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States' tactic to stem red ink: borrowing

As budget deadlines for 46 states arrive, officials beg, borrow, and repeal to fill gaps.

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OAKLAND, CALIF. - As 46 states turn the calendar to a new budget year, it is becoming clearer that many have put off until next year what they could not - or would not - handle now.

The unprecedented size of state deficits, swollen by dour economic factors unseen since the days after World War II, has played a part. Yet so has a new caution by state legislators, who have proved unwilling to significantly raise taxes for fear of a revolt like the one that launched the 1994 Republican Revolution.

The result is not only heightened gridlock, as an unusually high number of states passed yesterday's deadline with no fiscal plan, but also the rise of a budget tool rarely used in America's statehouses: borrowing.

Using an escape hatch

While the federal government has pushed its debt into the trillions to finance programs and tax cuts, states have historically avoided borrowing - discouraged by tangled rules and balanced-budget requirements. But deficit spending, as well as deferring payments and borrowing against tobacco-settlement funds, have provided an escape hatch for legislators desperate to avoid cutting teachers or raising sales taxes.

The strategy amounts to a stalling tactic, as statehouses hope for an economic turnaround. With no reversal in sight, it poses the risk of simply creating greater challenges in 2004 - and swallowing any future recovery in a tide of interest payments and overdue bills.

"There's been a lot of borrowing - more than we normally see in down times," says Claire Cohen, a state analyst at Fitch Ratings credit agency in New York. "Overall, I don't think that the problem has been faced, and that means the problems will just last longer."

Other people's money

In the past two years, credit agency Standard and Poor's has downgraded the bond ratings for six states, due in part to their increased use of borrowing. Among them, Wisconsin and New Jersey have relied heavily on loans that will be paid back by tobacco-settlement money. Other states, including Oregon and Connecticut, have floated bonds solely to pay off their deficits.

In addition, many states have delayed payments to pensions or shifted expenses from June to July so that it won't appear on the current budget. "States are doing more and more things that amount to borrowing," says Nicholas Johnson, an analyst at the Center on Budget and Policy Priorities in Washington.

To some degree, financial analysts understand that borrowing is necessary. The scale of the problem defies any one solution. While states continue to grow, adding more children to schools and more residents to healthcare rolls, states' incomes have hardly budged for more than two years. The lack of inflation has meant no rise in sales taxes; stagnant wages - combined with a rise in unemployment - have meant no rise in income taxes; and the bountiful capital-gains taxes of the 1990s have evaporated.

"Seven quarters of actual revenue decline is unprecedented," says Robin Prunty of Standard and Poor's in New York. "When it's part of the solution," and not the sole solution, borrowing is acceptable, she adds.

California, however, is fast becoming an example of what happens when avoidance becomes a state's primary political culture. The state was pushed to borrow by the collapse of stock-options and capital-gains taxes, which, in 2001, made up 25 percent of the budget, but have now fallen to 3 percent. Desperate to support a $100 billion budget, California has leaned heavily on loans.

Although California has no new budget in place, more loans will almost certainly be a part of the calculus - even though California has the lowest bond rating of any state, meaning it has to pay high interest. Moreover, with any chance for significant tax or government reform slipping away in partisan budget battles, analysts say California could well be revisiting the bond market next year.

"Usually people come to their senses and don't keep doing it year after year," says David Hitchcock, Standard and Poor's California analyst. "It's not a comfortable situation when the only brake on a state is the concerns of people on Wall Street."

The same economic pressures, however, are tapping more and more states. A study released last week suggested that 19 states are actually planning to lower their spending in 2004. Even in downturns, spending cuts are usually made from estimates of growth, meaning that spending still rises overall.

"It is extremely unusual to have a decrease," says Scott Pattison of the National Association of State Budget Officers, which released the report. "It really demonstrates how difficult this situation is."

As late as this weekend, eight states that were supposed to start their new fiscal year today were still working on this year's budget, according to the Center on Budget Policy Priorities. Usually, "one or two" miss the June 30 deadline, says Arturo Perez of the National Conference of State Legislatures.

The difference is the chronic lack of revenue and lawmakers' hesitancy to raise taxes. Indeed, observers say, politicians' light tread around taxes is a shift in the business of budget-making. "The climate around taxes has changed," says Ray Scheppach of the National Governors Association in Washington. "In 1991, [states] got through by raising taxes. Now you can't do that."

Yet, if there is no recovery soon, states may have to. Already, many are talking of convening special budget sessions in the fall as economic forecasts continue to be revised downward.

"Being finished doesn't mean a lot because the revenues aren't there," says Mr. Scheppach. "A lot of states are going to look at [the budget] in two or three months and need to come back and do more."

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