Thank you for inviting me and The Council of State Governments (CSG) to participate in your State Affairs and Political Mobilization Annual Meeting. CSG, established in 1933, serves all three branches of state government by fostering the exchange of insights and ideas. While I work for CSG's Southern Office, the Southern Legislative Conference in Atlanta, CSG is headquartered in Lexington, Kentucky with regional offices in California, Illinois, New York and Washington, D.C. I know a number of you are engaged in CSG's national and regional activities and we greatly value your participation.

My presentation this morning will cover five broad areas. Part I highlights key national economic trends and the fiscal position of states while Part II focuses on some of the strategies being deployed by states to balance budgets. Part III identifies several structural flaws in state tax systems that will continue to plague state finances going forward while Part IV explores some of the major expenditure categories looming on the state fiscal horizon. Finally, Part V hones in on some of the "bright sparks" on the state economic landscape that will contribute toward reviving state economies.

Part I: Key National Economic Trends and the Fiscal Position of States

The U.S. economy continues its cautious recovery from the Great Recession, the longest, broadest and most severe downturn since the Great Depression. What was most disconcerting about the Great Recession was that the U.S. economy had to face concurrent crises on multiple fronts: output declines, revenue shortfalls, credit freezes and confidence drops. While any one of these negative developments has the potential to stall the economy, the fact that they all occurred concurrently, in fall 2008, completely destabilized it. It was almost as if Hydra, the multi-headed monster bore down on the U.S. economy.

Even though the recession might have technically ended, the devastation caused by the Great Recession continues and will linger on for a number of years. At the end of October 2011, there were 13.9 million Americans unemployed, a massive number, and until there is a sharp turnaround on this front, overall consumer confidence will remain gloomy. In addition, the number of Americans "under-water" on their mortgages and/or in foreclosure, ongoing political gridlock in Washington, economic turbulence in Europe, political turmoil in the Middle East, volatile oil prices and the series of natural disasters across the globe continue to stymie our economic recovery.

As grim as the current economic situation is, particularly for the millions of unemployed and under-employed Americans, there are a number of signs that the U.S. economy is moving in the right direction. In terms of output, U.S. gross domestic product, GDP, after barely registering growth in 2008 (0.3 percent), plunged into negative territory in 2009 (-3.5 percent) and confirmed that the U.S. economy had fallen into recession. Thankfully, in 2010, GDP grew again by 3 percent and in 2011, this trend continues with the economy expanding by a surprising 2.5 percent in the third quarter of 2011. Yet, the November 2011 forecast from the Federal Reserve indicates a downward revision from earlier in the year: modest GDP growth between 1.6 percent and 1.7 percent in 2011 and between 2.5 percent and 2.9 percent in 2012, just enough to keep the unemployment rate from spiking significantly. The national unemployment rate, after soaring to a high of 10.1 percent in October 2009, the highest rate since April 1983, has started a slow descent (it was 9 percent in October 2011) though it remains stubbornly high. While private-sector jobs have grown by 2.8 million since February 2010, there have been severe cutbacks in government jobs. Between August 2008 and June 2011, state and local governments have shed 510,000 jobs and are expected to slash another 110,000 jobs in the fall of 2011.

The housing sector, one of the primary causes for the disintegration of the economy, continues to struggle but when compared to last year, there is room for optimism based on a review of foreclosure filings, housing starts and building permits. At the end of the third quarter of 2011 (September 2011), foreclosure filings, i.e., default notices, auction sale notices and bank repossessions, increased by less than 1 percent from the previous quarter but decreased by 34 percent compared to the same period in 2010. Housing starts, an important signpost of the housing sector, have risen from the slumps of 2009/2010 and in September 2011, increased by 15 percent over the previous month and by more than 10 percent over September 2010. Building permits in September 2011 were 5.7 percent higher than in September 2010. Nevertheless, the housing sector faces enormous challenges stemming from the weak economy that leads to the high foreclosure rates, under-water mortgages and excess inventory.

The stock market, reflected in the Dow Jones Industrial Average and Standard & Poor's 500, has also recovered substantially from the lows reached in March 2009. In fact, October 2011 represented the largest monthly points gain in the Dow's history and the largest monthly percentage gain since October 2002. Corporate profits, an important reflection of the vitality of our economy, remain in very good shape and for the third quarter of 2011, 73 percent of 413 companies reported earnings above the mean estimate and a blended earnings growth rate of 16.4 percent. This marked the eighth consecutive quarter of double-digit earnings growth. In addition, the Federal Reserve reported that at the end of June 2011, America's largest nonfinancial companies had accumulated a staggering $2 trillion of cash on their balance sheets, the highest level in half a century.

The highly-regarded University of Michigan Surveys of Consumers, after plunging to historic lows in 2008 and 2009, rose in 2010 but has declined somewhat this year. Given the fact that about 70 percent of the U.S. economy is driven by consumer spending, consumer confidence remains critical for the recovery of the U.S. economy. While the Sentiment

Index rose – marginally – in October 2011 compared to the prior month, it is lower than the level a year ago in October 2010.

Data and forecasts from UPS, FedEx and the Fibre Box Association offer useful hints on the trajectory of the economy. At any given moment, UPS is transporting 2 percent of world GDP and 6 percent of U.S. GDP so UPS shipping data is considered a good barometer of the economy. In late October, UPS officials indicated that they are “starting to see better economic numbers” and expressed “optimism.” UPS expects to handle 120 million packages globally in the 10 days before Christmas, an increase of more than 6 percent from the 113 million packages it delivered at the same time in 2010. FedEx forecasts handling 17 million packages on its busiest day, December 12, an increase of more than 10 percent compared to its busiest day last year.

Similarly, corrugated box shipments have long been viewed as a leading economic indicator given that virtually all manufactured products—from raw materials to finished goods—are put in a box for delivery at some point. Data from the Fibre Box Association, the trade association for the nation’s box manufacturers, documents that for the first 9 months of 2011, box shipments had exceeded levels reached for the entire year in 2009 and 2010.

In sum, while there are multiple positive developments related to the U.S. economy compared to the last few years, there are many obstacles ahead too. As Chairman Bernanke noted 10 days ago, "the pace of [the economy's] progress is likely to be frustratingly slow."

State Fiscal Picture

Even before the extreme economic turbulence in 2008 and 2009, states were looking at a very depressed financial picture. Then, the Great Recession brought on the largest state budget shortfalls on record and between fiscal years 2009 and 2013, states have either closed or will close an estimated $580 billion in shortfalls. Fiscal year 2010 was particularly torrid with states slashing $191 billion from their budgets. While the state revenue picture has improved, the latest report from the Rockefeller Institute—second quarter of 2011—indicates that revenues were still slightly lower than in the same period four years earlier. For instance, state revenues in the current fiscal year, 2012, are expected to crest at $656 billion, considerably lower than the $680 billion reached in fiscal year 2008, the last year before the Great Recession.

State tax revenues grew by 10.8 percent in the second quarter of 2011, the sixth consecutive quarter that states reported growth in collections on a year-over-year basis. In fact, every state but New Hampshire, recorded an increase in overall tax collections in this period. While the slowing national economy in the first half of the year resulted in less robust revenue gains for states, it was still an improvement over the same period in 2010. Going forward, state revenues are not expected to rise significantly given the assorted headwinds sweeping down on the national economy. In fact, in the current fiscal year, states are estimated to face a shortfall of at least $103 billion.

In the past few years, while state revenues plunged to unprecedented levels, simultaneously, the demand for such safety net services such as Medicaid and unemployment insurance skyrocketed. In 2012, some 5.6 million more people are projected to be eligible for subsidized health insurance through Medicaid than were enrolled in 2008. In the current 2011-12 school year, the U.S. Department of Education projects that there will be about 260,000 more K-12 students and another 1.5 million more public college and university students than in 2007-08. In sum, state budgets continue to feel pressure from the triple forces of rising costs (Medicaid, unemployment insurance, education), relatively anemic revenue flows (still below fiscal year 2008 levels) and diminishing federal aid ($135 billion received in federal stimulus monies in past three years).

A review of spending levels in fiscal years 2008 and 2012 demonstrate how the Great Recession has fundamentally altered the relationship between state governments and citizens. In fact, state expenditures during this 5-year period declined by an average of 3 percent with 31 states experiencing a percentage decline and 19 states experiencing an increase. Of the 31 states that experienced a decline, 14 experienced double-digit declines. Therefore, the Great Recession has forced states to enact a Great Transformation, a fundamental shift in the relationship between state governments and citizens brought on by the drastic reduction in the size of government. Despite larger state populations and higher levels of need for services between fiscal years 2008 and 2012, state spending has declined.

The perilous condition of state economies is further highlighted in a quick review of key economic data. For instance, state unemployment rates have soared to heights not seen in decades. According to the latest unemployment data (September 2011), there were 10 states with double-digit unemployment rates led by Nevada (13.4 percent) and California (11.9 percent). Another disturbing statistic, the fact that states like Florida, Georgia and North Carolina—states that ranked among the fastest-growing in the country for years—all have double-digit unemployment rates now. Foreclosures are another crippling drag on many state economies and according to October 2011 *Realty Trac* information, the filings in a number of states—Nevada, California, Arizona, Florida and Michigan—are the top five in the country. Now, while there have been improvements in both these indices compared to 2010 and certainly 2009, there is substantial room for improvement. Furthermore, a study on poverty released earlier this month documented that after declining in the 1990s, the population in extreme-poverty neighborhoods—where at least 40 percent of individuals live below the poverty line—rose by one-third between 2000 and 2009. Concentrated poverty nearly doubled in Midwestern metro areas and rose by one-third in Southern metro areas during this period.

Part II: Strategies Being Deployed By States to Balance Budgets

Given the constitutional requirement in 49 of the 50 states to balance their budgets, states have adopted a number of strategies to meet this condition. Prior to describing some of these strategies, it is important to mention that raising taxes continues to be a politically radioactive move, an option policymakers at every level are loath to pursue. Policymakers would rather adopt any other approach to balance their budgets.

1. Slashing Spending

As indicated earlier, states have enacted significant spending reductions to meet their balanced budget requirements. Since the onset of the recession and through the end of fiscal year 2011, 31 states have reduced healthcare spending; 29 states have slashed programs for the elderly and disabled; 34 states have reduced K-12 education spending; 43 states have cut aid to colleges and universities; and 44 states have shrunk their workforces.

2. Tapping 'Rainy Day' Funds

States have aggressively tapped their rainy day funds to balance budgets. In the aftermath of the 2001 recession, most states worked proactively to build up their rainy day funds and by fiscal year 2006, cumulatively they amounted to $69 billion or 11.5 percent of general fund expenditures. By fiscal year 2011, the cumulative total had dwindled to $31.9 billion or 4.9 percent of general fund expenditures. In fiscal year 2012, 18 states had zero balances in their rainy day funds.

3. Expanding Gaming

After a rough couple of years, state and local gaming revenues increased by 2 percent in fiscal year 2010, the most recent year available, but were still half a percent lower than collections in fiscal year 2008. The modest comeback was fueled in part by the gaming expansion in at least 10 states in the aftermath of the recession. The expansion efforts continue and Florida has proposed establishing the world's biggest casino in Miami; New Jersey wants to legalize sports betting; New York City's first casino opened in Queens; Massachusetts' Senate approved three resort-style casinos and a slots parlor; the Georgia Lottery Corporation conducted a feasibility study to introduce casinos in the state; and, Illinois lawmakers proposed slot machines at Chicago's two main airports.

4. Increasing Borrowing

According to a May 2011 report from Moody's, net tax-supported state debt increased by 8.5 percent from $460 billion in 2009 to $499 billion in 2010. While there were a number of factors accounting for this sharp increase, the low interest rate environment was one of them. Of note, median net tax-supported debt on a per capita basis in the U.S. increased from $936 in 2009 to $1,066 in 2010, or 14 percent.

5. Raiding State Funds

Cobbling together one-time pots of money for the general fund by raiding an assortment of trust funds scattered across state government has been popular in balancing state budgets. Governor Scott in Florida approved a $150 million raid on the state's transportation trust fund. Governor Abercrombie in Hawaii authorized a $42 million raid on the state's hurricane fund. In Washington, the Legislature proposed tapping a state fund that provides low-interest loans to local governments. In Louisiana, Governor Jindal proposed diverting a portion of the state's tobacco settlement fund to pay for the state's college scholarship program. Georgia (and another 10 states) re-allocated monies from their Nine One One funds to cover general budget shortfalls.

6. Raising Taxes and Fees

Despite its extreme political toxicity, policymakers were forced to raise taxes and fees in recent years given their dire revenue position. For fiscal year 2012, the current fiscal year, governors' budget proposals recommended tax and fee changes that will increase general fund revenues by a cumulative $13.8 billion. Twelve states recommended net increases (including California, Connecticut and Minnesota) while 12 states proposed net decreases (including Florida, Michigan and New Jersey). States have also raised cigarette taxes aggressively and since 2002, 47 states have increased their cigarette tax rates more than 105 times. For the current fiscal year, states proposed a total of $1.3 billion in an assortment of fee increases.

Part III: Structural Flaws in State Tax Systems

While the adverse effects of the Great Recession remain very severe, the unfortunate conclusion is that even when the economy begins to tick more robustly, states will continue to face significant challenges on account of structural flaws in their tax systems. These structural flaws currently pose, and will continue to pose, even more serious fiscal challenges in the future. There are three aspects to this conundrum:

1. Role of Services in the Economy

Over the past few decades, the role played by services in the economy has grown tremendously. The service sector is critically important because in 2009, services accounted for 79.6 percent of U.S. private-sector GDP, or $9.81 trillion, along with more than 80 percent of U.S. private-sector employment, or 89.7 million jobs. Yet, the sales taxes in most states do not cover a wide range of services.

When state sales taxes were first introduced some 75 years ago, the service sector occupied a miniscule share of the overall economy with manufacturing and agriculture holding sway. The following examples drive home this point. In 1955, the top company on the Fortune 500 list was General Motors, a manufacturing company; some 56 years later in 2011, the top company on this list was Wal-Mart, a service company. The next example involves IBM, a storied American company, ranked 18th on the 2011 Fortune 500 list. In the 1990s, Big Blue made the tough decision to move away from computer hardware to software and technology services with a heavy focus on R & D (spending $24 billion in 2010) and innovation. Consequently, the company filed more than 18,000 patents last year – more than any other company in the world – and generated $100 billion in sales in 2010, an example of IBM's success focusing on services.

However, despite this rapid movement towards a service-driven economy, the traditional state sales tax is applied to an increasingly shrinking proportion of economic activity. In other words, states currently have 20th century tax systems in a 21st century economy.

According to the latest Federation of Tax Administrators report, there are 168 different services taxed in the states across eight broad categories. Only Hawaii, New Mexico and Washington have broad-based sales taxes that include a bulk of the services (160 and 158, respectively) while South Dakota (146), Delaware (143) and West Virginia (105) also have tax systems that cover most services. Beyond these 6 states that tax more than 100 services, 19 states tax between 50 and 100 services and 25 states tax fewer than 50 services. Utility services are taxed in most all states while admissions and repair services are taxed in many states. On the other hand, fewer states tax personal and business services. Professional services (doctors, lawyers, accountants, engineers) are taxed in only 7 states. Recently, in order to update their tax systems and account for the structural transformation in the economy, a number of states have proposed broadening the sales tax to include services and mitigate the long-term decline of sales tax revenues. In most of these instances, this effort has involved lowering the tax rate and then broadening the base of services captured by the sales tax. Maine, North Carolina, Kentucky, California, Pennsylvania and Michigan are some of those states.

2. Role of e-Commerce in the Contemporary Economy

The explosive growth in e-Commerce transactions has profound impacts on many aspects of the contemporary economy. U.S. retail e-

Commerce sales exploded from a mere $8.3 billion in the first quarter of 2001 to an estimated $47.5 billion, in the second quarter of 2011, a remarkable increase. Of note, the share of e-Commerce sales as a percent of total sales has also risen steadily: from 1.1 percent in the first quarter of 2001 to 4.6 percent in the second quarter of 2011. Yet, due to U.S. Supreme Court rulings and federal inaction, state and local governments continue to lose sales and use tax revenues because of their inability to collect taxes that are due.

Recent research by the University of Tennessee indicates that states and local governments lost and continue to lose billions of dollars as a result of this restriction. Specifically, for the six-year period 2007 to 2012, the University of Tennessee study estimates that total state and local sales and use tax revenue losses from e-Commerce sales amount to an immense $56.4 billion. In 2012 alone, the aggregate losses are estimated to be around $12.6 billion. The nation's larger states, California ($9.4 billion), Texas and New York ($4.3 billion) and Florida ($4 billion) all have sizable actual numbers but other states, Louisiana (6.6 percent), Illinois (6.2 percent) and Nevada (5.6 percent), are estimated to have the highest revenue losses in 2012 as a percent of their 2007 sales and use tax collections.

3. Role of an Increasing Number of Sales Tax Exemptions

Given their dire fiscal positions, states across the country have initiated measures to first review and then consider eliminating some of the multitude of sales tax exemptions embedded in state tax codes. While the presence of these sales tax exemptions underscores the influence of special interests, even a partial repeal could result in hundreds of millions of dollars in new revenue for the states.

In sum, these important, fundamental shifts in the structure of our economy are affecting state fiscal systems and transforming them radically, a development that demands the attention of both state policymakers and citizens in figuring out what kind of state government services they want and whether they want to create adequate revenue streams to finance these state government operations.

Part IV: Looming Expenditure Categories

My presentation so far assessed the fiscal position of states and provided some details on the structural flaws that will continue to erode state finances even when the national economic recovery is more pronounced. Unfortunately, there is more grim news. What makes the state fiscal outlook quite daunting is that the current revenue shortfalls and huge budget gaps masks a number of enormous fiscal challenges looming in such areas as healthcare, education, public pensions, emergency management, infrastructure, transportation and unemployment insurance. While some states have addressed some of these challenges, all states will have to devise solutions in a more comprehensive manner. If I may briefly touch on three of these expenditure categories:

1. Public Pensions

This is an area I have done an extensive amount of research and it is quite apparent that our entire retirement architecture faces significant challenges. Every element of our retirement architecture—Social Security and Medicare; Corporate Pension Plans; Public Pension Plans; Personal Savings—all face unenviable choices. In terms of public pension plans, in 2010, the Pew Center on the States documented that there is a $1 trillion gap between what states have promised their current and retired workers in pension, health care and other retirement benefits and what they have on hand to pay for them. In response, states have and continue to enact a number of reforms to lower their unfunded liabilities.

2. Infrastructure

For some years now, experts, particularly those with the American Society of Civil Engineers (ASCE), have been emphasizing that policymakers at all levels of government need to urgently devote resources and attention to upgrade the nation's crumbling and aging infrastructure network. The 2009 ASCE report noted that America's infrastructure rates a cumulative grade of D and estimated that $2.2 trillion needs to be invested over five years to improve the nation's infrastructure.

3. Unemployment Insurance

As a result of the severity of the Great Recession, the doggedly high unemployment rates in so many states and the actions taken by states (such as expanding benefits and cutting taxes), the UI funds in a majority of the states are in perilous shape. The funds are being attacked at both ends: more people are tapping benefits while a fewer number of companies are paying taxes to replenish the funds. As of last week, 36 states owed a total of $37.3 billion to the federal government.

Part V: Bright Sparks on the State Economic Landscape

In the midst of all this gloom and doom, both in terms of the national economy and in terms of state finances, there are a number of encouraging economic development projects active in the states. An interesting development I have picked up recently is that while states are not announcing projects that will result in thousands of jobs, they are publicizing projects that involve small-to-medium sized companies that will employ hundreds of workers. In sum, there are many economic development success stories taking place across the nation. This is a strong reflection of the resiliency and vibrancy of the American economy and the astounding ability of the disparate elements within the U.S. economy to innovate, invent and improvise a way out of dire economic times. It is also evidence of the entrepreneurialism that has always been at the core of America, think Benjamin Franklin, Alexander Graham Bell and Henry Ford, in prior centuries and Sergey Brin, Andy Grove and Steve Jobs in the current era. Here is a fraction of the bright sparks and promising economic development projects from across the country:

- Solar
    - Tennessee has emerged as a dominant player in the solar industry and Hemlock Semiconductor and Wacker Chemie, the world's leading producers of polycrystalline silicon, have invested a total of $2.2 billion in the state recently. They join other solar-related

companies in the state including Sharp, AGC Flat Glass and Shoals Technologies.

- Wind
    - In Oregon, GE Energy will supply wind turbines to the nation's largest wind farm, a $2 billion project.
- Bio Tech
    - In Kannapolis, North Carolina, at the site of the former Pillowtex factory which closed down after 100 years of operation in 2003, the N.C. Research Campus (NCRC), a $1.5 billion private-public venture sprang up designed to further knowledge in biotechnology, nutrition, agriculture, and healthcare.
- Auto Industry
    - The "drive to move South," i.e., the location of a dozen or so foreign automobile manufacturers and an array of parts suppliers in many Southern states remains a major economic boost not only for the individual state economies but also the regional and U.S. economies.
- Aviation
    - At its operations in Westfield, Massachusetts, Gulfstream Aerospace is building a new maintenance hangar to build the new G650 luxury

business jet, an expansion project that will increase the number of employees at the facility to 230 full-time positions from 100.

- Exports
  - U.S. exports totaled nearly $722 billion during the January-through-June period of 2011, up 18 percent from the same period in 2010. The top four exports during this period were transportation equipment, chemicals, computer and electronic products and machinery. All this export activity has resulted in generating a tremendous amount of business at the nation's ports.
- Other
  - There are a number of additional companies that are experiencing promising growth prospects such as the Charlotte, North Carolina-based Celgard, a supplier of lithium-ion batteries used in electric vehicles that will add another 250 manufacturing and engineering jobs at its facility bringing total employment at the location to 600.

Conclusion

In closing, as foreboding as the severity of the Great Recession has been on both the national and state economies, there is a glimmer of optimism that we are moving in the right direction. Undoubtedly, there is more anguish on the horizon given the depths to which the economy plunged, particularly for those facing foreclosure and those still unemployed and underemployed. Policymakers at every level of government must remain vigilant to ensure that the ongoing recovery evolves into a self-sustaining expansion. At the state level, policymakers have to heed the structural flaws corroding contemporary state fiscal systems and devise adequate responses based on what programs citizens expect from their state governments and how they are going to pay for them. Redirecting the energies of our economy — beginning at the local and state levels along with engaging the federal government and the private sectors as partners — will eventually generate broad-based, sustained economic growth in all sectors of the country. Thank you for your attention.