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**States and the Ever-Deepening Fiscal Hole**

Some are managing fairly well, but a lot of them aren't, and a few are in a place where the math is "very difficult."

BY [CHARLES CHIEPPO](http://www.governing.com/authors/Charles-Chieppo.html) | JUNE 6, 2016

Two years ago, [I wrote about a fascinating study of state indebtedness](http://www.governing.com/blogs/bfc/col-state-debt-liability-j-p-morgan-report.html) published by J.P. Morgan. New rules from the Government Accounting Standards Board that standardize the reporting of liabilities have provided an opportunity to update the report, and the results should be required reading for state officials.

In "The ARC and the Covenants 2.0" (ARC refers to "annual required contribution"), author Michael Cembalest again shows how much each state spends on pension contributions for public workers, other post-employment benefits (OPEB) such as health insurance, and bonds as a percentage of state revenues, and what each state would have to spend to amortize the liability over 30 years assuming a 6 percent return on assets. Pensions and OPEB account for between $1 trillion and $1.5 trillion in overall state liabilities, while bonded indebtedness is about $500 billion.

The good news is that in 36 states it would take less than 15 percent of revenues to amortize liabilities over 30 years; in another 10 it would take between 15 and 25 percent of state revenues. The update finds Hawaii looking much better, going from requiring more than 35 percent to just under 25 percent. Oklahoma already contributes almost all that's needed to retire its liabilities.

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But four states are above the 25 percent mark, in a place where Cembalest says "the math becomes very difficult." Connecticut, Kentucky, Illinois and New Jersey are responsible for about 20 percent of the nation's total municipal-bond obligations. Each would each require more than 30 percent of revenues to amortize their liabilities over 30 years; Illinois would require nearly 40 percent.

To illustrate just what this level of indebtedness means, Cembalest calculates what would be required if each state were to solve the problem exclusively with additional revenue, spending cuts or increased public-worker pension and retiree health insurance contributions. New Jersey, for example, would either need to increase revenues by 26 percent or cut spending by 24 percent; Connecticut would have to raise worker contributions by 699 percent. (That's not a typo -- nearly 700 percent.)

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Not that there's a lot of capacity on the revenue side. Three of the four states in the worst trouble -- Connecticut, Kentucky and Illinois -- already have effective tax rates that are among the nation's highest. Rarely is there much of a political appetite for tax increases, but it seems particularly unlikely that voters in these states would support higher taxes as a significant piece of any fix.

But the pain is going to have to be felt somewhere. Two of the states in the worst shape, Kentucky and New Jersey, contribute less than half of what would be needed to amortize their liabilities over 30 years. Of the 10 states that would need to contribute between 15 and 25 percent of revenues to amortize liabilities, Texas and South Carolina are also contributing less than half of what they should, placing them in danger of rising above the 25 percent mark in the future.

It's clearly time for leaders in the four states that are in the worst trouble to roll up their sleeves and get about the work of making some very hard decisions. But "The ARC and the Covenants 2.0" is also a cautionary tale for the likes of Texas, South Carolina and the many other states that aren't contributing what they should toward their liabilities. As difficult as it might seem to address the issue now, it's nothing compared to what it will be like if they wait until they're in the same boat as Connecticut, Illinois, Kentucky and New Jersey.

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