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## **Bad moves, not economy, behind busted state budgets Governors, legislators failed to act quickly when boom began to fade, analysis finds**

By Paul Overberg

The financial problems racking many state governments this year have less to do with the weak national economy than with the ability of governors and legislators to manage money wisely.

That is the key finding of a USA TODAY analysis of how the 50 states spend, tax and balance their budgets -- or don't.

The National Governors Association says states are suffering their worst economic crisis since World War II. But for many states, the analysis shows, the fault is largely their own.

Some states that have enjoyed handsome growth in tax revenue nonetheless have huge budget shortfalls. At the other extreme, some of the best-managed states suffered sharp declines in tax collections but promptly took painful steps to balance their books.

Utah, Georgia and Delaware are the best financial stewards, according to the USA TODAY analysis of the states' financial performance. The key to their success: restraint. During the economic boom of the late 1990s, these states limited both spending growth and tax cuts. After the economy weakened in early 2001, they acted swiftly and decisively to keep their finances sound.

California, the worst-performing state in the analysis, did the opposite. It approved huge spending increases and tax cuts during the boom. When the economy soured, the state began borrowing money and using accounting gimmicks to avoid its day of reckoning. Today, it continues to spend \$ 1 billion a month more than it takes in.

The budget year ends next Monday in 46 states. All states except Vermont have laws requiring a balanced budget, although many use accounting maneuvers to skirt the requirement.

To make ends meet, some states have removed thousands of low-income adults from Medicaid and reduced benefits for others. Many states have raised college tuition, cigarette taxes and other narrowly targeted fees. Six states have increased sales and income tax rates, and several more might do so this week.

But one thing has remained constant throughout the crisis: State spending keeps growing.

It went up 6.3% for the fiscal year that ended June 30, 2002, and it's on track to rise about 5% in the 12 months that end June 30. The number of people on Medicaid, which pays for health care and nursing homes for the poor, remains at a near-record 40 million. That number is up 30% since 1998, the result of efforts to sign up people who qualify. And despite anecdotal reports of layoffs -- Oregon furloughed 130 state troopers, for example --

state governments have added 74,000 workers (an increase of 1.5%) in the past two years while the private sector has registered a net loss of 2.6 million jobs (a decline of 2.4%).

By almost any measure, state governments have suffered less than businesses and taxpayers during the economic downturn. Even so, nearly every state is struggling to balance its books.

USA TODAY's analysis examined how well states manage their finances -- not the quality of life in those states. For example, a state's decision to spend more money on schools without raising taxes might damage the state's finances, but it could help children learn more. Similarly, a decision to cut highway programs would improve the state's financial performance, but it could aggravate traffic congestion.

In states that manage money well, the benefits to residents are often invisible: service cuts that don't occur, tax increases that aren't needed and borrowing that doesn't have to be repaid by the next generation.

In California, Illinois and other states that have managed money poorly, residents will be paying off added debt for decades. Tax increases and spending cuts will be more severe than they would have been had the states addressed financial difficulties quickly.

"We've slipped out of a tradition of good fiscal management," says Donald Kettl, a political scientist at the University of Wisconsin who studies state finances. "California is an extreme example."

The principles of good financial management at the state level are the same as those for a household: Balance what you spend with what you make, or you're headed for trouble. A state that spends too much or suffers a drop in tax revenue has to raise tax rates, cut spending or borrow.

The longer it delays, the worse the problem gets.

#### Major conclusions

USA TODAY analyzed states' fiscal management by measuring their taxing and spending habits over five years ending June 30, 2002, based on audited financial statements. State bond ratings -- Wall Street's subjective assessment of financial health -- and a ranking by Governing magazine also were considered. State spending was adjusted for inflation and population growth.

#### Key findings:

\* Spending growth during the boom years haunts some states today. State spending was 38% higher in 2002 than in 1997 -- \$ 983 billion vs. \$ 710 billion. That was 18 percentage points higher than inflation and population growth combined during the period. This shows that policy decisions -- not just higher costs and more people -- drove spending to record levels.

Three types of spending fueled the expansion in state budgets: education, health care for the poor and property tax relief in which states reimbursed local governments for lost revenue. For example, a California program to reduce class size in kindergarten through third grade cost \$ 1.7 billion in 2003.

On the other hand, states that were frugal during the boom are generally in the best shape today.

\* The healthiest states avoided big tax cuts during the economic boom. The conservatively managed states of Utah, Georgia and Delaware have cut taxes and fees at half the national average since 1997, USA TODAY found. But tax cuts had mixed effects elsewhere. Hawaii cut taxes, but it also cut spending and is in better shape than it was five years ago. New York, in contrast, slashed tax rates at the same time that it was sharply increasing spending. It is now borrowing and raising taxes.

In addition to spending and tax policy, another critical factor in whether a state has sound finances is its politics:

\* Powerful governors manage money better. States in the best financial shape have governors with broad constitutional powers over spending. Forty-three governors have line-item vetoes, which allow them to reject individual programs within legislation. But governors in the top-ranked states usually have even greater power. Most can cut spending without legislative approval if state revenue isn't keeping pace with projections.

\* Divided government promotes fiscal restraint. States spend more when the same party controls both the legislature and the governor's mansion. States increased spending 6.8% annually from 1997 through 2002 when one party controlled state government, but only 5.9% when control was divided, USA TODAY found. That might seem a small difference, but because of compounding, the effect on a budget can total hundreds of millions of dollars after a few years.

On another front, tax cuts were only half as big when government was divided.

Quick action stops trouble

How do the most fiscally responsible states do it?

"We dealt quickly, openly and aggressively with our budget problems," says Utah Gov. Mike Leavitt, a Republican in his third term. "Over time, the piper has to be paid. Delaying or using smoke-and-mirrors accounting only magnifies the problem."

Utah has made hundreds of small but difficult changes to balance spending and revenue, while keeping a small reserve fund to protect against future problems. Spending cuts included releasing some prisoners early and eliminating such Medicaid benefits as dental and vision coverage for adults and circumcisions for baby boys. Tax increases included expanding the sales tax to cable television.

Utah's budget-balancing was made easier by its cautious behavior during the boom. Spending grew 5 percentage points faster than inflation and population growth from 1997 through 2002, compared with the national average of 18 percentage points.

What also set Utah apart from most other states is that it didn't dawdle. The Legislature began adjusting this year's budget within weeks after the fiscal year began last July.

Other states that acted decisively were Vermont and New Hampshire. Those two increased spending faster than all other states because of court-ordered increases in education spending. But they preserved their financial health by raising taxes to pay for the new spending and by tightly controlling other costs.

How to manage a budget well is no secret. "Deal with the problem early. Avoid accounting chicanery. Have a diversified revenue base. Don't approve expensive programs and bet that an economic boom will pay for them," Kettl says. "That's the key to fiscal health."

A political problem

Ohio Gov. Bob Taft won re-election in a landslide last November.

In January, he proposed a plan to balance the state's budget by raising taxes and trimming spending growth equally. His approval rating immediately plummeted from 66% to 40%. The Republican-controlled Legislature ignored the Republican governor and last week passed a budget that it had crafted itself. The governor is expected to sign the two-year budget, which increases spending 11% and raises taxes a record \$ 3 billion.

Today's financial problems in state governments -- gaps of billions of dollars between what they want to spend and the taxes they take in -- are as much a political crisis as a financial one.

Polls show that voters want what they cannot have: more spending and lower taxes simultaneously. Elected officials who deviate from this view have been punished harshly whether they support spending cuts, tax increases or both.

"Politicians have no cover to make tough decisions," says Eric Rademacher, director of the non-partisan Ohio Poll at the University of Cincinnati. "The message to elected officials is: 'Tackle the budget problem at your own peril.' "

Polls show that voters want to cut state spending in theory, but not in practice. In a USA TODAY/CNN/Gallup Poll, 79% said they preferred spending cuts to tax increases to balance state budgets.

Those who favored spending cuts were asked whether they were willing to cut education funding: 77% said no. On health care funding, 78% said no. Education and health care make up about two-thirds of state spending, so balancing budgets by cutting spending is nearly impossible if those programs are off limits.

Facing an unforgiving electorate, governors and legislators have mostly patched budgets, not repaired them.

"Doing as little as you can seems to be the strategy," says Chris Atkins, director of tax and fiscal policy at the conservative American Legislative Exchange Council.

Since tax collections started to weaken in January 2001, states have drained reserve funds and used gimmicks such as delaying paychecks for a day so the expense will count in the next year's budget. But mostly, states have borrowed unprecedented amounts of money. Last year, a record 10% of state revenue was borrowed.

The National Governors Association says state financial problems are the worst in 60 years. Sales and income tax collections, which account for nearly half of state revenue, fell 4.8% for the fiscal year ended June 30, 2002, according to the Census Bureau. Total revenue rose 1% during that time, according to a USA TODAY analysis of state financial reports. But that was far below the 6.3% spending increase.

In this fiscal year, sales and income tax collections are rising again, up 1.1% in the first six months. In addition, the federal government gave states \$ 10 billion in fiscal 2003 and will give another \$ 10 billion in fiscal 2004 as part of the tax-cut package President Bush signed into law last month. California will get \$ 2.4 billion over two years, Florida almost \$ 1 billion. Even so, many states have continued to rely heavily on borrowing, reserve funds and accounting tactics to balance budgets.

## Mixed-up politics

The public's conflicting demands -- for more spending but no tax increases -- have resulted in a topsy-turvy political world.

Republican governors proposed higher taxes in Arkansas, Connecticut, Georgia and elsewhere, although most were rejected or scaled back by legislatures. Some Democratic governors, who often favor more government spending, are emphasizing spending cuts.

"At some point, you can do permanent damage by continuing to cut," says Idaho Gov. Dirk Kempthorne, a Republican who persuaded his state's Legislature to pass a sales tax increase. "Raising taxes was not my first choice, but it's part of leadership. I'm not going to preside over the dismantling of essential government services."

In contrast, Wisconsin Gov. Jim Doyle, a Democrat, has kept his campaign pledge to balance the budget without raising taxes.

"Democratic governors live in deathly fear of being tarred as big-spending liberals," says Kettl of the University of Wisconsin. "And Republicans are afraid of being seen as the politician who gutted education."

Economic historian Richard Vedder says the public has signaled how much government it wants. State and local spending has accounted for roughly 11% or 12% of gross domestic product for the past 30 years.

"When we get to the top of the range, there's a tax revolt," says Vedder, of Ohio University. "When we get to the bottom, there's a push for more spending. We revert back to the middle."

Last year, state and local spending reached 13% of gross domestic product, the highest since record-keeping began in 1929.

That could indicate that states will now emphasize spending cuts more than tax increases. Or it could represent a fundamental shift in what people expect from state and local governments. Similar changes have occurred twice before: in the Depression and during the 1960s, when new social programs added to state and local spending.

Over the next few years, states will determine whether a new era has begun: Will citizens pay permanently higher taxes in exchange for better-funded public schools and health care? Or will they demand that taxes return to a more comfortable level?

The narrow question is: Tax increases or spending cuts? The broader question is: What do citizens want from government? In the boom, governors and legislatures gave people what they wanted. In the downturn, people will decide whether to pay for it.