THE PEW CENTER ON THE STATES

Beyond California

States in Fiscal Peril

NOVEMBER 2009

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ACKNOWLEDGMENTS

We would like to thank our Pew colleagues—Emily Askew, Nancy Augustine, Nicole Barcliff, Jane L. Breakell, Megan Cotten, David Draine, Jessica Goldberg, Natasha Kallay, Mia Mabanta, Mindy Moretti and Morgan F. Shaw—for their feedback on the analysis. We thank Nicole Dueffert and Andy McDonald for their assistance with communications and dissemination. We also thank Kathy Litzenberg for her editorial assistance and Don Boyd of the Nelson A. Rockefeller Institute of Government for his comments on earlier drafts. Finally, we thank the many state officials and other experts in the field who were so generous with their time, knowledge and expertise.

For additional information on Pew and the Center on the States, please visit *www.pewcenteronthestates.org.*

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November 2009

Dear Reader:

Many economists are optimistic that America's Great Recession may be turning the corner. States, however, are not celebrating. Plagued by record-setting revenue losses, the housing bust and credit crisis, high unemployment and a host of other challenges, states have struggled through nearly two years of budgetary pain—and are bracing for more.

California's fiscal problems are in a league of their own—but the Golden State is hardly alone. Some of the same factors driving California toward the brink of insolvency also are hurting an array of other states. This report, *Beyond California: States in Fiscal Peril*, takes a close look at nine states particularly affected: Arizona, Florida, Illinois, Michigan, Nevada, New Jersey, Oregon, Rhode Island and Wisconsin. While not a comprehensive diagnosis of states' fiscal health, this study begins to help us understand why some states are suffering more acutely from the nation's economic crisis than others—and which may have the toughest time regaining their footing.

Beyond California is just one of the Pew Center on the States' efforts to track, assess and improve states' fiscal health.

Our *Stateline.org* team of seasoned reporters monitors budget and policy developments across the 50 states, producing a daily roundup of news from around the country, original weekly analysis and ongoing coverage of critical topics such as the federal stimulus. Meanwhile, Pew Center on the States researchers generate in-depth reports that compare and contrast how states are faring on particularly important issues. For example, our *Clean Energy Economy* study was a first-ever, state-by-state count of jobs, businesses and investments aimed at both spurring economic growth and sustaining the environment. *Promises with a Price* revealed the extraordinary bill facing states for pension and health care benefits for their retired employees. And *Grading the States* assessed how well states are managing their fiscal resources. All of our reports seek to highlight factors that have contributed to states' financial stress and identify effective strategies and innovative approaches to help them meet their challenges.

America's economic recovery and prosperity hinge in key ways on how quickly and to what degree states emerge from the Great Recession. We will be releasing several reports over the coming year that will take a closer look at states in trouble and policy options that might be most effective in helping them weather the crisis. For now, this report shows California is not the only state whose fiscal health hangs in the balance.

Sincerely,

Susan Urahn
Managing Director, Pew Center on the States

Table of Contents

Executive Summary 1
Methodology 9
Arizona 13
Scorecard Indicator: Foreclosure rate 15
Rhode Island 17
Scorecard Indicator: Change in unemployment rate 20
Michigan 23
Scorecard Indicator: Government Performance Project's "Money" grade 26
Nevada 29
Scorecard Indicator: Supermajorities 33
Oregon 35
Scorecard Indicator: Change in revenue 38
Florida 41
New Jersey 45
Illinois 47
Scorecard Indicator: Budget gaps 49
Wisconsin 51
Endnotes 53
Appendix 64

Executive Summary

The nation is watching closely as California struggles to avoid going broke.

So far, the most-populous state—and eighth-biggest economy in the world—has unsuccessfully sought a $7 billion federal loan guarantee to pay its bills, temporarily issued IOUs to state employees and business contractors because it ran short of cash, and started shutting state offices several Fridays a month to close the largest state budget gap in the country. The same housing-market bust that triggered the national recession in December 2007 also set off the Golden State's fiscal crisis. But a challenging mix of economic, money-management and political factors has pushed California to the brink of insolvency.

California's problems are in a league of their own. But the same pressures that drove it toward fiscal disaster are wreaking havoc in a number of states, with potentially damaging consequences for the entire country.

This examination by the Pew Center on the States looks closely at nine states, in addition to California, that are particularly affected. All of California's neighbors—Arizona, Nevada and Oregon—and fellow Sun Belt member Florida were severely hit by the bursting of the housing bubble and landed on Pew's top 10 list of recession-stricken states facing a similar set of fiscal difficulties. A Midwestern cluster comprising Illinois, Michigan and Wisconsin emerged, too, as did the Northeastern states of New Jersey and Rhode Island.

These states' budget troubles can have dramatic consequences for their residents: higher taxes, layoffs or furloughs of state workers, longer waits for public services, more crowded classrooms, higher college tuition and less support for the poor or unemployed. But they also pose challenges for the country as a whole. The 10 states account for more than a third of America's population[1] and economic output.[2] And actions taken by state governments to balance their budgets—such as tax increases and drastic spending cuts—can slow down the nation's economic recovery.

The Pew Center on the States compiled its list by scoring all 50 states according to six factors that contributed substantially to California's ongoing fiscal woes: (1) high foreclosure rates; (2) increasing joblessness; (3) loss of state revenues; (4) the relative size of budget gaps; (5) legal obstacles to balanced budgets—specifically, a supermajority requirement for some or all tax increases or budget bills; and (6) poor money-management practices.

Pew's list is based on the best available data as of July 31, 2009. This snapshot captures an important juncture: the first and second quarters of 2009, the pressure point for governors and legislatures in the throes of crafting their budgets for fiscal year 2010 (which began on July 1, 2009, in all but four states).[3] This examination relies on economic and revenue numbers from that time period, rather than on the latest statistics, so that the Pew Center on the States could compare states at a similar stage in their budget process.

While California's fiscal problems are better known, our study identifies states that were impacted nearly as much or more by the recession in terms of some key factors, and

that at the same time exhibit some of the management challenges experienced by California policy makers. Our analysis is not a comprehensive diagnosis of states' fiscal health, which also is affected by issues such as demographics, debt burden and public pension liabilities. But each of the six factors we highlight is a warning sign, and collectively they allow one way of measuring how states are faring in comparison with California (Exhibit 1). (For details on how we chose the indicators and analyzed the data, please see the Methodology section.)

Close behind the 10 states on our list were states such as Colorado, Georgia, Kentucky, New York and Hawaii. (The full 50-state scorecard is included in the Appendix on page 65.) New York's revenue decline, for example, was steeper in the first quarter of 2009 than in all but four states, and its fiscal year 2010 budget gap was sixth-worst in the nation. In fact, all but two states, Montana and North Dakota, confronted budget shortfalls for fiscal year 2010, with some facing their largest deficits in modern history—an indication of the breadth of the recession.[4] States overall struggled to close an estimated $162 billion in gaps for fiscal year 2010; since July, that tally has grown by nearly $16 billion.[5] Tax collections in all 50 states for the first quarter of 2009 were down a record 11.7 percent from 2008.[6] Meanwhile, the unemployment rate was 9.2 percent nationally during the second quarter of 2009 (the latest figure available at the time of our examination), with 12 states suffering from double-digit jobless rates. That rate was up from 4.8 percent when the recession officially began in the fourth quarter of 2007.[7]

States' fiscal situations are widely expected to worsen even when the national economy starts to recover. In fact, unemployment jumped nationally in the third quarter to 9.6 percent. Federal stimulus money that helped states cover some expenses starts running out at the end of 2010. Plus, states historically have their worst years shortly after a national recession ends, as they cope with higher Medicaid and other safety-net expenses at the same time revenues lag because of stubborn unemployment.

Exhibit 1. **The California Scorecard: States in Fiscal Peril**

	Change in revenue[1]	Size of budget gap[2]	Change in unemployment rate[3]	Foreclosure rate[4]	Needs supermajority?	GPP "Money" grade	Score
United States	-11.7%	17.7%[5]	4.4	1.37%	17 yes, 33 no	B- [5]	17 [5]
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
Arizona	-16.5%	41.1%	3.0	2.42%	Yes	C+	28
Rhode Island	-12.5%	19.2%	4.5	1.50%	Yes	D+	28
Michigan	-16.5%	12.0%	6.0	1.47%	Yes	C+	27
Oregon	-19.0%	14.5%	6.4	.86%	Yes	C+	26
Nevada	1.5%	37.8%	5.2	3.12%	Yes	C+	26
Florida	-11.5%	22.8%	4.4	2.72%	Yes	B-	25
New Jersey	-15.8%	29.9%	3.7	1.18%	No	C-	23
Illinois	-10.9%	47.3%	3.5	1.44%	No	C-	22
Wisconsin	-11.2%	23.2%	4.4	.96%	No	C+	22

[1]From first quarter 2008 to first quarter 2009
[2]For fiscal year 2010, as of July 2009
[3]From second quarter 2008 to second quarter 2009
[4]New foreclosures in first quarter 2009
[5]Average of all 50 states

NOTE: Based on a highest possible score of 30
SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

The Pew Center on the States is pursuing a series of research studies that will take a closer look at states under fiscal stress and policy options that might be most effective in helping them find their footing. For now, this report shows California is not the only state whose fiscal health hangs in the balance.

The California Story

A quick look at California's troubles helps explain why the factors used in Pew's analysis are telling.

The state's history of budget deficits precedes the current recession. The Golden State had the largest budget shortfall during the last recession early this decade.[8] This time, the state's budget troubles are even bigger.

The problems stem in part from the housing market. Nationally, foreclosures on first mortgages hit a record high at the beginning of 2009.[9] During the first quarter, lenders began foreclosures on 1.37 percent of first mortgages. But California's rate was even higher, at 2 percent, the fourth-highest rate of any state. Unemployment surged as the housing market collapsed. The state's jobless rate increased 4.6 percentage points from 6.8 percent in midyear 2008 to 11.4 percent in midyear 2009, the eighth-biggest uptick in the country.

The weakening economy took its toll on state finances. Revenues fell sharply, by nearly a sixth between the first quarters of 2008 and 2009.[10] California topped all states for the magnitude of its budget shortfall in fiscal year 2010, both in total dollars and as a share—in this case, nearly half—of its general funds, which pay for most state operations. In July 2009, California lawmakers plugged a $45.5 billion hole in the fiscal 2010 budget,[11] but by October 2009 another $1.1 billion gap had emerged.[12]

The ability of lawmakers in Sacramento to fix budget problems is constrained by several voter-imposed restrictions, including requirements that all budgets and tax increases pass the legislature by a two-thirds majority.[13] Practically, the supermajority requirement means that Democrats, who firmly control the legislature, must win some Republican support for those proposals, creating a recipe for gridlock. In 2008, the constraints hampered efforts to pass a budget, which was finally signed a record 85 days late.[14] In 2009, the governor and legislators were unable to agree on how to fix the budget and turned to voters to try to pass $6 billion in tax increases the lawmakers could not enact themselves. When voters rejected those tax hikes, it fell back to lawmakers to erase the last $26 billion of red ink.

California's record of poor fiscal practices left its officials ill-equipped to handle the latest downturn in the economy. In 2008, the Government Performance Project (GPP), a Pew initiative, gave the state a D+ for its money-management practices, tied for the lowest grade among the 50 states. The GPP cited, in part, California's persistent structural deficit, which results when a state's expenses outstrip its revenues.[15]

Adding annually to the budget problems, California lawmakers since the late 1990s have increased spending by more than the rise in state population or inflation.[16] In the meantime, policy makers rarely set aside in the rainy day fund the 5 percent of general funds permitted by law, giving the state less of a cushion during lean times.[17]

At Least Nine Other States Worth Watching

While California takes the spotlight, at least nine other states face hardships nearly as daunting (Exhibit 2). They share important characteristics with California, but they may not be destined to follow in the Golden State's footsteps. Some states in this report already have responded aggressively to their budget crisis, although it is too soon to tell whether their actions will put them on solid fiscal footing. And again, these are hardly the only states at risk.

The state profiles in this report go beyond the data in the scorecard to give a fuller picture of the recession's deep and pervasive effects on states' financial and economic well-being. The report makes clear that the recession severely impacted states from different geographic regions with different types of economies, tax structures and political leanings.

Here are the major challenges facing each of the nine states profiled in this report:

Arizona

As the economic news grew bleaker and state revenues sank during the past two years, Arizona's lawmakers relied on one-time fixes to balance its budget instead of making long-term changes. In part, they were hamstrung by voter-imposed spending constraints, a tax structure highly reliant on a growing economy and a series of tax cuts, made in the 1990s, that has limited revenue. At this writing, policy makers still had not decided how to bridge a $1 billion gap in the current fiscal year's budget.

Rhode Island

The country's smallest state has big problems. It was one of the first states to fall into the recession because of the housing crisis and may be one of the last to emerge. Rhode Island consistently ranks near the top of states with the highest unemployment rates, and last year it had the highest home foreclosure rates in all of New England. State government has a poor record of managing its finances, and its economic recovery is hampered by high tax rates, persistent state budget deficits and a lack of high-tech jobs.

Michigan

Michigan never climbed out of the recession that started in 2001, and matters only became worse during the Great Recession. Two of the Big Three Detroit-based automakers went bankrupt in 2009, sending shockwaves through a state that is on track to lose a quarter of its jobs this decade. The recession accelerated drops in state revenues and has left Michigan's government trying to deal with today's problems on a 1960s-sized budget.

Nevada

Nevada's unique gaming-based economy is in jeopardy, as is its state budget that relies on gambling and sales taxes to provide 60 percent of its revenues. Year-over-year revenue has fallen for two consecutive years, a record. But changes to the tax system are difficult to make because, unlike most states, Nevada has written some of its tax laws into the state constitution. So increasing the sales tax or adding an income tax, for example, would be nearly impossible because it requires voters to amend the constitution.

Oregon

The downturn has severely affected some of Oregon's leading industries, such as timber and computer-chip manufacturing, and exposed the state's reliance on volatile corporate and personal income taxes—the result of voters

rejecting a statewide sales tax nine times. State revenues plummeted 19 percent between the first quarter of 2008 and the first quarter of 2009, a reflection of Oregon's heavy reliance on income taxes. Lawmakers this year approved more than $1 billion in new taxes to make sure the state can pay its bills. But voters in January 2010 will have the final say on $733 million in new income taxes that are part of that package, and the electorate historically rejects tax hikes at the polls.

Florida

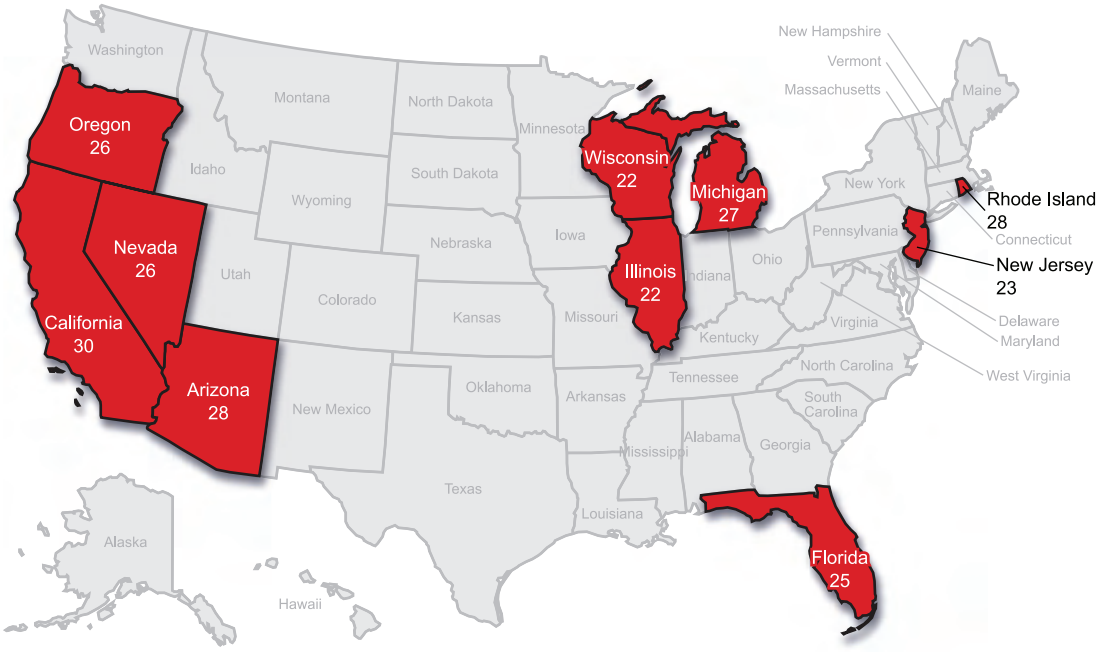
For the first time since World War II, Florida's population is shrinking. This is a disturbing revelation for a state that has built its economy—and structured its budget—on the assumption that throngs of new residents will move to its sunny shores each year. Lawmakers tried to head off trouble by agreeing in 2009 to raise $2 billion in new revenue, but it already appears that legislators will face a similar-sized budget shortfall next year.

New Jersey

New Jersey is playing catch-up after years of fiscal mismanagement and a daunting structural imbalance between what it collects and what it spends. The woes of nearby Wall Street—which supports approximately one-third of New Jersey's economy—only made matters worse. Growing debt payments and perennially underfunded pension systems will make the Garden State's road to recovery even rougher.

Exhibit 2. **At least nine states beyond California face fiscal peril**

The Pew Center on the States chose six factors that have contributed to California's fiscal crisis. All 50 states were scored based on those factors, with California receiving 30 out of a possible 30 points. This report focuses on the nine states with next-highest scores.



SOURCE: Pew Center on the States, based on analysis of data from the Nelson A. Rockefeller Institute of Government, the Center on Budget and Policy Priorities, the U.S. Department of Labor's Bureau of Labor Statistics, the Mortgage Bankers Association, the Public Policy Institute of California and the Pew Center on the States' Government Performance Project; best available data as of July 31, 2009.

Illinois

Illinois entered the nation's fiscal crisis in a precarious position. Since the last recession earlier this decade, the state piled up huge backlogs of Medicaid bills and borrowed money to pay its pension obligations. Its problems grew worse once the Great Recession hit. The state's current budget still relies heavily on borrowing and paying bills late. The budget shortfall lawmakers confronted for fiscal year 2010 topped $13.2 billion, among the worst budget gaps in the country.

Wisconsin

To most, Wisconsin does not seem to have the same problems managing its money as California, its dairy rival. But the recession has hit Wisconsin harder than most state governments, especially when it comes to lost tax revenues and the size of the hole in its budget. On top of that, unemployment is climbing as the state's largest sector—manufacturing—sputters. Wisconsin's history of budget shortfalls and pattern of borrowing frequently to cover operating expenses, among other measures, made it poorly positioned to weather the most recent severe economic downturn.

Key Takeaways

Each of these 10 states tells a unique story—but what lessons can be drawn from looking at them as a group? We observed four common threads that could point to vulnerabilities in others as they try to navigate their way out of the fiscal crisis:

- **Unbalanced economies.** A number of states in our top 10 list have struggled in part because their economies have depended on a particular industry hit heavily by this recession. Michigan's overreliance on the auto industry is a well-known tale, but other states have found themselves in a similar boat—for example, Nevada and gambling, Oregon and timber and silicon chips, and Florida and tourism and population growth. This emphasis on a sector may have paid off in times past, but it put these states at greater risk when the recession hit. (Two that to date have been relatively unscathed by the nation's fiscal crisis, Montana and North Dakota, rely more heavily on energy and agriculture than most, and those industries at the moment are doing better than many other sectors.) States cannot choose their natural resources, of course, but they can budget and manage for additional volatility that can result from dependence on a particular sector. Increasingly, states are seeking to diversify their economies.

- **Revenues and expenditures out of alignment.** The unusual severity of this recession has led to states across the country facing substantial gaps between what they collect in revenue and what they spend. But many of our top 10 states, including California, Illinois, Michigan, New Jersey, Rhode Island and Wisconsin, have a history of persistent shortfalls. Aligning revenues and expenditures is a key component of fiscal health; both Oregon and Florida took significant steps last spring to try to achieve that goal.

- **Limited ability to act.** In most of our top 10 states, lawmakers' latitude to respond to the fiscal crisis by raising taxes or cutting spending is especially limited. In Arizona, voters earlier this decade approved measures that, in essence, have pre-programmed spending on Medicaid

and education. In Florida, policy makers are struggling to find the funds needed to reduce class sizes to levels mandated by a 2002 constitutional amendment. Nevada lawmakers cannot raise the sales tax unless voters agree to amend the state constitution. Oregon has a revenue cap that forces the state to deliver rebates to taxpayers when times are good but that can strip it of much-needed revenue when times are bad. And in California, ballot measures approved by voters during the past several decades have bound policy makers on both the revenue and expenditure sides of the ledger, by directing funds to specific purposes and capping property taxes.

- **Putting off tough decisions.** Several states on the top 10 list were unable to muster the political resolve to make long-term fixes to their fiscal problems. Virtually every state had to make tough decisions this year about where to cut and how to raise additional revenues, including through taxes or fees. But in some states, lawmakers punted the responsibility—either by asking their voters or governors to make the call, or by relying heavily on borrowing or accounting methods that put off harder decisions until later. As noted above, lawmakers in California asked voters to enact $6 billion in tax increases, all of which were rejected. In Illinois, the legislature passed a budget significantly out of balance, leaving it to the governor to make the cuts. The state also has a history of deferring its bills, including payments to cover its public-sector pension liabilities; this year, Illinois borrowed money to pay for its annual pension contribution. And New Jersey has perennially borrowed money to balance its budget, and its total debt has soared as a result. With 37 governors' seats up for election and 46 states choosing legislators in November 2010, political leadership will be a potent factor in shaping how states meet their fiscal challenges going forward.

Methodology

Pew's researchers started with two basic questions: How did California get into its current fiscal situation, and could other states find themselves facing similar difficulties?

To empirically gauge California's fiscal conditions and assess whether other states share similar characteristics, Pew's researchers sought to understand the factors that contributed to the Golden State's economic predicament. We reviewed the relevant literature related to public sector fiscal/financial management. In addition, we closely followed news accounts of negotiations between California Governor Arnold Schwarzenegger (R) and the state legislature.

A state's fiscal health is determined and affected by a wide range of complex factors, including economic variables, demographics and political developments. But after consulting existing research, Pew's researchers chose to focus on six indicators:

1. Change in revenue
2. Budget gap as a percentage of general funds
3. Change in unemployment
4. Foreclosure rate
5. A supermajority requirement to raise revenue or ratify budgets
6. The "Money" grade from the Pew Center on the States' Government Performance Project, which assesses how well states are managing their fiscal affairs

We selected these factors because, as described in the Executive Summary, each played a significant role in creating California's fiscal crisis or in making its problems more difficult to fix.

The Data

Pew used the best available and most current data as of July 31, 2009 to score California and other states based on these six indicators. We chose this particular time period to reflect the circumstances as of the first and second quarters of 2009, when state lawmakers were crafting their fiscal year 2010 budgets.

Change in Revenue

Pew's researchers included change in tax revenue as one of our six indicators because if tax revenues decline, then states must use rainy day funds, cut budgets, issue additional debt or, in the case of this recent recession, look to the federal government for an infusion of funds. To calculate change in revenue, we used data on tax collections from the Nelson A. Rockefeller Institute of Government, which collects information directly from the states and shares its information with the U.S. Census Bureau.[18] Because the recession officially began in December 2007, we looked at the amount of total revenue collected in the first quarter of 2008 and the amount collected in the first quarter of 2009—the most recent information available as of July 31, 2009—and measured the change between those figures.

Budget Gap

Researchers looked at states' total budget gaps as a percentage of general funds for fiscal year 2010. This indicator is important because if states have budget shortfalls as a result of increased expenditures or decreased revenue, they must balance their budgets, typically by slashing services or raising taxes, both of which can worsen the effects of a recession, according to the economic literature.[19] States also can issue debt.

We used data measuring budget shortfalls collected by the Center on Budget and Policy Priorities (CBPP).[20] CBPP's calculations of states' budget shortfalls were originally published on September 8, 2008. These data are regularly updated, and Pew's researchers used the most recent data as of July 31, 2009.[21] We also consulted the National Conference of State Legislatures' (NCSL) data on budget gaps, which are derived from legislative fiscal offices across the country. NCSL indicates smaller budget gaps than CBPP does, but the NCSL data are incomplete and do not cover all states. Nonetheless, we found that CBPP's and NCSL's data are highly correlated.[22]

Change in Unemployment

Next, we examined the percentage-point change in unemployment from the second quarter of 2008 to the second quarter of 2009, the most recent data available as of July 31, 2009. A rise in unemployment increases demand for state benefits, such as unemployment insurance and Medicaid coverage. In addition, the resulting decrease in consumption can cause a decline in both payroll and sales taxes, in turn impeding revenue growth. Pew obtained unemployment rates from the U.S. Bureau of Labor Statistics, Local Area Unemployment Statistics dataset.[23]

Foreclosure Rate

We also looked at the total foreclosure rate by state in the first quarter of 2009—the most recent data as of July 31, 2009—from the Mortgage Bankers Association's National Delinquency Survey.[24] Foreclosures are an important indicator because they shrink the base of state and local property taxes. In addition, as foreclosures in a state increase, the possibilities of higher consumer debt burden and bankruptcy will lead to less consumption and a reduction in sales tax receipts. Finally, foreclosures decrease both the price and the demand for housing, which harms the construction industry—a major sector for many cities and states—and housing-related services.

Supermajority Requirements to Pass Tax Increases or Budget Bills

Seventeen states require a supermajority vote by their legislatures to pass some or all tax increases, budget bills or both.[25] We looked at supermajority requirements to enact tax increases because finance experts generally agree that this institutional arrangement significantly reduces taxes or constrains a state's ability to generate greater revenue by increasing taxes.[26] Pew's researchers also considered a supermajority requirement to pass a state's budget, which makes it imperative for state lawmakers to work together to cut budgets and pass budget bills.[27]

The Government Performance Project "Money" Grade

For more than a decade, the Pew Center on the States' Government Performance Project (GPP) has assessed how well states manage their money, people, information and infrastructure. For the "Money" component of the latest report card, issued in 2008, the project evaluated 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 mechanisms. The GPP typically surveys state budget offices, reviews state documents and public data and conducts in-depth interviews with state officials to determine how well states are managing their finances.[28] The latest set of grades was based on data from states' fiscal years 2005 and 2006, so it helps provide a measure of how well states were managing their finances leading up to the recession.

The California Scorecard

Pew collected data on all six indicators for all 50 states. We weighted each indicator equally and split the data into quintiles—assessing which states emerged as the worst in each category. Pew's researchers then "scored" the states. If a state was in the worst quintile for a given indicator, it was assigned five points; if a state was in the second-worst quintile for any given indicator, it was given four points, and so forth. There was one exception to the rule: the supermajority requirement to raise some or all revenues, pass budget bills or both. If a state had this requirement in place, it was assigned five points; if not, it was given no points. We then totaled the scores for each indicator to arrive at a final score. The highest and worst score a state could receive was a 30.

Researchers also consulted Moody's Rating Services to see how closely our list of states aligned with Moody's most recent municipal bond ratings for states. The ratings often are done on a schedule or triggered by an event, and as a result, the majority of states had not been re-rated as of the beginning of 2009. But we observed that five states with new negative outlook ratings were also among our scorecard's top 10: Arizona, California, Florida, Illinois and Rhode Island. The remaining five—Michigan, Nevada, New Jersey, Oregon and Wisconsin—were not reevaluated in 2009. Although this makes relying on any current evaluation a challenge, none of these states had a rating higher than AA+.

There certainly are other important variables to consider and other ways to slice the data to measure the relative fiscal stress of states. The scorecard used in this report is helpful because it provides a picture of the fiscal challenges that many states are facing through the lens of California's experience.

Arizona

At a Glance

	Change in revenue	Size of budget gap	Change in unemployment rate	Foreclosure rate	Needs supermajority?	GPP "Money" grade	Score
Arizona	-16.5%	41.1%	3.0	2.42%	Yes	C+	**28**
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
United States	-11.7%	17.7%	4.4	1.37%	17 yes, 33 no	B-	17

SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

If it was not already apparent to Arizonans that the housing bubble they had so roundly enjoyed had burst, the message hit home on August 16, 2007. That is the day one of the largest private mortgage companies in the country, headquartered in Tucson, suddenly shut its doors, turned off the phones and stopped lending. First Magnus Financial Corp. became one of the first victims of the housing market collapse, but the entire state would soon feel the pain.

The Great Recession officially started just a few months later, and Arizona was in the cross hairs. Its economy was based on sunshine and all of the benefits that good weather brought to the Grand Canyon State. Clear skies attracted aerospace companies, solar power producers and, during the spring, Major League Baseball teams. And that drew droves of people who wanted to live and work there, as well as the "snow birds"—retirees from colder climates who came for vacations and second homes. There was reason for optimism. In 2007, Arizona was the second-fastest-growing state. Since 2000, the population jumped by more than 25 percent, with similar growth in housing units.[29]

But since the recession hit and money dried up for housing and travel, the state in September 2009 became the first to lose 10 percent of its workforce, even surpassing Michigan.[30] As of the first quarter 2009, Arizona's foreclosure rate was the third-highest in the country, behind only Nevada's and Florida's (Exhibit 3).[31] Meanwhile, collections from Arizona's top three revenue-generating taxes—corporate income, personal income and sales—dropped more than 21 percent in fiscal year 2009.[32]

Early on, as the economy grew bleaker and state revenues sank, Arizona's lawmakers reacted slowly, looking to solutions they had used to deal with other, less serious recessions. In fiscal year 2008, they drained the state's rainy day fund, a sort of savings account set up to deal with any sudden revenue drop-offs, and delayed last-quarter payments to school districts to wipe those bills off the balance sheets of one fiscal year and push them onto the next.[33] "These are the type of gimmicks that are done every time we have a slowdown. They've just never been done to this magnitude before…[The state] never before had skipped the last quarter of school payments," said state Treasurer Dean Martin (R).[34]

When drafting the fiscal year 2010 budget, Arizona had $7 billion in revenue to pay for $11 billion in spending.[35] Martin said he thinks the biggest mistake the legislature made in handling this recession was failing to make drastic spending cuts. "The budget situation… is as bad as it is in California. That's a self-inflicted

phenomenon," Martin said. "It's basically because of what happened in the first two years of the recession. Rather than taking their foot off the accelerator, [legislators] basically floored it. They kept spending as if there was no recession."[36]

Eileen Klein, deputy chief of staff for finance for Governor Jan Brewer (R), traced the origins of the crisis to when Janet Napolitano, a Democrat, was governor, dealing with a GOP-controlled legislature. Napolitano left office in January to serve in President Obama's Cabinet. "You had a divide politically between the legislative branch and the executive branch. The Republican Party was in search of tax cuts when times were good, and the Democrats were in search of program expansion when times were good. The political compromise was a little bit of both," Klein said. "All of this came together at the time when the economy began to slide."[37]

Voters Hold the Reins, Limiting Cutbacks

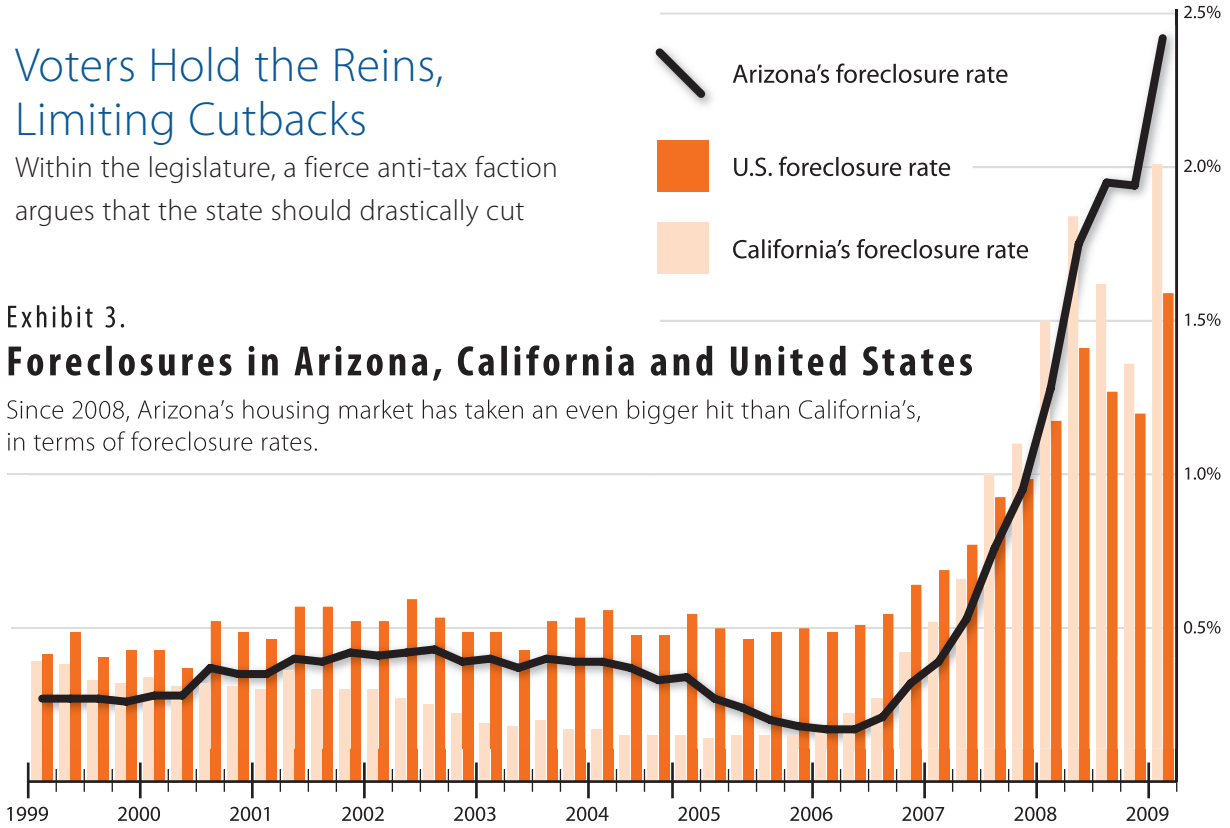
Within the legislature, a fierce anti-tax faction argues that the state should drastically cut services to balance the books. But lawmakers have been hamstrung by voter-imposed spending constraints. In 2000, for example, voters raised the sales tax to pay for schools. They also greatly expanded eligibility for the state's Medicaid program. In fiscal year 2009, the restrictions meant legislators had discretion over only 30 percent of state Medicaid spending and 37 percent of funding for elementary and secondary education.[38]

Since 2000, Medicaid rolls have more than doubled. Arizona began 2001 with more than 552,000 people on Medicaid.[39] By August 2009, that number exceeded 1.3 million.[40] Increased Medicaid enrollment led to higher state spending, even though the federal government picks up most of the tab.[41] Arizona's Medicaid expenses have been growing at a rate of more

Exhibit 3.

Foreclosures in Arizona, California and United States

Since 2008, Arizona's housing market has taken an even bigger hit than California's, in terms of foreclosure rates.



SOURCE: Pew Center on the States 2009, based on data from the Mortgage Bankers Association: National Delinquency Survey; Moody's Economy.com.

than double the national average,[42] putting even more pressure on the state budget. "We have pre-programmed expenditures that accelerate at about 7 percent each year. So the expenditure rate already presumes a pretty healthy or robust revenue [increase]," said Klein.[43]

Reversing voter mandates to make it easier for lawmakers to cut their way to a balanced budget is virtually impossible because of another proposition passed by voters in 1998 that requires changes in voter-approved spending to be approved by 75 percent majorities in the legislature. Any changes must "further the purpose," in the words of the law, of the original ballot initiative.

SCORECARD INDICATOR: FORECLOSURE RATE

The change in foreclosure rates in a state is an indicator of how severely it has suffered since the nation's housing market bubble burst. The market's demise hit Sun Belt states particularly hard. Arizona, like California, Nevada and Florida, depended on new construction to fuel its economy. One estimate by University of Arizona economist Marshall Vest concluded that in 2007, construction, lending and related industries accounted for 20 percent of Arizona's jobs.[44]

A change in foreclosure rates also can indicate how the economy is doing in general, because other factors, such as job losses or salary reductions, can cause people to fall behind on their mortgage payments. Also, when people stop buying houses—or borrowing against them—they also cut back spending on cars, appliances and construction materials, spurring declines in state sales tax collections.

Raising Taxes No Easier Option

The revenue side of the ledger offers no easier answers. With Arizona's tax structure heavily weighted toward sales and income taxes, the state's coffers have taken a significant hit during the recession. One issue is volatility. The state now depends on the sales tax for 48.4 percent of its general revenues, while the individual income tax generates about 16 percent. The income tax is particularly volatile in this economy because it depends heavily on capital gains. In fiscal year 2009, receipts from personal income tax fell 32 percent in Arizona and 14 percent from the sales tax.[45] The inability of Arizona's tax structure to cover spending levels in economic downturns led, in part, to a grade of C+ in 2008 from the Pew Center on the States' Government Performance Project, which assessed states on how well they managed their fiscal affairs.[46]

The prospect of raising taxes to generate additional revenue has faced stiff opposition. Since taking office in January 2009, Brewer has clashed with lawmakers over her support of a temporary sales tax increase, which, at this writing, she has yet to land. During a nine-month struggle, Brewer sued legislative leaders to force them to deliver a budget, which she later vetoed because it did not come with a ballot referral for her sales tax hike. As the standoff continued, the state nearly ran out of cash in late summer. In September, after signing the majority of bills for a spending plan, Brewer told the state, "We cannot cut our way out of this problem. We cannot tax our way out of this problem. Both solutions will be necessary to resolve this crisis and doing both will take incredible political courage and compromise."[47]

In the new budget, state universities are bracing for layoffs, about 10,000 parents who had been covered by a state-backed health insurance plan that covers their children will be dropped, and the Arizona Capitol itself may be sold to a private investor and leased back to the state to help make ends meet.[48] But that still leaves Arizona's government in a $1 billion hole this fiscal year.[49] Even Brewer's proposed sales tax increase would come too late to fill that gap. "We've basically used up all the gimmicks or tricks," said state Senate President Robert Burns (R). "Now we've come to the cliff."[50]

> "We cannot cut our way out of this problem. We cannot tax our way out of this problem. Both solutions will be necessary to resolve this crisis and doing both will take incredible political courage and compromise."
>
> —ARIZONA GOVERNOR JAN BREWER

The home state of conservative icon Barry Goldwater has one of the highest percentages of state legislators who have signed a national pledge not to raise taxes.[51] Brewer once signed the pledge, but that was before she became governor.[52] When her plan to put the sales tax on the ballot was finally brokered by Republican leaders, it failed by two votes in the Senate. Brewer blamed "extremists" in both parties for its demise.[53]

Meanwhile, past actions by elected officials also place hurdles on revenue generation. In the 1990s, then-Governor Fife Symington (R) led successful efforts to lower the state income tax. Other tax cuts followed, too. Income tax rates fell nearly 40 percent during the 1990s, and vehicle license tax rates were reduced. (Lawmakers recently eliminated the statewide property tax for three years, only to see it restored as a result of this year's budget battle.)[54]

Some see a treasure trove in reversing the earlier cuts. "If you would reasonably reverse [those tax cuts] … you'd pick up in the vicinity of $2 billion to $2.5 billion," said Dennis Hoffman, an economics professor at Arizona State University (ASU) who projects revenue income for the state.[55] That would be nearly enough to plug the state's budget gap.

For now, the immediate prospects of raising taxes seem limited to Brewer's push for the sales tax hike. Her administration predicts the change would boost state revenues by $1 billion a year for three years, when it would expire, and it would take about four months for the state to see new revenues after legislative approval.[56] Polls indicate the public supports the sales tax increase, but that support is soft, said David Berman, a senior research fellow at ASU's Morrison Institute for Public Policy. "The only way you're going to sell it is by wrapping it up in education spending. It'll be a tough campaign."[57]

Meanwhile, Brewer has asked state agencies to prepare for cuts of 15 percent to 20 percent starting in January 2010 when the legislature returns and begins plugging more budget holes.[58] Such cuts will come on top of reductions already made as part of the battle over this year's budget.

Rhode Island

At a Glance

	Change in revenue	Size of budget gap	Change in unemployment rate	Foreclosure rate	Needs supermajority?	GPP "Money" grade	Score
Rhode Island	-12.5%	19.2%	4.5	1.50%	Yes	D+	**28**
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
United States	-11.7%	17.7%	4.4	1.37%	17 yes, 33 no	B-	17

SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

Rhode Island's economic future once counted on budding companies like Vectrix Corp., designer of a high-end, electric scooter that comedian and motorcycle-aficionado Jay Leno showcased on his Web site going from zero to 50 mph in 6.8 seconds.[59]

But Vectrix, headquartered in Middletown, Rhode Island, announced in July 2009 that it would lay off its workers and file for bankruptcy. The national recession made it too hard for Vectrix to find investors and customers willing to shell out $11,000 for an environmentally friendly bike.[60]

Vectrix employees are among more than 24,000 Rhode Islanders who have lost their jobs since the recession officially began in December 2007.[61] As of September 2009, Rhode Island's unemployment rate—a record-high 13 percent—was the worst in all of New England and the state's highest level since the federal government began collecting such data in 1976.[62] Only Michigan and Nevada had higher jobless rates.[63]

The country's smallest state has big problems. It was one of the first states to fall into the recession because of the housing crisis, and it may be one of the last to emerge, hampered by high tax rates, persistent state budget deficits and a lack of high-tech jobs. Moreover, Rhode Island has a poor record of managing its finances.

In fiscal 2009, the state faced a budget shortfall that ranked behind only those of California and Arizona in its size compared with the state's general fund.[64] In fiscal 2010, its $590 million budget deficit amounted to about 20 percent of its general fund and was larger than those of more than half the states.[65]

The Housing Bubble Bursts

Many of the state's fiscal problems can be traced to the collapse of the housing market in Rhode Island, a state still recovering from the loss of its textile mills and defense work after the end of the Cold War.[66] Rhode Island's housing bubble had been fueled, in part, by its supply of cheaper homes within driving distance of jobs in higher-priced Boston. Between 2000 and 2005, the median price of a single-family home in Rhode Island more than doubled, peaking at $294,000 in 2005, well above the national average of $219,000.[67]

But the housing boom coincided with the rise in subprime mortgages, considered more risky because they often required little or no down payment and were made to borrowers who had limited or blemished credit histories. When borrowers holding subprime loans began to default, Rhode Island's home prices plummeted and the foreclosure rate began to climb. Of all

the New England states, Rhode Island suffered the highest number of foreclosures last year—more than half of which involved subprime mortgages.[68] Rhode Island also saw the steepest drop in average home prices—more than 15 percent in 2008—of all the New England states.[69]

The drop in home sales and prices set off ripple effects. Fewer home sales depressed purchases of items such as new appliances, carpeting and other home improvement items, and as a result, the state's sales tax revenue dropped. The state's construction sector has increasingly shed jobs—more than 5,500 overall since 2006 (Exhibit 4).[70] "Residential construction has come to a virtual standstill," said Roger Warren, executive director of the Rhode Island Builders Association.[71]

> Rhode Island routinely makes the lists of the 10 states with the worst business and tax climates.

Tighter credit also put the brakes on a commercial construction boom that had been spurred by tax credits enacted earlier in the decade, including one that made it easier to restore older buildings.[72] The tax breaks had generated so many new projects that some politicians jokingly dubbed the construction crane the state bird.

While 23 states ended calendar year 2006 with more revenue than expected, Rhode Island was among five states that had less.[73] The Ocean State's economy officially started to shrink in January 2007, making it one of the first states to experience the downturn.[74]

During the first quarter of 2009, total tax receipts were down 12.5 percent compared with the previous year, with the steepest drop in corporate income taxes.[75]

Highest Tax Rates in New England

It was not supposed to turn out this way. With much fanfare, Rhode Island Governor Donald L. Carcieri (R) and the Democratic-dominated legislature enacted a package of tax cuts in June 2006 aimed at keeping wealthy residents and luring entrepreneurs to a state with a population of just one million.

The Wall Street Journal, in a widely quoted editorial, hailed the move. "The very blue state of Rhode Island adopted one of the most sweeping pro-growth tax reforms in any state in recent years," the *Journal* wrote.[76]

The centerpiece of the package was a new flat-tax option that lets high-income residents choose to pay a lower tax rate on all income without deductions (7 percent in 2008, dropping to 6.5 percent in 2009 and 5.5 percent by 2011), rather than the state's personal income tax of up to 9.9 percent after deductions.[77] The tax cut was seen as a way to keep the state competitive. But the collapse of the housing market and the magnitude of the downturn overwhelmed the state, bringing widespread unemployment, not job creation.

"I don't think it has worked," said Russell Dannecker, a former fiscal advisor to the Rhode Island Senate, who said the tax package reduced much-needed revenue going into state coffers by some $180 million over four years.[78]

Even with the flat tax, the state's personal-income tax rate still is higher than that of its neighbors; so, too, are its corporate and sales tax rates. Rhode Island routinely makes the lists of the 10 states with the worst business and tax climates largely because it has among the highest personal-income, corporate-income and sales tax rates in the country.[79] Rhode Island's overall state and local tax burden has gone up while those in neighboring Connecticut and Massachusetts have gone down.[80]

"Rhode Island needs to reinvent itself," said Leonard Lardaro, a University of Rhode Island economics professor. He said the state has come to be viewed as "damaged goods" because of its high taxes, fees and electricity costs and a labor force that lacks the latest skills.[81]

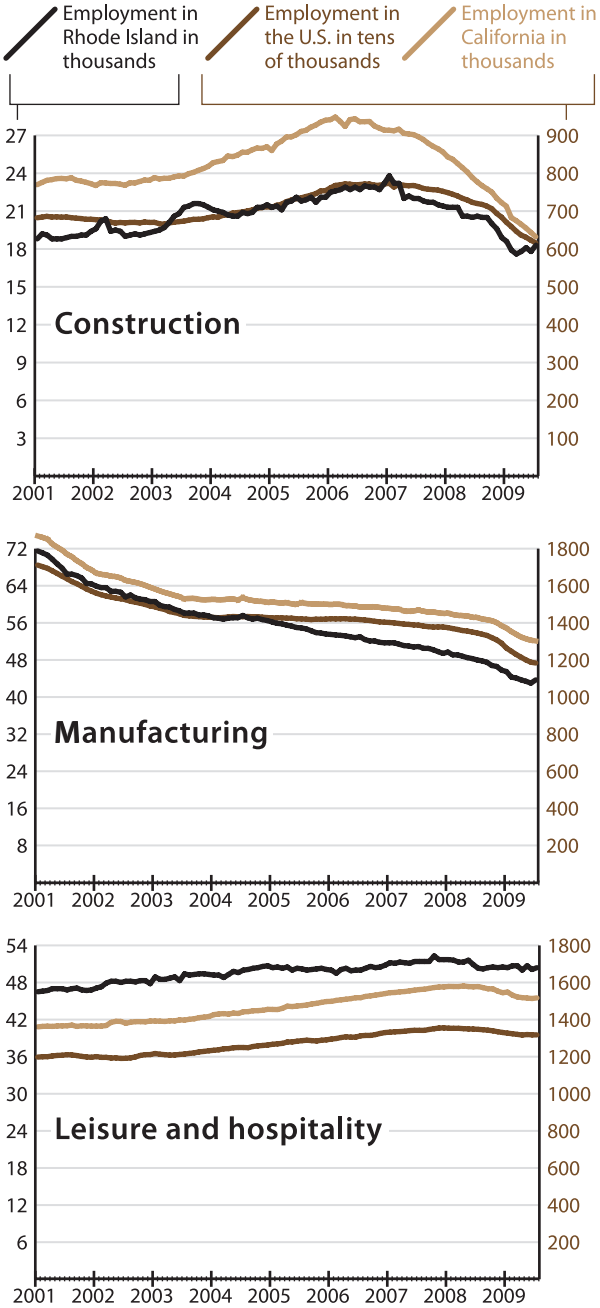
The issue of taxes is a key source of political discord between the Republican governor and a legislature dominated by Democrats in a heavily unionized state.

The legislature balked at Carcieri's proposals this year to phase out the corporate income tax completely by 2014 and reduce by half the top personal-income tax rate of 9.9 percent. Instead, lawmakers raised the state gasoline tax by two cents a gallon, increased the capital gains tax, cut aid to cities and towns, and relied on federal stimulus dollars to help close the $590 million budget deficit. Lawmakers also left it up to the governor to find an extra $68 million in unspecified savings.[82] Carcieri threatened to shut down state government and lay off workers unless they agreed to a pay cut and furloughs. After much wrangling and lawsuits, the union agreed that state workers would lose 12 days of pay and forego a pay raise.[83]

Exhibit 4.

Rhode Island loses jobs in manufacturing, construction

Jobless rates in Rhode Island hit record highs in 2009, consistently surpassing California and most other states except Michigan and Nevada. One area that has seen an upward trend in Rhode Island, California and the country has been the leisure and hospitality industry.



SOURCE: Pew Center on the States 2009, based on data from the U.S. Department of Labor's Bureau of Labor Statistics.

SCORECARD INDICATOR: CHANGE IN UNEMPLOYMENT RATE

The monthly unemployment rate had climbed to 9.8 percent nationally as of September 2009, from 4.9 percent in December 2007, when the recession officially began.[84] Unemployment imposes heavy burdens on state budgets in more ways than one. People without jobs no longer have salaries to tax and they often do not spend as much money, resulting in less tax revenue for states. But these same people often need more services from states, including unemployment benefits. Also, workers who lose their employer-sponsored health care coverage may apply for Medicaid, the federal-state program for the poor, or for the Children's Health Insurance Program (CHIP). The Urban Institute found that each percentage point rise in the national unemployment rate can boost Medicaid and CHIP enrollment by one million people, increasing costs by $3.4 billion, including $1.4 billion for states.[85]

The collapse of the housing market and the resulting downturn brought widespread unemployment to Rhode Island—the worst in New England. Michigan continues to suffer the highest unemployment in the nation, rising to 15.3 percent in September, followed by Nevada (13.3 percent), Rhode Island (13 percent), and California (12.2 percent), government figures show. The rates in Nevada and Rhode Island are the highest levels in those states since the government began collecting the data in 1976. Florida, at 11 percent, also posted a new high.[86]

Still Recovering from Loss of Textile Jobs

The state has yet to find jobs to replace its manufacturing base, once the mainstay of the state's prosperity. The number of manufacturing jobs in Rhode Island has dropped by half—from 95,000 in 1990 to 48,000 in 2008, according to Edinaldo Tebaldi, an economics professor at Bryant University in Smithfield, Rhode Island.[87] Just this year, manufacturing shed 4,900 jobs, a 10 percent drop.[88]

Jewelry-making, the state's second-largest manufacturing sector behind fabricated metals, is now taking a hit as the demand for luxury items dove in the recession.

Rhode Island's approach to economic development for years has been "fragmented, disjointed and without focus," concluded a 2009 report by a panel appointed by Carcieri and led by Al Verrecchia, chairman of toymaker Hasbro, one of five Fortune 500 companies headquartered in the state. "[T]here appears to be no clear strategy for economic development embedded in public policy," the panel said.[89]

Trouble Making Ends Meet

The recession has exacerbated some state fiscal shortcomings that may determine how smoothly—or roughly—Rhode Island navigates the economic downturn.

Going into the recession, the state already had a spotty record for the way it handles its finances. "Auditors haven't issued Rhode Island's financial reports a clean bill of health in more than 30 years," the Pew Center on the States said in 2008 when its Government Performance Project gave the state a D+ in money matters—tied for last place with California.[90]

Rhode Island has a history of balancing its budget by relying on rainy day funds or one-time revenue sources.[91] So budget holes are nothing new. The state has "never had structurally balanced budgets," said Paul Harrington, labor economist and associate director for the Center for Labor Market Studies at Northeastern University in Boston. "Every budget has been a patchwork."[92]

More trouble waits in the next year. Budget writers relied on $226.5 million in federal stimulus dollars to patch holes in fiscal 2010, but those recovery dollars will drop off for fiscal 2011.

"We've had this problem before, but something would come along and bail us out," said William J. Felkner, president of the Ocean State Policy Research Institute, a group that advocates limited government. "It's all coming to a head now."[93]

Rhode Island's approach to economic development for years has been "fragmented, disjointed and without focus," concluded a 2009 report.

When the state has cut back spending in recent years, it largely has come at the expense of state workers. The state's workforce has been reduced by 2,300 employees since 2000 and now stands at 16,000.[94] The governor touts that the state is operating with fewer employees than it has in more than 30 years.[95] State workers did not receive pay raises last year, and they have to pay a larger share for their health insurance.[96]

This year, state employee pensions were targeted. Lawmakers expect to save $21 million through several changes, including setting a minimum age for retirement based on how many years an employee has worked and how close to retirement he or she is under the current system.[97]

On the revenue side, Rhode Island still taxes few services compared with other states in the region that have begun broadening their sales tax base to reflect the economy's shift from manufactured goods to services. Maine, for example, in June 2009 decided to tax auto repairs, entertainment admissions and services such as laundry and car washes. The Center on Budget and Policy Priorities estimated that Rhode Island could increase its sales tax collections almost 50 percent if it began taxing similar services.[98]

Tebaldi, who also co-chairs the Rhode Island forecast for the New England Economic Partnership, said the state's fiscal situation is certain to worsen if the governor and legislature do not address the structural budget problems, particularly on the spending side. "The state may be the next California," he said.[99]

But Amy Kempe, the governor's spokeswoman, dismissed such talk. Kempe said that while California raised taxes on personal income and sales and slashed billions of dollars from state programs, Rhode Island has managed the downturn without drastic cuts to programs and without raising any broad-based taxes. "I would not compare the fiscal situation of Rhode Island to that of California," she said. "It is much different."[100]

Michigan

At a Glance

	Change in revenue	Size of budget gap	Change in unemployment rate	Foreclosure rate	Needs supermajority?	GPP "Money" grade	Score
Michigan	-16.5%	12.0%	6.0	1.47%	Yes	C+	**27**
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
United States	-11.7%	17.7%	4.4	1.37%	17 yes, 33 no	B-	17

SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

From the days of Henry Ford and the Model T, as long as people were buying American cars, Michigan prospered. But today Michigan is like one of Detroit's customers who no longer can afford an SUV and must trade down to something smaller, more efficient and less expensive.

Michigan has spent the past decade learning the hard way about downsizing. In 2001, the famed automobile capital of the world fell into recession with the rest of the country, but it was the only state never to emerge. By the end of 2010, approximately a quarter of its jobs will have vanished.[101] The Great Recession accelerated drops in state revenues and has left Michigan's government trying to deal with today's problems on a 1960s-sized budget.[102] Twice in the past 24 months, the daunting task of making ends meet has led to a partial shutdown of state government for a few hours, as lawmakers failed to agree on a budget by the start of the state's fiscal year.[103]

Michigan is still the eighth-most-populous state—but it has yet to come to terms with no longer being one of the most prosperous, said Donald Grimes, a senior research specialist at the University of Michigan and an expert on the Michigan economy. In 2008, Michigan ranked 37th for per-capita income, with peers that include Georgia (38th) and Montana (39th).[104]

"The state of Michigan still has to learn all the things that being a poor state means," Grimes said. When the federal Bureau of Economic Analysis releases finalized 2009 data, Grimes said, he expects Michigan to be among the 10 poorest states.[105]

Now that the national recession unofficially has been declared over, other state governments may be tempted to wait out the employment and housing slumps wreaking havoc on their economies in hopes the next business cycle will rescue their out-of-balance budgets. For Michigan, however, waiting is not an option. Economic forecasters from Moody's Economy.com said they do not expect Michigan to see another peak in its business cycle during their entire 30-year forecasting horizon.[106]

Adjusting to a New Normal

Left with few options, Michigan is being forced to diversify its economy and confront long-neglected structural imbalances in its budget under some of the most unfavorable conditions since World War II. The beleaguered state is adjusting to a new normal.

Even after nearly a decade of bad news, Michigan reeled from this year's hometown headlines: the bankruptcy of two of the Big Three Detroit

automakers, the highest unemployment rate in the country at more than 15.3 percent in September 2009, and one of the nation's worst mortgage foreclosure rates. Projections are that by the end of this decade, Michigan will have lost one million jobs, more than a third in 2009 and more than 268,000 in the auto industry.[107]

This year's bad economic news translated to a drop of 16.5 percent in all of the state's key revenue sources in the first quarter of 2009 compared with a year earlier, despite major tax increases enacted in 2007.[108] Declining revenues resulted in the latest in a series of annual gaps between what the state collects and what it expects to spend, the definition of a structural imbalance.

> "We have a revenue base that was designed for an industrial economy in the 1960s, and today that economic mix has changed dramatically."
>
> — MICHIGAN LIEUTENANT GOVERNOR JOHN CHERRY

"Even if we can straighten out our tax code some, I see no way around a dramatic change in government at all levels in Michigan," said Mitchell Bean, director of the House Fiscal Agency, a nonpartisan research unit within the legislature. "There's going to be fewer services."[109]

Despite a welcome injection of federal stimulus funds, state lawmakers still faced a $2.8 billion gap in trying to balance the state's budget by October 1, 2009. Governor Jennifer Granholm (D) found herself at odds not only with the GOP-controlled Senate, but also with fellow Democrats in the House, resulting in a month's delay in completing the budget. By November 1, all the budget bills had been signed by the governor, but she continued to press lawmakers to approve new revenue to soften cuts to schools and local governments. The final budget agreement included $1.9 billion in cuts, including drops in school funding of as much as $600 a student in some districts, an 8 percent cut in reimbursement rates for Medicaid and an 11 percent decrease in payments to local governments.[110]

Despite the state's economic troubles, Michigan's population count has not changed much over the past decade. But its composition is changing significantly (Exhibit 5). Like other states in the Midwest and Northeast, Michigan's schools have been losing students—as many as 27,000 in a single year since 2003.[111]

Meanwhile, the state's ranks of adults 65 and over have grown 7 percent since 2000, even as the state's non-elderly population has contracted slightly.[112] Retirees benefit from the state's generous income tax exemptions for pensions and other retirement income—which make it possible for a couple to receive up to $110,000 a year without owing anything to the state—while the economy has dragged down birth rates and forced some families to leave in search of work.[113] While the state saves because it has fewer students to educate at about $8,000 apiece, the trend may not bode well for the state's long-term future.

"The population is aging, and more and more people are going to be exempted from paying taxes," said Bean. "In 20 years, we're going to look like Florida does now if the demographic trends continue, and no one's going to be paying taxes except those that are working."[114]

Tax Base Out of Sync

The tax code exempts some of the most prosperous segments of the economy. For example, special tax breaks are offered not only to retirees but also to companies wooed to the state, and few services are subject to sales taxes. This is part of the reason that all of the state's taxes combined grow at only about half the rate of personal income.[115] So even if the state's economic development strategies succeed in putting citizens back to work, state revenues will have a difficult time catching up unless changes are made to the tax code. "We have a revenue base that was designed for an industrial economy in the 1960s, and today that economic mix has changed dramatically," said Lieutenant Governor John Cherry (D).[116]

Michigan's structural deficits can be traced to its reliance in recent years on temporary solutions to its budget shortfalls. During the last recession, Michigan, like many states, tapped its rainy day fund and resorted to short-term fixes such as accounting changes, fund transfers and bond refinancing that exacerbated the state's structural problems. According to data from the Citizens Research Council of Michigan, a nonpartisan research organization, the state over the past decade has relied on $8 billion in one-time measures to meet its constitutional balanced-budget requirement.[117]

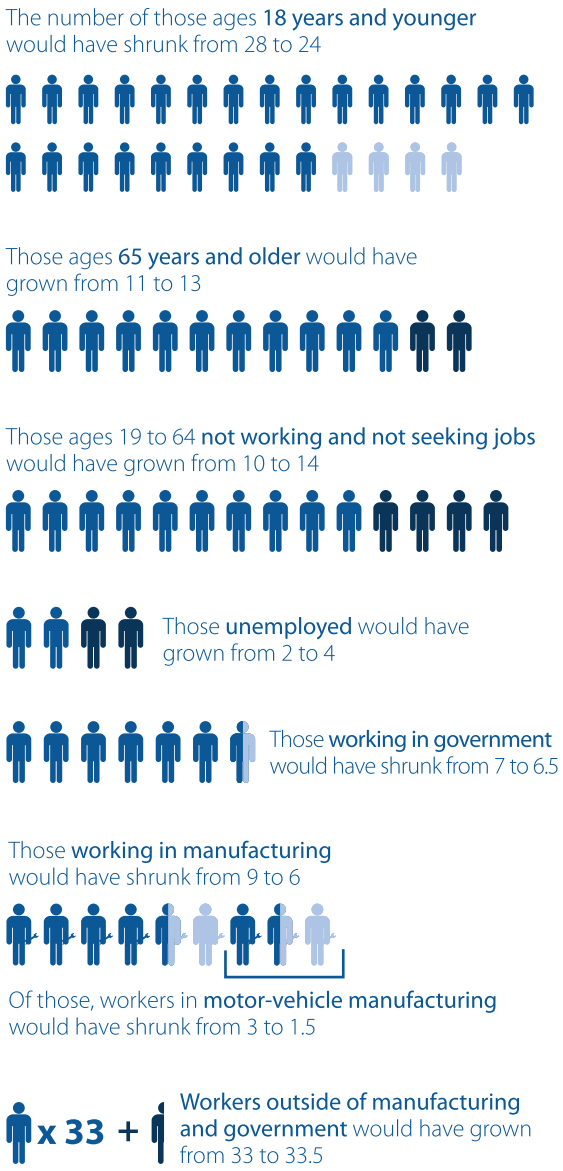
"The structural problem is resulting in almost annual crises," said Paul Hillegonds, senior vice president of DTE Energy and a former Republican speaker of the House, who was among three businessmen invited to closed-door budget negotiations this year. "Unless we as a state reach some kind of consensus about shrinking the size of government to bring it in line with revenues, we're going to be living with crises every year."[118]

Exhibit 5.

Population changes in Michigan, 2001 to 2008

Michigan's population has remained relatively constant since the state fell into recession in 2001. But the composition of its residents has changed dramatically, reflecting a rapid restructuring of the state's economy and workforce.

If Michigan's population had been 100 people in 2001, it would have added one person by 2008.



SOURCE: Pew Center on the States 2009, based on data from the U.S. Census Bureau and the Michigan Department of Energy, Labor & Economic Growth.

A four-hour shutdown of government in 2007 forced through $1.35 billion in tax changes once thought impossible: the state's first income tax hike since the 1980s and an expansion of the sales tax to an array of services. But the sales tax increase blew up in legislators' faces. Citizens and the business community criticized it as unfair and uneven—it would have taxed skiing but not golf, for example—and worried that small businesses would be stymied by taxes on services to one another. The legislature was forced to reconvene to repeal the tax. Lawmakers replaced it with a temporary surcharge on the state's newly overhauled business tax, which also has proven to be unpopular.[119]

A Decade of Downsizing

Michigan has made some headway in shrinking its government to bring it in line with revenues. A long series of across-the-board cuts has forced state agencies to lay off employees and trim programs. "There's been a general downsizing across all aspects of state government," said Gary Olson, director of the nonpartisan Senate

SCORECARD INDICATOR: GOVERNMENT PERFORMANCE PROJECT'S "MONEY" GRADE

For more than a decade, the Pew Center on the States' Government Performance Project (GPP) has graded states on how well they manage their money, employees, information and infrastructure. The project's "Money" grades speak to the health of states' fiscal management practices in the broadest possible sense. For the latest report card, issued in 2008, the project evaluated 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 mechanisms. The GPP typically surveys state budget offices, reviews state documents and public data and conducts in-depth interviews with state officials to determine how well states are managing their finances.

Michigan, along with a number of other states, was identified by the GPP as having serious structural challenges, and those problems have only worsened.[120]

The GPP's 2008 report card was based on data from 2005 to 2007, but it remains highly relevant to examining states' current situations. States that were operating from a weakened fiscal position—for instance, with deeply embedded imbalances between revenues and expenditures—going into the recession have tended to suffer the most and are more likely to experience ongoing challenges going forward.

The GPP's Money grade also captures how well states plan for the long haul—particularly salient as those state plans are now being tested. States were evaluated on whether they used a long-term perspective to make budget decisions, taking into account such factors as the level of debt they carried, the health of their rainy day funds and the size of their unfunded liabilities for their public sector retirement benefit obligations.

Fiscal Agency, which provides research to the legislature.[121] The number of classified state employees has decreased 16.9 percent between 2001 and 2009, coinciding with a 42 percent decrease in general fund revenue since 2000.[122]

Since 2001, the state has made a litany of cuts, including in aid to local governments, payments to Medicaid providers, and funding for higher education, state agencies, prisons, libraries, zoos, orchestras and day-care programs. "We've gotten to the point where I don't know what else we're going to cut," said Michigan Treasurer Robert Kleine (D). "You're going to be looking at things that can cause long-term damage to the state's future."[123]

Michigan also has made progress in getting control of its long-term obligations to public sector retirees. In 1997, it decided to move most new state employees from a traditional pension plan with guaranteed benefits to a system more like private-sector 401(k) plans, with limits on employer contributions. The change saved Michigan an estimated $25.4 million in 2008.[124] Despite the state's economic woes, Michigan's pension system is considered well-funded at nearly 84 percent as of 2008, and the state has not neglected its annual required pension payments during this recession as many other states have, according to an analysis conducted by the Pew Center on the States.[125]

Meanwhile, a working group led by Lieutenant Governor Cherry is developing a plan to consolidate the number of state agencies from 18 to eight or fewer. Yet even if they succeed, it is unclear whether the changes will provide much relief to state coffers. The working group's emphasis is on creating clearer and more efficient chains of command, rather than making cuts, and consequently no one—including the lieutenant governor—seems optimistic about significant savings.[126]

Diversifying the Economy

The state was slow to diversify its economy as the auto industry began to falter, but it since has poured billions in investments and tax breaks into fledgling industries such as clean energy, tourism and film-making and focused heavily on job retraining programs for displaced workers. These are difficult investments to make as revenues are plummeting—and some officials worry about the state's ability to afford them.[127]

In award-winning television commercials that have driven digital visitors to the state's top-ranked tourism Web site, picturesque landscapes of the Great Lakes and Michigan's lighthouses, beaches, golf courses, vineyards and ski slopes remind tourists of all the state has to offer. While other agencies' budgets have been slashed, the state's tourism promotion budget has grown from less than $6 million in 2005 to $30 million in 2009.[128]

Every dollar the state spent on out-of-state advertising from 2004 through 2008 created more than $40 of spending by tourists, benefiting Michigan businesses and generating $2.86 in new state tax collections, according to research cited by Travel Michigan, a division of the Michigan Economic Development Corporation.[129]

Film-industry tax breaks—now the most generous in the country—have attracted big-ticket productions such as Clint Eastwood's film, *Gran Torino*, much of which was shot in Detroit. And, thanks in part to a burgeoning advanced-battery sector, the jobs, businesses and investments that make up Michigan's clean energy economy grew by 10.7 percent between

1998 and 2007, even as overall jobs declined by 3.6 percent.[130]

The state's main business tax-credit program, dubbed MEGA, for the Michigan Economic Growth Authority, functions as a pay-for-performance program for businesses that diversify the state's economy by creating new jobs in targeted industries or regions. Businesses that succeed in meeting specified goals are rewarded with a refundable tax credit against the state's business tax. The program has created more than 20,000 jobs since 1995, and the state has retained more than 45,000 jobs it believes it otherwise would have lost, according to the Michigan Economic Development Corporation.[131]

> "We've gotten to the point where I don't know what else we're going to cut. You're going to be looking at things that can cause long-term damage to the state's future."
>
> —MICHIGAN TREASURER ROBERT KLEINE

Still, the state foregoes revenue through such programs. As of 2008, the state offered $6.3 billion more in total tax exemptions, credits and deductions than it actually collected in taxes.[132] So while tax incentives have played an important role in helping Michigan compete with more prosperous states for jobs, they take a toll on the state's pocketbook. A decade earlier, in comparison, the state was taking in $6.8 billion more in taxes than it was exempting.[133]

Kleine, the state treasurer, said that Michigan was creating jobs outside the auto sector before the latest recession hit, but that the gains were canceled out by auto job losses. "The good news for us is that the auto industry has become so small in Michigan that it's kind of lost its ability to hurt us," he said. "When we come out of the national recession, we'll be creating jobs again like any other state, and the auto sector won't have the ability to offset those."[134]

Still, Michigan's recovery is going to be a long haul. Even if the state were to immediately begin growing at the rapid rates of the 1990s, it would be 2025 or 2030 before it replaced all of the jobs it lost this decade.[135]

Nevada

At a Glance

	Change in revenue	Size of budget gap	Change in unemployment rate	Foreclosure rate	Needs supermajority?	GPP "Money" grade	Score
Nevada	1.5%	37.8%	5.2	3.12%	Yes	C+	**26**
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
United States	-11.7%	17.7%	4.4	1.37%	17 yes, 33 no	B-	17

SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

The last time the economy was this bad in Nevada, a first-year legislator-cowboy led a push to legalize gambling in what was then the nation's most sparsely settled state. Gambling would pump revenue into Nevada and help the state recover from the Great Depression, argued 29-year-old Republican Phil Tobin.

Tobin's "Wide Open Gambling Bill of 1931" launched what would become one of America's most unique state economies.[136] Nevada became synonymous with casino gambling, a desert oasis for millions of tourists who transformed Las Vegas into one of the top entertainment destinations in the world.

The money that rolled in from gaming and retail sales allowed the state to keep its tax burden among the nation's lowest. It also fueled one of the fastest growth spurts in U.S. history. Nevada's population mushroomed 30 percent between 2000 and 2008, compared with 8 percent growth for the rest of the country.[137] No state grew as fast or added jobs at as high a rate as Nevada, where workers flocked to take advantage of a residential and commercial construction boom.

Today, the state that set up an industry to dig out of one economic disaster is in a new crisis, and this time gambling is largely the cause. Travelers nervous about the economy have put off trips to Nevada; those who do come are spending less.

"Nevada is a state built on easy money," said Eric Herzik, a University of Nevada-Reno political scientist. "There isn't any easy money right now."[138]

The drop-off in visitors has rippled through the gambling-dependent economy. Construction of houses, casinos, shops, restaurants and offices has virtually stopped. Nevada's unemployment[139] and foreclosure inventory were the second-highest in the nation at the time of Pew's examination.[140] Its median home value dropped 16 percent in 2008, more than any other state.[141] Revenues from sales and gaming taxes have plunged to historic lows, forcing the legislature to enact record spending cuts and tax increases to close an unprecedented $3 billion gap in the biennial budget for fiscal year 2010 and 2011.[142]

"For many years, people believed that our state was 'recession-proof,'" Governor Jim Gibbons (R) said in a speech. "Unfortunately, this economic downturn has shown that this simply is not the case."[143]

Once-frozen credit markets have thawed, but financial institutions still are cautious about loaning money to businesses, consumers and

government. A few years ago, as housing prices soared in Nevada, almost anyone could get a loan with little or no down payment. When the housing market collapsed in part because of those shaky mortgages, many banks held onto their assets. Some still are struggling to collect enough in deposits to cover bad loans; Las Vegas' eighth-largest bank, Community Bank of Nevada, failed in August 2009.[144]

Nevada's problems have been overshadowed by those of its giant neighbor to the west—but the level of dysfunction is as severe as in California, if on a smaller scale. Its revenue from taxes does not keep pace with the rising cost of services, as in California. Both states allow ballot initiatives in which voters make direct changes to state government, such as blocking tax increases. Nevada and California also are sharply split by leaders who do not trust each other.

> "For many years, people believed that our state was 'recession-proof'...Unfortunately, this economic downturn has shown that this simply is not the case."
>
> —NEVADA GOVERNOR JIM GIBBONS

Interviews with a range of economists and state officials turned up deep worries about Nevada's future if the state does not change the way it finances government. Outside of Hawaii, few states depend on tourist dollars as much as Nevada does: $6 of every $10 in state tax revenue comes from gaming or sales,[145] and year-over-year revenue has fallen for two consecutive years, a record.[146]

New Gambling Strategy Backfires

Nevada has survived past recessions in part because gamblers usually are reliable customers during good and bad times. But a crucial change in the evolution of casinos 20 years ago, aimed at expanding tourism, actually has aggravated the statewide recession of 2007–2009.

The Las Vegas of Assemblyman Tobin's day was a series of casinos in the downtown area. Starting in 1941, developers began building insular, self-contained resorts with low-rise motel buildings around a main casino.[147] To accommodate gamblers from fast-growing Southern California, developers in 1955 switched to complexes of large, 1,500-room hotel towers and low-rise buildings with casinos, restaurants and theaters hosting big-name entertainers. Las Vegas "moved from a stopover in the desert to a real destination point and entertainment center," wrote Thomas Barker and Marjie Britz in *Jokers Wild*, a history of legalized gambling.[148]

By the late 1980s, Americans' attitudes about leisure time had changed. Gamblers had more choices, often in their own state, as legalized gambling spread across the country. If Nevada were to continue drawing tourists, industry specialists said, developers would have to build family-oriented entertainment centers that emphasized shows, shopping and eateries along with the gambling. In 1989, the 87-acre Mirage resort opened with a rainforest, active volcano, white tiger and dolphins.[149]

So began the billion-dollar megaresort building era. Developers added condominium towers and larger convention facilities as tourism

and gaming enlarged Nevada's economy. The construction industry took off, building 20,000 homes a year and dozens of office buildings and shopping centers around the Las Vegas area.[150]

The success of those large-scale, 3,000-room resorts depends on a steady volume of affluent tourists and convention-goers. When the economy was thriving, as it was during much of the 1990s and 2000s, Nevada capitalized on that growth more than other states did. But when the economy slipped into its deepest recession in 80 years, Nevada was slammed harder than most states (Exhibit 6).

One statistic among many stands out. Only 10 years ago, Nevada led the nation in the percentage of jobs created. In August 2009, Nevada passed Rhode Island as the state with the second-highest unemployment rate, 13.2 percent, up 6.2 points since the start of the year.[15`] Nevada's rate edged up to 13.3 percent in September.

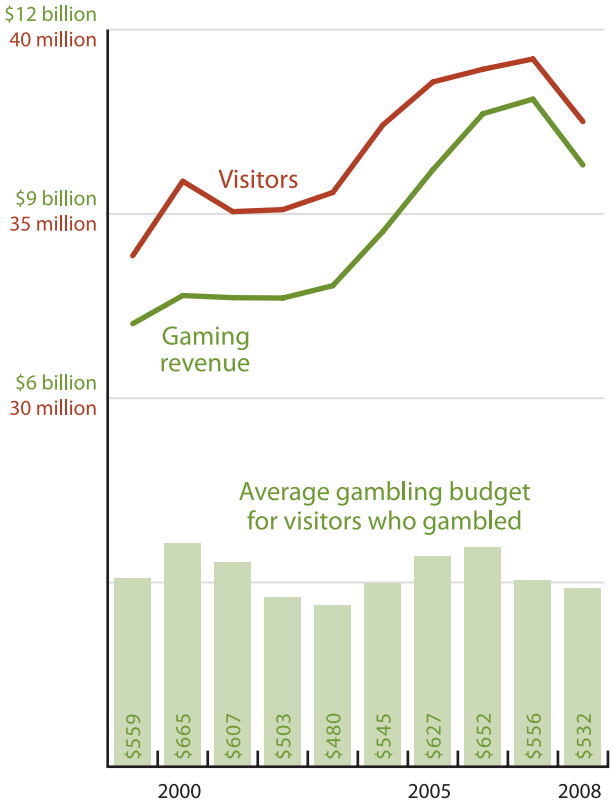
On the Las Vegas Strip, construction has stopped on two megaresorts, their owners buried under billions of dollars in debt. Five other major resort or condominium towers also are on hold.[152] The one exception, an $8.5 billion, seven-tower complex of casinos, hotels and residences nearing completion, attracted 160,000 applications for 12,000 jobs.[153] Office buildings and strip malls also sit unfinished. Nevada also built too many overpriced houses during the boom years; thousands now sit empty, losing value every day (Exhibit 7).

"We were the fastest-growing state, we sold more homes and office space than ever, and we had more and more tourists," said Jeremy Aguero, an economic analyst in Las Vegas. "Nevada was at the leading edge of the run-up [in consumer spending]. We're now uniquely positioned to take the hit on the other side."[154]

Meanwhile, the social costs are adding up. The number of homeless children in the Las Vegas school district rose 42 percent between June 2008 and June 2009, and Nevada leads the nation in the number of uninsured children.[155] Food bank demand went up 68 percent during the same period, with much of the gains coming from people over 60.[156] State officials are predicting that in the next two years, 43,000 more residents will be on Medicaid, the state-federal program that provides health care for low-income people.[157]

Exhibit 6. **Visitors' impact on Las Vegas gambling revenue**

Nevada's fiscal woes are largely tied to Las Vegas tourism. When the recession hit late in 2007, tourism dropped. The gamblers who did visit Las Vegas spent less money.



SOURCE: Pew Center on the States 2009, based on data from the Center for Business and Economic Research at the University of Nevada, Las Vegas and the Las Vegas Visitors and Convention Authority.

Spending, Revenue Decline Outpace Budget

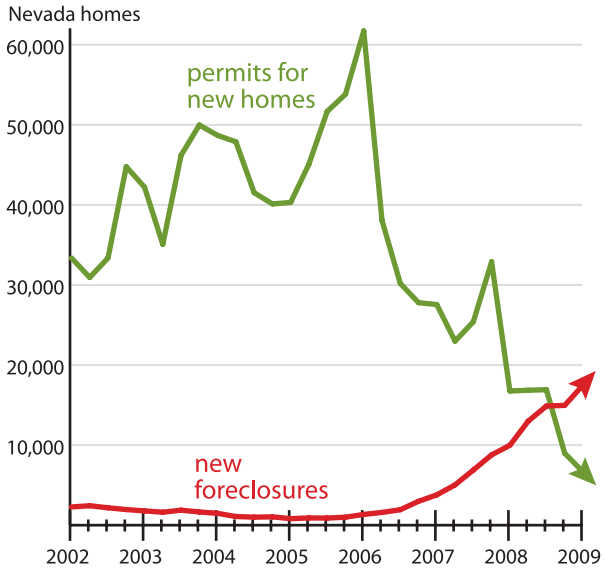
Nevada's state budget has not been able to keep up with the rising costs and precipitous decline in revenue. The legislature cut $1 billion in spending, raised taxes by $1 billion and used $1 billion in federal economic stimulus dollars to balance its current $6.9 billion, two-year budget. But nearly two years of declines in gaming revenues and double-digit drops in sales- and use-tax collections have punched a $3 billion hole in the budget lawmakers will take up in January 2011.[158]

The state's top political leaders are fractured. Gibbons could have trouble winning a GOP primary for re-election next year, according to polls. The governor and the Democratic-led legislature have battled often; even members of Gibbons' own party disagreed with him about how to rescue the economy. Gibbons vetoed 41 bills, including the state budget—the most since 1864, Nevada's first year of statehood. Meanwhile, the legislature set its own record for overrides.[159]

Exhibit 7.

Nevada foreclosures overtook new home construction in 2008

For most of the decade, Nevada built more homes than it had buyers. When the subprime mortgage crisis hit in 2006, home sales, values and permits began plummeting while foreclosures rose. The trend will continue in 2010 and 2011 as many mortgages reset at higher interest rates.



SOURCE: Pew Center on the States 2009, based on analysis of data from Mortgage Bankers Association: National Delinquency Survey; Moody's Economy.com; and the U.S. Census Bureau.

Some Nevada lawmakers say they are determined to use the gravity of the recession to persuade state officials and residents to make permanent fixes in the structure of state government. "Gaming and tourism will always be an important part of Nevada's economy, but those shouldn't be the sole sources," said state Senate Majority Leader Steven Horsford (D), who favors a corporate profits tax. "We need to change our revenue structure so it's able to meet essential needs—education, public safety, health and human services."[160]

Nevada is one of five states without a personal or corporate income tax, leaving state government to rely largely on the tax dollars it collects from now-shrinking gaming and sales to finance most services.[161] Among those services, public education and long-term health care will continue to vex policy makers because much of the growth in Nevada's population during the past 20 years was driven by people under six and over 65.[162] Increases in the cost of corrections, Medicaid and public employee pension plans also are challenging. The legislature has diverted unprecedented amounts of local government revenue to balance the state budget, which fiscal analyst Guy Hobbs of Las Vegas called "a clear indicator of … a continuously precarious fiscal situation."[163]

SCORECARD INDICATOR: SUPERMAJORITIES

Starting with Arkansas in 1934, certain states have made it more difficult for a legislature to raise taxes and approve budgets. Instead of requiring a simple majority for approval, states often demand a supermajority—or a two-thirds, three-fourths or three-fifths vote.

Whether a state requires a supermajority for raising some or all taxes, passing budgets or both was included as a criterion for this report because it impacts a state's ability to respond to a budget crisis. Sixteen states require supermajority votes to pass some or all tax increases or new taxes. Two of those, California and Arkansas, plus Rhode Island require supermajorities to approve spending bills, according to the Public Policy Institute of California.[164]

California's two-thirds supermajority constraint for both raising taxes and approving a budget is a factor in its recurring budget troubles. Critics say the requirement restricts the state's ability to raise revenue when it has little other choice, often leading to delays in passing a budget. Supporters say it is a check on government spending and tax increases, which is why voters consistently approve it in ballot measures.

In states closely divided along party lines, the supermajority requirement can get sticky. Six years ago, the Nevada Supreme Court intervened to resolve a stalemate between the Republican-controlled Senate and the Democratic-controlled House. The justices voted to invalidate the requirement that a two-thirds majority of the Senate and House was needed to pass tax increases. The court made the one-time exception because it said the state constitution required the state to fund education and the tax impasse was holding that up.[165]

Lawmakers set up a panel of elected officials and business, education, health, public safety and transportation leaders to recommend changes by July 1, 2010, including tax proposals.[166] It will be the fifth time since 1959 that officials have examined the state's tax system, and each time the previous groups proposed broadening the tax base.[167] The panels also have found that Nevada limits its sales taxes by allowing dozens of exemptions. The sales tax base also depends heavily on a flourishing construction industry—"not a very firm foundation upon which to build reliance," concluded the last panel in 2002.[168]

Some interest groups representing tax, business or political interests advocate higher taxes on mining, while others say sales taxes should extend to services such as cellular telephone use. Still others support a statewide lottery. In a move that could happen only in Nevada, the head of the state brothel association has promoted an entertainment tax on each transaction by a prostitute.[169]

But changes to the tax system are particularly difficult to make because, unlike most states, Nevada has written some of its tax laws into the state constitution instead of into statutes.

Amending the constitution to include a lottery or income tax or higher sales tax rate would be nearly impossible. If initiated by the legislature, a constitutional amendment must be approved by two separately elected legislatures and a vote of the people, a five-year process. If introduced by a ballot initiative, the proposed change must be approved by voters in two successive general elections.[170] Still, there are several taxes and fees that the legislature can enact by statute, which they did this year to balance the budget.

> "Gaming and tourism will always be an important part of Nevada's economy, but those shouldn't be the sole sources...We need to change our revenue structure so it's able to meet essential needs—education, public safety, health and human services."
>
> —NEVADA SENATE MAJORITY LEADER STEVEN HORSFORD

Unlike his GOP predecessor, Gibbons generally opposes tinkering with taxes. "Our existing tax system brought us record job growth and prosperity for decades," he said.[171] The governor preferred deeper spending cuts when the legislature was trying to balance the biennial budget earlier in 2009, though he did back an increase on hotel room taxes.

Lawmakers ignored Gibbons' proposals and put together their own budget, which he rejected. To win the two-thirds majority required to pass tax increases and override the governor's veto, Democrats went along with some GOP demands, such as reducing pension benefits for new state employees. They also agreed to allow the tax increases to expire in 2011. These temporary budget-balancing actions deferred long-term solutions.

Although Nevada has had some success in recent years diversifying its economy beyond gambling, analysts say the state still has a long way to go. Like a lot of western governors, Gibbons supports renewable energy as the key to Nevada's future—"the new gaming industry," he said in a speech.[172] Even after the economic recovery is well under way in other states, Nevada will be one of the stragglers, economists say, because it has so far to go to catch up. Revenues will not start growing again until 2011, they say. Bill Uffelman, chief executive officer of the Nevada Bankers Association, said the consensus is that it could be another two years before commercial real estate starts to rebound.[173]

"In previous recessions, we have been the last to feel it and the first to come out," said Richard Bryan, a former Nevada governor and U.S. senator (D). "That won't be the situation now."[174]

Oregon

At a Glance

	Change in revenue	Size of budget gap	Change in unemployment rate	Foreclosure rate	Needs supermajority?	GPP "Money" grade	Score
Oregon	-19.0%	14.5%	6.4	.86%	Yes	C+	**26**
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
United States	-11.7%	17.7%	4.4	1.37%	17 yes, 33 no	B- [5]	17

SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

Mountainous and largely rural, Oregon has fewer people than Los Angeles, and its politics, economy and state finances are easily overlooked amid the fiscal turmoil and legislative gridlock of its sprawling southern neighbor, California. Oregon Democrats hold the governor's mansion and supermajorities in both legislative chambers, dimming the chances of partisan stalemates like those experienced in Sacramento. The Portland metro region has a highly educated workforce that has long presented an attractive pool of recruits for potential employers, particularly the high-tech firms that have settled in the city's suburbs and spawned the area's nickname, the "Silicon Forest"—a Pacific Northwest counterpoint to the Golden State's Silicon Valley.

But the national recession, which has ensnared nearly every state from Alaska to Florida and is likely to upend state budgets through at least 2011, in many ways has hit Oregon as hard as California. The downturn has caused severe distress to some of Oregon's leading industries and exposed the state's overreliance on volatile corporate and personal income taxes—the result of voters rejecting a statewide sales tax nine times. The recession has drawn attention to Oregon's unique, voter-imposed revenue cap, which forces the state to give taxpayer rebates when times are good but, critics say, leaves it dangerously unprepared when times are bad.

And it prompted lawmakers to respond with $2 billion in spending cuts, aggressive use of federal stimulus dollars and more than $1 billion in new taxes, including $733 million in proposed income tax hikes that will be challenged at the polls in January 2010.[175]

Between the second quarter of 2008 and the second quarter of 2009, Oregon's unemployment rate more than doubled, outpacing California's job loss increases and surging faster than that of any other state.[176] Of the state's total job losses in 2008, about 70 percent happened in the year's final three months, just before shell-shocked lawmakers returned to work.[177]

A year later, the statistics are still eye-opening. Nine of the state's 36 counties reported unemployment above 15 percent in August 2009; unemployment in two counties approached 19 percent.[178] The state's overall jobless rate as of August, 12.2 percent, was tied for worst in state history and tied for fourth-worst in the nation, though it dipped to 11.5 percent in September.[179] More Oregonians than ever are receiving food stamps as demand for social services goes up.[180]

But perhaps no number tells the story of Oregon's bleak fiscal house like the 19 percent drop in revenue the state reported between the first quarter of 2008 and the first quarter of

2009.[181] The decrease is a reflection of Oregon's heavy reliance on income taxes at a time when incomes dropped and employers shed jobs by the tens of thousands. Only three states, Alaska, Georgia and Virginia, saw sharper revenue declines during the same period.[182]

To understand Oregon's soaring unemployment rate and its corresponding decline in tax revenue, look no further than the goods the state produces—many of which are going unsold.

The sudden plunge in cash forced Governor Ted Kulongoski (D), who had presented his draft budget to the legislature just a month earlier, to acknowledge during his state of the state speech to lawmakers in January that "the facts have changed. The general fund has changed. And our hope for an early economic recovery has changed."[183]

A Timber and High-tech Tumble

To understand Oregon's soaring unemployment rate and its corresponding decline in tax revenue, look no further than the goods the state produces—many of which are going unsold. Oregon's once-mighty wood products industry, whose workforce has been shrinking due to automation and technology advances, is projected to lose a jarring 21 percent of its jobs in 2009.[184] Driving the collapse is the nation's housing bust: When new homes are not being built, timber sales slump.

That reality is borne out in the high unemployment rates not only in Oregon's biggest timber-producing counties, but also in recreational hotspots such as central Oregon's Bend, where Californians and others have moved over the years for easy access to the snow-capped, 10,000-foot peaks nearby. As Bend's real-estate boom reversed, its unemployment rate climbed to 15.8 percent, the highest of any of Oregon's urban areas.[185]

Silicon Forest and other drivers of the state's high-tech economy also have not been spared, suffering from the economic downturn in Pacific Rim countries, which buy many of Oregon's high-tech products. Hynix Semiconductor, the world's second-largest computer memory-chip maker, last year closed its production facility in Eugene, eliminating 1,400 well-paying jobs.[186] Computer chip-maker Intel, the state's largest private employer, is planning to lay off 1,000 workers in the Portland suburbs, and Nike, another of Oregon's prominent corporate faces, has shed 500 jobs at its headquarters outside Portland.[187]

Months after the Hynix plant's closure, the now-bankrupt recreational vehicle manufacturer Monaco Coach Corp. laid off about 2,000 employees in Coburg, Oregon, 10 miles north of Eugene.[188] The state's substantial transportation equipment industry—which includes RV manufacturing—is projected to do even worse than the timber industry this year, losing 22 percent of its jobs, as consumers refrain from buying big-ticket items like RVs.[189]

Even as jobs are disappearing, Oregon's economic situation has been complicated by the fact that, until recently, its workforce had grown sharply, unlike those in many other states.[190] That means more competition for fewer jobs (Exhibit 8).

Some policy makers, including the governor, believe that one sector of Oregon's economy, clean energy, offers hope. Oregon had a bigger share of its jobs in clean energy than any other state as of 2007, according to a Pew report.[191] Kulongoski has worked hard to build a green legacy—insisting on generous tax credits for renewable-energy firms even as other Democrats sought to reduce them, for example, and publicly test-driving electric cars in an effort to lure their manufacturers to Oregon.[192] In a May 2008 campaign visit, then-candidate Barack Obama visited a Bend solar energy firm and hailed it as a "workshop of the future."[193] But some experts question whether the sector can lead Oregon out of its economic doldrums. "There are worries that we're getting in a little late, especially with all the investment that China is doing," said Jessica Nelson, an economist with the Oregon Employment Department.[194]

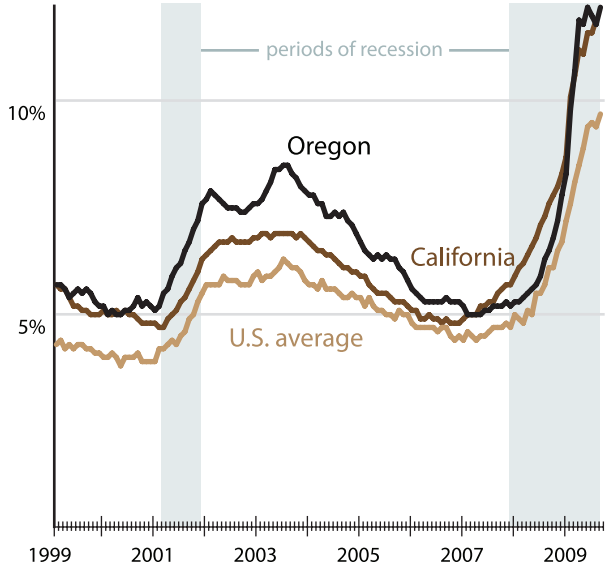
State Stimulus, Taxes Plug Holes

Confronted with a staggering loss of jobs and tax revenue that accompanied the state's economic nosedive, Oregon Democrats seized upon the supermajorities they won in last year's legislative elections. On February 5, less than a month after the session began and about two weeks before President Obama signed the federal stimulus package into law, Kulongoski signed Oregon's own, state-level stimulus initiative, a $175 million borrowing plan that promised to create jobs while making improvements to the state's roads and schools. At the same time, lawmakers made about $2 billion in cuts, including reductions to K-12 schools—which, in Oregon, rely on the state for about two-thirds of their operating budgets.[195] The education cuts have forced some districts to shift to four-day weeks. "This is my thirty-fourth year in education, and I've never seen a situation quite this bleak," said Randy Gravon, superintendent of southwestern Oregon's Central Point School District, which will close every Monday this school year.[196]

But the more than $1 billion in tax increases that Democrats pushed through to balance the budget and pay for major new initiatives in transportation and health care have proven most controversial. To help fund a massive road-improvement plan they said would create thousands of jobs, lawmakers raised the gas tax from 24 to 30 cents per gallon and hiked the cost of vehicle registration from $54 to $86. To expand health care for to up to 115,000 uninsured children, they created a new 1 percent tax on health insurance premiums and raised hospital taxes.

Exhibit 8. **Unemployment in Oregon surpasses California, nation**

Oregon tends to have higher unemployment rates than the U.S. average, but the recent recession has further increased this divide.



SOURCE: Pew Center on the States 2009, based on data from the U.S. Department of Labor's Bureau of Labor Statistics.

The vast majority of new tax revenue, $733 million, came in the form of new personal and corporate income tax rates that have drawn national attention and will go before the voters in a crucial special election in 2010. Like California, Oregon allows its citizens to make important decisions about state spending and revenue through referenda that are placed on the ballot by lawmakers or through initiatives that qualify with enough citizen signatures. But the electorate, which has repeatedly rejected higher taxes, could leave the legislature with a new hole, $733 million deep, in its two-year budget when it reconvenes in February 2010. "I've lived here 25 years now, and I have yet to see a statewide referendum pass that increases taxes or allows increased taxes," said Fred Thompson, a professor of management at Willamette University in Salem, Oregon.[197]

Strategies Debated

Oregon's economic woes and the steps the 2009 legislature took to address them have sparked a deeper debate about the state's fiscal and economic policies—and what legislators could

SCORECARD INDICATOR: CHANGE IN REVENUE

Tax revenue is the lifeblood of state government. When a recession dries up that revenue, legislators often must resort to emergency measures to keep government running.

Lawmakers in most states this year combined federal stimulus money with deep spending cuts to counter sharp revenue declines. State tax collections for the first quarter of 2009 were the worst on record, down 11.7 percent from last year.[198] More than half the states also raised taxes to balance their budgets. Every state but Vermont is required by law to have a balanced budget. In many states—including California, Hawaii, Massachusetts, Nevada, New Jersey, New York, North Carolina, Oregon and Wisconsin—those tax hikes included increases in "broad-based" income or sales taxes that provide the bulk of states' revenue and can be politically risky to pursue.

Oregon has an extremely volatile tax structure—a major factor in its current fiscal crisis.[199] With no statewide sales tax and a strict, voter-imposed cap on local property taxes, the Beaver State leans heavily on corporate and personal income tax revenues instead. But those revenues are closely tied to shifts in the economy. When Oregon's coffers took a 19 percent hit from 2008 levels earlier this year, lawmakers raised corporate and personal income tax rates. Oregon's top personal income tax rate, 11 percent, now is tied with Hawaii for highest in the nation.

Oregon voters have rejected a statewide sales tax nine times. Four other states—Alaska, Delaware, Montana and New Hampshire—collect no statewide sales tax. Seven states—Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming—do not have an individual income tax. The two states that have neither sales nor individual income taxes—Alaska and New Hampshire—rely heavily on other taxes, primarily on natural resources in Alaska and on property and corporate income in New Hampshire.

and should have done differently. Democrats defend this year's tax hikes as a long-overdue rebalancing of the tax code and necessary to avoid unthinkable cuts to core state obligations such as public safety and education. Republicans say Democrats abused their newfound supermajorities and are placing too much of a tax burden on the small businesses that will be at the heart of any economic recovery in Oregon.

Oregon's minimum wage is another line of demarcation. The $8.40 hourly rate is the second-highest in the nation, and while liberals see it as helpful to the poor, fiscal conservatives claim that it hurts businesses and even some low-wage workers who might not get jobs because of it.[200]

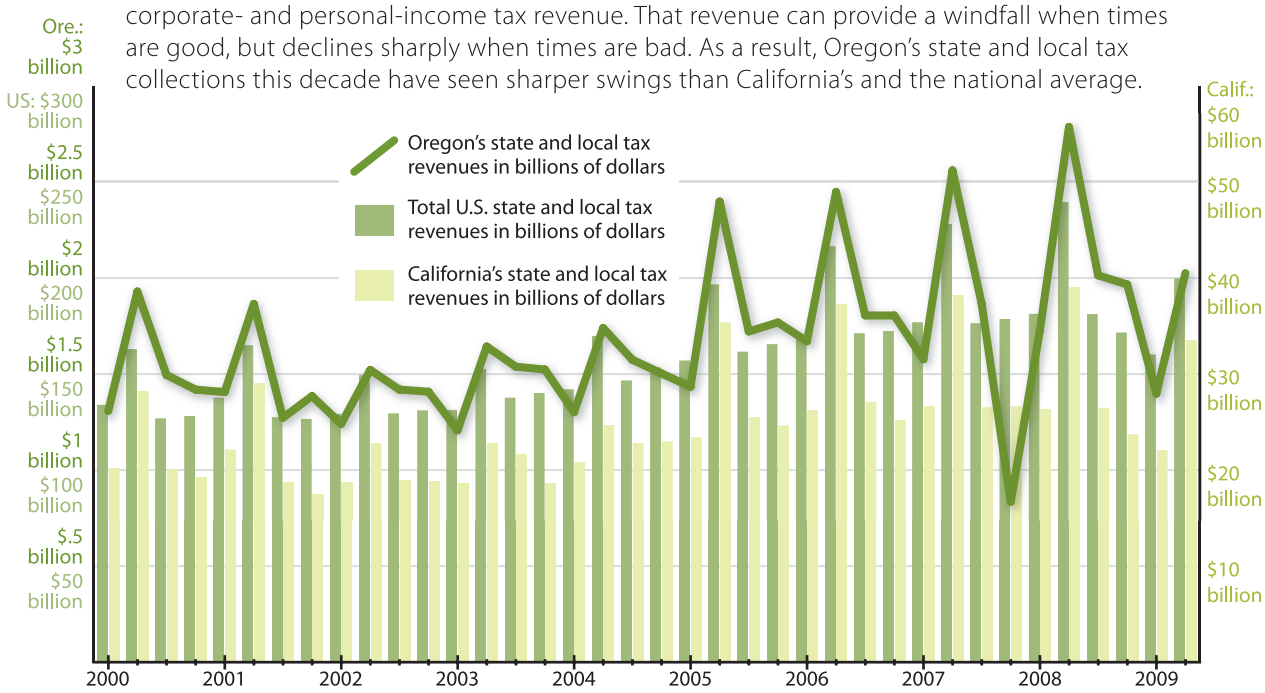
The state-level stimulus has provided its own controversy, similar to the national debate over the federal stimulus. The Oregon Legislative Fiscal Office credits the program with having "created or retained a total of 3,236 jobs" in its first three months.[201] But an Associated Press investigation questioned the way the state counted those jobs and found that each job lasted a total of 35 hours, or less than a week of full-time employment.[202]

Partisan charges aside, the system that allows voters the final say on state spending and revenue is a larger reality in Oregon's fiscal structure with which Democrats and Republicans alike must contend. The results of such votes often run counter to what state legislators want. While lawmakers from both parties are quick to note the volatility of Oregon's heavy reliance on the income tax (Exhibit 9), Oregon voters have repeatedly rejected a statewide sales tax. The state's K-12

Exhibit 9.

Oregon tax revenues more volatile than in United States, California

With no statewide sales tax and a limit on local property tax hikes, Oregon relies heavily on corporate- and personal-income tax revenue. That revenue can provide a windfall when times are good, but declines sharply when times are bad. As a result, Oregon's state and local tax collections this decade have seen sharper swings than California's and the national average.



SOURCE: Pew Center on the States 2009, based on data from the U.S. Census Bureau's "Quarterly Summary of State and Local Government Tax Revenue."

schools are funded primarily through direct state allocations—not from local property taxes, as in many other states—because voters agreed to that change in 1990.

> "I've lived here 25 years now, and I have yet to see a statewide referendum pass that increases taxes or allows increased taxes."
>
> —FRED THOMPSON, PROFESSOR OF MANAGEMENT, WILLAMETTE UNIVERSITY

Perhaps most important, many lawmakers now are pushing back against Oregon's one-of-a-kind "kicker" law, which voters placed in the state constitution in 2000 and requires the state to provide rebates to taxpayers whenever state revenue exceeds projected revenue by 2 percent or more. State Senator Ginny Burdick (D), chair of the Senate Revenue Committee, and other key players in Oregon's budget process said they plan to try to change the law in 2010 to allow the state to build its rainy day fund for the next recession.[203] Because the kicker is part of the Oregon constitution, however, any changes would have to be approved by the voters.

Florida

At a Glance

	Change in revenue	Size of budget gap	Change in unemployment rate	Foreclosure rate	Needs supermajority?	GPP "Money" grade	Score
Florida	-11.5%	22.8%	4.4	2.72%	Yes	B-	**25**
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
United States	-11.7%	17.7%	4.4	1.37%	17 yes, 33 no	B-	17

SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

For the first time since World War II, Florida's population is shrinking—a disturbing trend for a state that has built its economy, and structured its state budget, on the assumption that throngs of new residents will move to its sunny shores each year.

"Our number-one industry has been growth, and our number-one policy has been optimism," said State Senator Dan Gelber (D).[204]

The Great Recession has not just stalled Florida's growth—it has reversed it. In 2005, Florida ranked second among the states in economic growth. In 2008, it ranked 48th.[205] Not too long ago, Florida was adding as many as 445,000 residents a year;[206] between April 2008 and April 2009, its population actually shrank by 58,000.[207]

Only three years ago, Florida's job market was among the strongest in the nation, enticing workers with plentiful jobs in construction and tourism.[208] The state's unemployment rate of 11 percent as of September 2009 was eighth-worst in the country.[209] Meanwhile, property values rose so quickly during the housing boom that property tax revenues doubled in many cities between 2001 and 2006.[210] As of this writing, there were at least 275,000 homes for sale or rent in Florida that nobody wanted,[211] and the state has the second-highest foreclosure rate in the country.[212]

State and local budgets expanded dramatically during the housing boom, but now Florida's governments face significant problems raising enough revenue to cover expenses, despite efforts to tuck cash into reserves during flush times. Florida lawmakers in 2009 tried to head off trouble by agreeing to raise $2 billion in new revenue, but the state already is bracing for a deficit as high as $2.6 billion in fiscal 2011.[213]

This is uncharted territory for a state whose conservative budgeting practices, constitutionally required reserves and go-go economy largely have kept it out of fiscal trouble for the better half of the past century.

There are parallels between the plights of Florida and California, said Dominic Calabro, president and CEO of Florida TaxWatch, a nonpartisan research organization. "The only thing that keeps us from falling into the abyss is that our state constitution is fiscally conservative, which makes it harder—though not impossible—to become insolvent in the way that California has." The Florida constitution's balanced-budget requirements are among the most stringent in the country, Calabro said, and prevent the state from writing IOUs or borrowing to fund operating expenses.[214]

Few Options for Righting Budget Shortfalls

Florida's choices for bringing its ledger into balance are limited in the first place because it has no income taxes and its per-capita spending on education and social services is already low,[215] so cuts are difficult to make.[216]

Faced with a $5.9 billion budget shortfall for fiscal 2010,[217] Governor Charlie Crist (R) and the GOP-controlled legislature ultimately balanced the budget using a combination of cuts, fund transfers, federal stimulus money and more than $2 billion in tax and fee increases—including a $1-a-pack tax hike on cigarettes; college tuition increases; and higher fees on court filings, motor vehicle tags and driver's and fishing licenses.[218] Cigarette taxes and fee increases were among the most common ways that states nationwide filled their budget holes this year,[219] but doing so in Florida meant breaking campaign promises for many involved, including the governor.[220]

> This is uncharted territory for a state whose conservative budgeting practices, constitutionally required reserves and go-go economy largely have kept it out of fiscal trouble for the better half of the past century.

"The state government isn't burying its head and saying in a year or two we'll get through this like a lot of other states are," said Tony Carvajal, executive vice president of the Florida Chamber of Commerce Foundation. "We're making the necessary changes and hard choices now."[221]

According to Florida's budget office, haggling through those hard choices this year has put the state on firmer long-term fiscal footing. The next fiscal year, 2011, is expected to be the first in four that Florida takes in more revenue than the year before, with a 6.8 percent increase forecast, the result of both projected growth and recent tax and fee increases.[222]

Nevertheless, the state is not out of the woods yet. Even with revenue growth, state expenses are expected to outstrip state dollars and lead to budget shortfalls for each of the next three years.[223] Medicaid costs to provide health care for the state's poor and disabled are growing in this recession, and such increases are among the main reasons red ink is forecast for the state's budget next year.[224]

Just as in California, constitutional amendments passed by voters also tie the hands of Florida budget makers. Budget officials said one of the most daunting challenges will be finding the funds to bring class sizes down to levels mandated by a 2002 constitutional amendment, which will be phased in completely in 2010.[225] The state already has spent $13 billion to lower class sizes and will have to spend an additional $1.5 billion in fiscal 2011 to comply with mandated levels.[226]

Housing Is Key

Housing was the driving force behind both Florida's boom and its bust—and will be the biggest obstacle to its long-term recovery. The construction and real estate industries make up approximately 24 percent of Florida's economy.[227] Before the recession, investors, baby boomers and retirees flocked to Florida for its mild winters, underpriced real estate and low interest rates. By 2006, the state was welcoming more than 1,100 new residents every day.[228] The construction

boom sent tax revenues soaring at every level of government, service industries catering to retirees flourished, and low-wage workers bolstered the population growth.[229]

> Housing was the driving force behind both Florida's boom and its bust—and will be the biggest obstacle to its long-term recovery.

Florida's housing market collapsed so completely as the housing bubble burst and the mortgage crisis hit that it brought down the rest of the state's economy with it, seemingly overnight. Florida's housing market reacted so strongly because of the high cost of land in Florida relative to most other states, said David Denslow, an economist at the University of Florida's Bureau of Economic and Business Research.[230] Land prices are much more volatile than prices for structures, such as houses and condos, and are intimately tied to what happens in the national financial sector, leading to a bigger bubble—and a bigger bust—in Florida than in most places, he said.

Florida's housing market is in worse shape than California's and is expected to take longer to recover, according to forecasts by Moody's Economy.com.[231] "Foreclosure rates are still rising in both states, but they're rising with no slowing whatsoever in Florida, while they're really starting to slow a bit in California," said Marisa DiNatale, a senior economist at Moody's Economy.com.[232]

Although housing prices have dropped dramatically, the traditional pipeline of baby boomers and retirees from the Midwest and East Coast has been nearly shut off as homeowners in those regions have difficulty selling their homes and cannot move.[233] Analysts expect population growth to pick up very gradually as the national economy recovers.[234]

Florida House Speaker Larry Cretul (R) insisted Florida's long-term appeal for retiring baby boomers remains strong. "I don't think one can reach quick conclusions about demographics, based on a couple of years of experience. Florida is a very welcoming place," he wrote in an e-mail.[235]

Calabro, of Florida TaxWatch, said the recession shows that the Sunshine State rested too much on its laurels and had become "not just overconfident but arrogant" about its economic prospects. "I don't think Florida is over, like the articles calling us the 'Sunset State' have been saying," he said. "But this is more than just a temporary lull."[236]

New Jersey

At a Glance

	Change in revenue	Size of budget gap	Change in unemployment rate	Foreclosure rate	Needs supermajority?	GPP "Money" grade	Score
New Jersey	-15.8%	29.9%	3.7	1.18%	No	C-	**23**
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
United States	-11.7%	17.7%	4.4	1.37%	17 yes, 33 no	B-	17

SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

New Jersey's math does not add up.[237] The Garden State has the nation's highest property taxes and in recent years has hiked both its sales and personal income taxes to generate more revenue—yet it still faces among the biggest budget shortfalls of any state, at nearly 30 percent of its overall budget.[238] Governor Jon S. Corzine (D) has sought to curb what he calls the state's "credit card culture," but per-capita debt is huge and growing amid mounting interest payments and few sources to pay it off, earning New Jersey a C- grade in a 2008 Pew Center on the States report assessing how well states manage their budgets.[239] While its proximity to New York City and its educated workforce are appealing to many employers, New Jersey has been ranked the least friendly state for business four years running, largely because of its heavy tax burden.[240]

New Jersey, in short, is finding it difficult to play catch-up. Years of fiscal mismanagement have resulted in soaring debt and a persistent imbalance between what the state collects and what it spends. Factor in the collapse of neighboring Wall Street—which Corzine has estimated supports about one-third of New Jersey's economy—and it is no wonder that the state is among the hardest hit during this recession.[241] As in most other states, unemployment and foreclosures have climbed, contributing to a 15.8 percent decline in tax revenue from the first quarter of 2008 to the first quarter of 2009.[242] "When the recession hit New Jersey, it was like a tornado hitting a house that was already falling," said Jon Shure, deputy director of the State Fiscal Project at the Center on Budget Policy and Priorities, a Washington, D.C., research group.[243]

Still, for all of its woes, New Jersey placed far down the list of the nine states identified by Pew's California Scorecard as in fiscal peril.

Debt Soars

New Jersey has perennially borrowed money to balance its budget while avoiding tough decisions about recurring revenue shortfalls; as a result, state long-term debt has soared above $44 billion, an eye-popping figure that is 53 percent larger than the state's latest annual budget and is higher in per-capita debt than almost every other state.[244] The state's mandatory payments on that debt, in turn, have eaten up a growing slice of the budget. Meanwhile, the state pension fund—which lawmakers have raided over the years to cover operating costs—is dramatically underfunded.[245]

Court decisions also have left state lawmakers with less budgetary breathing room. The New Jersey Supreme Court, for instance, has ordered

the state to spend billions to fund urban school districts that are short on property tax revenue.[246] Soaring property tax rates, meanwhile, have ignited so much criticism that state lawmakers decided in the 1970s to return revenue from other taxes to taxpayers every year in a rebate program—again limiting the money lawmakers can use for other purposes.[247]

> "When the recession hit New Jersey, it was like a tornado hitting a house that was already falling."
>
> —JON SHURE, DEPUTY DIRECTOR OF THE STATE FISCAL PROJECT AT THE CENTER ON BUDGET POLICY AND PRIORITIES

Corzine has taken unpopular positions in an effort to shrink state government and bring spending in line with revenues. The $29 billion budget he signed in June 2009 is about $4 billion less than last year's, and he is the first governor in generations to reduce state spending over the course of his first term.[248] He aggressively sought to raise tolls on some of the state's major highways and use the money to cut New Jersey's debt—a plan ultimately rejected by legislators in his own party.[249] He also has furloughed state workers, consolidated school districts and presided over the elimination of the state departments of Commerce and Personnel to save money.[250]

But such efforts have barely made a dent. While the legislature included $650 million in last year's budget to help reduce the state's debt, for instance, it also approved a $3.9 billion borrowing plan to pay for school construction projects that Corzine said the state could no longer put off.[251] This year, Corzine touted an initiative to eliminate 26 school districts—but there are 613 in the state, many more than exist in its much larger and more populated neighbor, Pennsylvania.[252]

In need of more revenue even after making major cuts and using federal stimulus money, New Jersey raised taxes by about $1 billion this year, mainly through temporary income-tax hikes on wealthy residents who now face some of the highest tax rates on upper bracket earnings in the nation.[253] But even that dramatic step may suffer from the law of diminishing returns: Wall Street's collapse also has reduced the income from which the state can draw tax revenue. "The revenue sources have pretty much dried up," said Michael P. Riccards, executive director of the Hall Institute of Public Policy, a nonprofit research organization in Trenton.[254]

Illinois

At a Glance

	Change in revenue	Size of budget gap	Change in unemployment rate	Foreclosure rate	Needs supermajority?	GPP "Money" grade	Score
Illinois	-10.9%	47.3%	3.5	1.44%	No	C-	**22**
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
United States	-11.7%	17.7%	4.4	1.37%	17 yes, 33 no	B-	17

SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

During America's Great Recession, Illinois' budget situation has gone from shaky to unsustainable. But the state's fiscal woes began long before this downturn.

"Even if we hadn't had a recession, Illinois would've been pretty deep in the hole," said Jim Edgar (R), a former Illinois governor who ran the state during the downturn in the early 1990s.[255]

Illinois' diverse economy is not immune to the national economic crisis, including the impact of the housing market collapse. It had the seventh-highest foreclosure rate in the first quarter of 2009. Its unemployment rate hit 10.5 percent in September 2009, higher than the national average that month of 9.8 percent.[256]

But what puts Illinois squarely in the company of California is its lack of fiscal discipline to balance its state budget. That was apparent even before the latest recession. In 2008, the Pew Center on the States' Government Performance Project graded states on how well they manage their money. Illinois received a C-. Only California and Rhode Island scored lower.[257]

Illinois' budget gap for fiscal 2010 was one of the three biggest in the country: $13.2 billion.[258] But Illinois has run deficits every year since the last recession in 2001.[259] Officials have used all sorts of short-term approaches to address the budget gaps, but two of the most significant and consequential are to put off paying bills and skimp on the state's annual pension payments.

In summer 2009, California issued IOUs when it ran out of money. In comparison, since 2001, the Land of Lincoln repeatedly has let doctors, pharmacists, social workers and other contractors simply wait for compensation as lawmakers put off paying bills. In the past decade, payments to Medicaid providers were particularly affected. The amount of unpaid Medicaid bills pushed into the next fiscal year rose from $752 million in 1998 to $1.85 billion in 2003.[260]

When state officials decide the backlog has grown too large, Illinois borrows money to pay its bills, as it has done frequently since 2003.[261] But when the recession struck, Illinois could not borrow enough money to settle its accounts.[262] As a result, the amount of its unpaid bills quadrupled to $3.9 billion in a one-year span that ended in June 2009.[263] Illinois officials ended the legislative session in July 2009 without a plan to pay them off.[264]

Unfunded Pension Liabilities Grow

But borrowing was state officials' answer to making its annual payment of $3.4 billion in 2009

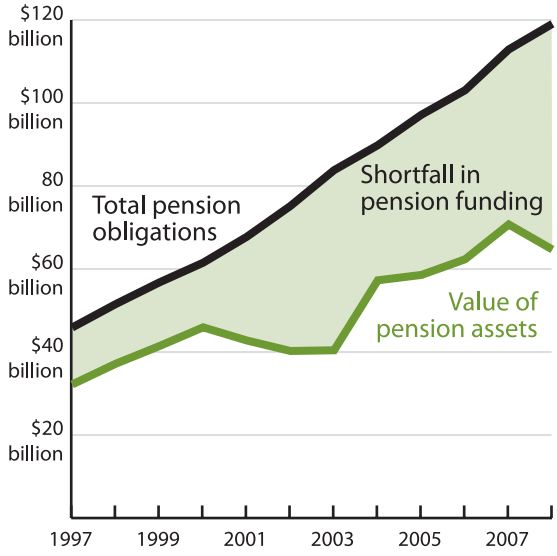
to fund public workers' pension benefits. The loan has to be paid back within five years.

Illinois' unfunded pension liabilities have been a significant and continuing problem, even as far back as 1995 (Exhibit 10).[265] That year, Republicans, who briefly controlled the legislature, devised a 50-year plan to gradually ramp up contributions to bring the public retirement systems closer to solvency. But the plan fell apart after only eight years, when lawmakers turned to a pension bond arrangement proposed by then-Governor Rod Blagojevich (D).

The lynchpin of Blagojevich's first budget in 2003 was a controversial move to float $10 billion in 30-year bonds and let the state pay two years' worth of pension payments with the proceeds. What

Exhibit 10. **Pensions: Illinois falls behind in saving for future costs**

There is a growing gap between what Illinois has promised its public-sector retirees and how much it has set aside to cover its pension obligations. As of 2008, the state's pensions were only 54.3 percent funded, short of the 80 percent that pension experts recommend.



SOURCE: Pew Center on the States 2009, based on data from the State of Illinois, Comprehensive Annual Financial Reports, 1997–2008.

raised the eyebrows of budget experts, though, is how Illinois accounted for the proceeds—it took credit up-front for all of the profits that would accrue over 30 years to justify taking a two-year break from chipping into its pension fund.[266] Recent years showed how risky that approach can be. Largely because of the recession, the profits did not materialize as expected. The state has earned an average of only 3.8 percent a year on investment of its bond proceeds, far less than the 8.5 percent annual average over 30 years on which the state had counted.[267]

In 2004, the year after Blagojevich's pension bond plan passed, legislators rewrote the law to temporarily reduce the annual catch-up payments.[268] Steve Schnorf, a top budget official for two former Republican governors, said the pension arrangements will put tremendous strain on the state next year.[269] Lawmakers not only will have to find $3.4 billion to make next year's annual pension payment, he said, they also must cover the annual increase required by the 1995 law. On top of that, the state will owe roughly $800 million to pay back this year's short-term loan.[270]

The state resorted to some of the same budget approaches before Blagojevich assumed office in 2003, but they grew during his tenure. Blagojevich came to office in the wake of the 2001 recession, which hammered state revenues for several years. He held fast to a campaign pledge to oppose income or sales tax hikes. And he championed new programs—including his signature AllKids health insurance initiative—without securing new funding.[271]

The acrimonious relationship between Blagojevich and the Democratic-controlled legislature made matters worse. In 2008, Blagojevich's last year as governor, lawmakers passed a budget that was $2

billion out of balance and left it to him to make cuts. He did not make much progress before he was impeached and removed from office and then replaced by his lieutenant governor, Pat Quinn (D), in January 2009.

Budget Solutions Demand Political Will

Illinois now is operating under a budget signed by Quinn in summer 2009 in which legislators left a $1 billion hole for the new governor to fix. "We have a lot of challenges in Illinois," Quinn acknowledged the night legislators sent him the spending plan. "That's why I think we need new revenue to pay the backlog of bills. I have inherited this. I am bound and determined to whittle it down. But right now this budget tonight is the best we can do to get the work done."[272]

Quinn has not given up on his proposal—rejected in May 2009 by the House[273]—to raise the state's 3 percent income tax to 4.5 percent. But Quinn put off a vote in the legislature until after the primary election in February 2010.

Meanwhile, experts predict next year's shortfall will top $11.7 billion even before taking rising costs into account.[274]

"The difficulty is there is not a tax increase big enough to allow the state to keep spending at the level it has," said Laurence Msall, president of the Chicago-based Civic Federation, a business-oriented group that studies state and local government. Quinn put forward ideas this year to tamp down spending but got a chilly reception from legislators, Msall said.[275]

Steve Rauschenberger, a former GOP state senator who served as president of the National Conference of State Legislatures in 2006, said he believes that the state could work its way back into the black, but only by taking on powerful interests in the areas of Medicaid, school funding and corrections policy.[276]

Former Governor Edgar, whom Chicago Mayor Richard M. Daley once dubbed "Governor No" for nixing so many spending ideas, said Illinois governors need to lead the way for the state to make cuts. "My experience has always been that the legislature is not usually the institution you're going to depend on to hold the line on spending. It's the nature of the legislature to make their constituents happy," Edgar said. "The governor has to be the one who makes the stop."[277]

SCORECARD INDICATOR: BUDGET GAPS

All but two states confronted budget shortfalls in the current fiscal year, an indication of the breadth of the current recession. State shortfalls totaled $162 billion in estimated budget gaps for fiscal year 2010—the equivalent of nearly $530 for every man, woman and child in the country.[278] And unlike the federal government, all states except Vermont are legally bound to balance their budgets, although many run short-term deficits.

Closing budget gaps proved hardest in states that had already struggled to make ends meet even when the economy was good. In the 2010 fiscal year, California was hit hardest, with a shortfall that by some estimates approached half of its operating budget. Illinois, Arizona and Nevada faced gaps greater than a third of their general funds, according to the Center on Budget and Policy Priorities.[279]

Wisconsin

At a Glance

	Change in revenue	Size of budget gap	Change in unemployment rate	Foreclosure rate	Needs supermajority?	GPP "Money" grade	Score
Wisconsin	-11.2%	23.2%	4.4	.96%	No	C+	**22**
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
United States	-11.7%	17.7%	4.4	1.37%	17 yes, 33 no	B-	17

SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

To most, Wisconsin would not seem to have the same problems managing its money as its dairy rival, California, which is in the news constantly for its fiscal nightmare. But the recession has hit Wisconsin harder than it has hit most state governments, especially when it comes to lost tax revenues and the size of the hole that made in its budget. And unemployment is climbing as the state's largest sector—manufacturing—sputters.[280] All of these factors have helped the state to narrowly make Pew's Top 10 list of states in fiscal peril.

Manufacturing in Wisconsin is one of the state's largest industries because of firms such as Harley Davidson and General Motors, as well as other automobile suppliers. Manufacturing's decline in Wisconsin is part of the larger trend seen in other "Rust Belt" states.

The recession has cost Wisconsin 140,000 jobs and one-eighth of its manufacturing workforce, according to the Center on Wisconsin Strategy, a nonprofit group based at the University of Wisconsin at Madison.[281] Wisconsin's unemployment rate rose 4.4 percentage points from the second quarter of 2008 to the same point in 2009.[282]

This fallout from the economic downturn that led to reduced revenues and more demand for state safety-net programs left the state with a $6 billion shortfall in its 2009–2011 budget.[283] The budget would have fallen short even without the national economic crisis, although the recession made the state deficit much larger than expected, said Andrew Reschovsky, professor of public affairs and applied economics at the University of Wisconsin at Madison.[284] Federal stimulus funds of $2.2 billion helped plug some budget shortfalls this year.[285] For the rest, lawmakers raised taxes on the wealthy, hospitals and smokers, and cut spending by $3 billion, mostly by cutting salaries for state employees.[286] Experts predict Wisconsin could face a $2 billion[287] deficit during the next biennium, which starts July 1, 2011, after the federal stimulus runs out.[288]

In Tough Times, Struggling to Deliver on Old Promises

Wisconsin's state government has struggled for years to keep its promises to pay a higher share of school costs while holding property taxes low. Often, lawmakers shifted money around, taking money from the state's transportation fund, for example, to pay for day-to-day operations—and then borrowed to cover the transportation budget.[289] Legislators also failed to put money in reserve before the recession hit. The Pew Center on the States' Government Performance Project noted in 2008 that Wisconsin had a negative

general fund balance for five straight years before the recession even started.[290]

"It's practically a textbook case of how not to engage in fiscal policy and budget making," said Mordecai Lee, a former Democratic state legislator and professor of governmental affairs for the University of Wisconsin at Milwaukee.[291]

> "Structurally, we are around the corner of becoming like California…In the next cycle we will be like California."
>
> —MORDECAI LEE, PROFESSOR OF GOVERNMENTAL AFFAIRS, THE UNIVERSITY OF WISCONSIN AT MILWAUKEE

During better economic times, the state used revenue surpluses to pay for property tax relief and to pump up school aid. The legislature clamped down on fast-rising property taxes in 1993, but that slowed the money going to schools.[292] So four years later, the state agreed to increase its share of education funding from one-third to two-thirds, a $1.2 billion commitment legislators have struggled to sustain.[293] Lawmakers also cut the income tax rate in 1998[294] and added a sales tax rebate in 1999,[295] limiting the state's ability to sock away money in reserve.[296]

"Structurally, we are around the corner of becoming like California," Lee said. "In the next cycle we will be like California."[297]

David Schmiedicke, state budget director for the Wisconsin Department of Administration, praised one specific aspect of the state's budget: The legislature passed the current spending plan on time, before the biennium started, for the first time in 32 years. The legislature also has an unallocated surplus of approximately $270 million[298] in the current budget in case revenues fall short of estimates.[299]

Endnotes

1 According to U.S. Census data released in December 2008, the 10 states had a total population of 106 million, or 35 percent of the U.S. population. *See* "Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico: April 1, 2000 to July 1, 2008 (NST-EST2008-01)," U.S. Census Bureau, accessed Oct. 22, 2009 at http://www.census.gov/popest/states/NST-ann-est.html.

2 According to data from the federal Bureau of Economic Analysis released in June 2009, the 10 states' combined gross domestic product (GDP) was $4.9 trillion, or 35 percent of the U.S. total. *See* "Gross Domestic Product by State," Bureau of Economic Analysis, U.S. Department of Commerce, accessed Oct. 22, 2009 at http://www.bea.gov/regional/gsp/action.cfm.

3 The exceptions are New York (April 1); Texas (Sept. 1); and Alabama and Michigan (Oct. 1). *See* "Budget Processes in the States," National Associations of Budget Officers (NASBO), Summer 2008, accessed Oct. 22, 2009 at http://www.nasbo.org/Publications/PDFs/2008%20Budget%20Processes%20in%20the%20States.pdf.

4 Pamela M. Prah, "States Plug Budget Holes, for Now," *Stateline.org*, Aug. 17, 2009, accessed Sept. 29, 2009 at http://www.stateline.org/live/details/story?contentId=419384.

5 Elizabeth McNichol and Nicholas Johnson, "Recession Continues to Batter State Budgets; State Responses Could Slow Recovery ," Center on Budget and Policy Priorities, updated October 20, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=711.

6 Donald J. Boyd, and Lucy Dadayan, "State Tax Decline in Early 2009 Was the Sharpest on Record," *State Revenue Report*, The Nelson Rockefeller Institute of Government, July 2009, No. 76, accessed Jun. 30, 2009 at http://www.rockinst.org/pdf/government_finance/state_revenue_report/2009-07-17-SRR_76.pdf. Second quarter statistics from the Rockefeller Institute, which came out after the study period, showed an even higher drop.

7 U.S. Bureau of Labor Statistics, Local Unemployment Statistics, accessed Jul. 31, 2009 at http://www.bls.gov/lau/.

8 Jason White, "Six states miss budget deadline," Stateline.org, July 1, 2003, http://www.stateline.org/live/ViewPage.action?siteNodeId=136&languageId=1&contentId=15303.

9 Mortgage Bankers Association, "Delinquencies and Foreclosures Continue to Climb in Latest MBA National Delinquency Survey," May 28, 2009, accessed Sept. 24, 2009 at http://www.mbaa.org/NewsandMedia/PressCenter/69031.htm.

10 Pew Center on the States analysis of Donald J. Boyd, and Lucy Dadayan, "State Tax Decline in Early 2009 Was the Sharpest on Record," *State Revenue Report*, The Nelson Rockefeller Institute of Government, July 2009, No. 76, accessed Jun. 30, 2009 at http://www.rockinst.org/pdf/government_finance/state_revenue_report/2009-07-17-SRR_76.pdf.

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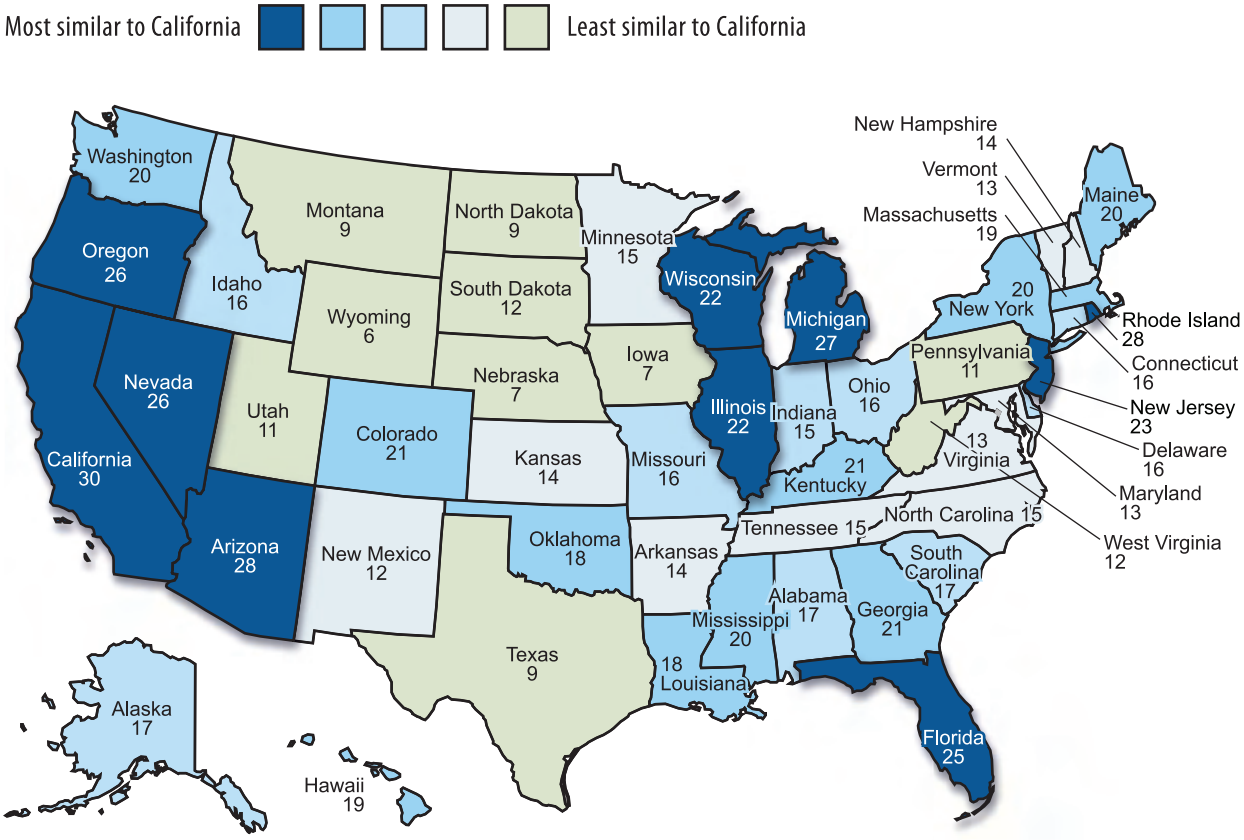
Exhibit A-1. **How does your state compare with California?**

Using indicators chosen to gauge California's fiscal conditions, Pew Center on the States collected data for all 50 states. Pew's researchers then "scored" the states based on the results, with California ranking highest at 30.



NOTE: For components of individual state scores, see Exhibit A-2, p. 65.
SOURCE: Pew Center on the States, based on analysis of data from the Nelson A. Rockefeller Institute of Government, the Center on Budget and Policy Priorities, the U.S. Department of Labor's Bureau of Labor Statistics, the Mortgage Bankers Association, the Public Policy Institute of California and the Pew Center on the States' Government Performance Project; best available data as of July 31, 2009.

Exhibit A-2. **The California Scorecard: States in Fiscal Peril**

	Change in revenue[1]	Size of budget gap[2]	Change in unemployment rate[3]	Foreclosure rate[4]	Needs supermajority?	GPP "Money" grade	Score
United States	-11.7%	17.7%[5]	4.4	1.37%	17 yes, 33 no	B- [5]	17 [5]
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
Alabama	3.0%	16.7%	4.9	.89%	No	C-	17
Alaska	-72.0%	30.0%	1.6	.40%	No	C-	17
Arizona	-16.5%	41.1%	3.0	2.42%	Yes	C+	28
Arkansas	-4.2%	3.2%	2.0	.72%	Yes	B-	14
California	-16.2%	49.3%	4.6	2.02%	Yes	D+	30
Colorado	-10.1%	18.6%	2.8	.86%	Yes	C+	21
Connecticut	-11.4%	23.2%	2.6	.94%	No	B-	16
Delaware	-3.0%	17.6%	3.6	.78%	Yes	A-	16
Florida	-11.5%	22.8%	4.4	2.72%	Yes	B-	25
Georgia	-19.1%	23.8%	3.7	1.34%	No	B+	21
Hawaii	-10.2%	19.1%	3.5	1.04%	No	C+	19
Idaho	-14.2%	16.4%	3.2	1.03%	No	B+	16
Illinois	-10.9%	47.3%	3.5	1.44%	No	C-	22
Indiana	-3.5%	7.5%	5.0	1.28%	No	B+	15
Iowa	3.6%	13.2%	1.7	.69%	No	B+	7
Kansas	-11.1%	22.6%	2.5	.70%	No	B-	14
Kentucky	-3.8%	11.3%	4.3	.91%	Yes	C+	21
Louisiana	-8.8%	21.6%	2.4	.86%	Yes	B	18
Maine	-11.0%	21.4%	3.1	1.04%	No	C	20
Maryland	-1.2%	18.7%	3.0	1.00%	No	B+	13
Massachusetts	-16.8%	17.9%	3.4	.90%	No	C+	19
Michigan	-16.5%	12.0%	6.0	1.47%	Yes	C+	27
Minnesota	-9.7%	21.0%	2.9	1.07%	No	B+	15
Mississippi	-7.6%	9.6%	2.6	1.11%	Yes	C+	20
Missouri	-1.3%	10.3%	3.1	.85%	Yes	B+	16
Montana	3.2%	0.0%	1.9	.50%	No	C+	9
Nebraska	-5.5%	4.3%	1.5	.72%	No	A-	7
Nevada	1.5%	37.8%	5.2	3.12%	Yes	C+	26
New Hampshire	-2.5%	16.2%	2.8	.95%	No	C-	14
New Jersey	-15.8%	29.9%	3.7	1.18%	No	C-	23
New Mexico	-12.8%	6.3%	2.4	.74%	No	B-	12
New York	-17.0%	32.3%	3.0	.76%	No	C+	20
North Carolina	-7.6%	21.9%	5.0	.65%	No	B-	15
North Dakota	-12.1%	0.0%	1.1	.35%	No	B	9
Ohio	-9.0%	12.3%	4.4	1.24%	No	B	16
Oklahoma	-12.6%	13.6%	2.7	.76%	Yes	B-	18
Oregon	-19.0%	14.5%	6.4	.86%	Yes	C+	26
Pennsylvania	-5.5%	18.0%	3.0	.70%	No	B	11
Rhode Island	-12.5%	19.2%	4.5	1.50%	Yes	D+	28
South Carolina	-11.0%	12.5%	5.5	.96%	No	B-	17
South Dakota	-6.2%	2.9%	2.1	.52%	Yes	B+	12
Tennessee	-10.2%	9.7%	4.3	.93%	No	B-	15
Texas	-8.8%	9.5%	2.4	.75%	No	B	9
Utah	-3.4%	19.8%	2.1	1.04%	No	A	11
Vermont	-7.2%	24.8%	2.8	.63%	No	B-	13
Virginia	-19.9%	10.9%	3.2	.83%	No	A-	13
Washington	-9.0%	23.3%	4.0	.71%	Yes	A-	20
West Virginia	-9.4%	4.9%	4.1	.77%	No	B	12
Wisconsin	-11.2%	23.2%	4.4	.96%	No	C+	22
Wyoming	19.7%	1.7%	2.1	.47%	No	B	6

[1]From first quarter 2008 to first quarter 2009
[2]For fiscal year 2010, as of July 2009
[3]From second quarter 2008 to second quarter 2009
[4]New foreclosures in first quarter 2009
[5]Average of all 50 states

NOTE: Based on a highest possible score of 30
SOURCE: Pew Center on the States 2009, reflecting best available and most current data as of July 31, 2009.

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