Whatever Happened to The Permanent Fiscal Crisis?

In recent months newspapers in many states have reported that state government revenues are soaring and state budgets are back in the black. So is the fiscal crisis over? Were Peter Hutchinson and I exaggerating when, in the subtitle to *The Price of Government,* we declared this fiscal crisis "permanent"?

In a word, no.

Because states rely heavily on income and sales taxes, their revenues have been lifted by the recovery. But they still face depleted reserves, and few have come anywhere near restoring the deep cuts of 2001-2004. Meanwhile, local governments, school districts, and the federal government are all still bleeding.

Our fiscal picture will surely improve as the economy improves, but we will never return to the flush times of the 1990s. We have entered a new reality, driven by the aging of our population and the ever-rising cost of health care. As the Brookings Institution's Isabel Sawhill, coauthor of *Restoring Fiscal Sanity,* put it, we face an impending "Category 6 fiscal hurricane." If recent headlines have made you wonder, consider the following:

- **The National Deficit:** The federal government still admits to roughly $400 billion dollar annual deficits. On top of that, it borrows about $200 billion from the social security Trust Fund every year. So the real operating deficit is in the neighborhood of $600 billion a year. Under status quo spending, the national debt will grow by more than $3 trillion through 2010, to $11.2 trillion — nearly $38,000 for every man, woman and child. The interest alone will cost $561 billion in 2010. All of that means the feds will continue to cut spending for state and local programs.

- **Depleted State Reserves:** At least a dozen states are still struggling. According to NGA's *Fiscal Survey*, "Five states experienced negative expenditure growth in fiscal 2005 and governors' proposed budgets in 10 states reflect the same in fiscal 2006. Additionally, 13 states have experienced expenditure growth of less than 5 percent in fiscal 2005 and 21 states expect the same in 2006." The National Conference of State Legislatures reports that in many states, the economic rebound "is not expected to be enough to relieve health and education funding pressures."

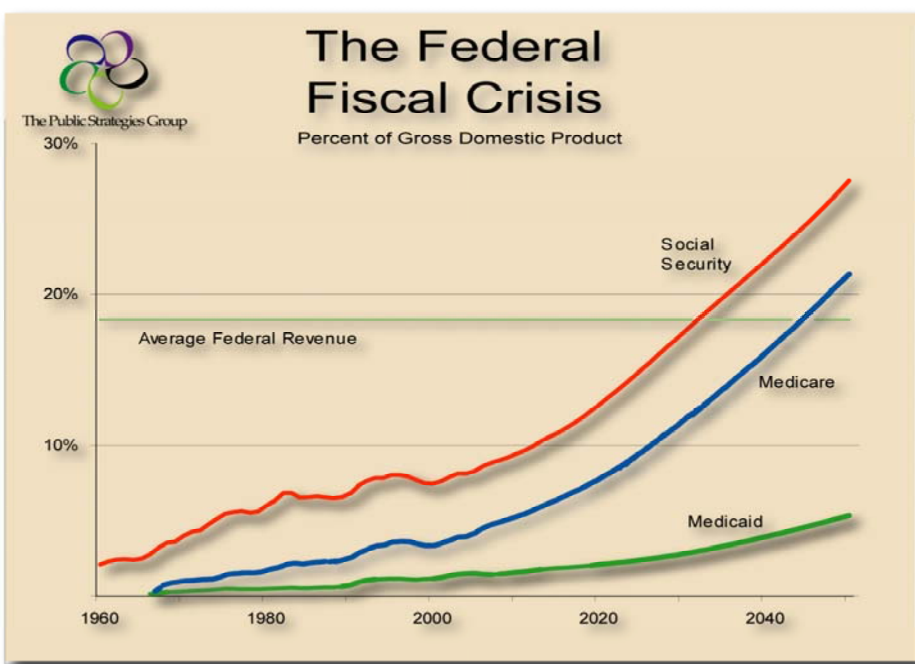
  Meanwhile, most states haven't fully replenished their rainy day funds or restored the deep cuts they made in fiscal years 2001-2004. According to NGA's *Fiscal Survey*, "Total [year-end] balances are declining. Balances totaled $26.9 billion or 5.5 percent of expenditures in fiscal 2004; $23.8 billion or 4.5 percent expenditures in 2005; and $20.5 billion or 3.8 percent of expenditures in fiscal

2006. By comparison, total balances peaked in fiscal 2000 at $48.8 billion, or 10.4 percent of expenditures."

- **Local Government Is Still Hurting:** Local governments rely primarily on property taxes, which are not nearly as volatile as income and sales taxes. So revenues have not bailed the cities, counties, and school districts out as federal and state cuts have left them strapped. The Rockefeller Institute Fiscal Studies Program reported that during the years 2002-2003, "The typical state reduced transfers to local government: 28 states reduced real per capita state aid for elementary and secondary education with a median reduction of 1.1 percent, and 27 reduced real per capita non-education aid with a median reduction of 0.4 percent."

- **Exploding Health Care Costs:** Health care has been rising by 15 percent a year in recent years, with no sign of a slow-up. Health insurance for employees and retirees is gobbling up local and state revenues, while states also stagger under the rising Medicaid burden. Health care now consumes about a third of all state budgets, up from less than 15 percent in 1985.

  The problem is even worse at the federal level, because the feds pay for Medicare, our biggest single budget buster. The Congressional Budget Office projects that within 25 years, if current trends continue, the federal government will be able to afford only four things: Medicare, Medicaid, Social Security, and interest on the debt. As the accompanying graph shows, Medicare is the big villain, because the aging of the population is the greatest cause. By my estimates, we spend 25-30 percent of our health care dollars on the last year of life. The alternative to gutting Medicaid and Medicare: virtually doubling federal income taxes.



- **New GASB Requirements:** Health insurance for retirees will take a huge new bite out of budgets beginning in 2007, when new Government Accounting Standards Board regulations require governments to quantify the health care promises they've made to retirees for the next 30 years. According to *The Wall Street Journal*, “In some states, the numbers are astronomical.

  To cite but one example, Maryland's unfunded liability is $20 billion” – which translates into an additional $1.6 billion in expenses a year. "When I got the number I was in shock," Maryland budget chief Cecilia Januszkiewicz told the *Journal*. "There are a limited number of things we can do."

- **Public Pension Funds and Social Security:** The leading edge of the baby boom generation turns 62 in 2008 and can begin to collect Social Security. As the baby boomers retire, the number of Social Security recipients is expected to grow from 47 million today to 69 million in 2020. The Congressional Budget Office projects that Social Security spending as a share of the U.S. economy will rise 40% by the year 2030. Meanwhile, growing pension obligations are bankrupting state and local governments, just as they are airlines and auto manufacuters.

So what has become of the fiscal crisis? Not much. The pressure is off in a few states, but most of the problems remain. David Walker, the comptroller general of the United States, knows more about our fiscal problems than anyone I know. He understands that as the average life span of Americans creeps into the eighties, “We face a demographic tsunami that will never recede.”