Lou Cannon: States Face Revenue and Pension Pitfalls

By Lou Cannon, State Net Capitol Journal | January 24, 2017

The U.S. economy is entering an eighth year of recovery and the stock market has reached record heights, but California and at least 24 other states face budget shortfalls in 2017 as revenues lag behind projections. Pension issues also continue to bedevil state and local governments.

So many shortfalls could be an economic harbinger.
"Growth has begun to slow in both the nation and California as the nation nears full employment," said a report issued this month by Democratic Gov. Jerry Brown as he unveiled his budget plan for the coming fiscal year.

This slowing growth is squeezing revenues from income, sales and corporate taxes in many states. Sales tax revenue has slumped the most, according to John Hicks, executive director of the National Association of State Budget Officers (NASBO). Hicks said this is partly because online sales are often not taxed, creating "a gap between consumption and taxability."

In its annual survey of the states in December, NASBO found that almost half the states cut their budgets in 2016 and said the trend was likely to continue this year. This forecast has been ratified as states begin to mark up their budgets for the next fiscal year, which in most states begins on July 1.

One of the significant shortfalls has occurred in California, which Brown said is projected to run a $1.6 billion deficit by next summer, its first since 2012.

“The trajectory of revenue growth is declining,” he said in presenting a $179.5 billion budget plan.

The Golden State obtains nearly 70 percent of its revenues from the personal income tax and imposes particularly heavy taxes on the wealthy. In 2014, the last year for which complete figures are available, 48 percent of California’s income tax was paid by the wealthiest 1 percent.

The top 10 percent of earners, with average incomes of $404,000, paid 79 percent of California’s personal income tax.

Relying on a relatively small slice of high earners for so much of state revenue makes for a volatile tax system. When the income of high earners declines even slightly, as happened in 2016, California faces budget deficits even in boom years.

Another reason for the shortfall is that wage growth has been spread more evenly toward lower income Californians who pay less in taxes, said Jay Chamberlain, who heads the revenue and taxation section of the state Department of Finance.

More evenly distributed wage growth has also reduced revenues in other states such as New York that disproportionately tax high earners, Hicks said.

Most states, including California and New York, will be able to manage revenue falloffs in 2017 with spending adjustments. But reduced revenues pose acute problems for energy-producing states that have been struggling ever since oil prices — and state taxes on oil extraction — declined steeply in the second half of 2014.

For some states in the oil patch, it’s been even a longer downturn. Oklahoma is entering a fifth consecutive year of revenue decline. Revenues are also down in the oil-producing states of Alaska, Louisiana, New Mexico and North Dakota.

Louisiana Gov. John Bel Edwards, a Democrat, said he will call a midyear special session of the Legislature if the state deficit reaches $300 million.

Even Texas, with a more balanced tax system than other oil-patch states, faces a budget shortfall. Republican Comptroller Glenn Hegar recently downgraded his annual growth forecast to 2.5 percent from 4.1 percent. Growth last year was a miniscule 0.2 percent.

Revenues are also slumping in West Virginia and Wyoming, largely because of a continued reduced demand for coal.

The difficulties of other states pale in comparison to Illinois, which has been without a budget since July 1, 2015, the longest budget-less period of any state since World War II.

The cause of the problem is a stubborn partisan deadlock between Republican Gov. Bruce Rauner and his Democratic nemesis, House Speaker Michael Madigan, D-Chicago, who has been speaker of the Illinois House of Representatives for 32 of the last 34 years.

Rauner, elected in 2014, contends that the Prairie State's businesses are hamstrung by restrictive laws and union requirements and that homeowners are harmed by high property taxes. But Rauner's attempts to remedy these conditions and win approval of a budget bill that restricts union power have been blocked by Madigan in the House, where Democrats until the last election held a super-majority and still hold control by a large margin.

Earlier this month the Democratic-controlled state Senate tried to broker a compromise. It sputtered when Minority Leader Christine Radogno, R-Lemont, was unable to muster sufficient Republican votes.

Political observers in Illinois say that the budget impasse could linger until 2018, when Rauner will seek re-election.
Every state has its own story to tell, but all states are shadowed by near-term and long-term fiscal threats.

In the near term, states face the potential loss of hundreds of millions of federal dollars if President Donald Trump and the Republican-controlled Congress carry out their promises to repeal the Affordable Care Act, known as Obamacare, and cut allocations for Medicaid, the federal-state plan that provides health care for the poor and disabled.

The 31 states that have expanded Medicaid under Obamacare would suffer most.

But the fate of Obamacare is shrouded in uncertainty with several members of Congress calling for a gradual phase out. Since states don't know what's going to happen, they are not currently budgeting for a loss of federal dollars in Medicaid or any other program.

I'll address this issue in Cannon Perspective next month, when more should be known about a phase-out timetable and possible replacement plan for Obamacare.

The longer-term danger, inching ever closer, is the threat posed by under-financed state and local public pension systems. Because of weak performance and insufficient contributions, unfunded liabilities for U.S. public pensions increased 40 percent over the past two years to $1.75 trillion through fiscal 2017, according to Moody's Investor Service. The unfunded liability is the difference between the amount due to retirees and current employees when they retire and the amount of money on hand to make those payments.

Over time, increased payments to pension funds by states and cities take a toll, crowding out spending on education and infrastructure. The five states with the biggest gap liability in percentage terms are Connecticut, Illinois, Kentucky, Massachusetts and New Jersey, but nearly all states have some unfunded liability.

In California the nation's largest state retirement system—the California Public Employees' Retirement System or CalPERS — slashed its investment forecast last month for the second time in five years. The CalPERS board cut the investment forecast to 7 percent from 7.5 percent in phases over three years.

Critics such as Dan Pellissier of California Pension Reform, who doubts if CalPERS or any pension system can earn 7 percent over the long haul, said the move did not go far enough.

Reducing anticipated income from investment means that the state, cities and school districts participating in CalPERS will have to increase contributions to the pension system. The first increases will be relatively small but unless investment income soars, this may be only the beginning.

“California and other states have promised far more to retired employees than they can deliver,” Joe Nation, a former Democratic legislator from California who heads a pension research project at Stanford University, told Los Angeles Times columnist George Skelton.

“What we need are honest numbers, to pare back future pensions and pour more money into it. Everyone has to take a haircut.” With state revenues dropping and pension costs rising, there are steep fiscal hurdles ahead.

— Lou Cannon, is a longtime national political writer and acclaimed presidential biographer. His most recent book — co-authored with his son, Carl — is Reagan’s Disciple: George W. Bush’s Troubled Quest for a Presidential Legacy*.*