



The Red Ink Tsunami: Why Old Ideas Can't Fix the New Government Perma-Crisis

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State and local governments have faced big budget gaps before. Typically, things get tight for a while, then the economy perks up, tax revenues recover, and deficits are eliminated. Life goes back to normal.

For a variety of reasons, however, today's budget deficits are different. Government at all levels now faces an inescapable reality – the promises of public services exceed our ability to pay for them – and will do so regardless of when the recession ends. The steady increase in the quantity and cost of public services, coupled with the needs of an aging population and public pension costs have produced a long term, structural deficit.

The scale of these deficits and the expected duration of the downturn will require a fundamental, transformational re-alignment of the way that governments choose their tasks, define success and generate the revenue to fund their work.

Even before the crisis took hold, unfunded liabilities for state and local retirees topped \$1.6 trillion. In Illinois alone future taxpayers are on the hook for over \$80 billion for public employee pensions.

Even worse, mandates from Washington are expected to further aggravate state costs. For example, a final health care reform bill will almost surely include an expansion of Medicaid coverage and the recent increases in unemployment insurance are expected to be made permanent.

Reductions in tax revenues will also ratchet up the pain. "The decline in government revenue is unprecedented for any period on record going back to 1952," according to Robert Ward, deputy director of the Rockefeller Institute for Government at the State University of New York (Albany). In the first quarter of 2009, Ward said revenue dropped 11.7% from a year earlier, the most on record.

In cities this deficit is compounded as asset values declined and many middle class jobs disappeared. The recent news about the last decade's economic stagnation stands in sharp contrast to the growth of government serving as a harbinger for permanent deficits. According to Paul Krugman "It was a decade with basically zero job creation ... And private-sector employment has actually declined — the first decade on record in which that happened ... It was a decade of zero gains for homeowners, even if they bought early: right now housing prices, adjusted for inflation, are roughly back to where they were at the beginning of the decade." Yet despite this state expenditures grew by an inflation-adjusted 34% over the same period of time.

Rainy day funds are depleted. There is no low hanging fruit to be found to patch over these deficits. There are also no more big accounting tricks to stave off the day of reckoning, no way to play kick-the-can down the road for the next administration.

California, like the canary in the coal mine, is a harbinger of the nation's fiscal future. In the past year, it has raised taxes by \$12 billion and received



\$50 billion in stimulus dollars from the Federal government. Yet, this summer the state still had to issue IOU's to its creditors. The latest projections have California staring up out of a \$21 billion hole.

Even worse, the costs from our past threaten our future. The debt service required for retired public employee pensions and health care entitlements must be paid – so where do we get the money for roads, schools, and prisons?

Like it or not, fiscal crisis is the new normal.

Projections are bleak. A December 2009 report from the National Association of State Budget Officers found that “Fiscal conditions significantly deteriorated for states during fiscal 2009, with the trend expected to continue through fiscal 2010 and even into 2011 and 2012.”

At the federal level, the long term projections are even worse. A new report from the Peterson and Pew Foundations found that: “Over the past year alone, the public debt of the United States rose sharply from 41 to 53 percent of gross domestic product (GDP). Under reasonable assumptions, the debt is projected to grow steadily, reaching 85 percent of GDP by 2018, 100 percent by 2022, and 200 percent in 2038. However, before the debt reached such high levels, the United States would almost certainly experience a debt-driven crisis...”

Governments at all levels face a tidal wave of red ink.

The consequences for public budgets and policymakers are immense. The scale of these deficits and the expected duration of the downturn will require a fundamental, transformational re-alignment of the way that governments choose their tasks, define success and generate the revenue to fund their work.

Fortunately, there are new approaches to rethinking the public sector that show promise. But before looking at those, it is important to examine some strategies that have been employed in the past, but which not only won't work today, they will actually be destructive. We need to break out of our old patterns of thinking and break some old habits.

5 Strategies of Yesteryear That Won't Work Today

1. *More Federal Aid:* Federal dollars from the American Recovery and Reinvestment Act (2009 Stimulus) pumped more than \$150 billion to the states. While it avoided short term pain, this aid has been largely counter-productive. By delaying tough choices, federal injections embedded the dysfunctional policies that led to these budgetary and economic crises in the first place.

According to a National Conference of State Legislatures budget report:

“Ironically, a contributing factor to future state budget gaps is the end of federal stimulus funds provided by the American Recovery and Reinvestment Act (ARRA). Those additional funds supported state budgets in FY 2009 and, to an even greater extent, in FY 2010. That money recedes in FY 2011 and, when it is gone, will leave big holes in state budgets – what many state officials are calling the “cliff effect.”

Congress actually aggravated the problem by preventing state and local governments from having to trim their budgets when they needed to. In many cases, federal money was contingent on states taking on more expenses (or spending more) at the very time they should have been on a rigid diet. For example, the ARRA stimulus provisions called for unsustainable extensions of services such as Medicaid.

The entire approach forced on states by Washington defies economic logic. It forces officials into ever deepening budget holes on the assumption that government creates wealth when it creates a public



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job. In effect, a bankrupt federal government is merely borrowing to help bankrupt state and local governments cover their operating expenses. Which brings us to our second failed strategy.

2. More Government Debt: The soundness of our debt-driven approach to financing states has come to an end – whether our leaders are ready to admit it or not. The shocking scale of our national debt (see here) and the threat it poses are becoming increasingly clear, in part due to the alarming data and outreach work by former Comptroller General David Walker. Under reasonable budget and economic assumptions, the federal debt, now at about 40% of GDP could reach 200% of our total annual economy by 2038. Systemic economic meltdown – a currency crisis, for example – would likely occur before lenders allowed debt to reach those astronomical levels.

Additional borrowing that allows states to operate above their means only hastens and exacerbates the day of reckoning.

3. More Taxes: At the state level, California has shown the futility of trying to tax your way out of a spending problem. In February 2009, California passed a historic \$12 billion tax hike. Less than a year later, the state is looking at a brand new \$20 billion budget gap. Business is fleeing the Golden State, where unemployment stands at 12.3%. Governor Schwarzenegger's approval rating is only 27 percent – just about where former Governor Gray Davis stood before he was recalled.

Tax hikes simply won't get governments through this one. Neither the economy nor the electorate will allow for much in the way of tax increases, not after states collectively enacted \$23 billion in tax hikes in 2009. In Indianapolis, where I served as mayor, voters two years ago refused to reelect my otherwise well regarded successor in a taxpayer revolt. Voters

instead chose an unknown and poorly funded but clearly anti-tax increase challenger. Taxpayers in recent gubernatorial elections in Virginia and New Jersey loudly proclaimed the same message.

4. More Delaying Tactics: The time-honored tradition of kicking the can down the road has reached its logical conclusion – we are at the end of the road. The weight of government debt service, unfunded pension obligations, and retiree health care is landing today. More delays will only make things worse.

5. Incremental, stop-gap measures: Hiring freezes. Moratoriums on travel. Across the board cuts. Deferred maintenance for infrastructure. A whole menu of inefficient, counter-productive short term measures won't close the gap either. Even more creative approaches, such as the employee furloughs tried by Atlanta, Utah, and Chicago, which in some cases may actually increase productivity, simply aren't going to be enough. When Atlanta went from a 40-hour work week to a 36 hour, 4-day workweek, city officials noted a boost in productivity and drops in absenteeism—but the city abandoned the program following a property tax increase. Utah started their four day work week during the energy cost spike, but the experience of having most state offices closed on Fridays has been so successful, they haven't switched back. The state's compressed workweek cut energy use 13%. States such as Iowa are considering following suit. There simply aren't enough small ideas to cobble together to fill the big gap between 'what is' and 'what needs to be.'

The Road Out of Crisis

So what's a government to do? How can we move beyond the strategies that have made the mess even worse? What are new ideas that can help shape a truly transformative change?