TOP STORY

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Nightmare scenarios haunt states

By Daniel C. Vock, Stateline.org Staff Writer

One question keeps coming up as governors and legislators grapple with a seemingly never-ending stream of gloomy budget news that keeps getting worse: How bad can it get?

The answer, according to experts and a look through history, is probably that it could get worse than it has been in a generation — maybe even a lifetime — but not catastrophic.

“If revenues don’t pick up, states are going to be in a pretty tough spot when we get to 2011,” said Kim Rueben, a state and local tax policy expert with the Urban Institute. “Do I think it’s going to be the end of the world as we know it? No.”

Bankruptcy, at least the scenario where a judge would take control of a state’s finances, is off the table. Bond defaults, the cardinal sin of public finance, seem highly unlikely for states. Another federal bail-out is plausible. Some state governments may even be fundamentally overhauled. But the worst for most states will sound familiar: service cuts, tax hikes, IOUs, layoffs, furloughs and political gridlock.

In other words, Rutgers University public policy professor Carl Van Horn said, state budgets for next year will look a lot like those passed for this year — “only worse.”

In the halls of many state capitols, many others are repeating that same refrain.

California legislators spent the last year closing a $60 billion gap for the last two fiscal years. Already, though, legislative analysts predict the state will be short another $20 billion by June 2011. The bad news is expected to continue even after that, with gaps of roughly the same size persisting through at least 2015.

“The scale of the deficits is so vast that we know of no way that the legislature, the governor and voters can avoid making additional, very difficult choices about state priorities,” the report from the Legislative Analyst’s Office stated.

Outgoing Virginia Gov. Tim Kaine, a Democrat, is preparing a budget plan for the state’s next two years, when the state’s revenues are expected to drop $3.6 billion. Kaine said he is worried about the proposal, even though his successor, Republican Bob McDonnell, will determine the budget’s final form.

"The things that get put in front of me in terms of cuts are ... tougher and tougher, and somewhere in whittling down that $3.6 billion number, I know I am going to get a cut that I don't want to make," Kaine told *The Associated Press*.

The nuclear option: bond defaults

Believe it or not, things have been far worse for states. Consider, for example, Arkansas during the 1930s.

Arkansas was already in bad shape when the Great Depression hit. In 1927, the state took over the task of building highways from local authorities, because the locals built far more roads than they could pay for. The state takeover included new revenue for the roads, but it also authorized the state to build even more highways.

The result, said University of Arkansas Little Rock history professor Fred Williams, is that the state debt mushroomed. The local economy took a big hit when a third of the state flooded in 1927, and the stock market crash two years later made things worse. By 1933, Arkansas piled up $160 million in debt. That meant, of its annual $14 million budget, the state spent $13 million on debt service for roads.

The state simply couldn't keep up with its bills. In 1933, Arkansas defaulted on its bonds — the only state to do so during the Great Depression — and its state government essentially functioned on federal money for two years. It started digging itself out only when it passed a sales tax, and even then, the state had to stop building roads for 16 years.

The Great Depression default wasn't Arkansas' first missed debt payment. The state was one of eight states, along with the territory of Florida, to miss its bond payments in the early 1840s.

That wave of defaults came in the wake of the Panic of 1837, a banking crisis that triggered a five-year recession. Generally, the Northern states of Illinois, Indiana, Maryland, Michigan and Pennsylvania were unable to pay debt service for bonds they used to build canals and other infrastructure improvements. Arkansas, Louisiana and Mississippi in the South, along with the territory of Florida, ran into trouble when state-backed banks for large landowners became insolvent.

The defaults didn't cripple the states' ability to borrow for long, but, in Mississippi's case, the state's refusal to pay bondholders hung over the state government until 1996. That's when the state Supreme Court dismissed a case brought by the heirs of British bondholders who sought $13.8 million for the $1.5 million of debt they held, plus 152 years of simple interest.

With the toll the Great Recession is taking on state governments, many people have asked whether the crisis again would lead to defaults on state bonds. New York Gov. David Paterson (D), who invoked the possibility of late payments to vendors and a credit rating downgrade to convince his own legislature to make mid-year cuts, raised the prospect that California would default.

California state officials quickly rebuked him.

After a newspaper columnist also broached the specter of a possible bond default, state Finance Director Mike Genest, state Treasurer Bill Lockyer and state Controller John Chiang asserted that even humoring the idea of a California bond default hurt the state.

"To suggest, much less assert, California will default is irresponsible. It hurts investors. Most important, it endangers the financial interests of taxpayers. They pay the tab if unfounded fears of default further erode California's credit standing," the three wrote in a letter to the *Sacramento Bee*.

The officials argued that in California, which has the worst bond ratings of any state, bondholders will be paid no matter what. Its annual debt payments are only about $6 billion, compared to $90 billion in yearly revenues.

Earlier this year, Lockyer said the only way California would default is a "thermonuclear war." In November, Genest said even that might not be enough. "I'm not even sure if thermonuclear war would prevent us. It would depend on whether it fell on the treasury," he said.

In fact, few people realistically expect California — or any other state — to skip its bond payments anytime soon. Alex Grant, a San Francisco investor who focuses on state and municipal bonds, said California's bonds are still attractive, despite the state's poor financial shape.

"There's a lot of press about (defaults) but I don't know if necessarily the professionals who deal with it on a daily basis are that concerned about it. I think they're viewing it as an opportunity," said Grant, a portfolio manager with the RS Tax-Exempt Fund. Grant, whose firm's investments include California bonds, said the low risk of default and the high returns make California bonds good investments.

The California constitution protects bondholders by requiring them to be paid right after schools. Indeed, California's controller in February put a rare 30-day hold on paying most state bills, including personal income tax returns, to guarantee there would be enough cash in the bank to pay schools and bondholders.

Even without such laws, though, states have plenty of motivation to honor their debts: they want to keep bondholders happy. So even in a state such as Vermont, where the constitution doesn't include specific protections for bondholders, officials say there is virtually no chance of default. Vermont Treasurer Jeb Spaulding (D) said the Green Mountain State won't have any problems paying its roughly $70.7 million in annual debt service, which is barely 7 percent of its $1 billion general fund.

"The state has pledged its full faith and credit and all the potential revenues of that state to support those bonds," Spaulding said. "I don't think it's within the bounds of reality that states are going to default on their bonds."

Other doomsday scenarios

Bond defaults are not the only nightmare scenario keeping state budget experts awake at night.

Genest, who is quitting at the end of this year as California Gov. Arnold Schwarzenegger's (R) budget director, said at a Washington, D.C., gathering in November that he researched several drastic options to solve the Golden State's seemingly intractable budget problems.

Whether California could declare bankruptcy or something like it was one possibility, he said. Basically, that would give the state protection from its creditors, while a judge would oversee a major reorganization of state finances.

For a company or a person, going bankrupt means the bankrupt party cannot pay its creditors. The debts are too high and income isn't enough. An outside mediator, usually a judge, decides which creditors should get paid how much. The referee also can order major changes in a company to make it viable going forward, which is how General Motors and Chrysler were overhauled during bankruptcy earlier this year.

But governments are a different story. It's assumed they can raise taxes or cut services and therefore find money to pay their creditors, explained George Mason University law professor Todd Zywicki.

That said, Congress gave municipalities the ability to declare bankruptcy during the Great

Depression, because so many local governments were struggling. Congress chose not to give states the same option, because it wanted to avoid interfering with states' constitutional protections against lawsuits. As a result, there is no firm legal process that states can follow to get protection from their creditors.

That doesn't mean states are in the clear, though. Courts still have a hand in determining what services states can cut and how much they must spend to remedy situations, such as jail overcrowding, that courts find unacceptable.

Such is the case in California. Federal courts have ordered the state to reduce prison overcrowding by a third. The state is also operating under several court-ordered mandates to provide certain medical services for Medi-Cal recipients. Medi-Cal is California's Medicaid program, a joint state-federal venture that provides health insurance for poor Americans.

Perhaps the most visible example is the court-appointed receiver who runs the state prison health system, independently of the state corrections department. Other court rulings blocked cuts in home health care services for disabled patients and prevented the state from using gas tax money in a road fund for general operating expenses instead.

"The biggest nightmare scenario for me is this: What if we get to the point where we cannot obey the courts and all of their orders to fund Medi-Cal and pay for Medicaid services?" Genest said at a Washington, D.C., gathering in November.

Too big to fail?

A far more likely outcome, experts said, is that the federal government would come to the aid of states again. Already, the $787 billion stimulus package, some $300 billion of which is directed to or through states, passed early this year, has cushioned the recession's blow to states by paying more money for Medicaid and schools, the largest two expenses on state ledgers.

"I can't imagine the federal government not extending (Medicaid relief) and stimulus money for schools," said Rueben, the Urban Institute economist. Indeed, President Obama suggested earlier this month that some of the leftover money in a fund used for bailing out Wall Street should go to help states and local governments. He did not provide much detail.

Federal intervention has happened before. Congress provided some relief for states following the 2001 recession. Congress in 2003 gave states $20 billion to help patch budget gaps after that downturn. Half of that amount was in federal funds to cover Medicaid costs.

Although relatively rare, a precedent for a federal rescue was set way back in the early days of the Republic, when Alexander Hamilton persuaded Congress to assume the Revolutionary War debts of the original 13 colonies.

Members of Congress likely will be skittish about providing more relief, but federal lawmakers' recent decision to extend the stimulus package's tax credit for first-time homebuyers shows Congress wants to ensure nothing drags down the recovery, Rueben said.

If all else fails, California and other troubled states could make the "too-big-to-fail" argument when asking for a federal bailout, said Zywicki, the George Washington law professor. The federal government turned down California's pleas for help twice — once last year and again this spring — but it may have to revisit that position if the state's outlook darkens.

"The reality may be that people perceive that there's an implicit federal government guarantee of the debts of states so that when push came to shove the federal government would not allow California to default," said Zywicki.

Rethinking the duties of state government

Talking to a national group of statehouse reporters this summer, Indiana Gov. Mitch Daniels (R) suggested that the Great Recession would force state policymakers to rethink what types of services states can provide, or even afford.

The head of the Michigan House of Representatives' non-partisan fiscal agency, Mitchell Bean, said lawmakers there have cut so much during the state's eight-year recession that they must now eliminate entire programs. More across-the-board cuts simply won't save enough, he said.

They could, for example, stop paying for prescription drugs for Medicaid recipients. They could rework their criminal sentencing laws so that the state doesn't have to house as many prisoners. Legislators could target cash assistance programs for the poor or support for public universities, Bean said.

There is some precedent for major changes during major crises. In the Great Depression, North Carolina overhauled its universities, highways and health services, based on the recommendations of a study requested by Democratic Gov. O. Max Gardner on ways to streamline government.

But the protracted fiscal crisis that could linger another several years may actually prevent state officials from stepping back to think strategically, Rutgers' Van Horn said. They simply may not have time.

"Long-term thinking doesn't apply to short-term budgets," he said.

For example, Van Horn said, if a state decided to privatize state parks or change its retirement options for new employees, the budget savings wouldn't come for years. Those changes don't solve lawmakers' immediate money problems, he said.

To make matters worse, the vast majority of today's state leaders haven't ever had to confront a recession as deep as the one now devastating state budgets, Van Horn said. The last downturn to come close to the current one occurred in the early 1980s, a generation ago. That means the current crop of elected officials "learned that a boom follows a bust."

Speaking as an economist, Van Horn said, "That's not true."

Rueben is more optimistic but concedes that it will be tough for lawmakers to look at the bigger picture.

"I do think there is going to have to be a fundamental thinking through of what government should be doing," she said. "Whether that's done in a measured way or it's just we're going to keep patching and not really think about what we're doing is the open question."

State shutdowns and finding solutions

Ultimately, budget crises in some states can even lead to the closing down of state government for brief periods, said Chris Mooney, a political science professor at the University of Illinois Springfield.

State shutdowns, or at least the credible threat of one, may be one of the few things that convince lawmakers to make the more difficult, sometimes unpopular decisions, like raising taxes and cutting services, he said.

"Kids have to go to schools, cops have to be on the streets, social services have to be provided," Mooney said. The shutdowns rarely last more than a week, because so many vulnerable people depend on state government, he said. "People starve to death otherwise. Kids die otherwise."

To break the political gridlock, leaders — especially governors — must step up and offer a plan, Mooney said. "It always takes leadership to do things that voters don't want. Somebody's got to say this is what needs doing," he said.

— *Stateline.org* intern David Harrison contributed.

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This article is starting to assemble the disturbing facts of the current situation found by state governments. See also "After furloughs, states mull permanent cuts"
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The main new model you are looking for one that can be implemented using the stateâ□□s resources, that permanently downsizes state government while maintaining services and empowering employees to innovate. This model can be found in the following articles on my website.

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