THE STATE OF THE STATES 2012

FULL REPORT

A Citizen's Guide To the State of The States

www.thestatesproject.org

PRODUCED BY

John F. Kennedy School of Government HARVARD UNIVERSITY INSTITUTE OF POLITICS

AEF AMERICAN EDUCATION FOUNDATION

Fels Institute of Government UNIVERSITY of PENNSYLVANIA

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INSTITUTE OF POLITICS AT HARVARD UNIVERSITY

FELS INSTITUTE OF GOVERNMENT AT UNIVERSITY OF PENNSYLVANIA

AMERICAN EDUCATION FOUNDATION

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Dear Citizens,

We are pleased to present to you The States Project, a joint venture of Harvard University's Institute of Politics at the Kennedy School, the University of Pennsylvania's Fels Institute of Government, and the American Education Foundation.

The States Project was launched to produce clear, reliable, nonpartisan information on states' financial health in a format accessible to citizens. Our goal is to shine a light on the fiscal problems our states face and spark a conversation about the solutions. Based on a familiar "10K" format, our annual reports on the states include traditional financial statements — an income statement and a balance sheet — as well as analyses of trends in state spending, revenue collection, and state debt. The report also surveys measures of demographic change and economic health such as unemployment and poverty rates.

The data in our reports are drawn primarily from the Comprehensive Annual Financial Reports ("CAFRs") produced by the comptroller of each state. We use CAFR data from 2002 to 2011, as well as official state budgets from FY 2012 and FY 2013, the 2010 U.S. Census, and other official data sets and reports that we've found to be reliable sources on state finance.

This year — our pilot year — we've studied four states: Massachusetts, New Jersey, New York, and Pennsylvania. In subsequent years we hope to expand our project to additional states in conjunction with more university partners. We hope that our reports are both informative and useful guides for understanding the many challenges that our states face. To find out more, please contact us through our website: www.thestatesproject.org.

Sincerely,

Meredith Bagby
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Alex Palmer
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{ summary of findings }

OVERVIEW

"The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

By virtue of Article 10 of the U.S. Constitution, American states have the lion's share of our government's domestic duties. Our states and cities — not the federal government — are in charge of educating our children, policing our streets, building our schools, maintaining our roads, regulating our hospitals, locking up our criminals, and carrying for our poor, unemployed, and sick. State and local governments spend $2.5 trillion annually and employ over 19 million workers, or 15% of total national employment.

"State and local governments spend $2.5 trillion annually and employ over 19 million workers, or 15% of total employment nationally."

The Great Recession of 2008 and subsequent years of stagnant economic growth have brought our states to a near critical condition, where the basic services they provide to citizens are threatened. As tax revenue fell, the country saw mass layoffs of state workers, from teachers to police officers to judiciary employees. Nevertheless, the demand for public services continued to increase. A stagnant economy sent more American seeking unemployment and Medicaid. Health care costs swelled and educational resources were stretched to fit shrinking budgets. Infrastructure, including government buildings, schools, roads, and bridges, deteriorated with little funding left for repair. In 2009, the federal government stepped in with much needed stimulus for the states. But those funds have now expired, leaving states with deficits to fill, despite a gradually improving economy.

What may be more concerning, however, are our states' long-term fiscal challenges – all exacerbated by the Great Recession. States are responsible for the pensions and health care of current and retired government workers. For decades, states have underestimated the true cost of these programs. As a result, nearly every state in the nation carries huge unfunded liabilities, estimated at anywhere between $1 trillion and $4 trillion, depending on how those liabilities are measured. These liabilities, coupled with large state debts that have accumulated from years of over borrowing paint a harrowing fiscal picture.

According to what we believe are the most accurate estimates, states owe a total of $4.5 trillion in debt, comprised of $2.9 trillion in unfunded pension fund debt, $627 billion in unfunded health

care benefits,[1] and $1 trillion in state borrowing (including general obligation bonds, special obligation bonds, notes payable, and etc.).[2] If we make similar assumptions for local governments, we come up with a total debt of $2.8 trillion, comprised of $1.6 trillion in local borrowing, $587 billion for unfunded pensions, and roughly $600 billion for unfunded health care benefits. Taken together, states and localities, have an estimated $7.3 trillion in debt, which is just under half of the total national debt, but far less known or talked about. In addition, more than half of this state and local debt is not reported on the financial statements of these entities.

STATE & LOCAL GOVERNMENTS OWE OVER $7 TRILLION IN LIABILITIES

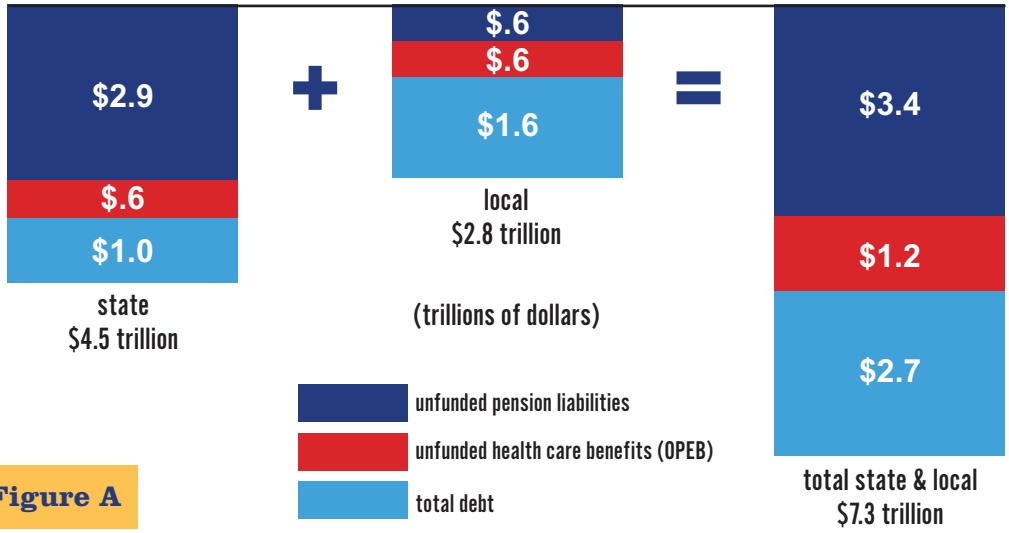

Figure A

The States Project follows four states: Massachusetts, New Jersey, New York, and Pennsylvania. Every state has reacted to these conditions differently, but there are patterns that cross state lines. Five major trends emerged from our analysis that were of particular concern:

1. The recovery from the Great Recession has been longer and slower than any recovery in the postwar period and has exposed structural weaknesses in state economies that need attention now.

2. Medicaid costs have escalated due to increased enrollment and rising heath care costs, threatening to "crowd out" other state priorities like education and infrastructure.

1 Our estimations of unfunded liabilities come from independent economists, who have made modifications to state and local actuarial estimates of liabilities. We believe these independent estimates best reflect the true economic condition of states' unfunded liabilities. State OPEB obligation as calculated by Susan K. Urahn, "The Widening the Gap Update." The Pew Center on the States, published June 20, 2012. [http://www.pewstates.org/uploadedFiles/PCS _ Assets/2012/Pew _ Pensions _ Update.pdf]. Local OPEB obligations extrapolated from 2009 GAO data, and estimated by Paul Volcker and Richard Ravitch: The State Budget Crisis Task Force (footnote #93). [http://www.statebudgetcrisis.org/]. State pension fund liabilities as calculated by Andrew G. Biggs, "The Market Valuation of Public-Sector Pension Deficits." American Enterprise Institute, published April 2010. [http://www.aei.org/article/economics/retirement/ the-market-value-of-public-sector-pension-deficits/]. Local pension fund liabilities calculated by Joshua Rauh and Robert Novy-Marks: The Crisis in Local Government Pensions. [http://www.stanford.edu/~rauh/].

2 We define state borrowing as total debt defined by the U.S. Census Bureau, Government of Finance and Employment, Classification Manual (2006), Chapter 6 and reported in the U.S. Census Bureau's State and Local Finances by Level of Government, estimates for 2010. [http://www.census.gov/govs/estimate/].

3. Pensions and health benefits for government workers are not properly valued or funded, resulting in huge unfunded liabilities for states.

4. Federal grants to states are headed for the chopping block as the federal government deals with its own budget deficits and debt.

5. States do not account to citizens in ways that are transparent, timely or accessible.

Our states' challenges are often made more difficult by the infighting of our political parties, which sometimes obscure underlying truths for political advantage. In order to create solutions rather than distractions, it is up to us to become educated voters who can understand the nuances of these difficult problems and find reasonable solutions. ★

{ structural weaknesses }

The recovery from the Great Recession has been longer and slower than any recovery in the postwar period and has exposed structural weaknesses in state economies that need attention now.

OVERVIEW

The U.S. economy has experienced a slower recovery from the recent economic downturn, which began at the end of 2008, than it has from other recessions in the post war era. Employment has been slower to recover, as have incomes, corporate profits, tax revenue, and overall GDP growth. Reasons cited for our slow recovery include: shaky economies abroad, especially in Europe, America's reduced manufacturing base, an American workforce which has not been educated to compete for high-tech jobs, inflationary worries in BRIC[3] nations, high worldwide commodity prices, and general uncertainty in the market, which hampers investment.

State governments — responsible for administering the bulk of our social safety net programs, such as Medicaid, unemployment insurance, public assistance and nutrition — have been hit particularly hard, as they try to deliver more services to needy citizens with fewer state dollars. In 2012, the state tax base has not recovered to its pre-2008 levels and the federal stimulus to states, which had cushioned the blow of the Great Recession, has ended, leaving states with deficits to shore up.

UNEMPLOYMENT AND UNDEREMPLOYMENT

The unemployment rate rose sharply in 2009, but has not fallen as quickly as in previous recoveries. Unemployment peaked at around 10% in early 2009. Since then, the decline has been slow and uneven. In late 2009, for instance, after months of slow decline, the unemployment rate peaked again at nearly 10%. A similar spike in unemployment occurred in mid-2010. By August 2012, the unemployment rate had declined to 8.3%, still well above the 4% to 5% unemployment rates seen in the mid-2000s.[4]

In addition, underemployment (i.e. when people take part-time work because they cannot find full-time work) is an especially pernicious effect of the recession. According to the Bureau of Labor Statistics, underemployment nationwide is 15% in August 2012. In some states, like California, Nevada, and Rhode Island, underemployment is around 20%.[5]

The troubling trend is that unemployment and underemployment have been more persistent in this recession than in the past. According to a June 2012 report by the Organization for Economic

3 Brazil, Russia, India and China.
4 U.S. Bureau of Labor Statistics. Historical Unemployment Data.
5 U.S. Bureau of Labor Statistics. Underemployment measured as total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers. [http://data.bls.gov/cgi-bin/print.pl/lau/stalt.htm].

Co-operation and Development (OECD), the economic recovery was initially on par with recent recoveries in the early 1990s and early 2000s. However, in the wake of a slowdown in the second half of 2011, the report says the U.S. has now experienced the slowest recovery in the postwar period.[6]

In particular, there is a growing risk that a rising share of the unemployed will become disconnected from the labor market and find it more difficult to reintegrate into the workforce once the market recovers. This disengagement occurs because people lose skills, as well as resolve, the longer they are out of work. Long-term unemployment (i.e. of more than one year) has increased as a share of total unemployment over the last three years. Those at high risk of marginalization include the young, low-skilled workers, and certain minorities. The long-term concern is that what has been cyclical unemployment could become structural.[7]

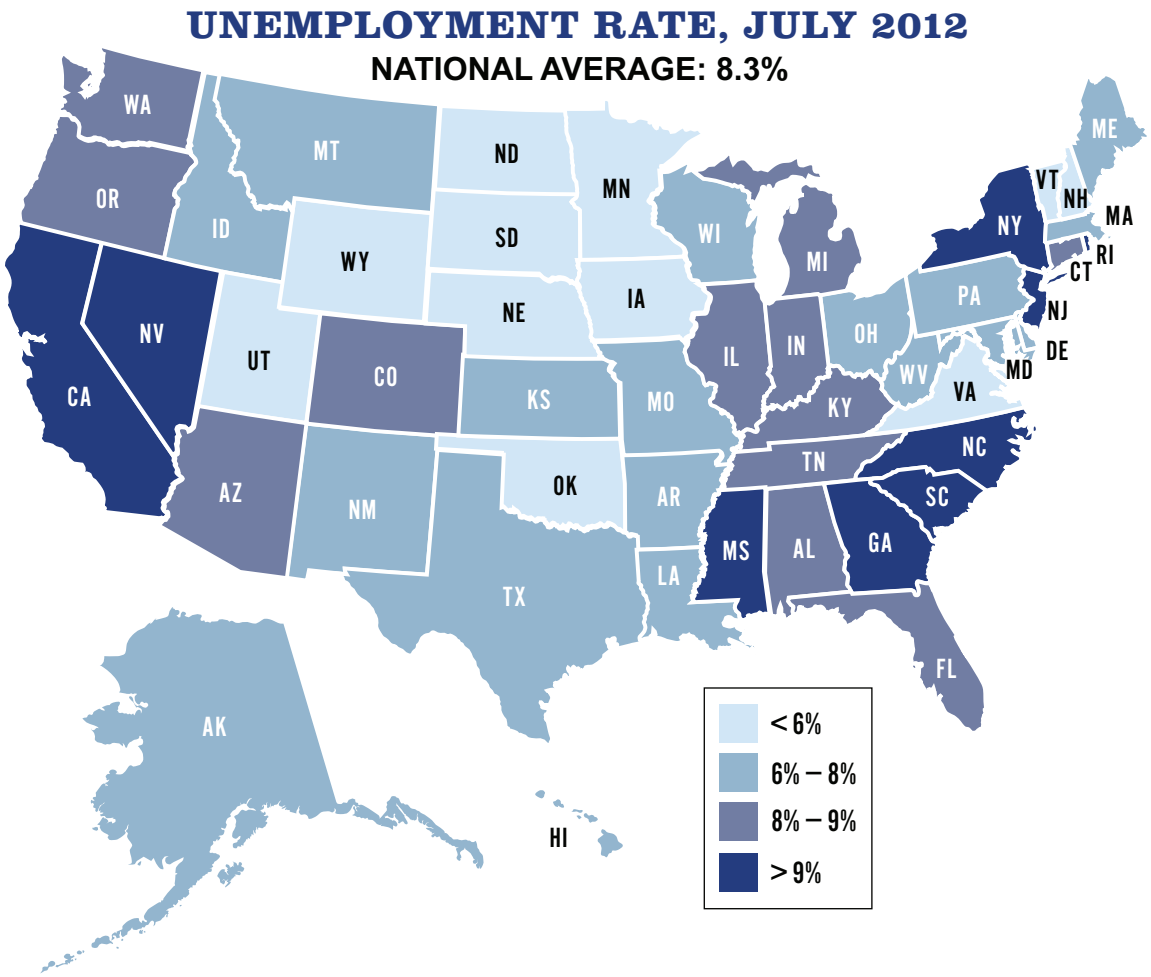

Figure 1 SOURCE: BUREAU OF LABOR STATISTICS, RATES FOR JULY 2012. RATES SHOWN ARE A PERCENTAGE OF THE LABOR FORCE. DATA REFER TO PLACE OF RESIDENCE.

6 OECD Publishing. "Waiting for the Recovery: OECD Labour Markets in the Wake of the Crisis."
7 Ibid.

FALLING TAX REVENUE

As the recession hit, state receipts fell across all major revenue streams — personal income tax, corporate income tax, sales tax, and user fees. The decline in tax revenue is tied closely to high unemployment, as struggling individuals and businesses pay less in taxes and are less likely to buy goods and services. From the boon of the economy in 2008 until the trough of the recession in 2010, state income tax, corporate tax and sales taxes fell by 16%, 22%, and 7% respectively.[8] While tax revenues have begun to recover, inflows are still well below their 2008 peak. These trends held true in all of our study states — Massachusetts, New Jersey, New York, and Pennsylvania.

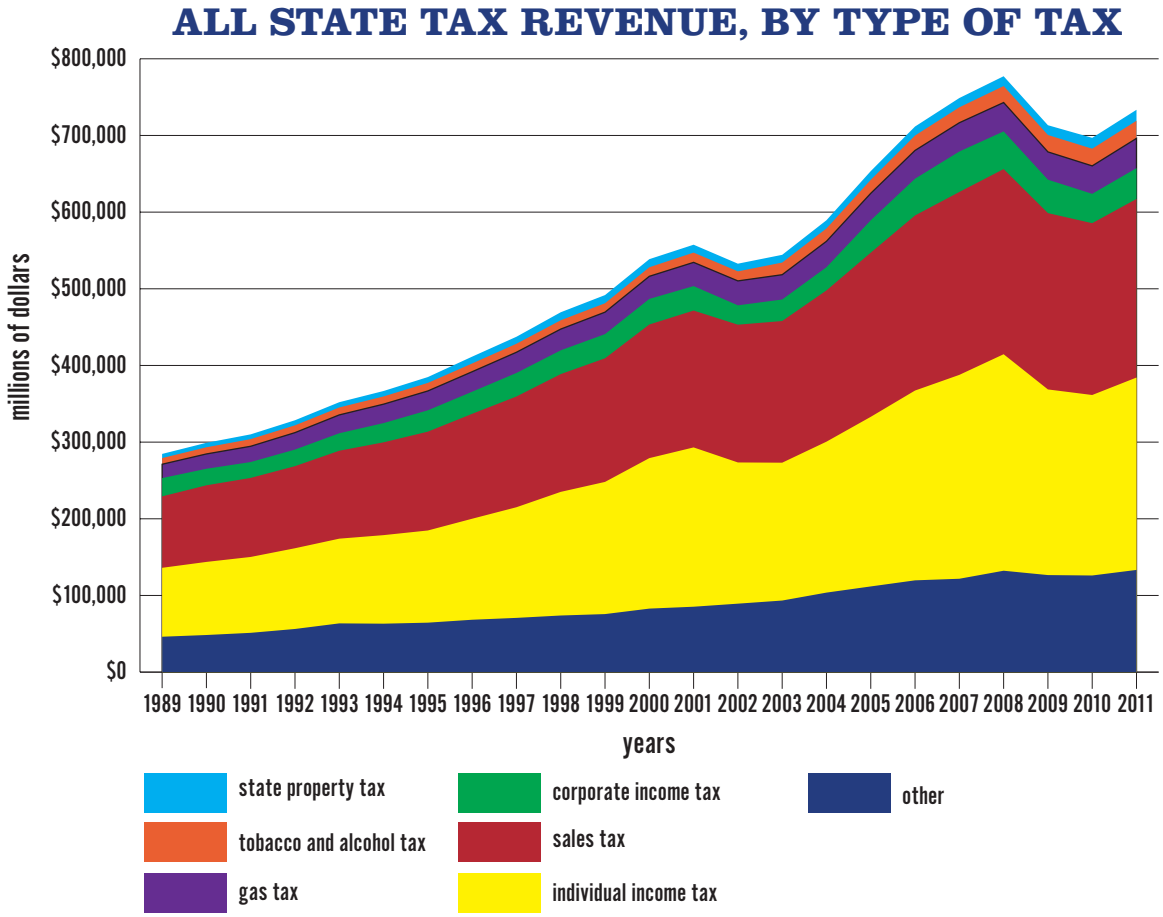

Figure 2 SOURCE: U.S. CENSUS BUREAU. QUARTERLY SUMMARY OF STATE & LOCAL TAXES

State tax revenues were hit much harder than the overall economy. Gross Domestic Product (GDP) declined by just 5.1% during the recession, compared to much larger drops in taxable personal income and consumption. Further, the recovery in state revenues has been slower than in previous recessions. Revenues from income tax, corporate tax and sales tax are still lower in FY 2012 by 11%, 18%, and 4%, respectively than in FY 2008. According to a 2012 report on state finance conducted

8 Calculated from data provided by the U.S. Census Bureau, Quarterly Summary of State & Local Taxes.

by former Federal Reserve Chairman Paul Volcker and former Lieutenant Governor of New York Richard Ravitch, "Many economists believe that the economy will grow sluggishly for years as it works off the excesses of the credit and real estate bubbles and endures slow employment growth."[9]

There is also evidence that state tax revenue may be more volatile than in previous economic downturns. The sales tax base — the value of all taxed goods and services — declined from just over half of personal income in 1970 to one-third of personal income today. This is not only because Americans are spending less on consumables in recent years, but also because consumers are shifting towards more lightly taxed items and services. In addition, the states have had difficulty collecting tax on Internet purchases.[10]

Corporate income taxes have also been more volatile in recent years, but not just due to the economic downturn. In an effort to create conditions to attract corporations, many states have lowered corporate taxes or awarded tax breaks. As a result, corporate taxes have eroded as a percentage of the overall tax base. In FY 1989, corporate tax made up 8.4% of overall state revenue. By FY 2011, that rate had fallen to 5.4%.[11]

THE PUBLIC SAFETY NET

Expenditures on the "Social Safety Net" exploded during the Great Recession. As the economy faltered and more citizens fell into lower income brackets, the number of citizens who qualified for unemployment insurance, public assistance, and Medicaid increased substantially.

Unemployment compensation saw the greatest increases across states, as more citizens fell into the ranks of the unemployed. Two hundred percent increases in unemployment compensation spending from just five years ago were common across states. Our study states were no exception. Now, as the economy slowly recovers in FY 2012, that spending is decreasing; however it is far from falling to pre-recession levels.

Increase in Unemployment Insurance (2007 to 2011)

	($ billions)	(% increase)
Massachusetts	$3.0	206.9%
New Jersey	$5.3	272.0%
New York	$7.1	301.6%
Pennsylvania	$5.4	259.7%

SOURCE: STATE CAFRS 2007 - 2011.

9 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
10 Ibid.
11 Calculated from data provided by the U.S. Census Bureau, Quarterly Summary of State & Local Taxes.

Medicaid, the health insurance program for low-income Americans, also saw increases in enrollment. According to the National Association of State Budget Officers (NASBO), Medicaid enrollment rose by 8.1% in FY 2010, 5.4% in FY 2011, and 3.8% in FY 2012.[12] The biggest driver in Medicaid costs (even more so than rising health care costs) is this rise in enrollment. Medicaid's caseload spiked in the last two recessions and has been persistent, a reflection of the increase in long-term unemployment. In FY 2011, Medicaid accounted for 24% of all state expenditures, up from 22% in FY 2019.[13]

Each of our study states saw increases in Medicaid enrollment and costs. However, because of the relatively generous Medicaid requirements in our study states, which were already in place before the recession, Medicaid grew at a slower pace in our study states than it did in the rest of the country.

In FY 2012, states were forced to dramatically increase Medicaid spending by an average of 28.7%, largely to replace temporary federal stimulus funds that expired in June 2011.[14] According to the Congressional Budget Office, total Medicaid costs are estimated to more than double from by FY 2022, with the implementation of the new national health care law, the Affordable Care Act, driving costs.

THE END OF FEDERAL STIMULUS

In the wake of the Great Recession, the federal government stepped in with the federal stimulus package of 2009, which gave billions in federal grants to states. This fiscal influx helped forestall cuts to Medicaid and education and bolster unemployment insurance across the country. In sum, states received more than $150 billion of nonrecurring budgetary relief from the federal stimulus package, primarily through higher Medicaid reimbursement rates and the creation of a "State Fiscal Stabilization Fund" that provided funding for K-12 and post-secondary education.[15] The stimulus package also included substantial aid for infrastructure.

"This fiscal influx helped forestall cuts to Medicaid and education and bolster unemployment insurance across the country."

In all four of our study states, federal stimulus funds helped fill in gaps in state revenues. After the Great Recession, for instance, New York's tax revenues fell by $7 billion in a single year. The federal government stepped in, increasing federal grants to the state by nearly $10 billion from FY 2009 to FY 2010. Similarly, Pennsylvania saw a 21% increase (or nearly $4 billion) in federal grants from

12 National Governors Association and National Association of State Budget Officers. "The Fiscal Survey of States, Fall 2011." November 2011.
13 "Medicaid Cost Containment: Recent Proposals and Trends." The National Association of State Budget Officers. [http://www.nasbo.org/publications-data/issue-briefs/medicaid-cost-containment-recent-proposals-and-trends-0].
14 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
15 Recovery.gov. "Tracking the Money."

FY 2008 to FY 2009 and a 38% increase in FY 2010. Massachusetts received $8 billion in grants, which the state largely dedicated to research and development, education and transportation. New Jersey received $5.5 billion, which went primarily to education, transportation, and infrastructure.[16]

"States have attempted to balance their budgets by reducing spending, cutting government workers, raising debt to cover budget shortfalls, pushing off certain expenditures into future years, and sometimes by manipulating accounting procedures."

Unfortunately for states, federal stimulus funds largely ended in 2012, before state tax revenue had recovered. As a result, forty-two states faced budget deficits in FY 2012 and thirty-one states have projected (and in most cases now have closed) budget gaps totaling $55 billion for FY 2013.[17] States have attempted to balance their budgets in a variety of ways — by reducing spending, cutting government workers, raising debt to cover budget shortfalls, pushing off certain expenditures into future years, and sometimes by manipulating accounting procedures. Very few states, however, have sought to increase revenues though increasing taxes.

LOOKING FORWARD

The Great Recession and its subsequent slow recovery have left states suffering still. Unemployment and underemployment has dampened state tax revenue, while increasing enrollment and expenses for social safety net programs such as unemployment compensation and Medicaid. What may be most concerning is that current unemployment and underemployment appears to be more persistent than in previous recessions with the long-term unemployed increasingly marginalized from the workforce. Meanwhile, as federal stimulus ends, states have to shore up budget gaps, while trying not to perversely affect the nation's recovery.[18] ★

16 Recovery.gov. "Tracking the Money."
17 Oliff, Phil, Chris Mai and Vincent Palacios. "States Continue to Feel Recession's Impact." Center on Budget and Policy Priorities. [http://www.cbpp.org/cms/index.cfm?fa=view&id=711].
18 Ibid.

{ medicaid costs }

Medicaid costs have escalated due to increased enrollment and rising health care costs, threatening to "crowd out" other state priorities like education and infrastructure.

RISING HEALTH CARE COSTS AND EXPANSION OF MEDICAID

Nearly one out of every five dollars spent in the U.S. goes towards health care. For more than a decade health care spending has risen faster than any other sector of the economy.[19] According to the RAND Corporation, between 1999 and 2009, total health care spending in the United States nearly doubled. Today, Americans spend almost $2.7 trillion on health care. Our federal, state and local government spend over 40% of that total.[20]

The Great Recession has made the skyrocketing cost of medical care particularly onerous on our state governments, which run Medicaid, providing insurance for low income families, children, and the disabled. As more Americans dropped below the poverty line, states saw huge increases in Medicaid enrollment.[21] Since June 2007, an additional 10 million people have enrolled in Medicaid programs across the country, over half of whom were children.[22] In 2012, 20% of Americans use Medicaid.

Higher enrollment translates into higher costs. According to NASBO, Medicaid accounted for 22% of all state expenditures in FY 2009, but is estimated to account for 24% in FY 2011.[23] The Medicaid program is only expected to grow into the future. According to the Office of the Actuary of the Centers for Medicare and Medicaid Services (CMS), total spending for Medicaid in this decade (2011-2020) will increase by an average of 8.1% per year assuming full implementation of the Affordable Care Act as it is now, or 6.6% excluding the effects of the ACA.[24]

Under the American Recovery and Reinvestment Act (ARRA), federal funding allowed states to reduce their state budget support for Medicaid when caseloads and resulting costs were growing at an increased rate. This aid kept states from having to raise taxes or cut spending in the short term. However, the expiration of ARRA funding in FY 2011 has now forced states to absorb three years of high growth in the program.[25]

19 "Accelerating Health Care Costs Wiping Out Much of Americans' Income Gains." RAND Corporation. [http://www.rand.org/news/press/2011/09/08.html].
20 Ibid.
21 "Resources Examine Recession-Driven Record Medicaid Enrollment and Assess Medicaid Spending Growth." The Kaiser Family Foundation. [http://www.kff.org/medicaid/Resources-Examine-Recession-Driven-Record-Medicaid-Enrollment-Assess-Medicaid-Spending-Growth.cfm].
22 "Medicaid Enrollment: June 2011 Data Snapshot." Kaiser Commission on Medicaid Facts. June 2012.
23 "Medicaid Cost Containment: Recent Proposals and Trends." The National Association of State Budget Officers. [http://www.nasbo.org/publications-data/issue-briefs/medicaid-cost-containment-recent-proposals-and-trends-0].
24 Office of the Actuary, Centers for Medicare and Medicaid Services. 2011 Actuarial Report on the Financial Outlook for Medicaid. March 16, 2012.
25 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].

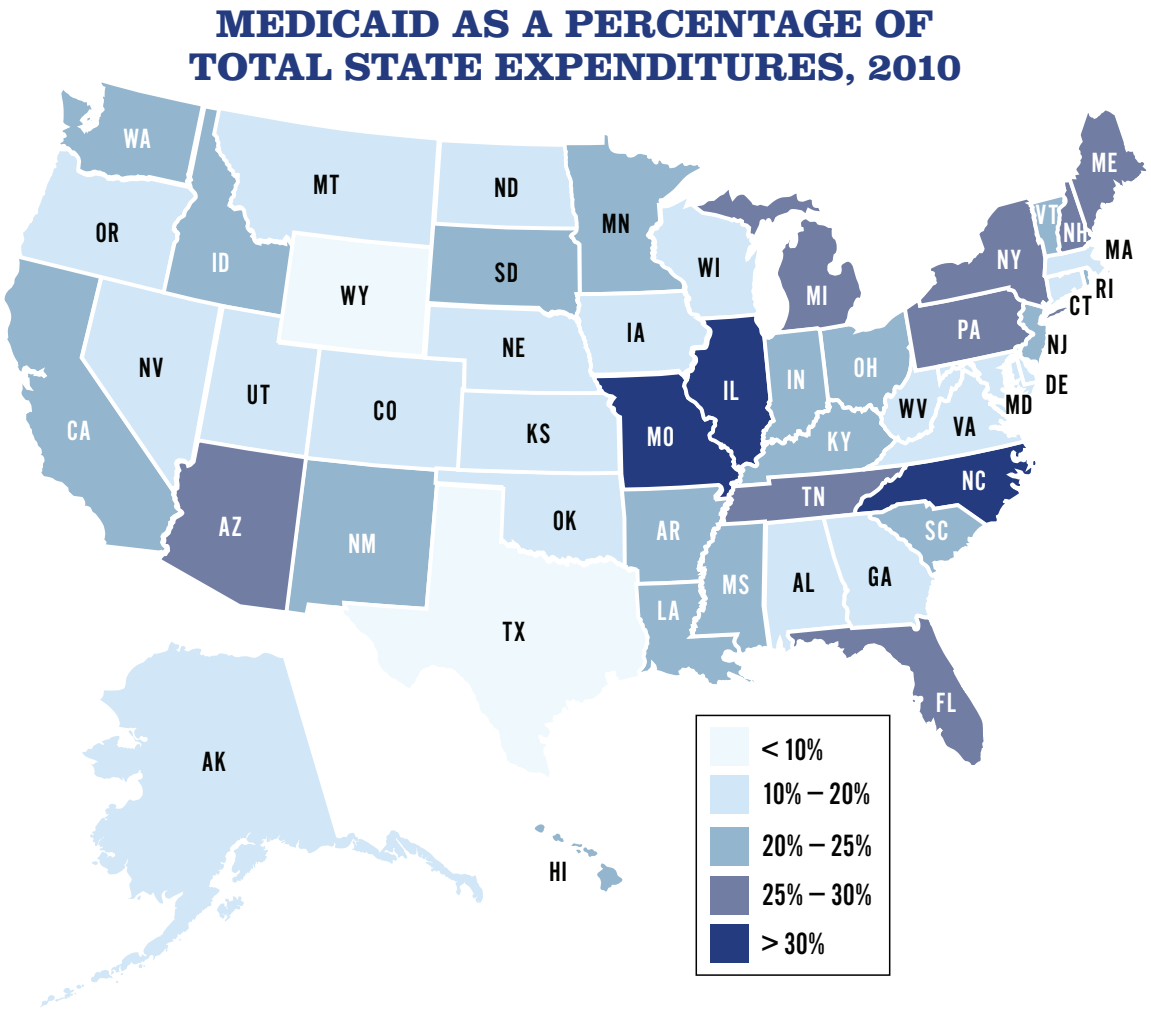

Figure 3 SOURCE: THE KAISER FAMILY FOUNDATION. WWW.STATEHEALTHFACTS.ORG.

A similar spending trend was seen in our study states. Health care (the largest component of which is Medicaid) is the largest single expense in the budget of each of our study states, except New Jersey where education is the largest expense. [26] As of FY 2011, New York's Medicaid payments per beneficiary were $9,057, the highest in the country. Pennsylvania and Massachusetts spend more than 40% of their budgets on health care, of which the largest expense is Medicaid.

Overall, the states we studied have more Medicaid enrollees and Medicaid per-capita spending than the national average. Our study states have generous Medicaid programs, which allow for greater enrollment, higher costs of living, and greater availability of more specialized and expensive care. In addition, our study states have older populations than the nation as a whole. In many ways our states are more predictive of where health care and Medicaid are headed. In other words,

26 "The Book of the States 2012: Facts and Figures." [http://knowledgecenter.csg.org/drupal/system/files/east _ medicaidspending _ 0.pdf]. Council of State Governments. January 2012.

demographically and policy-wise, America is becoming more like the Northeast, and health care expenditures are expected to follow suit.

MEDICAID CROWDS OUT OTHER SPENDING

Policy makers and economists have recently called attention to the "crowding out" effect of health care spending. This means that if our government spends more money on health care, we have less to spend on other important priorities — like education, infrastructure, environmental protection, or defense. This trend is true of our national budget, as more funds must be spent on the Medicare program as our population ages. It is also true of our state governments, struggling to keep pace with high Medicaid costs, as well as health care costs for public workers.

"Medicaid recently surpassed K-12 education as the largest area of state spending when all funds, including federal funds, are considered; and Medicaid appears likely to continue to claim a growing share of state resources."

K-12 Education

Medicaid recently surpassed K-12 education as the largest area of state spending when all funds, including federal funds, are considered; and Medicaid appears likely to continue to claim a growing share of state resources. During the worst part of the recession, states cut funds for education, adjusted for inflation.[27] The Volcker-Ravitch report explains: "Since K-12 education is the largest program funded by state taxes, a relatively small percentage cut in spending for this purpose can provide enough funds to support large growth in Medicaid. In contrast, cuts in all other state programs would have to be very large to provide the same budgetary resources."[28]

As NASBO warns, "Medicaid has steadily eaten up a growing share of state budgets over the past three years, while education has been getting a smaller slice of the pie."[29] Education used to make up a bigger share of state spending. In the 1980s, K-12 education made up the largest share of state spending, followed by higher education. Medicaid surpassed higher education as the second-biggest state program in 1990, and in 2003 it became largest state program for the first time. In each of the last three fiscal years, Medicaid has taken the largest share of state spending.

A reduction in education spending at the state level means that cities and localities must chip in more of the pie to cover costs through property taxes. A reliance on local funding, however, comes with its share of problems. First, school funding based on local tax revenue may disadvantage low-

27 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
28 Ibid.
29 Cooper, Michael. "Bigger Share of State Cash for Medicaid." The New York Times. [http://www.nytimes.com/2011/12/14/us/in-downturn-medicaid-takesup-more-of-state-budgets-analysis-finds.html].

income communities. The same tax rate in a low-income community will raise fewer funds than in a high-income community. There is a worry that funding will be unequal across counties. This was particularly true in two of our study states — New Jersey and Pennsylvania — both of which disproportionately rely on local property taxes to fund education. In addition, all of our states reported inequality of performance and funding across counties. In New Jersey there have been successful legal challenges to the way the state government funds education, with critics saying that the high spending skewed towards wealthier communities and was fundamentally unfair.

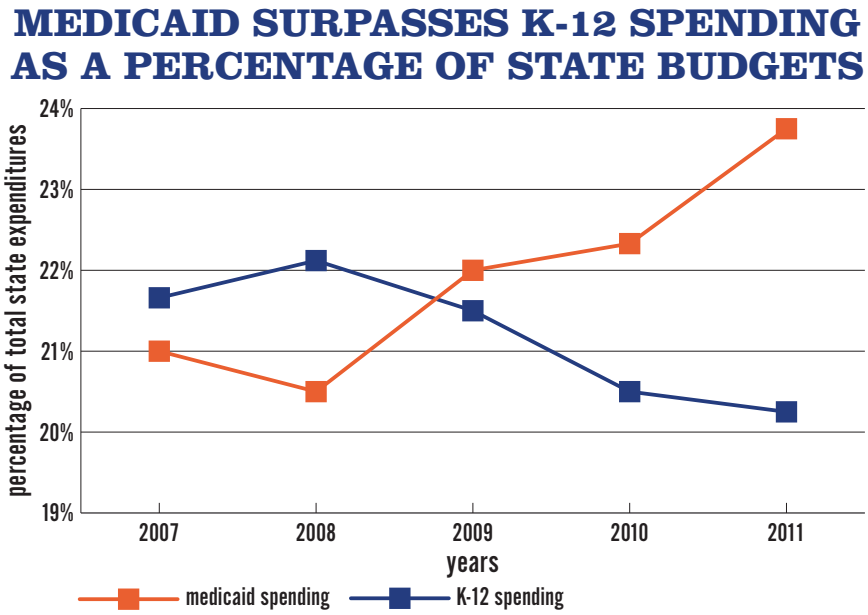

Figure 4 SOURCE: NATIONAL ASSOCIATION OF STATE BUDGET OFFICERS (NASBO), STATE EXPENDITURE REPORT, 2010.

Higher Education

When the Great Recession hit, states also began to make large cuts to their public universities and colleges, assuming that universities could cover costs by increasing tuition and attracting private investment. As a result, tuition costs are up nationwide, as is the percentage of students graduating with debt. States have cut their support for higher education despite rising college enrollment and a widely-accepted understanding that higher education plays an important role in national competitiveness, reducing the unemployment rate, and creating personal wealth. The unemployment rate for those who have a bachelor's degree or higher — at just 4% — is half the national average and one-third of the unemployment rate for those who never graduated from high school.[30]

Infrastructure

Lastly, infrastructure has also been a target in budget reduction efforts, despite the urgent need to restore America's deteriorating roads, buildings, and bridges. "The nation's infrastructure presents

30 Unemployment rates from the Bureau of Labor Statistics for August 2012.

a picture of failing report cards, visibly aged facilities, deferred maintenance, and mounting backlogs," said the Volcker-Ravitch report.[31] Despite the federal stimulus, public construction spending, including state, federal, and local projects, is down 20% from FY 2009 to FY 2011.[32]

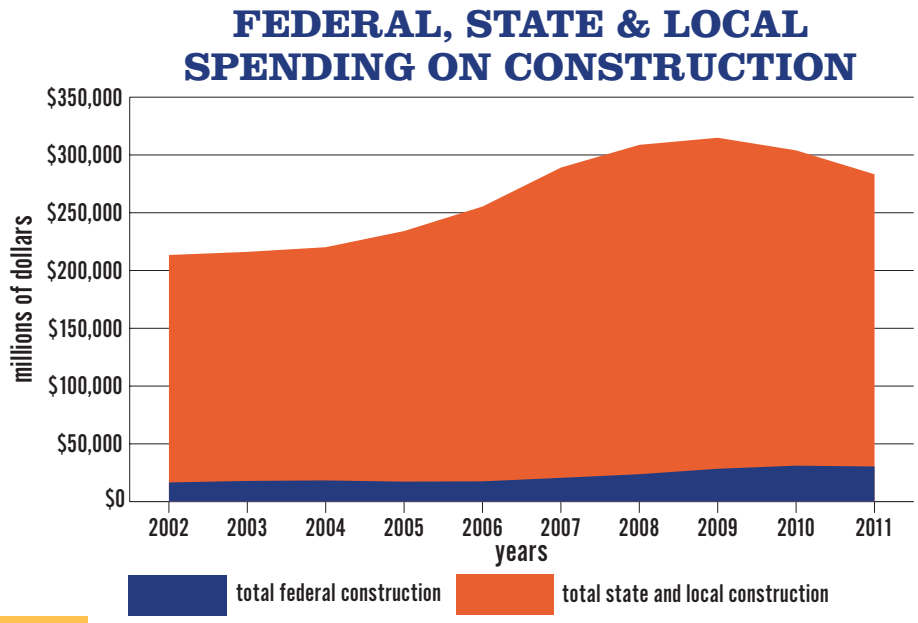

Figure 5 SOURCE: U.S. DEPARTMENT OF COMMERCE. U.S. CENSUS BUREAU.

Study States

In three of our study states, health care and Medicaid costs outpaced other priorities of the state budget:

- In FY 2011, Pennsylvania spent over $30 billion on health care, up 14% from FY 2009. By contrast, spending on public education, the second biggest budget item, grew only 6.4% during the same period.[33]
- In New Jersey, health care spending rose 18% from FY 2007 to FY 2011, however K-12 spending fell by 5.9% and transportation fell by 33.8%. New Jersey ranks 47th nationally in support for higher education and 47th in enrollment capacity.[34]
- In New York, health care spending increased 17% from FY 2007 to FY 2011, while K-12 education increased by 15%. From FY 2010 to FY 2011, transportation and higher education saw decreases of 4% and 3%, respectively, while health care increased by 2%.[35]

31 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
32 U.S. Department of Commerce; U.S. Census Bureau.
33 Pennsylvania CAFR 2009, page 40; PA CAFR 2011, page 48.
34 "Elevating Higher Education To A New Level of Excellence." NJ Fifth Legislative District. [http://www.njleg5.com/content/elevating-higher-education-new-level-excellence].
35 New York CAFR 2007-2011, Statement of Activities.

- The notable exception is Massachusetts where K-12 education spending, higher education spending, and transportation spending increased by 95.5%, 28.2%, and 79.6%, respectively, from FY 2007 to FY 2011. Health care spending increased by 24.1%. Health care in Massachusetts grew more slowly than the nation as a whole, in part due to the high levels of coverage already offered to its citizens through the Massachusetts Health Care Reform Act of 2006.

THE EXPANSION OF MEDICAID AND THE AFFORDABLE CARE ACT

With the expansion of Medicaid, under President Obama's health care bill, the "Affordable Care Act" (ACA), the numbers of Medicaid enrollees are expected to increase 27% by 2019, with total cost increasing 13%.[36] Under ACA, Medicaid will be expanded to all Americans with annual incomes up to 133% of federal poverty guidelines effective in 2014; in 2010, this figure was $29,327 a year for a family of four.[37] The federal government will pick up 100% of the cost of covering people made newly eligible for Medicaid for the first three years (2014-2016) and no less than 90% on a permanent basis.

Under the Supreme Court's understanding of the ACA, the decision to take those federal dollars is discretionary.[38] For our study states, which already run generous Medicaid programs funded by the state government, the ACA translates into new federal dollars and increased insurance coverage, with very little cost to our states. Meanwhile, states with currently low eligibility levels and high-uninsured populations, like Texas, Virginia, and Illinois could have a substantial increase in their Medicaid caseloads if they participate. With the notable exception of Pennsylvania, which has yet to decide to accept federal funds, our study states will accept these new federal dollars, as will the majority of American states.

The Congressional Budget Office (CBO) indicates that the overall costs to states will be relatively small, compared to the level of services they can now provide with the new federal dollars. The new federal dollars could provide health care coverage to 17 million citizens. The CBO reported that the federal government will bear 93% of the costs of the Medicaid expansion over its first nine years (2014-2022). The additional cost to the states represents a 2.8% increase in what they would have spent on Medicaid from 2014 to 2022 in the absence of health reform.[39]

However, critics argue that a 2.8% increase in spending is not insubstantial, especially given how strapped our state budgets are. Others worry that the federal government, while generous in the early years of the program, might have to cut funding in subsequent years to meet its own budget obligations. That could leave states holding the bag with a greater number of Medicaid recipients and less federal funding to cover costs.

36 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
37 Henderson, Ashley; Robinson, Wilma and Finegold, Kenneth. "The Affordable Cart Act and Latinos." U.S. Department of Health and Human Services. [http://aspe.hhs.gov/health/reports/2012/ACA&Latinos/rb.shtml] and "Medicaid and CHIP Eligibility Table by State." National Conference of State Legislatures. [http://www.ncsl.org/issues-research/health/medicaid-eligibility-table-by-state-state-activit.aspx].
38 Twedt, Steve. Pittsburgh's Post Gazette. "States must decide whether to expand Medicaid programs." July 1, 2012.
39 The Congressional Budget Office: Medicaid and CHIP. [http://www.cbo.gov/topics/health-care/medicaid-and-chip].

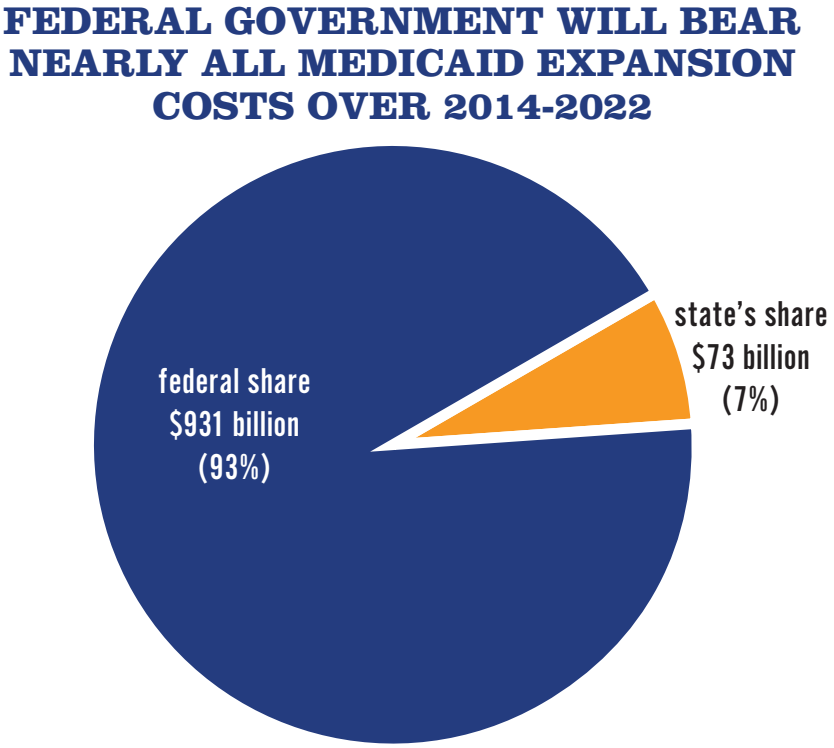

Figure 6 SOURCE: CENTER ON BUDGET AND POLICY PRIORITIES: ANALYSIS OF THE CONGRESSIONAL BUDGET OFFICE, MARCH 2012 BASELINE

PROSPECTS FOR REFORM

Since the loss of federal stimulus funds, states have tried to contain the growth of Medicaid spending. In our study states, reform took similar paths as efforts in other states, including transferring more services to the private sector, containing enrollment, moving patients from fee-for-service to managed care delivery systems, and eliminating fraud.

Massachusetts

In 2011, Governor Deval Patrick proposed a landmark bill to reform the way health care is paid for in the state and strengthen regulations of rate increases by providers. The legislation would facilitate a shift away from a "fee-for-service" model, where providers submit reimbursement requests to insurers for individual procedures, and toward global payments, in which providers are reimbursed for the overall cost of a particular patient or episode of treatment. Global payments give providers incentives to carefully choose the treatments that are the most effective and least costly.[40]

New Jersey

In response to the looming budget deficit, Governor Christie proposed cuts to the state's Medicaid program in 2012, including a reduction in eligibility for Medicaid. The transition to a reduced

40 Christine Eibner, Peter S. Hussey, M. Susan Ridgely, Elizabeth A. McGlynn. "Controlling Health Care Spending in Massachusetts: A Policy Brief." [http://www.rand.org/pubs/research _ briefs/RB9464-1.html]. RAND Corporation. 2009.

beneficiary pool has already begun, owing in large part to decreased enrollment as the economy has recovered.[41] Another cost containment strategy involves fundamental changes in the system. Since 1995, New Jersey has been moving recipients from the traditional "fee-for-service" model, where health care providers are paid directly for the services they perform, to a "managed care" model, in which health care providers are paid a certain fee to cover all specified medical expenses for a recipient.[42]

New York

In January 2011, Governor Cuomo issued an executive order creating the Medicaid Redesign Team tasked with reforming the state's huge Medicaid program.[43] The Team recommended introducing a cap on state Medicaid spending of $15.1 billion, or more than a quarter of the state's total health care expenditure as of 2011. The report included 78 additional proposals for reform and restructuring including: reforming the Medicaid payment and program structure; implementing a 2% across-the-board Medicaid rate reduction; reforming medical malpractice insurance; and expanding the use of care management so that Medicaid enrollees will have more direct access to a health care professional for routine issues rather than relying on expensive visits to specialists and hospitals.

According to its own estimate, the MRT saved the state Medicaid program $2.3 billion in FY 2012. Additionally, the initiatives helped New York spend $14 million less than projected in the Medicaid Global Spending Cap.[44] Governor Andrew Cuomo has made the job of controlling Medicaid spending a major priority in his budget for FY 2012 and FY 2013. Despite the usual problems in securing quick federal approval for its proposed cost control efforts, the state reports that it has achieved savings target of $973 million for FY 2012 and is working to achieve its target of $1.1 billion for FY 2013.

Pennsylvania

To contain costs, Governor Tom Corbett reduced the Medicaid enrollment numbers by 150,000 people in the second half of 2011. According to Pennsylvania's Department of Public Welfare, these cuts removed the deceased, those who had moved out of state, and ineligible recipients from the enrollment database. However the governor's office could provide no breakdown of those affected.

"Advocacy groups, clients, and representatives for caseworkers paint a different picture. Pressure to quickly review a backlog of files and close cases overwhelmed the system as reams of paperwork were lost and computer programs automatically ended benefits when patients' responses had not

41 New Jersey Department of Human Services. "NJ Medicaid & Managed Care." The Official Web Site for The State of New Jersey. State of New Jersey. Web. 09 Mar. 2012. [http://www.state.nj.us/humanservices/dmahs/info/resources/care/].

42 New Jersey Department of Human Services. "Medicaid Managed Care Enrollment Initiative." The Official Web Site for The State of New Jersey. State of New Jersey. Web. 09 Mar. 2012. [http://www.state.nj.us/humanservices/dmahs/home/carve.html].

43 "Governor Cuomo Issues Executive Order Creating Medicaid Redesign Team." Office of the Governor of New York. [http://www.governor.ny.gov/press/01052011medicaid].

44 The Council on State Governments. Knowledge Center. [http://knowledgecenter.csg.org/kc/content/new-york-medicaid-redesign-team-saves-state-23-billion].

been entered by preset deadlines," reported *The Philadelphia Inquirer*.[45] Because of complaints, the federal agency that monitors Medicaid has launched an investigation as to whether benefits were wrongly terminated.[46] In the meantime, Governor Corbett hasn't said yet whether he will accept new federal dollars from the ACA. The governor was one of 25 other governors in challenging the President's Patient Protection and Affordable Care Act (ACA) in the U.S. Supreme Court.[47]

"All states have been limited by the need to obtain federal approval for virtually any change they want to make that would reduce costs significantly."

THE FUTURE OF MEDICAID

While the aggressiveness and inventiveness of reform has varied from state to state, all states have been limited by the need to obtain federal approval for any change that would reduce costs significantly.[48] As a result, governors are petitioning the federal government for more flexibility in implementing Medicaid in their states. In addition, Medicaid reform is often blocked by entrenched provider groups, who resist reductions in provider rates and changes in delivery systems — even using litigation to prevent or delay reform. States must find ways to circumvent these obstacles and find ways to cap costs, otherwise Medicaid will take up increasingly larger shares of state budgets, crowding out other important state responsibilities like K-12 education, higher education, and infrastructure. ★

45 Sapatkin, Don. "Pa.'s Drop in Medicaid Rolls Stirs Controversy." [http://articles.philly.com/2011-12-15/news/30520624 _ 1 _ advocacy-groups-welfare-office-caseworkers]. December 15, 2011.
46 The Philadelphia Inquirer. July 12, 2012. "U.S. Agency asks about the sharp drop in Pa's Medicaid rolls. [http://articles.philly.com/2012-07-12/news/32633443 _ 1 _ medicaid-rolls-eligibility-dpw].
47 Twedt, Steve. Pittsburgh's Post Gazette. "States must decide whether to expand Medicaid programs." July 1, 2012.
48 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].

{ unfunded liabilities }

Pensions and health benefits for government workers are not properly valued or funded, resulting in huge unfunded liabilities for states.

$4 TRILLION IN LIABILITIES

As part of their compensation, state workers, ranging from clerks to police officers, receive pensions from the state. State pension systems have come under fire in recent years, as the Great Recession drove down the funds' investment returns and revealed that state pension systems were poorly funded. These funds hold huge future liabilities, threatening both the long-term viability of the pension system and the states responsible for paying out benefits.

"According to current assumptions used by pension actuaries to value liabilities, state pensions are underfunded by over $1 trillion...under a more market-based approach, total unfunded pension liabilities are closer to $3 trillion.

According to current assumptions used by pension actuaries to value liabilities, state pensions are underfunded by over $1 trillion. However, many economists believe that the true value of these liabilities is much more. Using a discount rate in line with private sector estimates for investment returns leads to much higher liability estimates. Under this more market-based approach, total unfunded pension liabilities are closer to $3 trillion.[49]

A less well-understood problem it that of underfunded health care benefits. Most state and local governments have promised substantial retirement health care benefits to their workforces, also referred to as other post-employment benefits (OPEB). These liabilities have barely any funding, and are often underreported or not reported at all by the states responsible for them. According to actuaries, the total state liability for these health care benefits is $600 billion. If local governments (which have many more employees than do states) are included, the number is closer to $1 trillion.

To address these huge shortfalls, states will need to increase the retirement age for public workers, decrease cost of living adjustments (COLAs), increase the amount government workers pay into the system, and increase the amount that states pay into these systems from their general tax revenue. Public employee unions are highly resistant to such changes and have launched legal challenges in many states to block reform.

49 Rauh, Joshua. "Pensions in Peril." Kellogg Insight. [http://insight.kellogg.northwestern.edu/index.php/kellogg/article/pensions _ in _ peril].

THE PENSION SYSTEM

Across states, there is a great diversity of pension systems and funding levels. States vary in the number of public pension systems they have, how employees can qualify, and how funds are managed. For instance, New York has three separate public employee pension systems, for teachers, police officers, and firefighters and general public employees. The State Comptroller oversees the funds. In New Jersey, the state manages all state and local pension obligations, rather than just state funds. The two New Jersey funds are overseen by the State Department of the Treasury. Massachusetts has just one statewide fund for public employees managed by the Massachusetts State Board of Retirement. Finally, Pennsylvania has two large pension funds, for teachers and for public employees, and a smaller fund for municipal employees, each of which is administered independently.

There are two major types of pension plans: defined benefit and defined contribution. A defined benefit pension plan entitles retirees to a predefined monthly payment from their former employer. A defined contribution pension plan, on the other hand, entitles a retiree to a contribution from the employer to a retirement fund, which the employee then invests and receives access to upon retirement. With defined benefit pension plans, the state government can decide to either prefund its obligations or pay as it goes. Prefunding involves the state putting money aside in advance to pay for retiree benefits; the money is subsequently invested.

When the employee retires and the benefits come due, the state can pay for the benefits with a combination of money from the general fund and investment returns. If a state chooses to pay as it goes, retirement benefits are more expensive because the state must pay for all current benefits out of the general fund without investment returns to defray the cost. In the private sector, defined benefit pensions plans are disappearing rapidly in favor of defined contribution plans, because of the lower cost to employers of defined contribution plans.

VALUING PENSION LIABILITIES

One of the most difficult issues in state pension reform is estimating the liability that a pension system has to its beneficiaries. Estimating the total liability requires projecting benefits that will be paid in the future and "discounting" those benefits to the present. The choice of discount rate is critical; indeed, many state leaders and pension fund administrators have had difficult debates over the last few years about what discount rate to use.

The discount rate is by definition equivalent to the earnings assumption rate of the fund. The majority of states used an expected return rate of around 8%. Only nine states used an expected return rate of 7.5% or lower.[50] Many argue that these rates are too optimistic — especially given the current economic climate. As a result, there has been political pressure, with some success across states, to lower the discount rate used to estimate pension fund returns.

50 "Public Pensions Are About to Look Less Healthy." Planet Money - NPR. July 20,2012. [http://www.npr.org/blogs/money/2012/07/20/157060335/public-pensions-are-about-to-look-less-healthy].

The danger in using an inflated discount rate is that it can make a pension plan appear healthier than it really is. This can create false incentives to expand benefits or reduce contributions. A high discount rate can also create incentives for managers to make riskier investment to achieve the higher level of return promised. Moving to a lower rate does not solve the pension problem, but rather reveals the true extent of the problem: with a lower discount rate, future liabilities increase, because the state is now assuming that the same amount of money invested today will earn less money through investment to pay toward liabilities.

Our study states use different assumed rates of return to value their pension funds. In Pennsylvania, the State Employee Retirement System (SERS) recently lowered their expected rate of return from 8.0% to 7.5%. Massachusetts' pension fund uses an expected rate of return of 8.25%. While there has been some discussion of moving to a rate of 8.0% or 7.5%, there has been no action thus far. The New York State and Local Retirement System had used a rate of 8.0% until September 2010, when the Fund lowered its long-term expected rate of return to 7.5%.[51] New Jersey, on other hand, uses a 7.95% rate of return despite much lower returns in recent years.

UNFUNDED LIABILITIES: PENSIONS & OPEB OBLIGATIONS

TEN BEST STATES				TEN WORST STATES			
Rank	State	%GSP	(In Thousands)	Rank	State	%GSP	(In Thousands)
1	Indiana	13.26%	$34,138,998	41	West Virginia	34.28%	$21,344,541
2	North Dakota	13.32%	$4,212,440	42	Mississippi	34.67%	$32,953,427
3	Tennessee	13.34%	$32,259,493	43	Alabama	34.75%	$58,503,809
4	Florida	14.13%	$103,050,955	44	Kentucky	35.23%	$54,457,754
5	Virginia	14.31%	$58,157,373	45	Illinois	38.06%	$236,364,439
6	South Dakota	15.61%	$6,052,651	46	New Mexico	41.97%	$31,222,662
7	Iowa	15.99%	$21,804,426	47	Alaska	43.72%	$20,402,227
8	Utah	16.88%	$19,024,129	48	New Jersey	45.20%	$216,241,387
9	Washington	17.47%	$58,743,651	49	Ohio	46.60%	$217,169,878
10	Arizona	17.99%	$45,712,189	50	Hawaii	49.54%	$32,540,878

SOURCE: PENSION LIABILITIES FROM ANDREW BIGGS: "PUBLIC SECTOR PENSIONS: HOW WELL FUNDED ARE THEY REALLY?" STATE BUDGET SOLUTIONS. JULY 2012. OPEB CALCULATIONS FROM SUSAN K. URAHN: "THE WIDENING THE GAP UPDATE." THE PEW CENTER ON THE STATES, PUBLISHED JUNE 20, 2012

UNDERFUNDING OF PENSIONS

In theory, pensions should be funded in advance to ensure that sufficient funds are available upon workers' retirement. Most public employees contribute to their own retirement funds, as does the state government through its general funds. Those funds are then invested with the goal of earning investment income to bolster the fund.

51 "Investments." NYSTRS. [http://www.nystrs.org/main/about/investments.htm]. and "DiNapoli: State Pension Fund Posts Strong Gain." Office of the New York State Comptroller. [http://www.osc.state.ny.us/press/releases/may12/052312.htm].

In practice, however, such prefunding has been dangerously inadequate, and as a result nearly every state is dealing with huge unfunded liabilities. Estimates of the liabilities differ. As reported by the pension actuaries, the liabilities may be about $1 trillion. However, if private-sector accounting standards are applied (i.e. using a lower discount rate), unfunded liabilities could be as much as $3 trillion nationwide. The states in the most dire situations are Ohio, New Mexico, Mississippi, Kentucky, Rhode Island, Hawaii, South Carolina, New Jersey, and Illinois, all of which have unfunded liabilities greater than 13% of their Gross State Product.[52]

"...prefunding has been dangerously inadequate, and as a result nearly every state is dealing with huge unfunded liabilities."

The main explanation for the recent rise in underfunding is that the Great Recession drove down investment earnings. Rather than covering shortfalls in the pension system, states diverted funds to more pressing concerns such as unemployment insurance, health care, and education.

Nevertheless, the economics of these pensions plans had been shaky for much longer. New Jersey, as an example, has underpaid its pension contributions for years. Contribution shortfalls have totaled about $14.5 billion over the last half-decade alone. Despite recent reforms that required the state to ramp up its payments, Governor Chris Christie's administration has only paid one-seventh of the stated required amount in FY 2012. Faced with a huge budget deficit at the state level, Christie decided that paying into the pension system, which he called "broken," was the not the best use of tax dollars.

Pennsylvania has the 7th highest pension debt in the country. Estimates of that debt range from $30 billion on the low end (as reported by pension fund actuaries)[53] to $114.1 billion on the high end as calculated by outside economists.[54] The two major state public employee pension funds — the Public School Employees' Retirement System (PSERS) and the State Employees' Retirement System (SERS) — have funded ratios of 75% and 65%, respectively. Together, the state's pension liabilities make up 22% of the state's total liabilities.

Massachusetts is only slightly better off than the average state, with a reported unfunded liability of $19 billion. The state's funded ratio has declined since the onset of the Great Recession, and is now hovering around 80%.

52 Calculations based on the work of Robert Novy-Marx and Joshua D. Rauh. "Public Pension Promises: How Big are They and What are They Worth?" Journal of Finance. [http://papers.ssrn.com/sol3/papers.cfm?abstract _ id=1352608].

53 SERS, PSERS Say Unfunded Pension Liability Reaches $30 billion. PA Capitol Digest. [http://pacapitoldigestcrisci.blogspot.com/2011/03/sers-psers-say-unfunded-pension.html].

54 State Budget Solutions. "State Budget Solutions' third annual State Debt Report shows total state debt over $4 trillion." August 28, 2012. [http://www.statebudgetsolutions.org/publications/detail/state-budget-solutions-third-annual-state-debt-report-shows-total-state-debt-over-4-trillion#ixzz2S07P9hXY] and "Pension assets and pension liabilities: Calculations by Robert Novy-Marx and Joshua Rauh, as of June 2009"; Public Pension Promises: How Big Are They and What Are They Worth?" (with Robert Novy-Marx), October 2010, Journal of Finance, forthcoming [http://papers.ssrn.com/sol3/papers.cfm?abstract _ id=1352608].

Among the states that we studied, New York had the best-funded pension plan, ranking as one of the five best-funded pension plans in the country along with North Carolina, Tennessee, Nebraska, and Delaware. Indeed, New York's funding ratios are near 100%, according to pension actuaries. New York's funds are in this position because the state has higher annual required contributions from its general revenues than other states, and because New York has increased contributions in response to investment income shortfalls. Finally, New York law requires state and local governments to pay the full annual required contribution, rather than deferring that responsibility into the future.

"States are now pursuing legislative reform to address the pension issue by raising retirement ages, imposing additional years of service to qualify, increasing employee contributions, offering other options like 401Ks, and reducing COLAs."

REFORM AND PROSPECTS FOR REFORM

States are now pursuing legislative reform to address the pension issue by raising retirement ages, imposing additional years of service to qualify, increasing employee contributions, offering other options like 401Ks, and reducing COLAs. In general, there has been an effort to shift the burden of the state pension problem from states to state employees.

The legal protections given to public employees vary by state. As state governments are now discovering, it is easier to achieve changes to agreements with new employees than with current employees or retirees, as their contracts have not started yet. It is more difficult to cut spending for current retirees, whose contracts have been in place for decades and are protected under contract law as well as many state constitutions.

The states we studied have put forward a number of similar plans and ideas to address the burgeoning pension crisis.

Massachusetts

In 2011, Governor Patrick signed a reform law aimed at reducing pension costs through small adjustments and closing legal loopholes. Some of the key measures in this reform include: 1) the elimination of double compensation for elected officials and early retirement subsidies (more commonly called "double dipping," where an elected official receives a pension, while at the same time receiving compensation for an elected position);[55] 2) raising the minimum retirement age; 3)

55 Chabot, Hillary. "Gov to retire double dipping." Boston Herald. [http://bostonherald.com/business/general/view/20110119gov _ to _ retire _ double _ dipping]. January 19, 2011.

capping the maximum pension a retiree can earn; 4) establishing new criteria to limit the payment of excessive benefits, like basing pensions on average salary over a longer period of time.[56] The move by the governor is expected to save taxpayers $5 billion over a 30-year period.

New Jersey

New Jersey pursued reform with mixed results. In June 2011, Governor Christie and top state legislators reached a deal to reform the state's public employee pension and health care benefits programs by boosting employee pension and health care contributions, raising the minimum retirement age for new workers and freezing annual cost-of-living adjustments to pension payouts. After the law was signed, New Jersey's unfunded pension liability dropped from $53.9 billion to $35.4 billion, as reported by the state in bond documents. By late 2011, however, the unfunded liability had increased again to $41.8 billion after Governor Christie skipped a $3.0 billion pension payment, calling the pension fund "a broken system" and refusing to pay more into the system until even more reforms were implemented.[57] According to the Volcker-Ravitch report, New Jersey's unfunded pension liability was closer to $42.6 billion.[58]

Pennsylvania

In Pennsylvania, major pension reform was passed in November 2010. The changes included: lowering retirement benefits for new employees, mandating an "actuarial fresh start," and capping future employer contribution increases to predictable intervals.[59] As a result of the plan, the state's pension obligation from the general fund will increase dramatically in the coming years from $1.1 billion in FY 2012 to $4 billion by FY 2016.[60] By early 2012, however, state leaders had acknowledged that the 2010 reforms were not enough to solve the state's pension crisis. As of May 2012, the state owed its pension funds more than it spends on its annual operating budget. The pension liability was reported at $37 billion. "Act 120 bought us some time, and that time is coming to an end," said state Rep. Scott Boyd, a Republican from Lancaster County of the 2010 reform. Governor Corbett is currently lobbying for new reform.[61]

New York

In March 2012, Governor Cuomo successfully pushed a pension reform bill through the legislature, promising to save the state and local governments a combined $80 billion over the next thirty years. The law requires new employees to contribute more of their salary for a smaller pension benefit, raises the retirement age, increases the pension eligibility requirements, penalizes early retirement, reduces the number of sick days that can be cashed out, and attempts to move new workers from a

56 "Governor Patrick Signs Pension Reform Legislation." [http://www.mass.gov/governor/pressoffice/pressreleases/2011/111118-pension-reform-signed.html]. November 18, 2011.
57 Dopp, Terrence. "New Jersey's pension-funding deficit climbs more than 17% to $53.9 Billion". [http://mobile.bloomberg.com/news/2010-12-23/new-jersey-s-pension-funding-deficit-climbs-more-than-17-to-53-9-billion]. December 23, 2010.
58 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
59 Pennsylvania SERS CAFR 2011, iii-iv.
60 Olson, Laura. "Gov. Corbett adds pension reform to budget agenda." Pittsburgh Post-Gazette. [http://www.post-gazette.com/stories/local/state/gov-corbett-adds-pension-reform-to-budget-agenda-636794/].
61 Ibid.

defined benefit pension to a new portable defined contribution plan.[62] Some questioned whether Governor Cuomo's pension reform bill went far enough. The measure only reduces benefits for new employees, which means the reform will have little impact in the short term. The measure only saves $1.2 billion over the next five years.[63]

HEALTH CARE AND OPEB BENEFITS

Most state and local governments have promised substantial health care benefits to their workforces. In addition to health care, sometimes there are other benefits provided in retirement, such as life insurance. In combination all these benefits are known as "Other Post-Employment Benefits" (OPEB). These benefits are rarely prefunded and are often underreported or not reported at all. In 2004 the Governmental Accounting Standards Board (GASB) issued standards requiring disclosure of the nature of the liabilities. Before that, most state and local governments did not regularly report OPEBs.[64]

"Public OPEB plans have unfunded liabilities of more than $600 billion."

Public OPEB plans have unfunded liabilities of more than $600 billion, according to the actuaries of the plans. If promises to local workers are factored in, the combined total is well above $1 trillion. There are almost three times as many local public workers as state workers. It is also worth mentioning that if Medicare reform raises the age of retirement, the cost for OPEB benefits, which cover the transition time between retirement and Medicare, could increase substantially.

New Jersey

In New Jersey, the unfunded health care liability is estimated at $58.3 billion.[65] New Jersey funds these benefits on a pay-as-you-go basis rather than contributing to an established fund, which leaves the state far behind in its promises. The state passed reform measures increasing employee contributions under Governor Christie — who pointed out the average New Jersey public employee contributed only 8% of the cost of his or her health benefits, compared to 34% for the average federal employee. That said, the state has far to go to shore up the billions of OPEB liabilities it still has.

62 "New York cuts pension benefits for public workers." Reuters. [http://www.reuters.com/article/2012/03/15/us-newyork-pensions-idUSBRE82E00F20120315] and "Governor Cuomo Signs Law to Enact Major Pension Reform." Office of the Governor. [http://www.governor.ny.gov/press/031612pension].

63 "Gov. Cuomo proposes landmark changes." New York Daily News. [http://articles.nydailynews.com/2012-01-17/news/30637347 _ 1 _ teacher-evaluation-system-pension-change-cuomo].

64 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].

65 Ibid.

New York

New York's state OPEB obligations were estimated at $56 billion in 2010[66] and $62 billion in FY 2012.[67] However, if local obligations are added to the mix, liabilities skyrocket to $250 billion in FY 2012. The Empire Center for Public Policy of the fiscally conservative Manhattan Institute reported in September of 2012 that state and local OPEB obligations may have increased by $45 billion since 2010.[68] The Volcker-Ravitch report put liabilities at $196 billion.[69]

Pennsylvania

Pennsylvania's OPEB liabilities are estimated at $17 billion.[70] However, the state has saved less than 1% of the money needed to cover these costs. This puts Pennsylvania among the 17 states that have little to no money set aside to pay OPEB benefits.

Massachusetts

Estimates from the consulting firm AON put total unfunded liabilities in Massachusetts at $16.6 billion.[71] When the costs of benefits for local employees are included, the total tops $40 billion.[72] In order to prepare for these expenses, Governor Deval Patrick included a set-aside of 10% of the state's receipts from lawsuits against tobacco companies, or $27 million, to be put towards this liability in the FY 2013 budget.[73] This percentage will grow each year by 10 percentage points (e.g., in FY 2014, 20% of tobacco settlement costs), until 100%, or an estimated $276 million, is dedicated annually to help offset these health care costs. In addition, the Governor also proposed transferring 5% of excess capital gains tax revenues into the state's retiree health liability trust fund. [74]

LOOKING AHEAD

While the solutions needed to address the states' pension and OPEB crisis are clear and well-known — raising the retirement age, decreasing COLAs, increasing employee contributions, and paying annual required state contributions — they are nonetheless difficult to implement and politically unpopular. Retirees do not want to see their pensions or other benefits cut, and in many cases their benefits are protected by contract law and state constitutions. Cutting pensions and OPEB for new employees, on the other hand, serves as a disincentive to individuals interested in working for the state government.

66 Urahn, Susan K., "The Widening the Gap Update." The Pew Center on the States, published June 20, 2012. [http://www.pewstates.org/uploadedFiles/PCS _ Assets/2012/Pew _ Pensions _ Update.pdf].
67 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
68 Chin, Tonya. "New York State's Unfunded OPEB Liability Nears $250 Billion." The Bond Buyer. [http://www.bondbuyer.com/issues/121 _ 173/new-york-state-local-governments-face-250-billion-unfunded-health-coverage-1043690-1.html].
69 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].
70 Urahn, Susan K., "The Widening the Gap Update." The Pew Center on the States, published June 20, 2012. [http://www.pewstates.org/uploadedFiles/PCS _ Assets/2012/Pew _ Pensions _ Update.pdf].
71 "Commission Focuses on Healthcare Finances." [http://www.massretirees.com/article/issues/state-gic/commission-focuses-healthcare-finances]. Mass Retirees. April 6, 2012.
72 Ibid.
73 Ibid.
74 Governor's Budget FY 2013. FY 2013 Budget Recommendation: Issues in Brief. "Improving Fiscal Management and Transparency." [http://www.mass.gov/bb/h1/fy13h1/exec _ 13/hbudbrief19.htm]. Executive Office for Administration and Finance. 2012.

{ unfunded liabilities }

The many protests and rallies against cuts to public employee benefits in the last year are stark evidence of the difficulty and political sensitivity of the subject. However, with pension funds in a state of crisis in nearly every state, changes will need to be made. Cuts to benefits and increases in contributions must come from somewhere. If the states are to address the pension crisis and stop their budgets from succumbing to billions in liabilities, they will need to find a way to implement these reforms — and soon. ★

Federal grants to states are headed for the chopping block as the federal government deals with its own budget deficit.

THE FISCAL CLIFF AND STATE BUDGETS

In September of 2012, the U.S. debt stood at just over $16 trillion. The projected budget deficit for FY 2012, according to the Congressional Budget Office, will be $1.1 trillion. Our federal government will likely pay just over $240 billion in the interest on our debt.[75]

Persistent federal deficits and debt have been a part of the American landscape since the 1970s. Deficits exploded in the 1980s due to a series of tax decreases and spending hikes, took a breather under President Bill Clinton under whom the budget was actually balanced for the first time in 30 years, and then skyrocketed again due to the Bush-era tax cuts and the heavy war spending of the early 2000s. The Great Recession of 2008 brought with it decreasing tax revenues and increased spending on stimulus — a formula however needed for the short term — added trillions to the national debt in the course of just a few years.

For decades, our government officials have passed the problem of deficits off to future generations. That said, it is widely agreed, that the U.S. must finally "face the music" on our debt and deficits. Watching nations near bankruptcy in Europe in the last few years as well as suffering a U.S. credit downgrade in August 2011, has likely sobered policy makers into understanding that what's happening abroad could happen here.

Last year, unable to come to compromise on balancing the U.S. Budget, Republicans and Democrats agreed to what is popularly described as a "fiscal cliff," in which each side will face an unacceptable reality if they do nothing: $1.2 trillion in automatic spending cuts over 10 years, starting January 1, 2013. These cuts would be divided between nondefense programs (which the Democrats care deeply about protecting, like Medicare) and defense projects (which the Republicans care deeply about protecting). In addition, the agreement calls for the sunset of the Bush-era tax cuts. If Congress does not come up with an alternative plan to shave $1.2 trillion in spending over the next ten years, the "fiscal cliff" reductions will be enacted by default. If that happens, the CBO predicts a 4% reduction in economic output due to the draconian nature of those cuts. Some say that level of economic shock could put us into another recession.[76] The idea behind the fiscal cliff was to get policy makers to act by the end of 2012 — or else.

If past is prologue, lawmakers may still try to avoid big cuts to the most politically protected programs — Social Security, Medicare, and defense. Together these programs take up over half of the budget. Further, Republicans may continue to block any and all tax increases, limiting the

75 FY 2012 Historical Tables. Budget of the U.S. Government. Office of Management and Budget. [http://www.budget.gov].
76 Beard, Rebecca. "Fear of Year-End Fiscal Stalemate May Be Having Effect Now." New York Times. July 11, 2012.

prospect of raising revenues to close the budget deficit. Once all mandatory spending (spending mandated by legislation like Social Security, Medicare, interest on the debt, and block grants to Medicaid) is removed from the equation, then a relatively small portion of the national budget — less than 30% — is left to debate.[77]

"While grants make up only 16% of federal outlays as a whole, they make up more than 40% of this discretionary portion of the budget — and therefore are more likely targets for federal budget cuts."

Contained in that 30%, however, are many of the discretionary block grants to states, which help support K-12 education, colleges and universities, unemployment compensation, public housing, school lunch programs, and infrastructure. While grants make up only 16% of federal outlays as a whole, they make up more than 40% of this discretionary portion of the budget — and therefore will are more likely targets for federal budget cuts.

DISCRETIONARY VERSUS MANDATORY SPENDING

Of the federal grants to the states, Medicaid is the largest category by far at $265 billion in FY 2011, accounting for almost 43% of all federal grants.[78] Other social safety net programs account for 17%; education (including K-12 and higher education) makes up another 17%, and infrastructure and physical capital grants account for 16%. Medicaid is considered "mandatory" spending, since it is dictated by legislation and its costs are therefore fixed unless that legislation is amended.

The President's Budget for FY 2013, as submitted to Congress, projects increases in grants to states for "mandatory" programs — driven primarily by rapid growth in Medicaid, which will be expanded by the federal health care bill, or ACA. The same budget projects a decline in inflation-adjusted outlays for discretionary grants. The CBO projects that selected discretionary spending for education, transportation, and housing programs benefiting state and local governments will shrink by 35% between FY 2012 and FY 2022 and that selected income security programs, primarily those benefiting children, will decline by 35% for the same period. Conversely, the CBO expects federal spending for Medicaid and CHIP to increase by 47% in those years.[79]

These projections indicate that a "crowding out" effect may be occurring at the federal grant level in regards to Medicaid. Assuming that the federal government has limited funds for block grants to states — especially given the federal fiscal crunch — Medicaid will take a greater share of

77 The Center on Budget and Policy Priorities. Policy Basics. August 13, 2012. [http://www.cbpp.org/cms/index.cfm?fa=view&id=1258].
78 Grants include those made to Medicaid and the related Child Health Insurance Program (CHIP), estimated at $265 billion in 2012. Office of Management and Budget.
79 Ravitch, Richard and Volcker, Paul. Report of the States Budget Crisis Task Force. [http://www.statebudgetcrisis.org].

the total, leaving less available for other state spending needs like education, infrastructure, and income assistance.

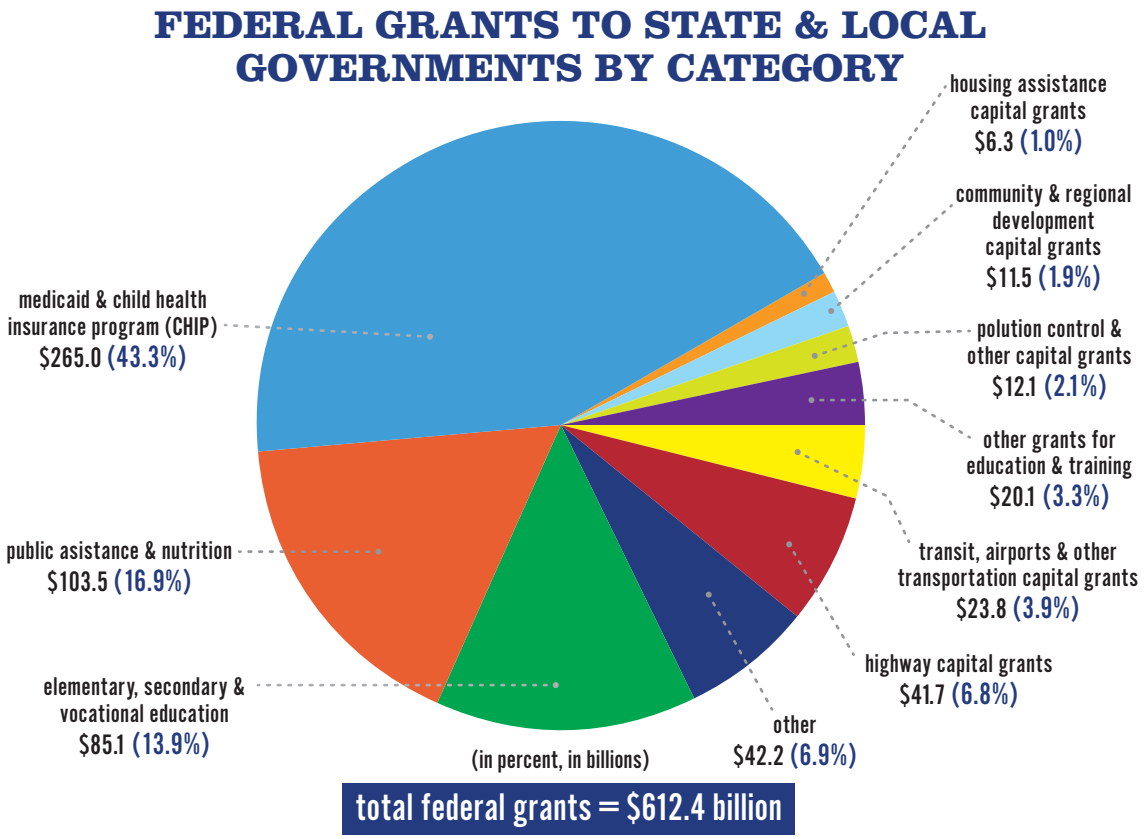

Figure 7 SOURCE: OFFICE OF MANAGEMENT AND BUDGET

REDUCED GRANTS FOR CITY GOVERNMENTS

The reductions in federal block grants to states will be passed down to cities and localities, which are in many ways the most vulnerable part of our governmental structure. In order to balance budgets, state governments will likely have to cut spending to local governments affecting K-12 education, infrastructure, and other basic services. State aid to local governments represents the largest source of revenues for municipalities at approximately 34% of budgets.[80]

"The trouble is many local governments have already used up or reduced their "rainy day" funds during the Great Recession."

80 Welber, Peter. "Understanding complexities in the municipal bond market." The Washington Business Journal. September 5, 2012. [http://www.bizjournals.com/washington/blog/2012/09/understanding-complexities-in-the.html?page=all].

The trouble is many local governments have already used up or reduced their "rainy day" funds during the Great Recession. In addition, raising debt may be more difficult if cities are perceived to be a bad credit risk. The recent Chapter 9 defaults of some larger cities like Stockton or San Bernardino, as well as a plethora of credit downgrades for other cities may give some investors pause. From 2009-2011, for example, municipal downgrades by Moody's have outnumbered upgrades by three to one.[81]

Since cities are the last stop on the government money train, budget gaps for localities will have to be addressed primarily with a combination of reductions in public services, some privatization, and tax increases. ★

81 Ibid.

{ accounting procedures }

States do not account to citizens in ways that are transparent, timely or accessible.

UNTIMELY REPORTING

Each state produces a Comprehensive Annual Financial Report (CAFR), an annual report of expenditures, revenues, assets and liabilities. CAFRS typically give the most thorough account of the state's finances in a given year. Unlike the budgets produced by the governor and legislators, CAFRs report on what was actually spent. They are retrospective rather than prospective.

While CAFRs, which form the basis of our reports, are incredibly useful documents, they are not without flaws. First and foremost the timeline for producing CAFRs are incredibly long. From the time that the fiscal year ends (for most states June 30th), it can take six months or more to publish the CAFR. Most CAFRS come out well after January of the following year. By contrast, the SEC requires large corporations to issue their annual reports within 60 days of the end of the fiscal year. Similarly, the federal government requires its agencies to publish their financial statements in 45 days.[82]

> "By the time CAFRs are released, the state government has passed a budget for the interim year and is submitting budget proposals to be debated for the year thereafter."

By the time CAFRs are released, the state government has passed a budget for the interim year and is submitting budget proposals to be debated for the year thereafter. In other words, the fact that CAFRs are so untimely makes them less useful as planning tools to craft future budgets.

CASH VERSUS ACCRUAL ACCOUNTING

Nearly all major U.S. Corporations use accrual accounting rather than cash accounting to produce their income statements and balance sheets. The federal government also provides accrual accounting measures in its statement of activities and balance sheet. The states, however, use a form of cash accounting.

In cash accounting receipts are recorded during the period they are received, and the expenses in the period in which they are actually paid. In accrual accounting economic events are recognized by matching revenues to expenses at the time in which the transaction occurs rather than when payment is made (or received). This method allows the current cash inflows or outflows to be

82 Ravitch, Richard and Volcker, Paul. Report of the State Budget Crisis Task Force, page 63. [http://www.statebudgetcrisis.org].

combined with future expected cash inflows or outflows to give a more accurate picture of an entity's current financial condition.

Cash and accrual measures serve different purposes. Cash accounting approximates the state's short-term borrowing needs. Accrual measures are useful for understanding a state's annual operating cost, including costs incurred today, but not payable for years to come. Accrual accounting adds a longer-term focus to the states' financial picture by providing more information on longer-term consequences of today's policy decisions, operations, and events.

"CAFRs do not provide reliable information on states' unfunded liabilities."

While CAFRs have moved towards accrual accounting in recent years, they are still largely a cash-based exercise. Most importantly, for example, CAFRs do not provide reliable information on states' unfunded liabilities for the pensions or health care of government workers. Estimates of those unfunded liabilities are often provided by the actuaries of the actual pension or health care plans themselves, however the data is never consolidated in the CAFR, which would provide a more accurate and complete picture of the states' future liabilities as set against its current financial position.

BALANCING BUDGETS WITH ACCOUNTING TRICKS

Unlike the federal government, most states are not permitted to run deficits due to balanced budget provisions in their constitutions. However, states often spend more than they take in through revenues but are still able to "balance their budgets" by manipulating their accounting procedures. Here are just a few examples:

States can deny or delay certain payments until subsequent years.

- In 2009-2010, New York balanced its budget by delaying income tax refund payments until the following year.
- Pennsylvania may have avoided Medicaid payments by wrongly removing over 100,000 citizens off their roles. The state is currently under investigation by the federal government.

Because a "deficit" is often an ill-defined concept in state budgeting, many states can simply raise debt to cover their deficits.

- New York and New Jersey have raised high-levels of debt through component units of their government (like transit authorities). This debt does not have to be reported in the balance sheet. This allows states to finance spending without increasing state debt as reported in the CAFR. Non-general obligation debt (the type of debt issued by independent units) constitutes more than 90% of net debt in New York and New Jersey.[83]

- California, while not one of our study states, has been particularly guilty of using debt to cover deficits in a similar way. California is the largest debtor state in the nation having over $81 billion in general obligation bonds at the end of 2011.[84]

States can redirect state funds meant for other uses.

- New York moved funds from their legally dedicated purpose to other projects, like transferring $264 million meant for environmental protection programs and wireless network improvements.[85]

- New Jersey shored up a large budget in FY 2011 by avoiding paying $3 billion from their general fund into the pension system. New Jersey has been underfunding its pension plans for years.

States can securitize future revenue streams.

- New Jersey securitized tobacco settlement revenue in FY 2003 and again in FY 2004, and in FY 2005. The state issued bonds supported by new revenues from motor vehicle surcharges for $1.9 billion. The State Supreme Court, however, found the transaction unconstitutional.[86]

- New York securitized tobacco settlement revenue to generate approximately $4.2 billion, which the state used to close budget gaps in the early 2000s.[87] ★

83 Ibid at 80.
84 California's State Treasurer. General Obligation Debt as of December 31, 2011.
85 Walsh, Mary Williams; Cooper, Michael. "Gloomy Forecasts for States, Even if Economy Rebounds." [http://www.nytimes.com/2012/07/18/us/in-report-on-states-finances-a-grim-long-term-forecast.html? _ r=1&ref=business]. July 17, 2012.
86 Ravitch, Richard and Volcker, Paul. Report of the State Budget Crisis Task Force. Pages 57-58. [http://www.statebudgetcrisis.org].
87 Ibid at 60.

{ recommendations }

Persistent unemployment, a reflection of a slow national recovery, has translated into less state tax revenue and a surge in the costs of Medicaid and unemployment insurance. Medicaid, in particular, has crowded out spending on the other state government priorities like K-12 education, higher education, and infrastructure. Further, the Great Recession has exacerbated the underfunding of the health care and pension systems for government workers, which carry trillions of dollars in liabilities nationwide. Lastly, inaccurate and untimely accounting practices have masked deficit spending and debt accumulation and fail to offer the transparency needed to solve these impending issues.

If our states are to weather recent economic storms, the States Project puts forth the following recommendations:

1. **States must move towards accrual accounting and away from cash accounting. Accrual accounting better reflects the true liabilities that states face and makes it more difficult for states to obscure deficit spending.**

2. **States should provide financial reports in a timely and transparent fashion. Accounting principals should be standardized across states and made accessible to policymakers as well as citizens.**

3. **States must reduce Medicaid costs. While supporting the public safety net is an important priority, states must balance this need with other objectives, such as supporting education and infrastructure.**

4. **States must tackle persistent unemployment by supporting education on all levels, giving citizens the skills necessary to compete in a 21st century job market.**

5. **Federal, state, and local governments must create formal dialogues on budgeting — none currently exist. Most pressingly, we must assess how the budget-cutting efforts of Washington will affect states and localities and how we might mitigate some of the harshest cuts at the local level.** ★

For more information on how to get involved,
please visit us at
www.thestatesproject.org