It's Crunch Time for State Budgets

Richard P. Nathan, Donald J. Boyd, Nicholas W. Jenny, and Patricia L. Billen

A Special Report from
The Nelson A. Rockefeller Institute of Government
November 13, 2003

State and local governments play *the* central role in financing, overseeing, and delivering domestic public services in the United States. For example, state and local governments pay more than 90 percent of the costs to educate 48 million children in 93 thousand public schools; they implement Medicaid and other health care programs covering about one half of poor children, one quarter of poor adults, and two-thirds of all nursing home residents; they educate 12 million students in public degree-granting institutions; they finance and operate most law enforcement; they administer the nation's public welfare system; and, by no means least, state and local governments are the front line of defense in homeland security.

To be sure, state and local governments do all of this with financial assistance from the federal government, especially for Medicaid. Nevertheless, if we look only at domestic services, excluding defense spending and payments to individuals for Social Security and Medicare, state and local governments actually spend more than the federal government. In addition, the federal government transfers about a third of what it spends on domestic services to state and local governments, for Medicaid and other programs that they implement. For those concerned about how programs are managed and implemented – and whether they can be sustained in a budget crisis – state and local governments are where the action is. Moreover, for those concerned about the taxes raised to finance these services, state and local governments are where the action is.

State governments, in particular, play a crucial role: They define what local governments must do, what they cannot do, and how they may finance what they do. Increasingly, they set the rules by which local governments deliver important services such as education. Their role has been growing for more than 50 years: In 1950, states raised 8 percent *less* revenue than local governments, but by 2000 they raised 32 percent *more*, as they took on increasing responsibilities for financing education, health care, and other services.

The crisis in state and local finance in America is at a modern high. Everyone interested in the condition of domestic public services should watch closely what is happening now, and what happens next year, to state budgets as the barometer of these unprecedented fiscal woes. Budget gaps will reappear next year in many states, and will not go away anytime soon, and there are several reasons why:

1. <u>This fiscal crunch is much worse than either of the last two, and is worse than the economy might suggest.</u> State tax collections fell by 7.4 percent in fiscal year 2002, adjusted for inflation, population growth, and tax law changes — more than twice as steep as in each of the last two crises, in the early 1990s and early 1980s, even though the economy was not as weak this time around. The economy is recovering but the effects of this falloff are still being felt in state budgets.

2. When next year's state budget debates begin in two months, states will enact more spending cuts, tax increases, and one-shots. States used many one-time actions in solving current-year budget gaps — reserve funds, tobacco settlement securitization, pension obligation bonds, and other special actions (some gimmicks and some not). Most will provide only temporary benefit. That might not be troubling if tax revenue were recovering quickly and spending growth were slowing sharply. However, state tax collections were weak again in fiscal year 2003, declining 2 percent after adjusting for inflation and legislation. Revenue has been growing this fiscal year due to the improving economy and stock markets, and to state tax increases, but underlying growth remains tepid.

   States have slowed the growth of many spending programs, but Medicaid, a large and difficult-to-control entitlement program, has slowed only slightly. Put it all together — large and widespread one-time actions, slow revenue growth, and continued spending pressure – and many states have not yet brought recurring revenue and spending into line.

   Although some states are recovering, fiscal gaps will resurface in many others when governors release their budgets in January and February. Many will grapple once again with tough decisions. In fact, some states already have announced gaps for this year or next, including Georgia, Kentucky, Massachusetts, Michigan, New York, and, of course, California.

3. Even after the crisis is over, many states will face fiscal difficulties for several years to come. State tax structures are unlikely to generate a revenue boom like

that of the late 1990s for quite a few years. Financial markets have risen sharply this year but remain far below their peak, capital losses from three successive years of market declines will allow many taxpayers to reduce future income tax liabilities, and difficulties collecting sales taxes on Internet transactions will continue to be a drag on the second-largest state tax source. Meanwhile, expenditures on Medicaid and other public health care programs are growing rapidly, as are their private sector counterparts. States also face continued pressure to increase spending on elementary and secondary education in response to the standards movement and the *No Child Left Behind* act.

4. State and local policy responses will play out over several years. States cannot respond to a crisis like this in one fell swoop. Although budgets were under pressure in 2000 and 2001 due to a slowing economy, the crisis began in earnest with a devastating 22 percent drop in income tax revenue in the April-June quarter of fiscal year 2002 — scant weeks before the fiscal year ended, and just at the time that states were negotiating budgets for 2003. In most states, it was too late for the political process to come to grips with this bad news. FY 2003 budgets were largely patched together with reserve fund withdrawals, one shots, cigarette tax increases, and modest spending cuts. Tax revenue continued to slide and most FY 2003 budgets unraveled, leaving governors and legislators needing to close huge gaps when their 2004 budgets were unveiled in January and February of this year. The adopted budgets for 2004 included sharper spending cuts and larger tax increases than 2003 budgets, but as already indicated states will be back at the

negotiating table in just a few months to present their FY 2005 budgets, and will be facing more gaps and difficult decisions. Even that will not be the end of it. Budget problems roll downhill, and many of the actions states take in coming months will lead local governments and nonprofit organizations to consider and implement their own policy retrenchment responses, which will take time to play out. States could still need to go back at the drawing boards early in 2005. Continuing policy response to the crisis could take another two years or more.

5. <u>We do not know as much as we should about how states are responding to this crisis and how people will be affected.</u> Data in the public domain paint a very mixed picture of how states have responded and will respond in the future to the current crisis. Surveys show that tax increases are bigger this year than last, but smaller than in the prior crises. Public opinion polls and recent election results suggest voters are less willing to support tax increases than in the past, although this is not universal. Polling data also show continued strong support for elementary and secondary education spending, even at the cost of tax increases. The picture for Medicaid is unclear. Surveys suggest that many states have proposed or enacted cost-containment measures, but some such measures have been scaled back by legislatures, the courts, or through administrative ingenuity. Analysis by the Rockefeller Institute suggests that many Medicaid changes had little impact on services by the time they worked their way through legislative, administrative, and judicial systems. The jury is still out on the Medicaid changes enacted this year. We know that higher education, the third-largest area of state

spending, has been hit early and hard in this crisis, with many state universities adopting double-digit tuition hikes. Analysts and advocates have argued that social service programs (outside of Medicaid) are being hit hard, but at this point we have little comprehensive and rigorously collected data to confirm or refute this. State governments in aggregate also have cut payrolls substantially over the last year, even though they increased employment in every other recession since World War II. Twenty-one states have reduced state government employment over the past year, with seven cutting it by 3 percent or more.

The conclusion we reach, and we would print this in red if we could, is that despite the welcome economic recovery, this is still crunch time for state and local finance and public services. Furthermore, states and their citizens will probably continue feel the crunch for quite some time to come.