cyclical deficit and for two states, Arizona and California, a large structural deficit as well. A snapshot of both the cyclical and structural deficit estimates for 2011 is presented in Table 1, while Figure 1 shows ongoing revenues and expenditures per $1000 of personal income in each of the four states over time.

Table 1. The magnitude and components of the deficits among the states vary considerably

Surpluses (positive) and deficits (negative) expressed as a percentage of stable expenditures

Fiscal Year	Arizona	California	Colorado	Nevada
TOTAL DEFICIT				
2007	-1%	-3%	7%	-2%
2008	-14	-2	4	-9
2009	-31	-24	-10	-16
2010	-38	-27	-11	-16
2011	-33	-21	-7	-18
CYCLICAL DEFICIT				
2007	17	5	5	3
2008	7	7	2	-4
2009	-11	-15	-12	-10
2010	-17	-18	-13	-15
2011	-12	-12	-9	-17
STRUCTURAL DEFICIT				
2007	-18	-9	2	-5
2008	-20	-9	2	-5
2009	-21	-9	2	-5
2010	-21	-9	2	-1
2011	-21	-9	2	-1

Source: Brookings Mountain West / Morrison Institute / ASU

Nevada has the largest *cyclical deficit* of the four states for FY 2011, when compared against 2008 baseline expenditures, at 17 percent of general fund spending. This is followed by Arizona and California, each at 12 percent, with Colorado boasting the smallest gap of 9 percent.

Estimates of the *structural deficits* in the four states are more varied. Arizona has by far the largest estimated structural deficit for FY 2011 when compared against FY 2008 baseline expenditures, standing at a mammoth 21 percent of general fund spending. This figure roughly equals total state spending on the university/board of regents system along with all state spending on protection and safety. Nevada's estimated structural deficit is only 1 percent of baseline general fund spending for the same year, while Colorado boasts a structural surplus of 2 percent. The biggest dollar denominated structural deficit is in the largest of the four states, California, which has an imbalance of $9.2 billion; Nevada's shortfall runs to only $33 million.

As noted above, these estimates do not consider future economic and demographic trends and assume that the economy will in fact cycle back to its pre-recession levels.

In this way they may paint a far rosier fiscal picture than is warranted, particularly in Nevada. Given the massive long-term restructuring now likely underway of the state's migration, gaming, and consumption-based economy, the Silver State almost certainly now suffers from a serious structural challenge that will manifest itself clearly in the coming years.[12] This issue is discussed in more detail below.

Cyclical surpluses and deficits in the four states have fluctuated over the past five years while structural deficits have largely held steady. All four states enjoyed cyclical surpluses in FY 2007 as a percentage of stable expenditures and all but Nevada—which suffered from a 4 percent deficit—retained a cyclical surplus in FY 2008.

That all changed as the economy tanked and revenue yields fell. In FYs 2009 through 2011, all four states experienced a cyclical deficit. While the size of the cyclical deficit in Arizona, California, and Colorado decreased several percentage points from FY 2010 to FY 2011, in Nevada it has continued to climb each year since it first appeared in FY 2008—a year earlier, as noted above, than in the other states.

Arizona, for its part, saw the most dramatic swing during this five-year period, since it began with a far higher cyclical surplus (17 percent) than the other states in FY 2007 and thus experienced the largest reversal of fortunes. This swing owes to the way its particular revenue system interacts with the state's extremely cyclical economy. Arizona's significant shifts in revenue over the last two decades, even after adjusting for tax law changes.

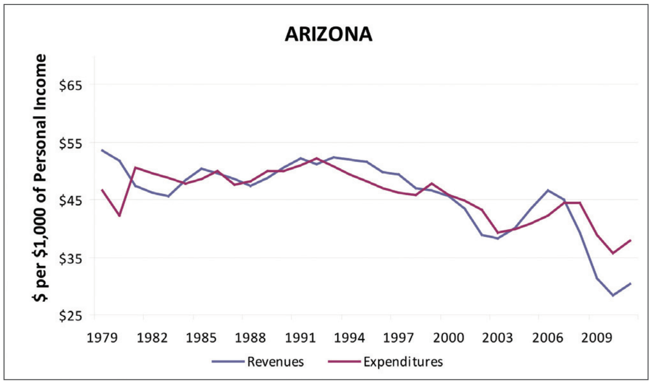
Structural deficits, meanwhile, remained stable over the past five fiscal years in California (at 9 percent of stable expenditures) and increased 3 percentage points in Arizona from 18 percent to 21 percent. Permanent tax increases introduced since the onset of the recession have helped reduce the structural deficit in Nevada from 5 percent of stable expenditures in FYs 2007 through 2009 to just 1 percent in FY 2010 and 2011. Colorado, the outlier, experienced a stable structural surplus of 2 percent during the entire five-year period.

Deficits in the four states are caused by a mix of factors. That all four of the states in this analysis are experiencing cyclical deficits—as are nearly all states in the nation—is not surprising. Though the magnitude of the deficit varies somewhat among them, the source is largely the same: dramatic drops in revenue due to the recent recession and protracted economic downturn. As the economy slowly recovers, the cyclical deficit will decline and eventually become a cyclical surplus—but any underlying structural deficits will remain, poised to aggravate the next economic slump.

Structural deficits like those presented here represent longer-term imbalances between revenues and expenditures. As discussed in section II, they arise from the complex interaction between the states' fiscal and institutional structures, economic and demographic change, and, critically, policy decisions about taxing and spending. All of these factors have had some degree of influence on the structural deficit estimates for California and the Mountain states. For example, a growing school-aged population on one end of the population pyramid and a growing graying population on the other has created expenditure pressures, while sales tax revenue growth has been weakened (beneath the wave of strong economic growth) by shifts in consumption toward largely untaxed services. These trends have been compounded by discretionary policy changes and voter initiatives that have both permanently diminished revenue productivity and increased spending on services over time to where the states simply cannot make ends meet. Constraints have also been introduced by voters that limit the revenue raising capacity of the states; all four Mountain states have some form of ongoing supermajority requirement over some facet of the budget.

But while there are numerous common threads, understanding the causes of these states' fiscal problems requires a state-by-state perspective.

Figure 1. Revenues in Arizona have dropped precipitously over the past several years following a series of permanent tax cuts implemented since the 1990's.



a. For this and the following three charts, the difference between the two lines represents the total deficit or surplus: Where the expenditure line is higher, the difference is the total deficit; where the revenue line is higher, the difference is the total surplus. However, the deficit indicated by a comparison of the two lines is definitionally different than the deficits estimated for this paper.

b. One-time or temporary budget fixes are not included in the revenue figures.

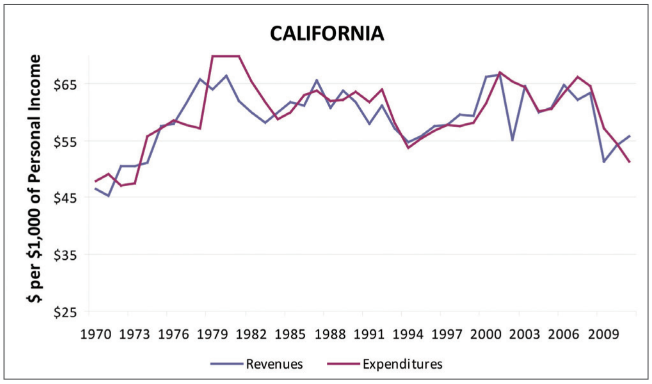
c. Expressing the revenues and expenditures per $1,000 of personal income automatically adjusts for inflation, population growth, and real per capita economic growth.

Arizona's fiscal problem is largely, but not exclusively, rooted in policy actions that over time have significantly eroded the state's available revenues. From FY 1993 to 2010 the state cut all kinds of taxes, but 58 percent of the total reductions in nominal dollars came from the personal income tax; these reductions gave rise to a structural deficit that predates the current economic cycle. Nominally, the net changes during this 17-year period totaled some $1.7 billion. Adjusting for inflation, population growth, and real per capita economic growth, the cumulative impact climbs to $2.9 billion.[13]

On the other side of the budget ledger, two major impacts on general fund expenditures have occurred since the structural deficit began in the early 1990s. First, funding for school construction was shifted into the general fund in FY 1999, with no additional revenue being provided. The annual expense has been as high as $500 million. Second, in 2000 voters passed two competing ballot initiatives to expand Medicaid by using tobacco settlement monies. However, the specified funding source was inadequate to support the expansions, and additional funding had to be drawn from the general fund. As Figure 1 shows, though, overall general fund expenditures in the state have actually decreased over time.

Meanwhile, Arizona confronts several constraints on fiscal flexibility that will make eliminating its massive structural deficit all the more challenging. Most notably, the state's requirement for a supermajority for any revenue increase will seriously hinder revenue-side responses. While there are those who argue such a provision may protect the budget process from capricious increases in spending, it greatly complicates prudent fiscal management.

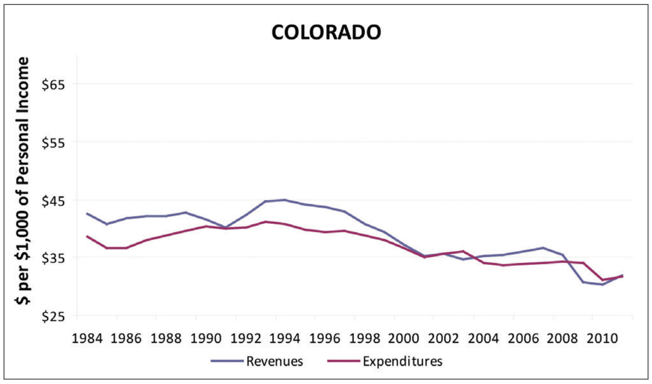
Figure 2. Until very recently spending in California has outpaced revenue collections.



Unlike Arizona, **California** suffers from more of a spending problem than a revenue problem, a result of permanent spending increases that were introduced during years of economic expansion. For example, the state significantly increased spending on education during the 1990s as the dot-com boom boosted the economy and personal income tax revenues; further spending increases were implemented in the relatively healthy years of the mid-2000s.

Voter mandates and other institutional constraints have further strained budgeting in California. California's Proposition 98—the Classroom Instructional Improvement and Accountability Act passed in 1988—requires that nearly one-half of all new revenue be dedicated to support schools. While it is hard to argue against funding for education, the fact is that Proposition 98 reduces lawmakers' ability to address the state's structural deficit even as it hampers its ability to fund other programs. California also had required a two-thirds legislative majority to approve the state budget, one of only three states in the nation (along with Arkansas and Rhode Island) with such a requirement. In the November 2010 election California voters approved an initiative requiring only a simple majority for budget approval. However, the same voters also approved a measure that would require a two-thirds majority for not only any tax increases but fee increases as well.[14] And then there is Proposition 13, the 1978 People's Initiative to Limit Property Taxation, which has enshrined as an amendment to the California constitution limitations on local property tax revenue growth. Proposition 13 has succeeded in limiting local government revenue, but it has also depressed localities' capacity to fund services from their own sources and placed significant new spending obligations on state government, adding to the structural deficit.[15]

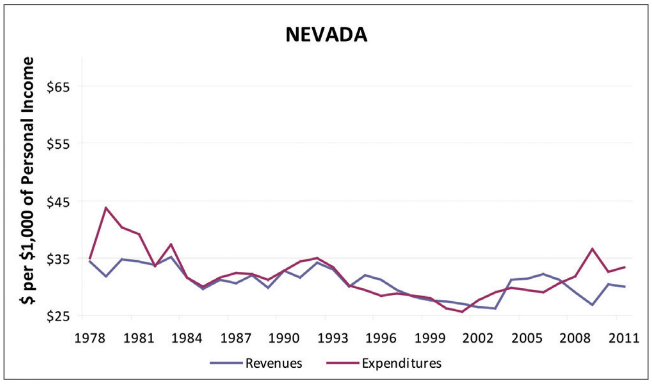
Figure 3. TABOR has kept Colorado's spending and revenues in line but led to serious declines in both.



Colorado's small structural surplus, meanwhile, is unique and reflects the influence of the Taxpayer Bill of Rights, or TABOR, which was adopted as a constitutional amendment in 1992. TABOR limits revenue and expenditure increases to the sum of population growth plus inflation. However, when revenues slow or contract as the economy slows, this establishes a lower budget threshold under the formula—the so-called "ratchet effect." TABOR has led to a decline in the size of state government in Colorado through both the population and inflation formula, and the ratchet effect.[16] But while TABOR has helped Colorado avert a structural deficit as traditionally defined, this has come at the expense of state-provided public services. For example, elementary and secondary education spending and spending for higher education have fallen to near the lowest levels in the nation among all states. For the budget as a whole, ongoing expenditures were 4.1 percent of personal income in 1993 but had fallen to 3.1 percent of personal income by 2010.

Voters suspended the TABOR formula for five years in 2005, and it has now been reinstated with looser restrictions. Indeed, Colorado voters generally appear to be increasingly reluctant to add more binding limits on budget growth. The repudiation of the proposed Amendments 60, 61, and 101 in the November 2010 election, for example, offers strong evidence that voters are worried about further cuts in state services. These proposed amendments would have reduced local property taxes (shifting school finance burdens to the state), limited state and local debt, and reduced the state's personal income tax rate.

Figure 4. During the economic downturn revenues in Nevada have declined as spending rose.



Nevada's cyclical deficits in FYs 2009 and 2010 resembled those in the other four states, but instead of narrowing in FY 2011 as in the other states, these shortfalls have continued to grow. This may be the result of a conservative forecast by the state, one complicated by Nevada's budget running on a biennial cycle.

At any rate, Nevada's fiscal challenges go beyond the current period, however, with constraints on revenue capacity and decisionmaking an enduring issue. The sales tax rate is written into the constitution, for example, and there is a constitutional prohibition against an income tax. Earmarks and formula mandates also limit Nevada's fiscal flexibility and discretion, with over 50 percent of revenues dedicated to supporting specific spending programs. These restrictions have already led, in better times, to a serious legal crisis: In 2004, the Nevada Supreme Court intervened following a budget impasse that involved a proposed controversial tax increase, ruling that the constitutional requirement to fund schooling trumped the state's supermajority requirement for increasing taxes.[17]

Nevada's near-term structural deficit reflects a small mismatch between expenditure commitments relative to taxes. However, pressures on the budget will be acute in coming years, reducing the likelihood that the state can avoid creation of a more serious structural imbalance down the road. Economic and demographic trends in particular are not favorable from a budget perspective. The region's sunny climate, along with now-reduced housing costs, will eventually again attract new residents, but, given its excess existing housing stock, this won't lead to a commensurate increase in property and sales tax revenues. Meanwhile, the expected growth in its elderly and school-aged population will mean higher expenditure commitments. At the same time, the employment and wealth shocks of the recession will likely temper growth in gaming revenues, while growth in gaming opportunities outside of Nevada, including Internet gaming, will put further downward pressure on the state's most important economic sector. Together the economic and demographic trends will interact with the tax system to create an especially harsh budget climate throughout the decade such that this state, which does not now struggle with a large structural deficit, will likely gain one.

V. State Impacts, Recent Responses, and Continuing Implications

Cyclical and structural budget imbalances of the scale roiling California and the Mountain states have already had, and will continue to have, disturbing practical consequences.

Most notably, dramatic spending cuts have already caused significant reductions in service provision across critical program areas, including especially education and the social safety net. What is more, state distress is also exacerbating local budget distress, as the states have increasingly reduced aid to local governments in order to redirect money to the general fund to make up for reduced tax revenue collections.[18]

And yet, for all the painful actions states have taken in the last two years to close their recent budget gaps, little has yet been done to address the longer-term structural pressures on revenues and expenditures. Instead, a considerable share of increased revenue generated by these states over the recent cycle has come from one-time fixes like asset sales and the draining of rainy day funds rather than through permanent, if more difficult, revenue enhancements. At the same time, policymakers continue to ignore the crucial need to update outmoded revenue systems to better reflect economic and demographic shifts. While tax reform is challenging, a failure to modernize state revenue systems puts states in a poor position for the next economic downturn.[19]

A state-by-state synopsis of recent budgetary actions illustrates at once the pain being inflicted by the states' efforts to address their fiscal challenges and the largely shortsighted nature of those efforts:[20]

Arizona: Arizona has relied disproportionately on temporary or one-time measures to close budget gaps rather than permanent repairs to the tax and expenditure system, despite the fact that many of the problems are long run in nature. For example, a temporary one-cent sales tax rate increase was implemented in 2010 with great controversy to help close a budget gap that was well over $1 billion. The state also garnered national attention for its asset sales, which included the state Capitol and Supreme Court building. Of the $12.5 billion in total budget adjustments since 2008, 80 percent of the balancing act has been realized by one-time measures.[21] On the other side of the budget, meanwhile, the cuts have already been sharp and painful. Educational funding reductions from the general fund have been significant to the point that from FY 2008 to 2010 K-12 funding declined 20 percent while university budgets were cut 28 percent.[22] Some of this reduction has been temporarily masked by additional federal stimulus dollars. Those, however, are coming to an end. Likewise, the state halved the school day for kindergartners earlier this year to free up $218.3 million.[23] In another move the state reduced the lifetime eligibility for Temporary Assistance for Needy Families (TANF) benefits to just 36 months from 60 months, revoking support for 8,200 families.[24] Further, the state recently cut off financing for certain organ transplants under the Arizona's Health Care Cost Containment System, the state's version of Medicaid.[25]

California: California enacted the 2010 Budget Act in October to address a shortfall of $19.3 billion in the FY 2011 budget. Together nearly $8 billion in ongoing and temporary service cuts along with $3.3 billion in additional revenues were included in the budget. Of the total package, about one-third represent one-time or temporary fixes: The state assumed that the federal government would contribute $5.4 billion in yet-to-be approved assistance, while one-time efforts produced $2.7 billion in funds, including $1.2 billion funds from the sale of 11 office buildings that it would then lease back from the buyer. Spending was also slashed, and included $3.3 billion in reductions and deferrals to the state's K-14 education system for 2011, as well as myriad health and social services cutbacks. The Office of AIDS saw a $52.1 million budget reduction, for example, the Department of Mental Health's budget was cut by $82.4 million, and funding for Child Welfare Services dropped $80 million. There was also a one-time $70 million reduction in state benefits for Seriously Emotionally Disturbed children in foster care.[26]

Impacts in Arizona: State Aid Cuts Hit Rural and Urban Counties Alike

Arizona's current 12 percent cyclical deficit and whopping 21 percent structural shortfall are forcing headline-grabbing state government cuts to education and services. Less covered but nearly as disruptive are the grinding, now intensifying impacts of the crisis on the state's rural and urban counties.

Arizona's 15 counties—which manage such critical matters as public safety, health, economic development, and land management—have been working since 2007 to adjust their budgets in response to the economic downturn by laying off personnel, reducing service levels, tapping financial reserves, eliminating non-mandated programs, and decreasing capital projects and road building. But even as county leaders have struggled to get their own fiscal houses in order, the reality of shared state revenue and program responsibility and the need to balance the state budget has piled on an additional load of fiscal burdens. Put simply, the state's budget problems are now dragging these local governments into crisis, with troubling implications for both rural and urban Arizonans.

All told, from FY 2008 to FY 2011, Arizona counties suffered a collective loss of $193.6 million due to the state's budget woes. Statewide program shifts, where the state pushes the cost of a particular mandated program further downstream onto localities, have cost counties $44.6 million over these past four budgets. And county receipts of Highway User Revenue Fund monies have fallen by $40.4 million. County transfers (i.e. the statutorily required transfer of tax dollars from the county to the state general fund) and lost revenue streams from, for example, the elimination of counties' share of lottery revenues, account for the remaining $108.6 million.

The fiscal impacts of these state-induced revenue drops vary across the state's counties, particularly between its rural and urban jurisdictions. Rural counties, for their part, are hamstrung by a very limited tax base, a result of both their small populations and state legislation passed in the early 2000s that requires hard-to-gain voter approval for any tax hikes. This lack of flexibility leaves these counties' hands tied and unable to react nimbly to volatility in the economy, and the whims of the state. The nearly 40,000 residents of Graham County, for example, have experienced first hand the combined impacts of the state's fiscal laxity—which has translated into a $1.01 million loss for the county in FY 2011 alone—and the county's own downturn-related budgetary shortfalls.[22] Plans to improve and expand the county jail have been halted, for instance, forcing Graham to use its already scarce resources to transport female prisoners to a neighboring county. Similarly, it has had to table a Gila River bridge reconstruction project such that five dozen of its citizens must travel an extra 20 miles to access schools and the nearest community. With reserves gone and no ability to raise taxes, any additional state impacts will necessitate dramatic reductions in full-time county staff, the numbers of which have already been cut by 10 percent.

Meanwhile, Arizona's urban counties have had their own fiscal struggles. The capital county of Maricopa displays what is happening. The County Supervisors Association of Arizona reports that the state has burdened Maricopa County alone with $116 million in extra expenses since FY 2008, ranging from one-way transfers (to the tune of $77.3 million), to reductions in shared revenues, to the shifting of responsibilities for certain programs like juvenile corrections. Maricopa has acted swiftly to keep its budget in balance going into the downturn—but its largely successful efforts have come at a hefty price. The number of county staff has been cut by 10 percent since 2007 to approximately 12,500, and it has been forced to make drastic reductions in non-mandated and non-voter-protected services, especially human services. Meals-on-Wheels and the Special Needs Transportation program—which provided home-delivered meals and rides for the elderly and disabled—have both been suspended indefinitely, demonstrating in very real terms how the state's balance sheet problems fall upon its most vulnerable residents.

All of this is hitting counties just as their own revenues, which lag cyclical developments in the economy by about two years, reach their low points. Developing a county budget for FY 2011-12 will be the most challenging yet. In addition to the ongoing legislative impacts enacted to date, local revenues continue to be anemic, and mandated payments to the Arizona long-term care system are expected to shoot up about $80 million as enhanced federal assistance to the state expires. Making matters worse, eight counties have experienced substantial reductions in their local property tax base (as much as 11 percent) due to home devaluation, creating significant political pressure to reduce property taxes.

As county leaders continue to try to balance dwindling resources with needed local service delivery, they face the unsettling fact that the fate of their operations may largely be determined by how state lawmakers choose to deal with Arizona's fiscal deficit—and the extent to which they will continue to off-load major expenses to the county taxpayer. Their fear is informed by history. In recent years, legislative proposals put on the table included increasing the counties' share of state health care costs, and transferring state juvenile corrections responsibilities and thousands of adult prisoners to county facilities. Though rejected at the time, state leaders just may well entertain similar concepts again. For Arizona counties, then, the worst may be yet to come.

Colorado: Balancing the FY 2010-2011 budget gap of $1.2 billion required an array of initiatives, including temporary suspension of the homestead property tax credit for seniors.[27] Two additional rounds of reductions have been required since the 2009-2010 budget was enacted. The most recent cuts, in October, included $231.8 million to higher education, $92.1 million to Medicaid, and $122.5 million to corrections.[28]

Nevada: The state's budget collapsed in response to sagging sales and gaming tax receipts as construction ground to a near halt and tourism activity slumped. In response, the sales tax rate has been increased (by 0.35 percentage points), and modifications have been made to business, hotel, and business license taxes.[29] General fund spending, meanwhile, fell 12.6 percent in FY 2010 compared to the previous year. The state made cuts to all major program areas in 2010, including education, public assistance, Medicaid, corrections, and transportation. K-12 and higher education funding were each dealt 6.9 percent cuts for FY 2011 during a special session of the Legislature in February, 2010, as the state attempted to plug an $887 million hole in its balance sheet.[30] The National Association of State Budget Officers reports that further reductions are planned for all of these areas in 2011, with the exception of transportation. The outlook next year is even bleaker: Nevada lawmakers will confront a projected $2.5 to $3 billion shortfall in the FY 2012-2013 biennial budget of over $8 billion.[31]

And yet, those are only the initial impacts and responses in the four states—and, unfortunately, their budget situations are likely to get worse before they get better. In fact, the Government Accountability Office (GAO) projects a continued deterioration in the budget outlook for the states for decades to come absent fundamental policy changes that address core imbalances between revenues and spending.[32]

Unfortunately, the states' budget situations are likely to get worse before they get better.

There are several interrelated reasons that the future looks so grim:

First, it will take years for levels of economic activity to return to their pre-recession peaks: Job growth will likely remain anemic while unemployment rates will remain stubbornly high, perhaps through the entire decade. The upshot is that the revenue side of state budgets will not likely fully rebound in Arizona, California, and Colorado until 2013 or 2014. Revenues in Nevada, meanwhile, may not return to their previous peaks until the latter part of the present decade, as the housing and tourism boom that preceded the recession is not likely to be repeated any time soon. As economic growth is slowly restored, meanwhile, sales tax growth is likely to be muted. Fewer homes will be built, consumers will increasingly purchase largely untaxed services, and the need to replenish household savings will dampen overall consumption spending. These trends will hit Nevada particularly hard, as well as the other 45 states with a sales tax.

Secondly, however dire states' fiscal situations may become, with the withdrawal of federal fiscal stimulus funds in 2011, and little chance of further relief in store, states will almost certainly be left to their own devices. Stabilization funds embedded in the American Recovery and Reinvestment Act ensured that education spending did not fall below "maintenance of effort" levels, but maintenance will become more difficult to achieve without the influx of federal funds. Additional cuts in education spending from pre-K to higher education will likely be the result. The increased federal matching rate for Medicaid spending will also end in 2011 and absent the full restoration of state revenues more service cuts can be expected. Arizona alone is looking at the loss of $800 million in federal Medicaid funds in 2011, and the Center on Budget and Policy Priorities estimates that eliminated services have impacted approximately 1 million enrollees.[33]

And then there is the potential for new federal mandates—a third unwelcome possible impact. In this respect, not only can the states no longer look to Washington for fiscal support, but, given the federal government's own budget challenges, they can also expect federal mandates to grow. A case in point is the higher health care costs associated with national health insurance reform. While reform will achieve the goal of bringing large numbers of the uninsured into the service net, it offers no effective means of fostering health care cost containment. Moreover, a significant financing burden will be shifted to the states after the initial period of transition.

In sum, while cyclical surpluses will return to the region—eventually and temporarily—the stark fact remains that California and many of the Intermountain states face a very bleak fiscal prognosis.

California and the Intermountain states must look within and make wise policy choices to address their cyclical and structural fiscal imbalances, including not just strategic program cuts, but also the tax reforms essential to improving revenue streams over the long haul.

First off, when revenues do eventually recover to pre-recession peaks, the states will face a pent-up demand for the full range of publicly provided services. Public employees will have gone several years without pay raises, infrastructure maintenance has been put off, and no public service program will have seen any improvements—to the contrary, these programs have been cut. Difficult choices will have to be made over which spending cuts to restore and how to address spending needs that have been ignored—decisions made all the more difficult as the imperative of replenishing the states' diminished or emptied rainy day and other funds looms.[34] Aggravating all these burdens will be demographic trends, including more children to serve in the public schools, and a growing, aging population in need of increasingly expensive health care services. All the while, rising anti-tax sentiment will make it exceedingly difficult to raise taxes or broaden tax bases to pay for growing encumbrances, however essential or unavoidable they may be.

In the end California and the Intermountain states must look within and make wise policy choices to address their cyclical and structural fiscal imbalances, including not just strategic program cuts, but also the tax reforms essential to improving revenue streams over the long haul. Inaction is an option that will only lead to unending budget pressures that will ultimately undermine the economic prosperity of these states and their residents.

VI. Narrowing the Gap: Reducing Cyclical and Structural Budget Deficits and Improving State Fiscal Stability

The deficits confronting California and the Intermountain states are enormous. Though the states' cyclical shortfalls will start to fade as the economy improves, a host of forces will conspire to place heavy upward pressure on structural deficits. Responding to those dynamics will not be easy and will require a relentlessly strategic approach to both reducing expenditures and reforming revenue structures.

What is more, such a response is going to require better than budgetary business-as-usual in these states as reflected in ratings like those issued by the Pew Center on the States' Government Performance Initiative. In 2008 the Center assigned grades of C+, D+, C+, and C+ to Arizona, California, Colorado, and Nevada, respectively, for their fiscal management practices—grades below the average state grade.[35]

And so these four states need to break with their past budgeting habits and move urgently to inaugurate—starting now—more prudent, strategic, and better-informed tax, spending, and budget planning practices. To this end, a broad principle should be adopted to ensure that permanent policy changes on one side of the budget are matched by permanent policy changes on the other side of the budget. More specifically, two sorts of steps need to be taken to begin reducing these states' present structural gaps and preventing their return. First, states need to improve the quality of their fiscal policymaking by steadily working to broaden, balance, and diversify their revenue bases while looking to the long-haul balance of taxing and spending. And, second, these states need to improve the information sharing and budgeting processes through which fiscal problems are identified, analyzed, and addressed. Each of these changes will require of leaders substantial self-discipline.

Improving Fiscal Stability Through Better Policymaking

Questionable past policy decisions have played a large role in the emergence of significant structural deficits in California and the Mountain states. It follows, therefore, that improved policymaking represents the key to improved fiscal stability going forward. To that end, lawmakers in these states should embrace a number of widely recognized tenets of good management that ensure appropriate responses to a fluid economic and fiscal environment, including the ability to meet changing and newly emerging budgetary needs. These tenets—which include balanced approaches, broad tax bases, diverse revenue sources, and a close fit of revenue adequacy to necessary expenditures—should motivate of number of concrete actions:

Commit to a balanced approach. Budgetary balance and revenue diversification are crucial. Diversification can ensure greater adaptation to economic and demographic changes, though there can be no absolute protection against the vagaries of the business cycle. In view of that, lawmakers should embrace balance as a key watchword as they seek to stabilize year-to-year finances and narrow structural gaps. One sort of balance should be a balance of revenue-and spending-side responses: The region's massive budget gaps cannot responsibly be closed with only spending reductions. Yet there is another sort of balance that should be sought and that is the sort of revenue system balance that arises from diversification of the tax system. Nevada, for example, has one of the least diversified tax systems in the country, and relies disproportionately on sales and gaming revenue. Consideration could be given there to variants of the new business activity taxes, like the commercial activities tax in Ohio or the "margins" tax in Texas, since these gross receipts taxes may not run afoul of the state's constitution.[36] In Arizona, meanwhile, the proliferation of tax reductions implemented since the early 1990s have made the revenue system not only narrower but also more subject to cyclical variations in the economy. Both states need to commit to a more balanced approach.

Broaden tax bases and improve their responsiveness. In addition to balance and diversification, broad bases and tax system responsiveness should be mantras of fiscal system repair. Tax policies that increase the base and elasticity of state tax systems would help mitigate structural deficits and reduce the need for discretionary rate increases. For example, expanding the sales tax base to include more consumer services would both account for the growing importance of services in the economy and increase the tax's revenue yield.[37] Now, of course, it is true that elastic tax systems are a two-edged sword, producing strong revenue gains when the economy grows but also contracting sharply during recessions. Personal income tax systems are a good example, often producing significant revenue growth with growth in the economy, though this increased revenue is often given back to taxpayers via rate reduction or used to support unsustainable spending programs. Going forward, the new revenues could be used to enhance rainy day fund balances and so bring greater stability to the overall system.

Commit to maintaining adequate rainy day funds. With the exception of Colorado, the Mountain states all exhausted their rainy day funds well before relieving their acute fiscal stress. (Colorado tries to retain idle balances but it does not have a formal rainy day fund.) As the economy gets back on its feet, state governments need to not just replenish, but increase the size of their rainy day funds so that they can better weather protracted economic downturns. These funds must balance the loss of private consumption when excess revenues are saved during periods of fiscal health against sustained public service delivery during periods when revenue collections are diminished.[38] Local governments typically maintain and shift forward significant idle balances in their general funds. They, too, should develop formal rainy day funds to support accountability and transparency while enabling an enhanced fiscal response to weak economic conditions. Rainy day funds can help address cyclical revenue shortfalls as well as diminish the otherwise dire consequences on the budget arising from a structural imbalance in the midst of recession. A properly established rainy day fund designed to smooth cyclical revenue and expenditure flows would also help expose the scope of any underlying structural deficit.

Increase local flexibility and control. State legislators and voters (via statewide ballot initiatives) have a history of passing measures that constrain local governments' ability to raise revenues and respond to changing fiscal circumstances. Capping the property taxes that localities are permitted to levy—a measure imposed by Arizona's state legislature on localities, for example—severely constrains fiscal flexibility at the local level, where governments are similarly mandated by law to maintain a balanced budget. Local governments exist in an asymmetric relationship with states as well: They are dependent on states for large portions of their budgets and can be forced via state mandates to pick up unexpected tabs, as they have been in Arizona. (See sidebar.) Local governments in California, too, contend with an increasingly unbalanced system as a result of Proposition 13, which limits property tax collections in the state. And municipal governments in Nevada are fiscally constrained by having much lower own-source revenue than in the average state. In a

2008 National League of Cities report, Christopher Hoene and Michael Pagano offer a series of recommendations that can accommodate greater local control over revenue generation and public service provision, under the premise that local governments can assure greater public service accountability with voters than can higher levels of government. The recommendations include access to a variety of general tax instruments (sales, property, and income), increased state aid, and fewer tax and spending limitations.[39]

Improving Policymaking through Better Budget Processes and Information Sharing

There are, however, no easy answers to complicated budget puzzles. And for that reason, sound processes and quality information about real and projected conditions and the range of policy options and their consequences are critical to improved policymaking. What processes and sorts of information would make a difference? Above all, a solid and common foundation of data and information is a necessary prerequisite to good citizenship and policymaking, but this is often lacking in practice. Detailed time series data on state budgets are typically not easily accessible by the public, both within and across states. Nevada is a case in point as government websites offer little in the form of useful data and narrative on the recent budget crisis and the state's response. This near vacuum can severely impede discussion, debate, and the implementation of good policy.

In order to reach a sustainable fiscal trajectory states should move to:

Report budgets in a transparent manner. Budget problems are of sufficient complexity during periods of economic and fiscal health. But the problems are of considerably greater complexity and much more acute in the midst of crisis. States should therefore report critical budget data in a user-friendly format along with interpretative narrative on state government web pages. Copious data should be easily available online. Budget guides for the public and legislators should explain in clear language historical budget patterns, current budget policy issues, and the long-term pressures on public finances.[40] Such information will help lawmakers and the public understand the implications of their decisions for the state's budget future. Transparency is essential to accountability and sound policymaking for both states and their localities.[41]

Stability in Utah: Maintaining Balance With Good Information and Sound Processes

One Mountain state that does not contend with massive budget problems is Utah. The Beehive State faces only modest cyclical deficits currently and had no structural one until a round of tax reductions took effect in FY 2008 and 2009.[45] Why is this? One reason is that the state was relatively less invested in the housing boom that led to the recent real estate crash and associated budget disasters of the Great Recession.[46] But another influence on the state's enviable condition has been its strong embrace of quality budget information and sound budget processes.

In Utah, planning and budgeting are undertaken as a collaborative process and are so well informed by good data and strong processes that in 2008 the state garnered "A" grades on both fronts from the Pew Government Performance Project, which named it the best managed state in the union.[47] Epitomized by the Performance Elevated initiative instituted in 2004 by then-incoming Gov. Jon Huntsman Jr., and continued by current Gov. Gary Herbert, the Utah approach centers on the aggressive use of common data and the pro-active alignment of year-to-year expenditures with the long-term strategic direction of the state. In this fashion, all agencies and both branches of state government use the same data, adopt agreed-upon targets, and align budgetary priorities in a strategic, collaborative process built on the collection, interpretation, and dissemination of quality information. Budget requests are tied to agency performance measures as well as the state's strategic plan. Annual reviews ensure that budgets remain lean by flagging ineffective programs and unanticipated operational expenses. And for its part the legislative branch utilizes the same financial system and the same measures as the executive, allowing decisions by both branches to be based on the same data. Above all the public's access to fiscal and process information is unfettered.

Such practices—with their attention to both good data and good processes—have meanwhile seemed to work. In dealing with immediate issues, the availability of fine-grained, timely information about state activities and finances enabled the governor and legislature to act swiftly to slash expenditures surgically and strategically rather than bluntly to close the $272 million, 5 percent projected budget gap for FY 2009.[48] Regarding the bigger picture, the state's processes also seem to be helping it manage long-term issues: As Pew notes, the state is managing its long-term pension liability well and carries relatively little debt. In sum, routine, evidence- and process-driven review has enabled one Mountain West state to catch an incipient structural deficit early and act intentionally to rectify it before it becomes entrenched.

Adopt multi-year budgeting. Fiscal year budgets and two- and four-year election cycles can easily be in conflict with one another. Multi-year budgets that cross election cycles and seek to measure structural budget deficits would help overcome these inherent frictions. Moreover, policymakers would be confronted by the fiscal consequences of permanent changes to the tax and expenditure mix that can lead to or aggravate a structural deficit. Long-term liabilities like pension fund commitments should also be fully accounted for in accessible budget reports. The states' present approach to capital budgeting, meanwhile, offers little clarity on investments, their return, and the consequences for long-term financial obligation. Sinking funds and schedules of debt liability repayment exist, but seldomly fully rationalize capital spending in the eyes of the public. Transparency using fully integrated capital and multi-year budgets would offer greater assurance of accountability for many spending deferrals and any sweeping of fund balances during periods of fiscal stress. According to the National Association of State Budget Officers the capital budgeting plan is nine years in Nevada, but only five years in California, only three years in Colorado, and just one year in Arizona.[42] Short time frames for capital budgeting simply do not make good sense from a planning and long-term financial perspective. Comprehensive multi-year budgets would help demonstrate the long-term consequences of prevailing fiscal policy as well as changes to the tax/expenditure mix.

Account for policy changes with long-term impacts. Multi-year, long-term fiscal notes should be used for significant changes to tax and expenditure policies. Projecting changes to revenue streams and expenditure programs can be problematic in practice. But the process of discovery associated with developing such projections can inform the policy debate and keep the electorate informed.

Improve tax expenditure reporting. Giveaways of the tax base in the form of new and ongoing exemptions and incentives that typically receive no formal budgetary accounting are key contributors to state structural distress. Such giveaways include the largely wholesale exemptions from sales tax bases of services, discretionary incentives to promote economic development, and preferences granted under personal and corporate income taxes. Tax expenditure reports should be developed on an ongoing basis to allow citizens and policymakers to observe the near-term and long-term consequences of exemptions to state taxation. Nevada does not provide a tax expenditure report of any form; Colorado's most recent report considered only exemptions under the state sales tax; and the full documentation of tax expenditure reports is not available online for California. None of the states in this analysis provide forward-looking estimates of tax expenditures and none provide any narrative explaining why the tax expenditures were put in place.[43] Data on these costs would surely help reduce such giveways and loopholes.

Educate citizens about the fiscal implications of referenda. Voter rights for referenda and citizen initiatives empower state residents, whose voices need to be heard and respected. But voter mandates can have unintended, or at least not well understood, budgetary consequences, particularly when economic, demographic, and/or fiscal conditions shift after the initiatives were approved. Legislators can wind up hamstrung, without sufficient flexibility to make needed and appropriate policy changes that are responsive to those changing conditions. Therefore, state governments should work with universities and other groups to provide unbiased, readily accessible, and transparent information to voters on how proposed referenda are likely to impact budgets in the short and longer term so that they can carefully weigh the benefits of new mandates against their fiscal implications before making their decisions at the ballot box.

VII. Conclusion

California and the Intermountain states have implemented massive budget cuts, a mix of temporary and permanent tax increases, and a number of one-time budget tricks to manage the largest deficits in modern history. The scope of public service reduction has been unprecedented, affecting education, public health, public safety, and other essential service categories—and ultimately undermining states' ability to build strong, resilient economies. Further problems are on the immediate horizon with the upcoming loss of fiscal stimulus funds from the federal government and the expectation of a tepid economic expansion. The states have positioned themselves poorly to address near-term pressures on fiscal finances and have done little to mitigate long-term structural imbalances.

The ultimate return to economic and fiscal health will be slow and painful. The legacy of huge cyclical deficits will last for years and potentially mask underlying structural imbalances for the states. Policymakers can choose to ignore these deficits as they have done in the past, setting up another budget calamity that will emerge at the onset of the next business cycle. Alternatively, steps can be taken now to at once close cyclical gaps and address long-term budget imbalances in ways that will reduce the adverse consequences of revenue shortfalls when they next emerge.

Appendix: Detailed Description of Methodology

This analysis of structural deficits is limited to the state government general fund in four Western states: Arizona, California, Colorado, Nevada. It extends from FY 2007 through the current fiscal year. FY 2011 in each of these states runs from July 1, 2010 through June 30, 2011. The FY 2011 data consist of projected revenues and the latest appropriation figures in each state. In some states, actual figures for FY 2010 were not yet available by mid-October, so projections had to be used.

Measuring revenues and expenditures

To the degree possible, revenue numbers used in this analysis are limited to "ongoing" revenues. This excludes transfers to and from the general fund from other funds (e.g. rainy day funds) and other one-time revenues (e.g. federal stimulus dollars). Expenditures are also "ongoing," but the raw data include a few unusual one-time expenditures that were adjusted for in the analysis.

Calculations were made based on revenues and expenditures per $1,000 of personal income. Personal income, produced by the U.S. Bureau of Economic Analysis, is a measure of the size of the economy of each state, reflecting population growth, inflation, and real per person economic growth. Personal income was selected instead of gross product for three key reasons: (1) gross product is much slower to be released (the latest data are for 2008); (2) personal income is available quarterly, such that an annual average for the fiscal year can be calculated; and (3) personal income is the most common measure used by states that have in place a revenue and/or expenditure limitation. In order to calculate revenues and expenditures per $1,000 of personal income through the current fiscal year, a projection had to be made of personal income in FY 2011 (the latest actual data are for second quarter 2010).[49]

Because each state defines its general fund differently, the levels of revenues and expenditures cannot be compared across states. For example, in some states, a particular program may be funded through a dedicated fund, while in other states that program may be part of the general fund. The inclusion of capital expenditures in the general fund also varies by state. The direction and magnitude of the change in revenues and expenditures over time are more comparable across states, however. This assumes that substantial changes in state versus local government responsibilities, or in the use of the state general fund versus a special state fund, did not occur (none were identified).

Obtaining a historical time series of revenues by source and expenditures by category was difficult in some of the states. Only Arizona and California had a readily available time series already in electronic form. In each state, revenue and/or expenditure data obtained from different state agencies frequently are not consistent due to differing accounting systems used by the various agencies. In addition, some of the time series data obtained proved to consist of original appropriations, for example, rather than the final actual figures. While care was taken to obtain consistent figures in each state, it is acknowledged that inconsistencies may exist in the raw data series used in each state.

Measuring deficits

No standard method of estimating budget deficits exists and the calculation of budget deficits is complicated by data inconsistencies, missing data, and the need to make multiple assumptions. Thus, more than one estimate of the deficit can and does exist in each state.

For this study a specific method was used to estimate the deficits in each state, though special circumstances in Arizona required that a variant of the methodology be used.[50] Thus, using a normalized measure, the results of this analysis can be compared across the four states. Most commonly, the deficit for each year is expressed as a share of appropriations. However, this is not an ideal measure since the magnitude of the deficit will appear to be larger in states that have aggressively combated the deficit through spending reductions. Therefore, in this study the deficit is compared to what expenditures would have been had reductions not occurred as a result of having to balance the budget. The representative expenditure figure (per $1,000 of personal income) is defined as the figure immediately prior to recession-caused reductions in expenditures. It is held steady in each year and multiplied by personal income in each year to obtain the modeled expenditures against which the sizes of the deficits are measured.

Total deficit

The first step in this analysis was to estimate the size of the total deficit (or surplus). The total deficit (or surplus) is simply the imbalance between revenues and expenditures. However, the estimated size of the total deficit depends on various assumptions, so different analysts will come up with differing estimates. Most commonly, a publicized deficit in the general fund refers to the projected shortfall of revenues relative to appropriations in the current fiscal year. Appropriations are set at the beginning of a fiscal year, typically equal to the projection of all revenues (including one-time transfers) during the year. If actual revenue flows are less than projected revenues, a deficit develops that must be eliminated by the end of the fiscal year, due to state governments' balanced budget requirement. Estimates of the size of the deficit vary over time as revenues fluctuate, and the estimate at any point in time may vary from one analyst to the next depending on their projection of revenue during the year.

This study uses an alternative definition, with the deficit calculation based, as noted above, only on ongoing revenues and ongoing expenditures. It excludes one-time transfers into the general fund and other actions taken to produce a balanced budget in a given year, including temporary tax increases and temporary spending reductions. Estimates of the deficit sometimes ignore even permanent changes in revenues and expenditures that were made in response to a deficit. In this study, permanent revenue changes implemented in the last few years are considered in the calculation of the baseline deficit. Spending cuts made in the last few years are excluded from the calculation, however—even if the cuts are labeled as permanent—because of the history of spending reductions that are made during a recession to balance the budget generally being reversed after the economy improves.

In the calculation of the total deficit, actual ongoing revenue per $1,000 of personal income was adjusted for temporary revenue changes for each year from FY 2007 through FY 2011. This adjusted revenue was compared to the representative spending level. FY 2008 was selected as representative in order to best remove the cyclical influences on spending—the temporary reductions that had occurred as a result of the 2001-02 recession had been made up, to the extent that legislators chose to offset the earlier spending reductions, and the new reductions in expenditures due to the latest recession had not yet begun. The selected expenditure figure was adjusted for any known one-time aberrations that occurred during that year.

The study compares the estimates of the total deficit (in nominal dollars) to other estimates that have been made. The Center on Budget and Policy Priorities (CBPP), a Washington, D.C.-based organization, has collected estimates of the total deficit from each state, publishing figures for each year from FY 2009 through FY 2012 in a report last updated on October 7, 2010. However, because of the multiple ways in which legislative budget offices, governor's offices of planning and budget, and other organizations calculate these deficits, the estimates from state to state may not be comparable. Even within a state, the method used to estimate the deficit may have varied over the four years. For example, in both Arizona and California, the reported deficit in FY 2010 is much higher than that in the preceding or succeeding years. This may result from the addition of any remaining deficit in the prior year to the estimated deficit for the next year, which results in an artificially high estimate due to a double counting of the remaining deficit.

A comparison of the total deficits reported by the CBPP to those calculated in this study reveals an inconsistent pattern in the differences across time and across states. This study's estimated deficits in the four states were smaller for FYs 2009 and 2010. However, the comparison for FY 2011 shows that this study's estimates were smaller in some states but larger in others.

Cyclical and structural deficits

The total deficit consists of two parts: a cyclical deficit (or surplus) and a structural deficit (or surplus) but estimating the size of the two components is rarely done. Some analysts ignore the cyclical deficit entirely, using "structural" deficit synonymously with "total" deficit. This is undesirable given the very different nature of the two components and potentially leads to misleading projections of future deficits. The estimate of cyclical and structural deficits must therefore take a broader perspective than focusing on the current year's budget.

A *cyclical deficit* is largely the result of a decline in revenue during an economic recession. However, countercyclical increases in demand for certain governmental programs, such as food stamps, can also contribute, if states opt to boost spending on high-demand programs.[51] As the economy recovers, the cyclical deficit will decline and then become a cyclical surplus. A cyclical deficit will return during the next economic downturn.

This analysis calculates the cyclical deficit (or surplus) as the actual ongoing revenue per $1,000 of personal income in each of the recent years adjusted for all changes in the tax code, whether intended to be permanent or temporary. Each year's figure was compared to the average annual adjusted revenue figure over the 2003-09 economic cycle.[52]

A structural deficit is a permanent shortfall in revenue relative to expenditures, after cyclical fluctuations in revenues and expenditures are accounted for. A structural deficit typically is created during periods of strong economic growth, when decision-makers fail to recognize that a cyclical surge in revenue is temporary. Permanently reducing tax rates without reducing expenditures and/or permanently increasing spending obligations without increasing revenues will cause a structural deficit. Barring any further adjustments to the revenue structure or to appropriations, the structural deficit will remain steady over time relative to the representative expenditure level.

In this study, the structural deficit was calculated simply as the difference between the total deficit and the cyclical deficit.

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Endnotes

[1] See Howard Wial and Richard Shearer, "Metro Monitor: Tracking Economic Recession and Recovery in America's 100 Largest Metropolitan Areas" (Washington: Brookings Institution, 2010). Available at www.brookings.edu/~/media/Files/Programs/Metro/metro_monitor/2010_09_metro_monitor/0915_metro_monitor.pdf Also see Jonathan Rothwell and Kenan Fikri, "Mountain Monitor: Tracking Economic Recession and Recovery in the Intermountain West's Metropolitan Areas" (Washington: Brookings Institution, 2010). Available at www.brookings.edu/~/media/Files/Programs/Metro/metro_monitor/2010_09_metro_monitor/0915_mountain_monitor.pdf

[2] For the nation as a whole, state general fund spending was $687.3 billion in 2008, falling to $657.9 billion in 2009 and to $612.9 billion in 2010. Spending would have been diminished further absent rate increases, one-time budget fixes and federal stimulus funds. See National Association of State Budget Officers, "Fiscal Survey of the States: June 2010." Available at www.nasbo.org/LinkClick.aspx?fileticket=gxz234BlUbo%3d&tabid=38. The National Governors Association and the National Conference of State Legislators discuss spending cuts enacted by the states. See National Governors Association, "State Government Redesign Efforts 2009 and 2010" (2010). Available at www.nga.org/Files/pdf/1010STATEGOVTREDESIGN.PDF And National Conference of State Legislators, "Actions and Proposals to Balance the Budget" (2010). Available at www.ncsl.org/?tabid=17255

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[4] See, for example, Adam Nagourney, "For California, A New Month, a New Deficit" *The New York Times*, November 17, 2010.

[5] Bruce Katz, Jennifer Bradley, and Amy Liu, "Delivering the Next Economy: The States Step Up" (Washington: Brookings Institution, 2010). Available at www.brookings.edu/~/media/Files/rc/papers/2010/1117_states_next_economy/1117_states_next_economy.pdf

[6] Andrew Reschovsky, "Wisconsin's Structural Deficit: Our Fiscal Future at the Crossroads" (2002). Available at www.lafollette.wisc.edu/publications/otherpublications/wisconsinprimer/2002/StructuralDeficit2002.pdf. Also see Richard F. Dye and David F. Merriman, "Fiscal Condition Critical: The Budget Crisis in Illinois." Available at http://igpa.uillinois.edu/IR_2010/PDF/pg14-27z_FiscalCondition.pdf

[7] See National Education Association, "The Outlook for State and Local Finances: The Dangers of Structural Deficits to the Future of American Education" (1998). There appears to be greater interest in the notion of structural deficits in the European Union than in the U.S. A possible explanation is the set of budget rules that are intended to impose fiscal discipline and limit deficit growth for member nations.

[8] Mark Muro and Christopher Hoene, "Fiscal Challenges Facing Cities: Implications for Recovery" (Washington: Brookings Institution and National League of Cities, 2009).

[9] Ezra Klein, "You've Seen the Stimulus; Now Meet the Anti-Stimulus" *The Washington Post*, June 20, 2010.

[10] For a full presentation of the methodology utilized and key results see Tom Rex, "Estimated Budget Deficits in Five Southwestern States." Working Paper. (Tempe: Arizona State University / W.P. Carey School of Business, 2010). The authors of this brief want to express their sincere appreciation to Tom for his outstanding empirical work and analytical guidance.

[11] Certainly this is the case in terms of the initial adoption of TABOR. However, subsequent decisions by residents of Colorado, including the suspension of its formula for five years in 2005 and voters' recent rejection of new more stringent budget controls in the November 2010 elections, call into question the long-term consequences of TABOR for state service delivery, discussed in more detail in Section IV.

[12] See, for example, Moody's Analytics, "Envisioning Nevada's Future: Goals and Strategies for Advancing Our Quality of Life" (Las Vegas: Nevada Vision Stakeholder Group, 2010). Available at www.leg.state.nv.us/Interim/75th2009/Committee/Interim/NevadaVisionStakeholders/Other/EnvisioningNevadasFutureSept3.pdf See also Mark Muro, "Metropolitan Las Vegas: Challenges and Opportunities." Presentation. Nevada Vision Stakeholders Group. February 11, 2010 and Bruce Katz, "Restoring Prosperity: Repositioning Southern Nevada for the Next Economy." Speech. University of Nevada at Las Vegas, April 5, 2010. Available at www.brookings.edu/speeches/2010/0405_nevada_katz.aspx

[13] The Arizona Joint Legislative Budget Committee. See www.azleg.gov/jlbc/10taxbook/10taxbk.pdf

[14] Pamela M. Prah, "Sweeping Statewide Tax Proposals Nixed," Stateline November 3, 2010. Available at www.stateline.org/live/details/story?contentId=525565.

[15] For background on post-Proposition 13 fiscal policy in California, see Robert W. Wassmer, "California's Revenue Roller Coaster After Proposition 13," State Tax Notes, July 21, 2008, 173-182.

[16] See the Center on Budget and Policy Priorities, "The Flawed 'Population Plus Inflation' Formula: Why TABOR's Growth Formula Doesn't Work" (2005). Available at www.cbpp.org/files/1-13-05sfp3.pdf.

[17] Pew Center on the States, "Beyond California: States in Fiscal Peril" (2009). Available at http://archive.stateline.org/images/2009_Nov_11-BeyondCalifornia/BeyondCalifornia.pdf

[18] National Association of State Budget Officers, "The Fiscal Survey of States: Fall 2010" (2010). Available at www.nasbo.org/LinkClick.aspx?fileticket=C6q1M3kxaEY%3d&tabid=38

[19] Iris Lav, Elizabeth McNichol, and Robert Zahradnik, "Faulty Foundations: State Structural Budget Problems and How to Fix Them" (Washington: Center on Budget and Policy Priorities, 2005).

[20] The budget estimates presented here were made by each of the four states using their own methodologies.

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[22] Joint Legislative Budget Committee. "General Fund Operating Budget Spending. Fiscal Years 1979-2011" (2010). Available at www.azleg.gov/jlbc/GF10yearweb.pdf

[23] Joint Legislative Budget Committee, "Summary of Enacted FY 2011 Budget and FY 2010 Revisions" (2010). Available at www.azleg.gov/jlbc/enactedbudgetproposal040910.pdf

[24] Nicholas Johnson, Phil Oliff, and Erica Williams, "An Update on State Budget Cuts" (Washington: Center on Budget and Policy Priorities, 2010). www.cbpp.org/cms/index.cfm?fa=view&id=1214

[25] Marc Lacey, "Arizona Cuts Financing for Transplant Patients" *The New York Times*, December 2, 2010.

[26] California Department of Finance, "California State Budget 2010-11: Summary of Significant Solutions by Category." Available at www.ebudget.ca.gov/Enacted/BudgetSummary/BSS/BSS.html

[27] National Association of State Budget Officers, "The Fiscal Survey of States: Fall 2010."

[28] Ibid. See, also, Debi Brazzale, "Seniors Lose Property Tax Exemption-Yet Again." *Colorado News Agency*, June 1, 2010. Available at www.coloradonewsagency.com/2010/06/01/seniors-lose-property-tax-exemption-yet-again/

[29] National Association of State Budget Officers, "The Fiscal Survey of States: Fall 2010."

[30] David McGrath Schwartz and Cy Ryan, "Budget gets OK as session ends; sales tax extended for road." *Las Vegas Sun*, March 1, 2010.

[31] Cy Ryan, "Economists project rebound in gaming but disagree about how much." *Las Vegas Sun*, November 6, 2010.

[32] U.S. Government Accountability Office, "State and Local Governments: Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs" (2010).

[33] Ronald J. Hansen, "As Stimulus Funds Near End, New Pain Will Begin." The Arizona Republic, November 21, 2010. Available at www.azcentral.com/arizonarepublic/news/articles/2010/11/21/20101121stimulus-funds-near-end.html and Center on Budget and Policy Priorities, "An Update on State Budget Cuts," November 5, 2010. Available at www.cbpp.org/cms/index.cfm?fa=view&id=1214

[34] Arizona, California, and Nevada have zero balances in their rainy day funds as of FY 2011. National Association of State Budget Officers, "The Fiscal Survey of States: Fall 2010."

[35] Pew Center on the States, "Government Performance: Grading the States" (2008). Available at www.pewcenteronthestates.org/gpp_report_card.aspx Pew notes that its performance grades reflect "the degree to which a state takes a long-term perspective on fiscal matters, the timeliness and transparency of the budget process, the balance between revenues and expenditures and the effectiveness of a state's contracting, purchasing, financial controls and reporting mechanism."

[36] The new gross receipts taxes have encountered stiff opposition from economists since they are similar to the now antiquated turnover taxes of a much earlier era and lead to tax pyramiding along the production chain. The appeal of these taxes is the large base and low rate that together can yield significant revenue streams. There is also the perception of fewer tax planning opportunities under a gross receipts tax relative to the corporate income tax. For background, see LeAnn Luna, Matthew Murray, and Zhou Yang, "Entity Taxation of the Business Enterprise." In Robert Ebel and John Peterson, eds., *Handbook on State and Local Government Finance* (New York: Oxford University Press, forthcoming).

[37] Business-to-business services should remain exempt to avoid distorting the location of service provision. The Federation of Tax Administers has conducted surveys that assess the scope of taxation of services under state sales taxes. See www.taxadmin.org/fta/pub/services/services.html

[38] According to the Center on Budget and Policy Priorities, Colorado does not have a formal rainy day fund though it does maintain general fund reserves. For more information on structuring rainy day funds, see Center on Budget and Policy Priorities, "Rainy Day Funds: Opportunities for Reform" (2007). Available at www.cbpp.org/files/4-16-07sfp.pdf

[39] National League of Cities, "Cities and State Fiscal Structure" (2008). Available at www.nlc.org/ASSETS/0DDECC2E56D446B8BE0A9607590DCB1E/CitiesandStateFiscalStructures.pdf

[40] Non-governmental entities like the League of Women Voters often develop budget, issue, and policy guides for the public. The Minnesota Center for Public Finance Research has recently released a useful guide to the property tax in Minnesota that serves as a model for information sharing. See www.mntax.org/cpfr/documents/UYPT_PAY_2011_FINAL.pdf

[41] See National Association of State Budget Officers, "Transparency in Government: State Finances on the Web" (2008). Available at www.nasbo.org/LinkClick.aspx?fileticket=ZrB5okUDqi0%3d&tabid=83. The National League of Cities notes that "Governments should convey reliable information about the efficiency and quality of publicly funded services so people can make informed decisions…" See National League of Cities, "Taxing Problems: America's Flawed System of Public Finance" (2006). Available at www.nlc.org/ASSETS/EC15AAB9C3184B56A798CCD4A9169891/cityfuturestaxingproblems.pdf

[42] National Association of State Budget Officers, "Budget Processes in the States" (2008). Available at http://nasbo.org/LinkClick.aspx?fileticket=AaAKTnjgucg=&tabid=80

[43] Jason Levitis, Nicholas Johnson, and Jeremy Koulish, "Promoting State Budget Accountability through Tax Expenditure Reporting" (Washington: Center on Budget and Policy Priorities, 2009). Available at www.cbpp.org/files/4-9-09sfp.pdf

[44] To put the $1.01 million figure into perspective, the impact equates to 29.4 percent when measures against the county's state shared sales taxes allocation (also known as state shared transaction privilege taxes, or SSTPT). SSTPT is the major shared revenue to the counties and it is intended as partial compensation to county government for implementing state laws.

[45] Tom Rex, "Estimated Budget Deficits in Five Southwestern States."

[46] Brookings Mountain West, "Mountain Monitor" (Washington: Brookings Institution, 2010).

[47] Pew Center on the States, "Government Performance Project: Utah" (2008).

[48] Pew Center on the States, "Trade-off Time: How Four States Continue to Deliver" (2009).

[49] If total revenues and expenditures per $1,000 of personal income are stable over time, the tax burden remains steady and a roughly consistent quality and quantity of public services are provided. In reality, of course, ongoing revenues and expenditures are highly cyclical, going up or down with the economy.

[50] The calculation of Arizona's deficit was made somewhat differently from the methodology used in other states. The primary reason is that, unlike the other states, Arizona had a sizable structural deficit entering the 2003-09 economic cycle. Thus, the methodology used in the other states that focuses on the latest cycle understates the size of Arizona's structural deficit. In addition, the availability of estimates of the effects of tax law changes since 1989, produced by Arizona's Joint Legislative Budget Committee (JLBC), allows for a more precise estimate of the state's cyclical and structural deficits. Still, the methodology requires that assumptions be made. Other reasonable assumptions exist than those made in the calculation of the figures, such that the size of the structural deficit, for example, could be a few hundred million dollars larger or smaller.

[51] Increasing demands for social services during a recession can put added pressure on state budgets. A state can respond either by (1) temporarily boosting expenditures to cover the increased costs, or (2) by controlling expenditures through either (a) making program changes to reduce eligibility and benefits or (b) offsetting the increase in costs by decreasing spending elsewhere. In recent recessions, the Western states generally have selected option (2).

[52] In order to adjust the actual revenue, an estimate of the dollar impact of any tax code change is required. Unfortunately, while each state has a record of tax law changes, some of the Western states did not begin to make regular estimates of the revenue effects of the tax code changes until quite recently. Even in those states that provided estimates of the impacts for the entire economic cycle, estimating the overall effect of multiple tax changes made over a period of years on the revenue collected in any one year is complex and subject to assumptions. Especially in those states in which a complete record of the effects of tax law changes is not available, the resulting calculation of the cyclical deficit must be interpreted as only an approximation.

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