

The Fiscal State of the States

National Federation of Municipal Analysts

Chicago, IL
April 30, 2003

Donald J. Boyd, Director of Fiscal Studies

Nelson A. Rockefeller Institute of Government
Richard P. Nathan, Director

boydd@rockinst.org • 518-443-5284

www.StateAndLocalGateway.rockinst.org



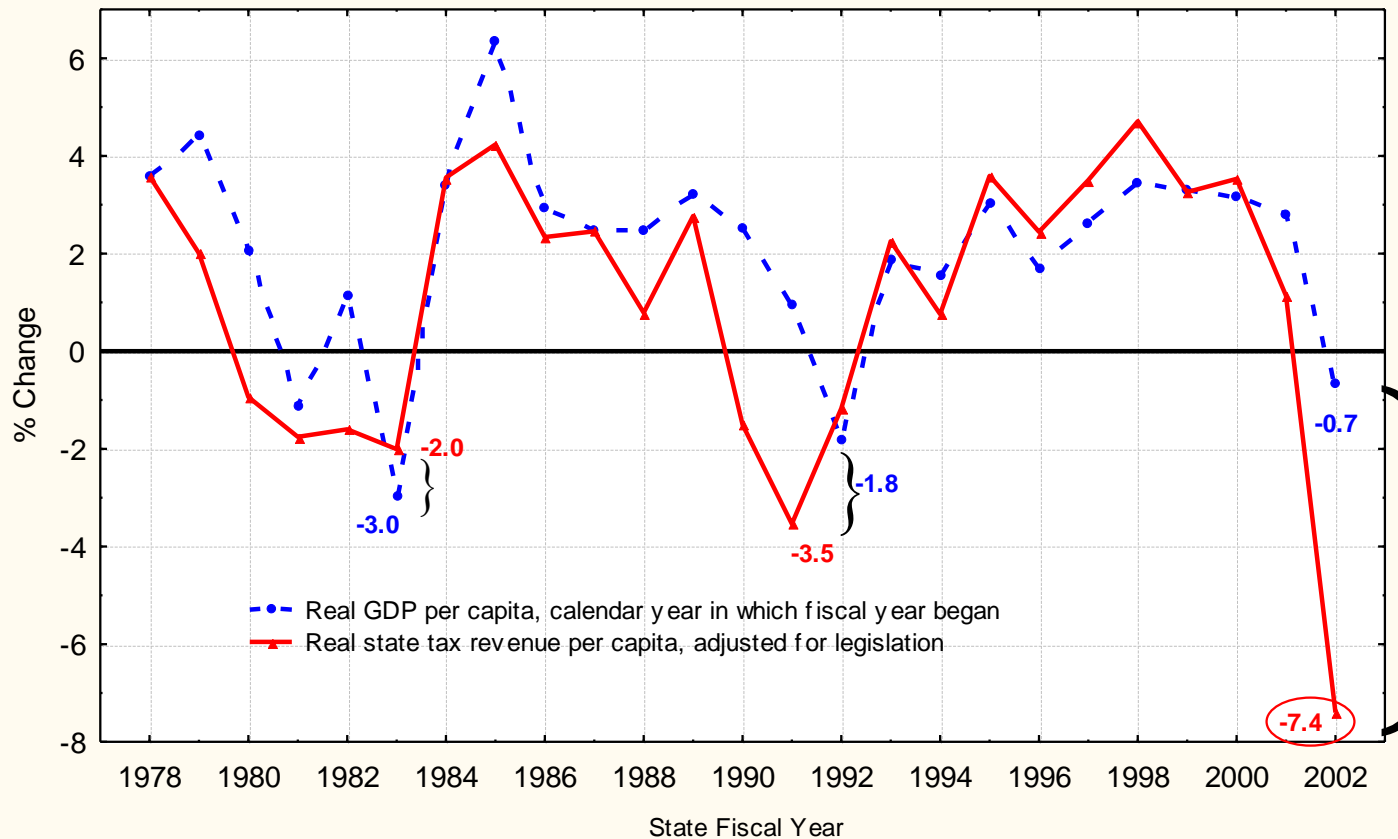
A Two-Pronged Crisis

This crisis has roots in two related problems:

- *Bursting bubble* - undoing of unsustainable trends of late 1990s
coupled with
- *Cyclical downturn*

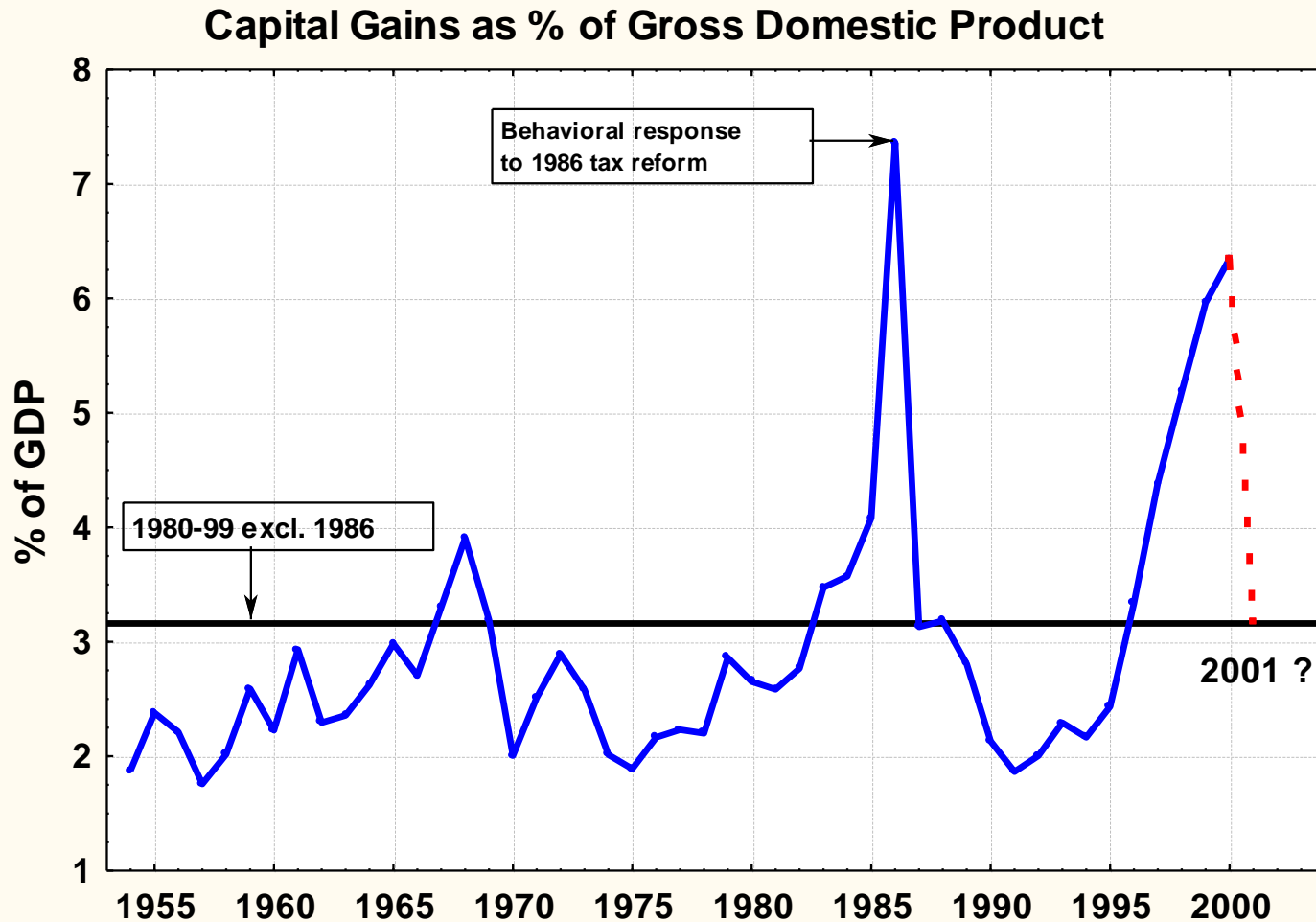
Tax Revenue Decline Much Worse Than Economy Might Suggest

State Tax Revenue Has Fallen Far More Sharply Relative to Economy Than in 1980-82 and 1990-91 Recessions



Sources: U.S. Bureau of Economic Analysis, U.S. Bureau of the Census, *Significant Features of Fiscal Federalism* - 1984 (ACIR), *Fiscal Survey of the States* (NGA), Rockefeller Institute of Government

Major Culprits: Falloff in Capital Gains; Drops in Wages, Too



SOURCE: Internal Revenue Service, Statistics of Income Branch

A Rough Measure Of Capital Gains Reliance

Index of Capital Gains Importance

California	204.5	Ohio	70.3
Colorado	172.8	Pennsylvania	67.1
Connecticut	167.2	Delaware	65.0
Massachusetts	162.8	Oklahoma	61.2
New York	160.3	Michigan	60.2
Oregon	143.6	Iowa	60.0
Idaho	117.1	Kentucky	56.8
Virginia	115.4	Indiana	56.3
Maryland	112.5	Wisconsin	53.3
Minnesota	112.4	Alabama	46.3
Georgia	110.8	South Carolina	39.4
New Jersey	106.9	Louisiana	34.1
Maine	106.2	West Virginia	31.3
Illinois	103.0	New Mexico	28.5
Nebraska	101.8	Mississippi	28.5
Rhode Island	101.3	North Dakota	23.8
United States	100.0	Arkansas	15.5
		New Hampshire	11.0
		Tennessee	4.1
North Carolina	92.4	Alaska	-
Utah	86.0	Florida	-
Vermont	80.7	Nevada	-
Missouri	80.2	South Dakota	-
Kansas	74.9	Texas	-
Montana	74.7	Washington	-
Hawaii	73.3	Wyoming	-
Arizona	72.2		

Index takes into account amount of capital gains in each state, and relative reliance on the income tax. The higher the index, the greater the exposure.

Sources: IRS Statistics of Income data; U.S. Bureau of the Census

Far West, Northeast Hit Hard

Percent Change in Tax Revenue FY 2001 to FY 2002

	Personal Income Tax	Corporate Income Tax	Sales and Use Tax	<i>Total Taxes</i>
Far West	(24.5)	(23.5)	(1.9)	(15.3)
New England	(17.2)	(40.3)	(1.3)	(11.3)
Mid Atlantic	(11.9)	(19.4)	0.7	(7.3)
Rocky Mountain	(10.9)	(37.0)	(0.2)	(7.1)
United States	(12.2)	(19.9)	0.7	(6.3)
Great Lakes	(4.7)	(13.7)	1.6	(2.5)
Southwest	(1.6)	(28.9)	2.7	(1.5)
Southeast	(4.1)	(12.4)	1.7	(1.3)
Plains	(5.4)	(18.8)	(0.7)	(0.2)

Uses Standardized July-June Fiscal Year

Big Revenue Shortfalls in the 50 States

Tax Revenue Shortfalls in Fiscal Year 2002

(Amounts in \$ millions)

	Shortfall	% Shortfall
Personal income tax	\$ 27,508	12.8%
Sales tax	4,810	3.2%
Corporate income tax	<u>5,921</u>	<u>21.5%</u>
Sum of 3 main taxes	\$ 38,239	9.7%

Source:

National Association of State Budget Officers, Fiscal Survey of the States
November 2002, Table A-9

Tax Revenue Weakness Continues

- Tax revenue declined sharply at end of FY 2002, straining policymaking process
- Revenue weakness continued in FY 2003. Adjusted for inflation and legislation:
 - down 0.9% in July-Sept
 - down 1.9% in Oct-Dec
- States face big uncertainty as we speak, for income tax returns on 2002 tax year (due April 15)
 - Carryover of capital losses could depress capital gains in 2002 and later years

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
 - (plus efforts to maximize federal reimbursement)

SOURCES: Kaiser Commission/HMA survey,
National Conference of State Legislatures

What Do States Do In Difficult Fiscal Times?

- ❖ Hierarchy of pain (varies over states, circumstances, political cycle). Examples (low to high pain, my view of state behavior):
 - Avoid actions that make problem worse (e.g., uncouple from federal tax cuts)
 - Reserves and off-budget funds, debt refinancing, one-time actions
 - Defer spending, accelerate revenue
 - Hiring freezes
 - Taxes on out-of-favor industries or activities (e.g., cigarettes; “loopholes”)
 - Across-the-board and moderate spending cuts
 - Freeze planned state tax cuts, spending programs
 - Significant tax increases and spending cuts, layoffs

Multi-Year Impact Of States' Actions

- States, understandably, usually take least-painful actions first
- Low-pain actions can make finances worse later – e.g., reserve funds, off-budget funds, spending deferrals, revenue accelerations, some refinancing
- States, living with balanced-budget requirements, stretch budget problems over several years, rather than closing gaps for good all in one year
- → States may be raising taxes and cutting spending even as economy recovers

State Responses in FY 2002 and 2003

- **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 (*at least* 16 states), corrections (14), and Medicaid (12) – with Medicaid cost containment planned in many states (but how real?)
- **Tax increases:**
 - $\geq 1\%$ 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

Actions Have Slowed State Spending Growth

Percentage Change in State Government Spending By Function and Funding Source
Fiscal Year 2000 to Fiscal Year 2002

	FY 2000 to FY 2001 Actual Growth			FY 2001 to FY 2002 Estimated as of early 2002		
	State Funds	Federal Funds	Total	State Funds	Federal Funds	Total
Elementary and secondary education	8.0	7.0	7.9	3.3	4.4	3.4
Medicaid	9.8	11.7	10.9	11.0	10.0	10.4
Higher education	7.6	11.5	8.1	4.3	3.1	4.2
All other	7.5	7.4	7.5	1.2	14.2	4.2
Total	7.9	9.4	8.3	3.3	10.8	5.2

Source: State Expenditure Report 2001, National Association of State Budget Officers, Summer 2002
Note: States cut FY 2002 spending after the date of estimates presented here, but details by function are not available.

- FY 2003 general fund growth initially estimated at 1.3%; 17 states projected declines
- Actual spending growth for 2003 likely to be lower than budgeted

More Cuts Coming: Which Targets Are Big? School Aid, Medicaid, Higher Ed.

State Government Expenditures - Intergovernmental and Direct State Fiscal Year 2000

	Expenditure (Billions of dollars)	% Share
General expenditures of state governments	<u>\$ 964.7</u>	<u>100.0</u>
<i>Intergovernmental expenditure</i>	<u>327.1</u>	<u>33.9</u>
Elementary-secondary education	199.5	20.7
Other intergovernmental aid	127.6	13.2
<i>Direct general expenditure</i>	<u>637.7</u>	<u>66.1</u>
Public welfare (includes most Medicaid)	198.7	20.6
Higher education	112.9	11.7
Highways	61.9	6.4
Health and hospitals	59.5	6.2
Corrections	33.0	3.4
Interest	29.2	3.0
All other direct spending	142.4	14.8

Source: U.S. Bureau of the Census

State Aid – Especially For Education – Is Important To Local Budgets

Local Government Reliance on State Aid, By Function Local Fiscal Year 2000

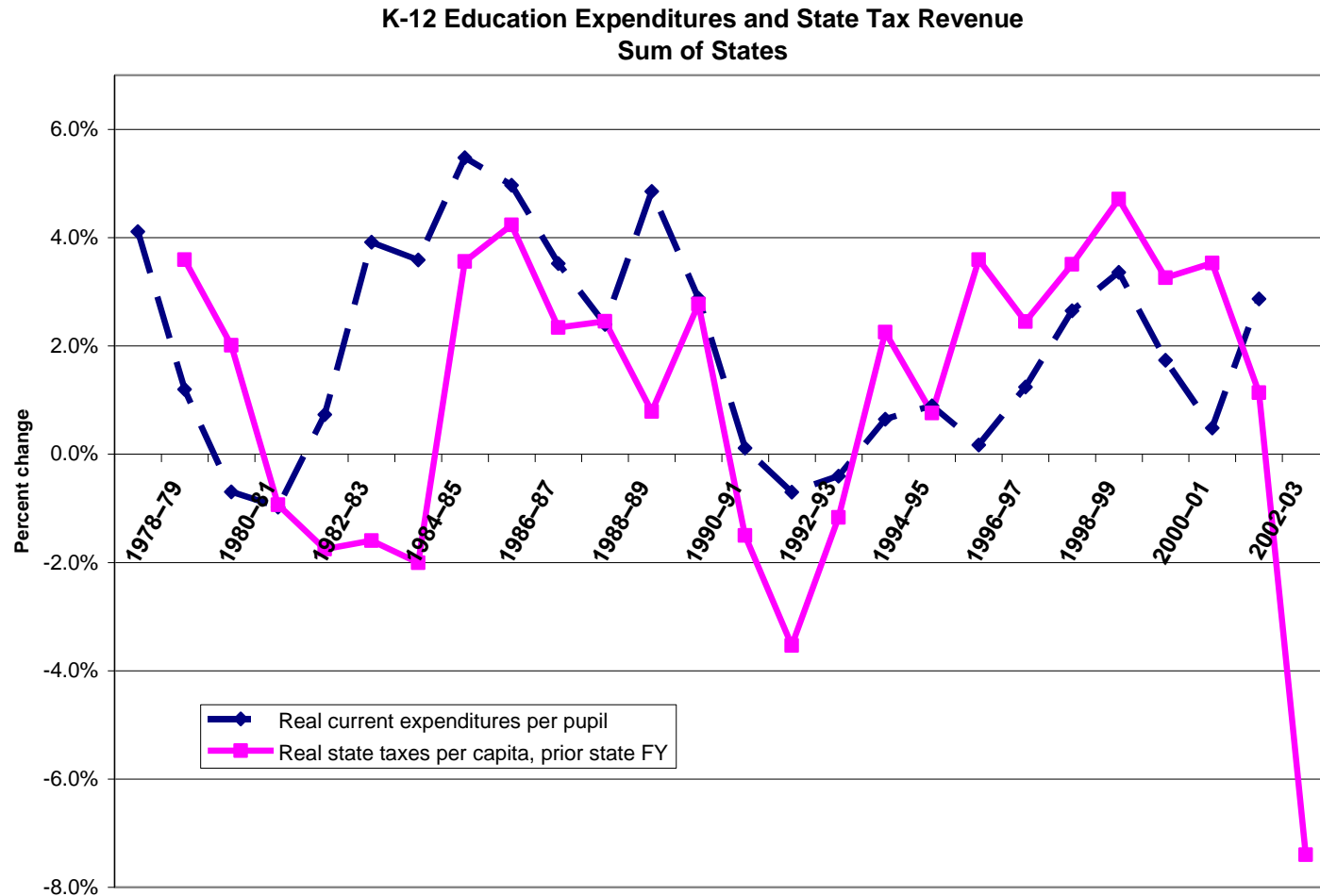
	Amount of Aid (Billions of dollars)	% Share
Local government general revenue, total	\$ 888.9	
Local government revenue from state governments	<u>317.1</u>	<u>100.0</u>
Education (K-12 and higher education)	209.4	66.1
Public welfare	29.5	9.3
General support	24.3	7.7
Health & hospitals	13.5	4.2
Highways	12.2	3.8
Transit utilities	5.9	1.9
Housing & community development	1.3	0.4
All other	21.1	6.6

Source: U.S. Bureau of the Census

Notes: (1) Some regional transit and other "utility" functions are classified by the Census Bureau as part of the state government. Aid to these entities is not included above.

(2) Local revenue from states differs somewhat from state aid to local governments (prior slide) due to timing, classification, and other differences

K-12 Spending Growth Slows In Recessions; Outright Declines Have Been Modest, But...



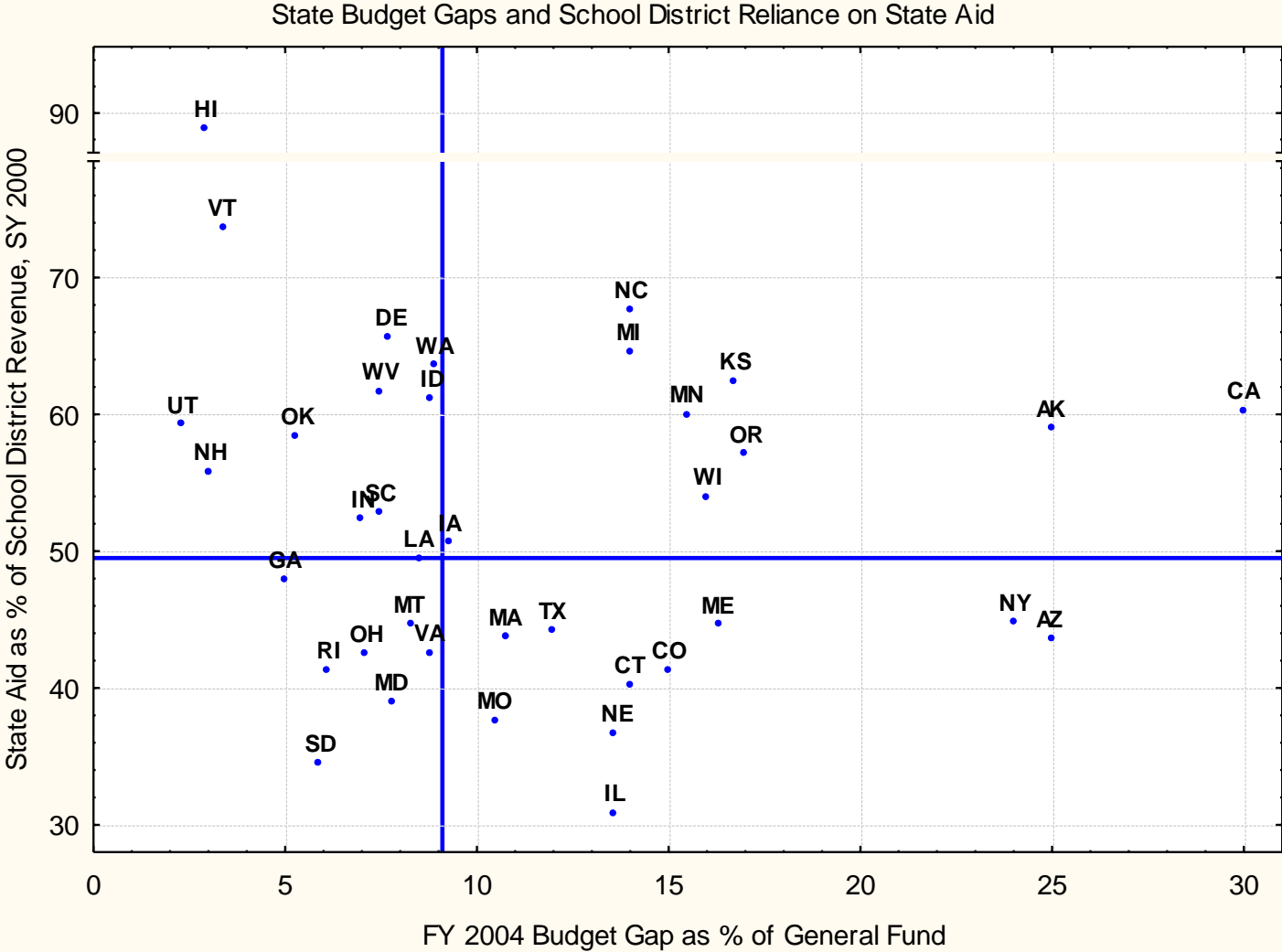
In Which States Do School Districts Rely Heavily On State Aid?

State aid as percentage of school district revenue School year 1999-2000

Hawaii	88.8	United States	49.5
Vermont	73.6		
New Mexico	71.5	Florida	49.5
North Carolina	67.6	Louisiana	49.5
Delaware	65.6	Georgia	47.9
Michigan	64.6	Tennessee	45.8
Washington	63.5	New York	44.8
Kansas	62.4	Montana	44.7
Alabama	62.2	Maine	44.6
West Virginia	61.7	Texas	44.2
Idaho	61.1	Massachusetts	43.7
Kentucky	60.7	Arizona	43.6
California	60.3	Virginia	42.6
Arkansas	60.2	Ohio	42.5
Minnesota	60.0	Colorado	41.3
Utah	59.2	Rhode Island	41.3
Alaska	58.9	New Jersey	41.2
Oklahoma	58.4	Connecticut	40.2
Oregon	57.1	North Dakota	40.2
Mississippi	56.2	Maryland	39.0
New Hampshire	55.8	Pennsylvania	37.8
Wisconsin	54.0	Missouri	37.6
South Carolina	52.8	Nebraska	36.6
Indiana	52.3	South Dakota	34.5
Wyoming	51.9	Illinois	30.8
Iowa	50.6	Nevada	29.1

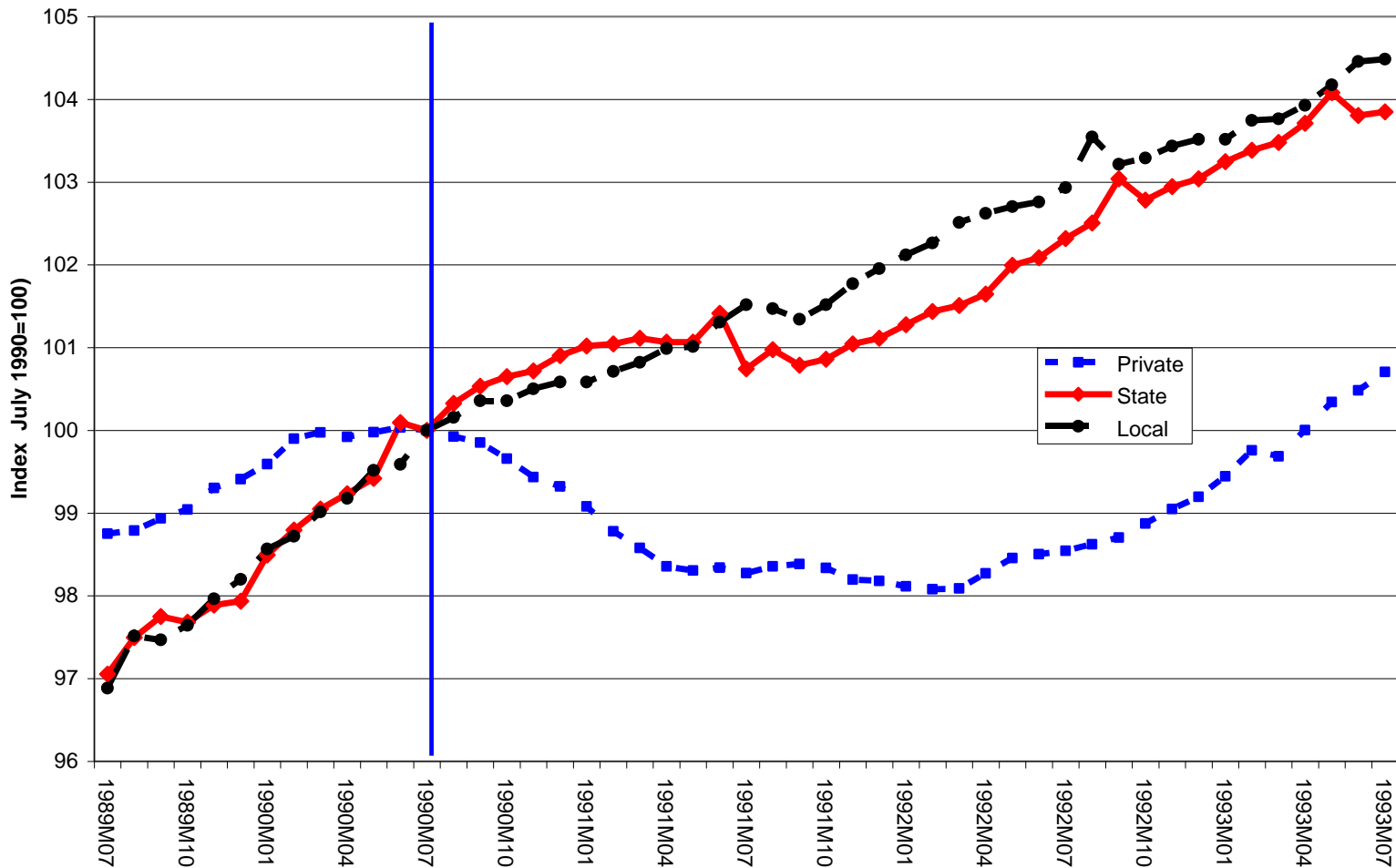
Source: National Center for Education Statistics, National Public Education Financial Survey, 1999–2000

Double-Whammy Risk In Some States – Large State Gap, High District Reliance On State Aid

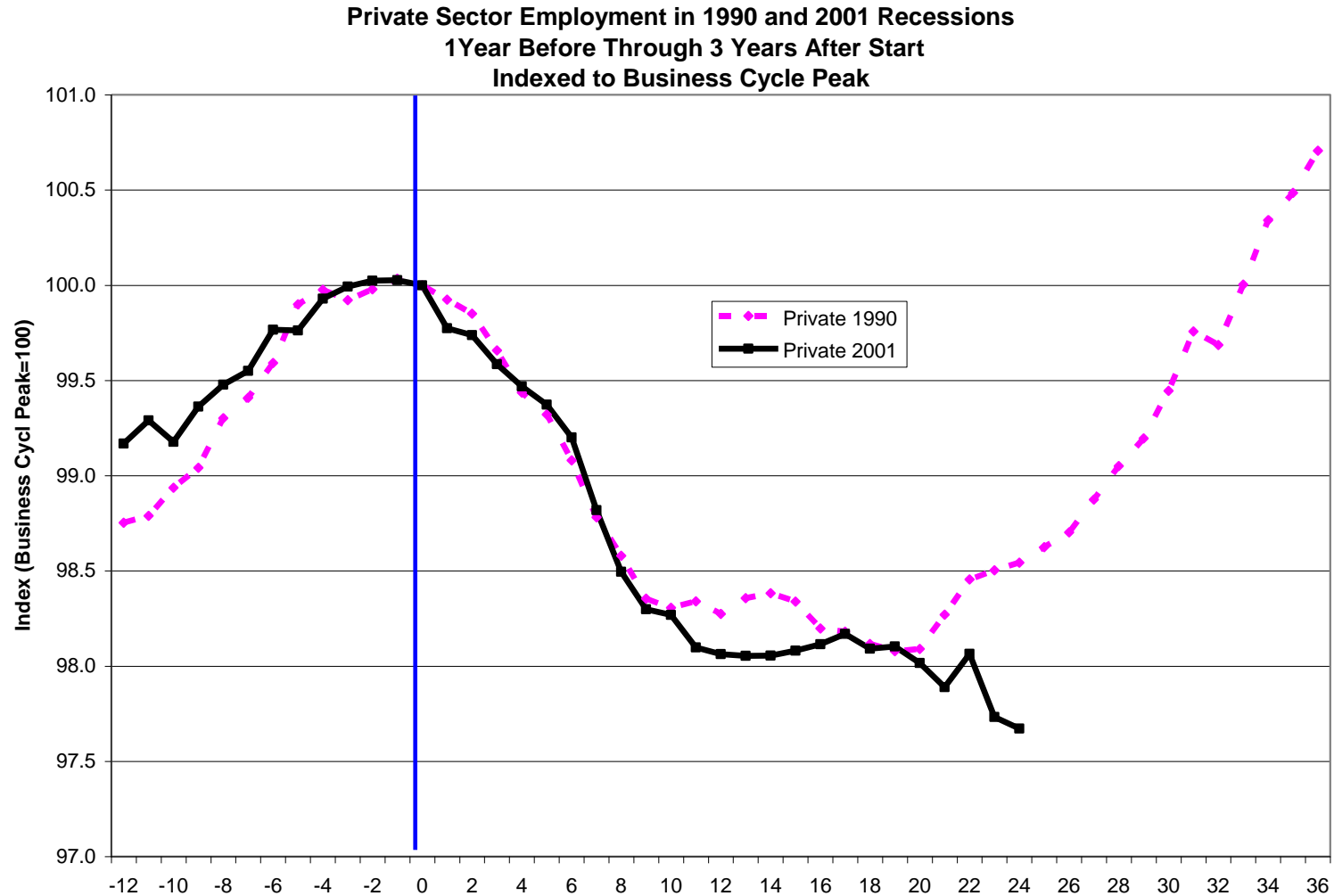


Governments, In Aggregate, Generally Don't Reduce Employment in Recessions – 1990 Fairly Typical

Employment By Sector Indexed to Start of 1990 Recession
1 Year Before Peak, Through 3 Years After

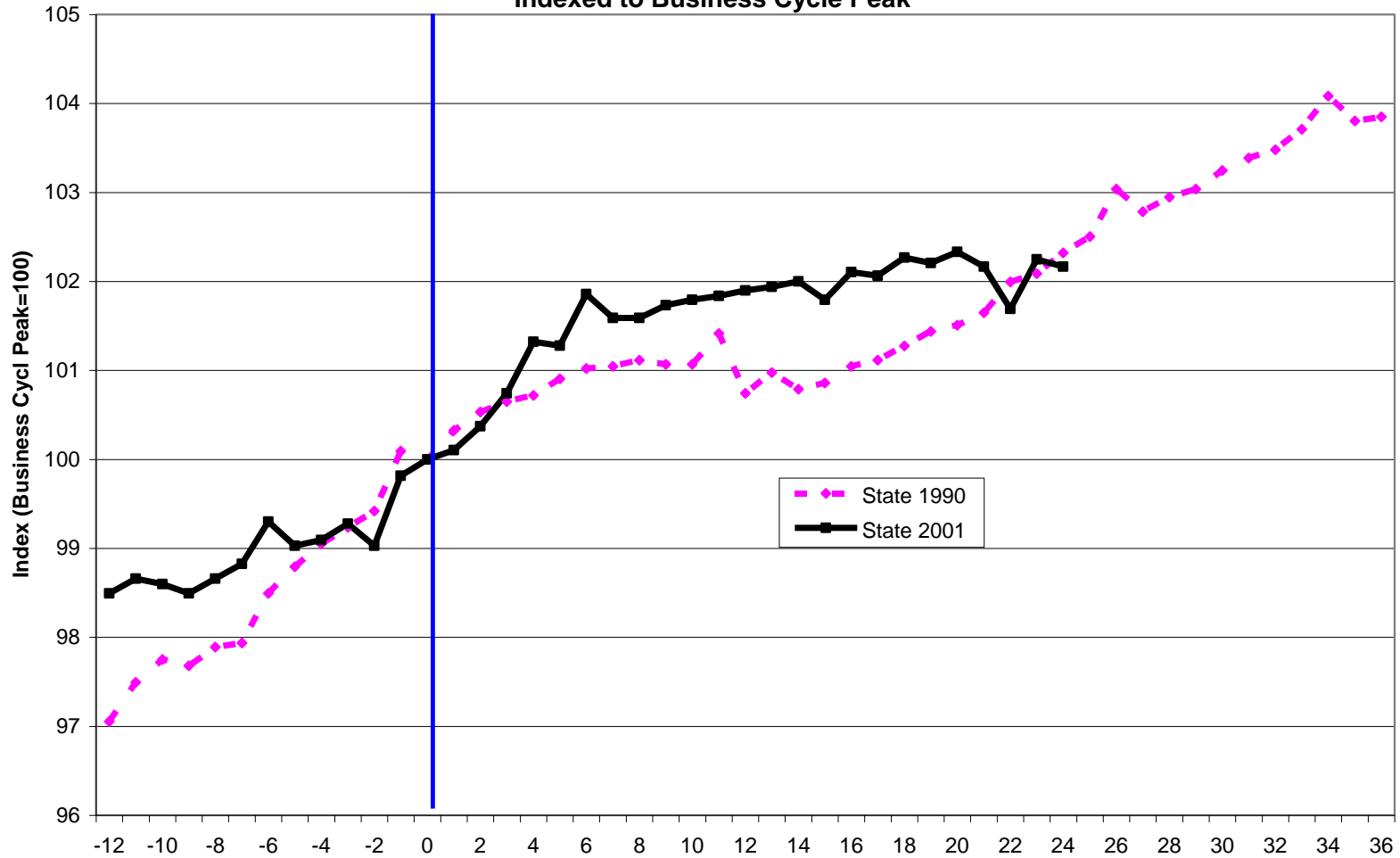


Current Recession - Private Sector: Recently Somewhat Worse Than 1990 Recession



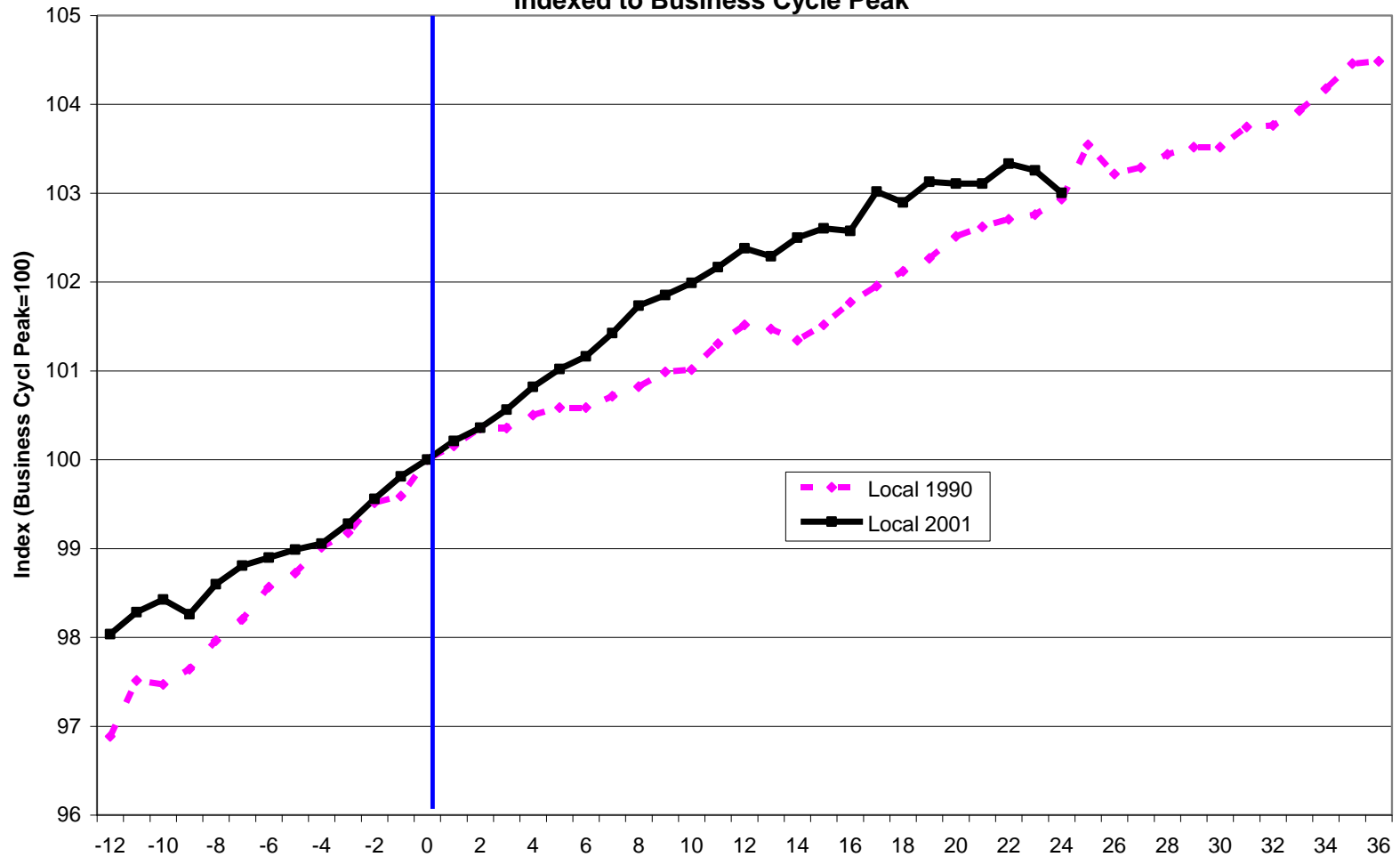
Current Recession – State Gov't: Now About Same As 1990 Recession

State Government Employment in 1990 and 2001 Recessions
1 Year Before Through 3 Years After Start
Indexed to Business Cycle Peak



Current Recession – Local Gov't: Now Also Similar To 1990 Recession

Local Government Employment in 1990 and 2001 Recessions
1 Year Before Through 3 Years After Start
Indexed to Business Cycle Peak



How Will It All Play Out? (1)

- K-12 education has strong political support, and pressures related to accountability and standards
- Medicaid hard to cut:
 - must cut \$2-4 in services for \$1 state savings
 - strong constituencies
 - federal rules
- Higher ed. cuts and tuition increases already have been widespread and dramatic
- State & local gov't employment is hard to cut

How Will It All Play Out? (2)

- Anti-tax sentiment remains strong
- Tax increases on table in 24+ states, but
 - mostly cigarette, nuisance taxes
 - few large income, sales tax proposals -- yet
- Gambling/lottery revenue potential is limited
- Expect lots of one shots:
 - tobacco funds
 - reserve funds
 - off-budget funds
 - accelerations; etc.

When Will Finances Of State Governments Recover?

- Economy currently at least as weak as state government forecasters expected
- Additional near-term risks for income taxes, related to financial markets
- Will be many years before markets, and associated income, recover to 2000 and 2001 levels
- Continued erosion of states' sales taxes
- Most states will solve 2003-04 problems in ways that make 2004-05 and 2005-06 much worse
- → Good times for most states probably at least 3 years away