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PLATTE CHAT

The Coming Reset in State Government

We found the following editorial, written by Indiana Gov. Mitch Daniels, in the Sept. 4 Wall Street Journal exceptional and wanted to pass it along to our followers. You may click [HERE](#) to read the editorial on the Wall Street Journal Website or you may read it below:

By Mitch Daniels

State government finances are a wreck. The drop in tax receipts is the worst in a half century. Fewer than 10 states ended the last fiscal year with significant reserves, and three-fourths have deficits exceeding 10% of their budgets. Only an emergency infusion of printed federal funny money is keeping most state boats afloat right now.

Most governors I've talked to are so busy bailing that they haven't checked the long-range forecast. What the radar tells me is that we ain't seen nothin' yet. What we are being hit by isn't a tropical storm that will come and go, with sunshine soon to follow. It's much more likely that we're facing a near permanent reduction in state tax revenues that will require us to reduce the size and scope of our state governments. And the time to prepare for this new reality is already at hand.

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The coming state government reset will be particularly wrenching after the happy binge that preceded this recession. During the last decade, states increased their spending by an average of 6% per year, gusting to 8% during 2007-08. Much of the government institutions built up in those years will now have to be dismantled.

For now, my state's situation is far better than most, but it won't stay that way if we fail to act in Indiana. At present, we are meeting our obligations, without raising taxes, and still have over \$1 billion in reserve. But the dominant reality is that even assuming the official revenue projections are accurate (and they have been consistently too rosy for the past two years), the state of Indiana will have fewer dollars to work with in 2011 than it did in 2007. Most other states face similar or worse prospects.

And, unlike the aftermath of past recessions, odds are that revenues will take a long time to catch back up to their previous trend lines—if they ever do. Tax payments have fallen so far that it would require a rousing economic rally to restore them. This at a time when the Obama administration's policies on taxes, spending and more seem designed to produce the opposite result. From 1930 to 2008, our national average annual real GDP growth rate was 3.49%. After crunching the numbers, my team has estimated that it would take GDP growth of at least twice the historical average to return state tax revenues to their previous long-term trend line by 2012.

I doubt even that would suffice to rescue most states. Instead, historical forecasting models need to be revised. One-third of state revenues (over half in seven states) come from sales taxes, but it's hard to imagine them snapping all the way back up to where they were just a few years ago. Americans are now saving much more than they used to relative to how much they are spending. This sudden shift will mean that even in good economic times to come consumers will likely spend less and therefore pay less in sales taxes than they did during bubble years.

Even if Americans wanted to go back to their high-spending, high-borrowing ways, will anyone lend them the funds to spend like it's 2007 all over again? Consumer credit will remain tighter as a matter of both

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sound business practice and new government regulation. Home equity appreciation is gone as a huge source of collateral, even if lenders were either willing or permitted to loan freely against it.

The "progressive" states that built their enormous public burdens by soaking the wealthy will hit the wall first and hardest. California, which extracts more than half its income taxes from a fraction of 1% of its citizens, is extreme but hardly alone in its overreliance on a few, highly mobile taxpayers. Both individuals and businesses are fleeing soak-the-rich states already. Those who remain in high-tax states will be making few if any capital gains tax payments in the years to come. Even if the stock market comes roaring back to life, the best it could do is speed the deduction of recent losses.

Sadly, the political impulse to protect government largess leads many states to aggravate their dilemma. Already more than half have raised taxes, often on businesses, serving only to chase them and their tax payments away and into the open arms of states like Indiana. Our traffic flow of interested investors is as heavy as it was in 2007. Since January we have welcomed the consolidation of more than 30 firms that closed up shop elsewhere and chose us as the low-cost, enterprise-friendly environment among their current locations.

Indiana was near bankruptcy five years ago but is relatively solvent today because we have spent the intervening years making hard choices. We have reformed state procurement, contracted out some jobs, cut costs, and relentlessly scrutinized expenditures in pushing for annual improvement in departments large and small. We've also reduced the number of state employees by some 5,000 from the 2004 level.

In contrast to the national pattern, our per capita state spending has cut, on average, 1.4% each of the past five years. Indiana is now the sixth thriftiest state by this measure. And if we Hoosiers are realizing that we need to re-examine what we can afford to have our government do, what must they be thinking in Albany, Lansing or Trenton?

Truth be told, officials in those cities are probably not thinking about this at all. But they will because state

governments will soon have to choose between a major downsizing or consigning themselves to permanent decline. Wishing for an improbably huge boom while chasing your own tail through self-destructive taxes won't prove much of a strategy.

Unlike the federal government, states cannot deny reality by borrowing without limit. The Obama administration's "stimulus" package in effect shared the use of Uncle Sam's printing press for two years. But after that money runs out, the states will be back where they were. Even if Congress goes for a second round of stimulus funding, driven by the political panic of bankrupt Democratic governors, it would only postpone the reckoning.

The time to plan and debate is now. This is a test of our adulthood as a democracy. Washington, as long as our Chinese lenders enable it, can practice denial for a while longer. But for states the real world is about to arrive.

—Mr. Daniels, a Republican, is the governor of Indiana.

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