RESEARCH RAP
Special Report

Budget Gaps and Balanced-Budget Proposals in Third District States[*]

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The Great Recession has severely tested the strength of state finances and the soundness of state budget practices. Quarterly state tax revenues have declined year-over-year for a record five quarters, from the fourth quarter of 2008 through the fourth quarter of 2009.[1] The depth of decline is also unprecedented, with a 16.5 percent drop in the second quarter of 2009. An immediate consequence is that states are facing massive fiscal shortfalls, triggering rounds of tax increases and service cuts, plus reliance on federal stimulus money, reserves, one-off actions, and borrowing against the future. The Third District states (Delaware, New Jersey, and Pennsylvania) have been similarly affected. Examining how each state is coping with the worst fiscal crisis of the last half-century sheds light on their respective fiscal practices and raises questions for further research. This report describes the scope of each state's fiscal problems, including current and projected budget gaps, the effect of stimulus funding, and anticipated state-level policy responses.

Key findings from this report include:

- Budget gap estimates for Third District states vary significantly on a percentage-of-budget basis. The District's aggregate gap is virtually identical to the national aggregate in FY 2009 and FY 2010, and somewhat smaller in FY 2011 than nationally.
- Federal stimulus funding has reduced, but not eliminated, state budget gaps.
- Delaware has avoided persistent structural budget problems and has been able to address this budget crisis with a balance of revenue increases, expenditure cuts, and federal stimulus aid, rather than deferring pension payments or employing other one-off strategies.
- New Jersey has faced annual structural deficits since at least FY 1994 and will close its FY 2011 $10 billion budget gap in a technical sense. However, by relying on deferred payments and one-off policies, New Jersey will fail to balance its budget from a long-term perspective.
- Revenue declines were smaller for Pennsylvania, but the state has been heavily reliant on stimulus funds, it faces mounting long-term pension obligations, and it is responsible for an unusually large number of distressed cities and municipalities.

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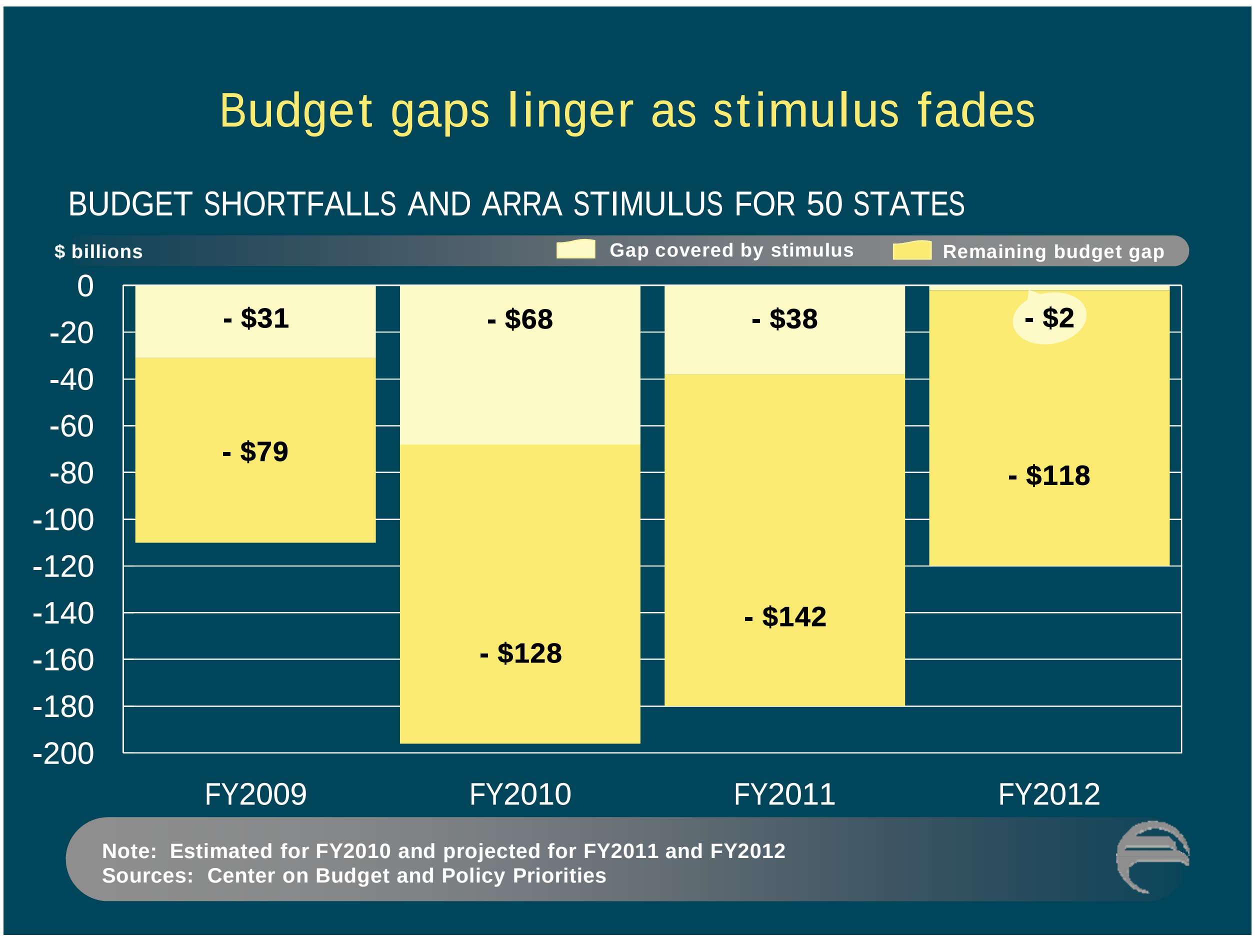
[*] The views expressed here are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System. Paul R. Flora is an economic analyst in the Research Department and may be reached at paul.flora@phil.frb.org.

[1] For this comparison, the Rockefeller Institute's State Revenue Report (April 2010) used nominal data from the Census Bureau going back to 1962.

Current Shortfalls

For any given fiscal year, an initial state budget gap (or surplus) is calculated at the onset of the budgetary process as anticipated revenues less anticipated expenditures. Revenue and expenditure estimates are based on existing revenue policies and cost obligations prior to any solutions proposed by a governor's initial budget or those adopted in the final budget to close the gap. After final adoption of the budget, a state's budget gap is re-estimated as actual revenues and expenditures are realized. For example, the original gap will grow larger if actual revenues fall short of the final budget estimates and larger still if actual expenditures exceed final budget estimates.[2]

Given that the definition of a budget gap changes with time, measuring and comparing budget gaps is an inexact science and a process fraught with imprecise measures, inconsistent methods (across states and over time), timing issues, and political spin.[3] With the caveat that states' reported gaps may vary in their definitions, measures, timing, and objectivity, several sources provide frequent estimates of budgetary gaps.

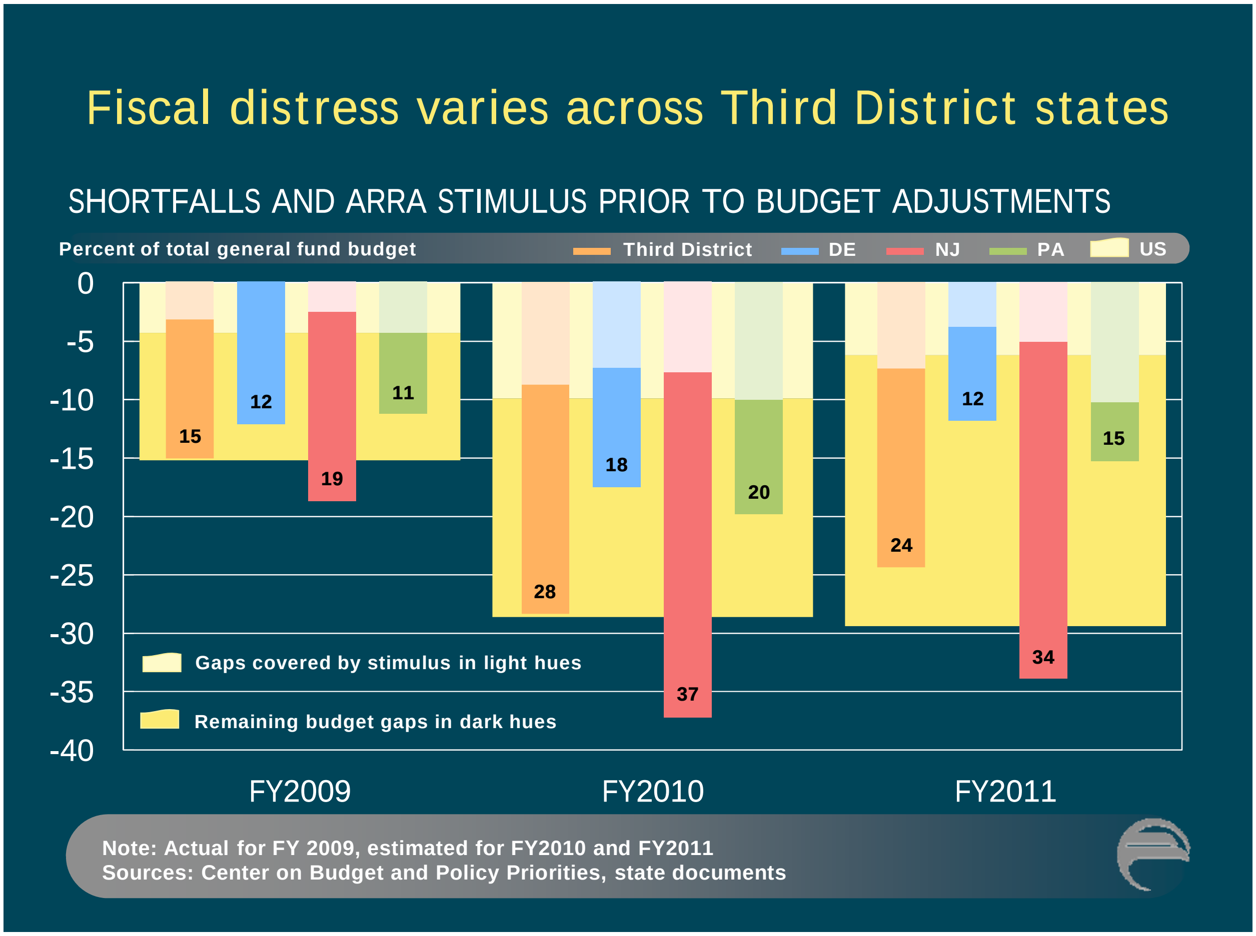


[2] When a budget year is finally closed out, the total general fund budget gap for a given fiscal year may be written as:
state budget gap = anticipated revenues - anticipated expenditures (at the outset of the budget process)
+ (final actual revenues – adopted budget revenue estimates)
+ (adopted budget expenditure estimates – final actual expenditures).

[3] For example, expenditure measures might reasonably include or exclude pension obligations that have been deferred in the past. Anticipated revenues are as straightforward as any forecast, which is to say they are open to debate.

According to the Center on Budget and Policy Priorities (CBPP), the aggregate budget shortfall for all 50 states (prior to using fiscal stimulus money) has grown from $110 billion for FY 2009 to $196 billion for FY 2010.[4] The aggregate shortfall is projected to ease slightly in FY 2011 to $180 billion and shrink further to $120 billion in FY 2012.[5]

Federal stimulus funds from the American Recovery and Reinvestment Act (ARRA) kicked in before the end of FY 2009, helping to offset 28 percent of that year's gap. For the current FY 2010, states will receive a full year's funding under aid formulas, covering an estimated 35 percent of the gap. Most of the ARRA funds for states will be expended by December 2010, reducing FY 2011's shortfall by 21 percent. A few billion dollars of stimulus funding may straggle into expenditures for later fiscal years, providing negligible assistance in meeting deficits that are projected to persist. Congress might approve an additional stimulus package, which would lessen, but not likely eliminate, deficits in FY 2011 and FY 2012.



[4] FY 2010 runs from July 1, 2009 to June 30, 2010 for Delaware, New Jersey, and Pennsylvania.

[5] The CBPP estimates budget gaps prior to accounting for certain federal stimulus funds. The American Recovery and Reinvestment Act (ARRA) of 2009 provides two key sources of fungible state aid that can effectively offset a state's own lagging revenues. The Federal Medical Assistance Percentage, or FMAP, was increased through December 2010, providing about $87 billion of stimulus, and a State Fiscal Equalization Fund established two block grants, providing about $48 billion of stimulus for states and localities, primarily for education. See the article by Iris J. Lav, et al.

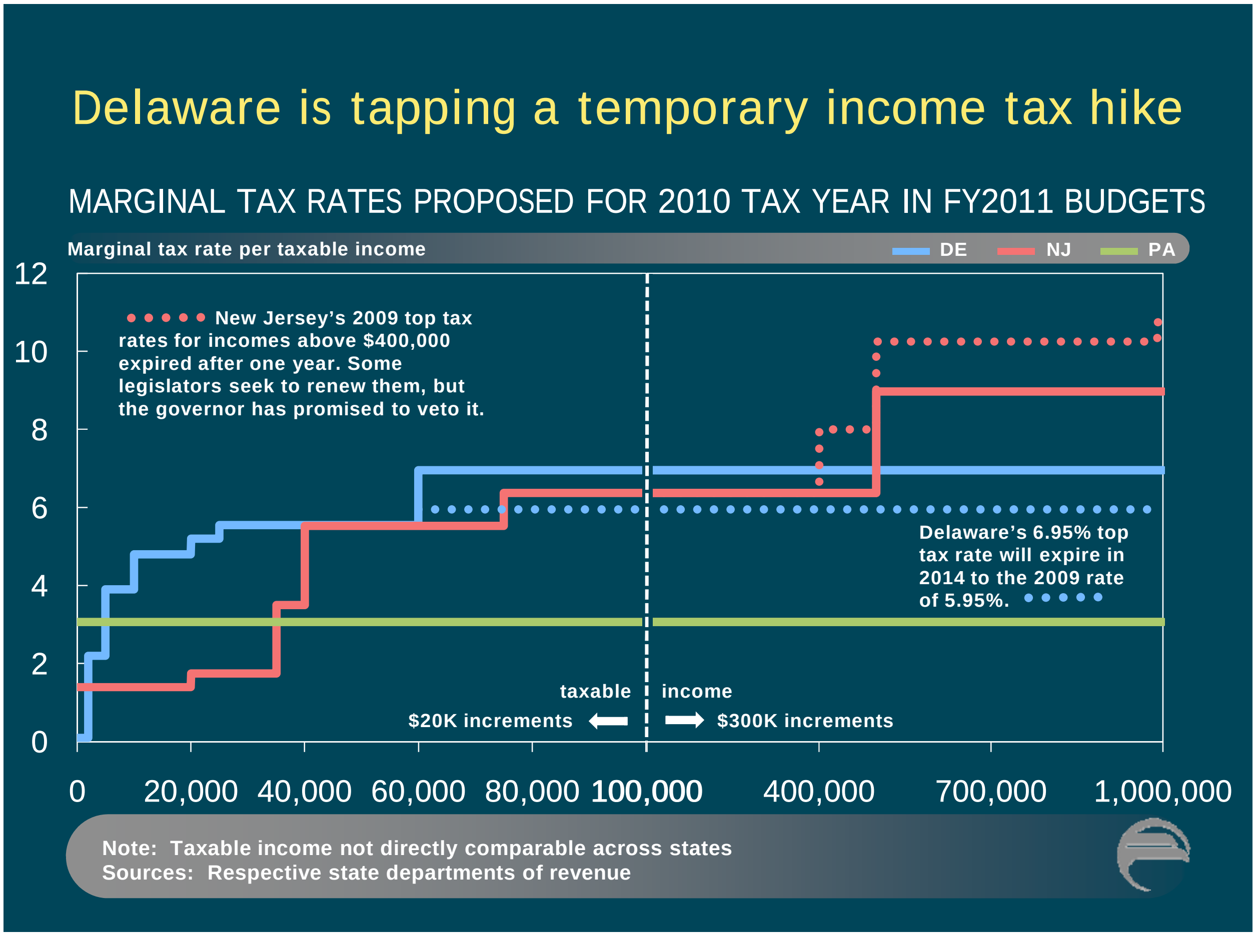
As a percent of total general fund expenditures (actual for FY 2009, and as budgeted in FY 2010 for all other years), the CBPP's estimates show budget gaps growing from 15.2 percent in FY 2009 to 28.6 percent in FY 2010. Gaps edge higher in FY 2011, to 29.4 percent, before retreating to 19.6 percent in FY 2012.

Estimates for our Third District states (Delaware, New Jersey, and Pennsylvania) vary significantly on a percentage-of-budget basis, but the aggregate for our District is virtually identical to the national aggregate in FY 2009 (a 15.1 percent gap) and FY 2010 (a 28.4 percent gap). In FY 2011, Third District states anticipate a somewhat smaller 24.5 percent gap than nationally.

Delaware Is Coping Well in a Harsh Fiscal Environment

As depicted on a percent-of-budget basis, Delaware is faring better than New Jersey and Pennsylvania. The FY 2010 gap, which deepens to almost 18 percent of expenditures, is attributed in part to $238 million in revenue declines, a $110 million reduction in prior-year level of ARRA funding, $110 million of cost drivers, and $60 million for programs to improve government services and efficiencies.

Delaware's total general fund revenues fell 4.5 percent in FY 2008 and 3.8 percent in FY 2009, and they are estimated to fall 7.0 percent this fiscal year. A small 1.0 percent increase is projected for FY 2011. Over the past three years, reductions of over $500 million in Delaware's revenue stream have contributed to



estimated budget gaps of $443 million in FY 2009, $557 million in FY 2010, and $377 million in FY 2011 (projected).

Delaware got ahead of the crisis by enacting the deepest cuts for FY 2010 with $300 million of expenditure reductions by eliminating 485 positions and all nonessential travel and by reducing state employee pay, consulting costs, and fleet size. The full effect of these cuts is ongoing in subsequent fiscal years. For FY 2011, Delaware proposes an additional $143.6 million of net agency cutbacks.

Similarly, Delaware boosted its revenues early by incorporating several tax increases and revenue enhancements in time to affect the FY 2009 budget and carry through until mid-way of FY 2014, at which time some of the tax increases return to their prior levels.

For FY 2011, Delaware made one other significant revenue change: liberalizing gambling laws by including table games to stay competitive with Maryland and Pennsylvania. This prescription has already been approved, and the FY 2011 budget assumes $39.7 million in revenue as a result.

Delaware will rely on $123.5 million of stimulus funds to help close its FY 2011 gap. In the past, Delaware has been excessively cautious and never used its rainy day fund, but currently, the state plans to tap $10.8 million (of $186.4 million) to help balance next year's budget. Delaware claims to export more of its tax burden than other states via corporate and abandoned property taxes on its unusually large corporate base.[6] With fewer long-term problems, Delaware has been more successful at maintaining fiscal discipline. The state has addressed this budget crisis with a balanced mix of revenue increases, expenditure cuts, and federal stimulus aid, rather than deferring required pension payments or employing other one-off strategies.

New Jersey Is Still Struggling to Overcome Lack of Sound Fiscal Discipline from Prior Years

New Jersey has faced annual structural deficits since at least FY 1994 (at $1.5 billion). Total deficits ballooned to $6.6 billion in FY 2004 (27 percent of total budget expenditures), the lingering effect of the 2001 recession. Subsequent budgets trimmed (or deferred) structural deficits. Now, as cyclical deficits mount from waning revenues, the costs of long-deferred obligations are also quickly escalating.

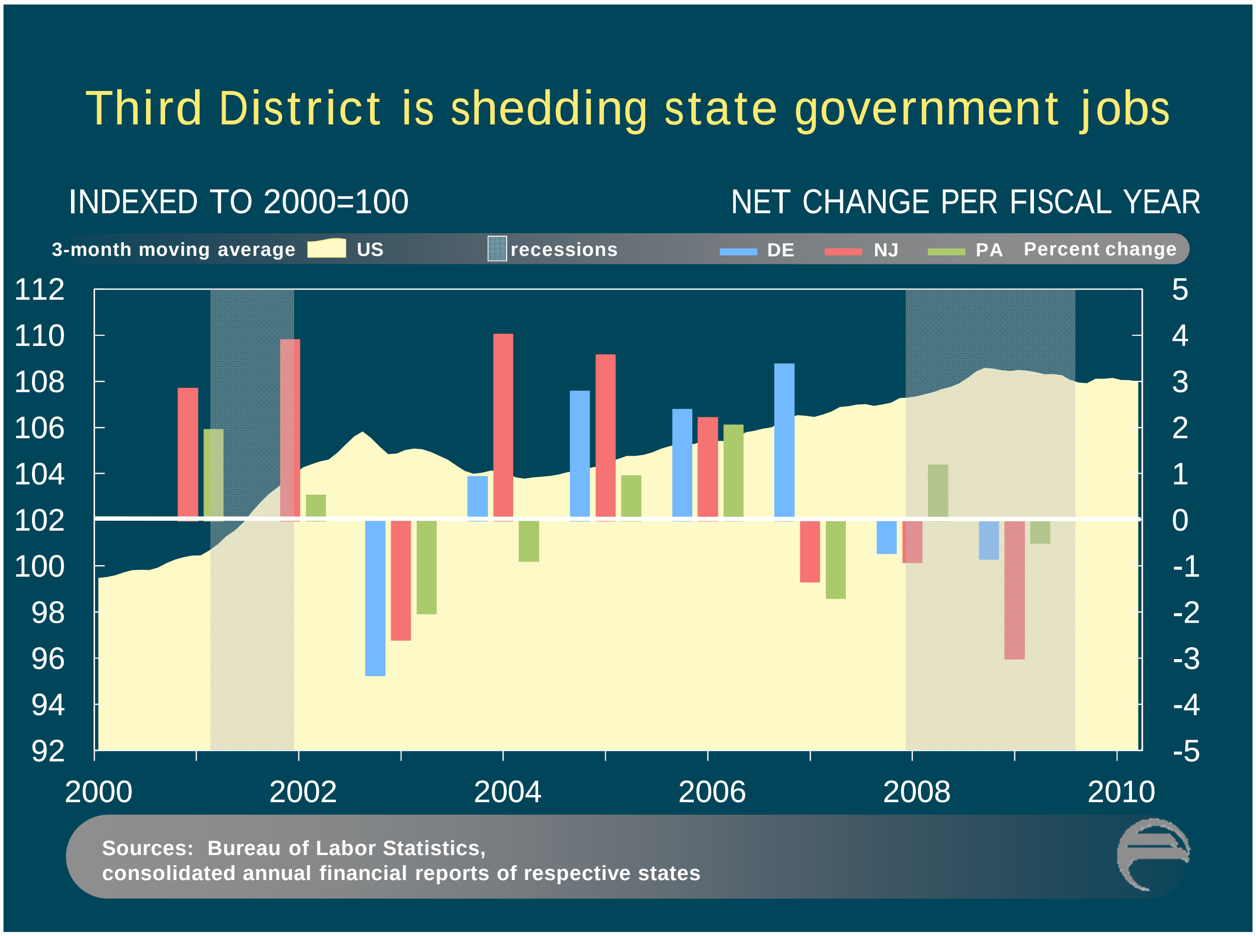
New Jersey's estimated budget gaps are $6.1 billion (19 percent of expenditures) in FY 2009, $11.0 billion (37 percent) in FY 2010, and $10.0 billion (34 percent) in FY 2011 (projected). The scale of New Jersey's deficits is attributable to large revenue declines (e.g., $3.5 billion from FY 2009's adopted budget) and to persistent use of nonrecurring revenues or deferrals in prior budgets.

Prior to FY 2002, New Jersey regularly tapped surplus pension assets during rising stock markets to pay its annual pension fund contribution. From FY 2002 to FY 2006, New Jersey deferred $4.5 billion of pension contributions; securitized $4.7 billion of tobacco settlement money, cigarette taxes, and motor vehicle revenues; and diverted $1.6 billion from the unemployment insurance fund. Now, unable to bear the burden from rising unemployment benefits, New Jersey has begun borrowing from the federal

[6] See State of Delaware, 2008, pp. 22-23.

unemployment account.[7] Loans totaled $1.7 billion as of May 27, 2010.[8] State employers will likely see the federal unemployment insurance surcharge increase.

New Jersey has provided significant state aid to offset local property taxes, although this aid is proportionally less than Delaware's direct expenditures on local services. For FY 2011, New Jersey plans less state aid to school districts and municipalities, potentially encouraging local fiscal discipline or generating local fiscal problems as in Pennsylvania. New Jersey will realize revenue gains by a one-off strategy that shifts most of the year's property tax relief forward a year, gains partly offset by not renewing the one-year hike in the top marginal tax rate. New Jersey also plans reductions in funded state positions for the fifth consecutive year (FY 2007 through FY 2011).



In balancing the FY 2011 budget, New Jersey appears to rely on $1,033 million in ARRA funds, plus an additional $490.6 million of enhanced federal Medicaid funds, the latter not yet approved by Congress. Proposed pension reforms are not designed to reduce current unfunded liabilities, so the budget defers this year's $3 billion payment. New Jersey retains a small level of general fund reserves but earlier drained its

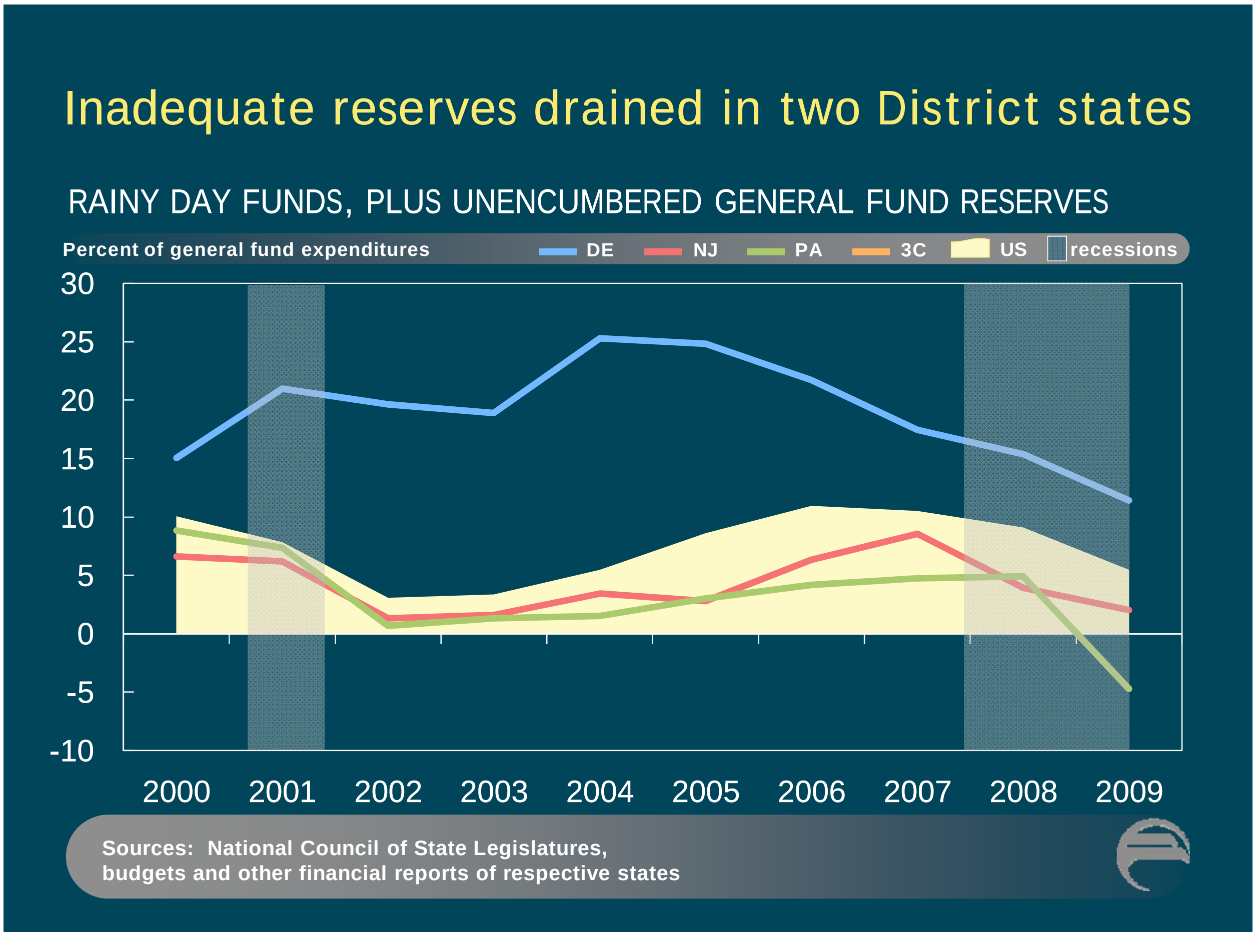
[7] New Jersey began borrowing in March 2009. See State of New Jersey, 2009, p. 96.
[8] U.S. Department of Labor (http://workforcesecurity.doleta.gov/unemploy/budget.asp), accessed June 1, 2010.

rainy day fund of $742 million to balance the FY 2009 budget. In effect, New Jersey will balance its FY 2011 budget in a technical (legal) sense but will fail again to balance its budget from a long-term perspective.

Pennsylvania's State-Local Fiscal Relationships May Mask Greater Problems

On a percent-of-budget basis, Pennsylvania's budget gap is nearly on par with Delaware's. Pennsylvania's estimated budget gaps are $3.2 billion (11 percent of expenditures) in FY 2009, $5.3 billion (20 percent) in FY 2010, and $4.1 billion (15 percent) in FY 2011 (projected). After accounting for federal stimulus aid, Pennsylvania appears less distressed than Delaware, probably because Pennsylvania has been least affected by revenue declines among the three states. However, Pennsylvania is also not fully funding its pensions.

One factor that complicates state fiscal comparisons is the degree to which states carry the burden of certain public services versus pushing costs down to municipalities or school districts. Delaware tends to fund a higher share of some services (e.g., courts, corrections, and public education); New Jersey funds a smaller share. Bearing an even lower share of the burden, Pennsylvania has placed 19 municipalities under state receivership while Harrisburg contemplates bankruptcy.[9]



[9] Act 47, Pennsylvania Municipalities Financial Recovery Act, designates fiscal oversight for distressed municipalities. Philadelphia is treated separately. One small township in Pennsylvania has just emerged from bankruptcy.

Pennsylvania's distress is evident in that it has not only depleted its rainy day fund, withdrawing $755 million last fall to help balance the current fiscal year budget, it closed FY 2009 with a negative reserve balance.

Pennsylvania, like New Jersey, has now borrowed $3.0 billion from the federal unemployment account to maintain its share of rising unemployment benefits.[10] Unless repaid or granted an exception, loans may accrue interest after January 2011, and employer surcharges may increase after November 2011.[11]

Pennsylvania's FY 2011 budget proposal is balanced with additional cuts, no new revenues, and a heavy reliance on $2.8 billion of federal stimulus (including the not-yet-authorized Medicaid funding). The budget proposes an array of new revenues to be placed in reserve to address the loss of stimulus aid and ballooning pension liabilities. Included are a broad expansion of services covered by the retail sales tax — while lowering the rate from 6 percent to 4 percent — and a severance tax on the flourishing Marcellus Shale gas industry. Pennsylvania, like New Jersey, faces severe long-term fiscal problems with which it, and its many localities, may expect to struggle for years to come.

Summary

The financial health of states has severely deteriorated — a consequence of the Great Recession — as revenue streams declined and social welfare obligations rose. Among Third District states, Delaware faced the greatest revenue declines due to its somewhat unique revenue portfolio but was most capable of responding because it was not burdened by long-term structural deficits. New Jersey has been shouldering such a large structural deficit that the added revenue declines make a true balanced budget virtually impossible. After projecting a $10 billion deficit, then making numerous difficult choices, the state in its proposed budget still defers a $3 billion pension obligation into the future in order to balance the budget. Revenue declines were smallest for Pennsylvania, but still the state struggled more than Delaware and will struggle further as stimulus funding ends and its long-term pension obligations mount.

This paper presents observations from a first pass through those financial records that were readily available from Third District states. Addressing the issues raised by the states' fiscal problems is increasingly important. The U.S. Government Accountability Office projects (absent significant policy changes) that state and local operating budgets will run perpetual structural deficits even as the economy recovers, unlike in the past when surpluses resumed after cyclically induced deficits ended.[12]

[10] Pennsylvania began borrowing in March 2009. See Commonwealth of Pennsylvania, January 2010, p. 29. U.S. Department of Labor (http://workforcesecurity.doleta.gov/unemploy/budget.asp), accessed June 1, 2010
[11] See the article by Julie M. Whittaker for more information.
[12] See the United States Government Accountability Office report, pp. 2-3.

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