Overview Of The Current State Fiscal Crisis

The Welfare Reform & Beyond Initiative

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A Two-Pronged Crisis

This crisis has roots in two related problems:

- *Bursting bubble* - undoing of unsustainable trends of late 1990s

  exacerbated by

- *Cyclical downturn*

Many Favorable Trends of Late 1990s Now Stalled Or Reversing...

- ***Economy*** - growth in late 1990s consistently was higher than forecasted
- ***Financial markets, capital gains surged*** (27% average annual growth 1994 to 2000, quadrupling)
- ***Consumption soared*** (savings rate plummeted) and sales tax benefited
- ***Medicaid*** growth came to a halt
- ***Welfare windfall -*** caseloads fell, new block grant did not → "surplus" for states

Major Sources Of ***Cyclical*** Risk In Typical State Budget

- **Tax revenue is volatile**, especially PIT, sales tax:
  - Taxes: 55% of state revenue

    Income tax: 37% of taxes

    Sales tax: 32% of taxes

- **Medicaid - far more volatile** than other state spending
  - *Large*: 21% of state all-funds budget, 12% of "own funds"
  - *Economically sensitive*: 1% pt. unemployment rate ↑ could cause \$2.7B spending ↑ (Holahan/Garrett, Urban Inst.)
  - *An entitlement*
  - *Hard to cut* – federal reimbursement; care standards

These are averages - state fiscal structures vary greatly

RECAP: 3 biggest risks - income tax, sales tax, Medicaid

Tax Revenue, Once Booming, Is Now Crashing

% Growth in State Tax Revenue

	Average: FY 1995 to FY 2000	FY 2001	FY 2002
Personal income tax	9.1	7.0	(12.0)
Sales tax	5.7	2.9	0.4
Other taxes	3.8	1.2	(5.8)
Total taxes	6.2	3.8	(6.3)

NOTE: Not adjusted for legislative actions. States cut taxes for every FY from FY 1996 through FY 2000, plus a little for FY 2001
SOURCES: U.S. Bureau of the Census, Rockefeller Institute

Revenue Crash Is Widespread

- Most Recent Quarter -

Percentage Change in State Tax Revenue
April-June 2002 vs. Same Quarter in 2001
Adjusted for Legislation

	Personal Income Tax	Sales Tax	Corporate Income Tax	Total Taxes
Far West	(37.4)	(0.8)	0.6	(21.9)
New England	(26.9)	2.7	(9.8)	(15.7)
Mid Atlantic	(21.8)	0.7	(41.1)	(14.8)
United States	(22.7)	0.1	(15.1)	(11.8)
Plains	(13.1)	(1.9)	(13.2)	(9.4)
Rocky Mountain	(14.8)	(0.8)	(26.6)	(8.8)
Great Lakes	(11.6)	(0.1)	(9.9)	(6.3)
Southwest	(11.2)	(2.3)	(20.7)	(6.2)
Southeast	(12.4)	2.1	(9.2)	(4.6)

Source: Rockefeller Institute of Government

Medicaid Cost Pressures

- FY 2001: overall growth accelerated to 10.9%; exceeded budget in 31 states
- FY 2002: estimated growth of 13%; 36 states exceeded original budget
- Growth surge driven by:
  - increases in prescription drug costs (now approximating 20% annually)
  - enrollment increases
  - increasing costs of long-term care

SOURCES: Kaiser Commission/HMA survey, NCSL

Problems Large and Widespread

- FY 2002 budget gaps in 43 states, FY 2003 gaps in 40+
- Aggregate FY 2003 gap was at least $57 billion
- 14 states had FY 2003 gaps of 10% or more of budget

SOURCE: NCSL

State Responses

- **Fund balances:** drawn down in 42 states in 2002 - from $32 billion to $18 billion; further declines in 2003
- **Special funds:** At least 23 states tapped capital, highway, other funds; 16+ used tobacco settlement money
- **Spending cuts:** At least 26 states cut 2003 spending plans: higher education (16 states), corrections (14), and Medicaid (12) – with Medicaid cost containment planned in many states
- **Tax increases:**
  - >= 1% in 16+ states, for $6.7 billion, 40% of $ was cigarette taxes
  - a few large broad-based tax increases – KS, IN, MA, NJ, TN – but these were exceptions, not the rule

CAUTION: tax and spending changes not always as large as they sound

States rolled problems forward: "Solutions" in many states include actions that postpone significant part of problem to the future, or that exacerbate future problems

Source: mostly NCSL

Outlook: Unattractive

<u>Short term: BIG problems in FY 2003, 2004</u>

- Economy, stock markets weaker than expected
- Tax collections deteriorating further, some shortfalls already
- Medicaid projections may be too optimistic: appropriations assume only 4.8% growth! (Kaiser/HMA Survey)
- FY 2003 “solutions” pushed problems into post-election 2004

<u>Mid term: continuing pressure</u>

- PIT: huge loss of income in top brackets means slower growth than in late 1990s (absent miraculous market recoveries)
- Sales tax - 3 negatives: (1) slower consumer spending growth, (2) continuing shift to consumption of lightly taxed services, (3) difficulty collecting tax on Internet/mail order sales
- Accelerating spending pressures in Medicaid (9+% growth), continued pressure on K-12 and higher education spending

CONCLUSION: Several years of hard choices!