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Is the State Fiscal Crisis Over? A 2004 State Budget Update

By Donald Boyd and Victoria Wachino

After a fiscal crisis that some have called the worst in more than 50 years, recent news about the nation's economy and states' budgets has been positive. The nation's real gross domestic product grew more than 8 percent in the third quarter of 2003, the biggest quarterly gain in almost 20 years. Business productivity has been increasing and the unemployment rate has recently fallen slightly. At the same time, the state fiscal situation has been improving. State tax revenue is starting to increase slightly and states, which faced budget shortfalls totaling almost $80 billion in fiscal year 2003, are reporting significantly smaller budget shortfalls this year. What does this recent good news really mean for state budgets? Have states turned a corner? This paper, which updates a September 2003 analysis by the Rockefeller Institute of Government for the Kaiser Commission on Medicaid and the Uninsured[1], finds that although the state fiscal situation is improving, states are by no means out of the woods yet.

The Good News: The Economy Is Improving, and Has Coincided with Modest Improvement in the State Fiscal Outlook

The nation's economy has improved significantly. Real gross domestic product in the United States grew 8.2 percent in the 3rd quarter of 2003, accelerating from an increase of 3.1 percent in the second quarter (Figure 1). [2] At the same time, nonfarm business productivity was up 9.4 percent in the 3rd quarter.[3] The unemployment rate has also fallen slightly, down from its June 2003 peak of 6.4 percent to 5.7 percent for the fourth quarter of 2003.[4] And the stock market began to rebound in 2003, with the Dow Jones average exceeding 10,000 for the first time since May 2002 and the S&P 500 up 26 percent, its fifth-best year since 1980.

This recent economic growth has coincided with positive news on the state budget front. Far fewer states are reporting that they will face budget shortfalls this year than

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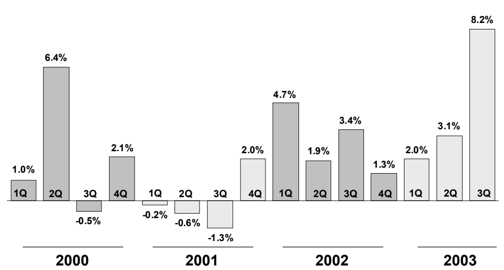
[1] Donald Boyd, The State Fiscal Crisis and its Aftermath, Kaiser Commission on Medicaid and the Uninsured, September 2003, http://www.kff.org/medicaid/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=22130
[2] http://www.bea.gov/bea/dn1.htm
[3] http://www.bls.gov/news.release/prod2.toc.htm,
[4] http://www.bls.gov/news.release/empsit.toc.htm

last: according to the National Conference of State Legislatures, only 10 states have reported that budget gaps have opened up in FY 2004 after the fiscal year began, down from 31 last year.[5] The cumulative budget shortfall states face in FY 2004 is much smaller than the shortfall they reported facing in FY 2003. And, after stabilizing in FY 2004, state tax revenues have been growing for the first time in several years, albeit at fairly modest rates. The Rockefeller Institute of Government reported that state tax collections were up about 4.5 percent in the July-September quarter. After adjusting for legislation and inflation, collections were up 0.4 percent for the quarter[6] but total fiscal year tax revenue collections were down. States expect FY 2004 tax revenues will grow by more than 5 percent in nominal terms.[7] For the year so far, tax revenue is on target to meet or slightly exceed projections in most states, although some states still report that revenue is falling short of expectations.[8]

Figure 1

Change in Real Gross Domestic Product

By Fiscal Year and Quarter, 1999-2003



SOURCE: U.S. Bureau of Economic Analysis

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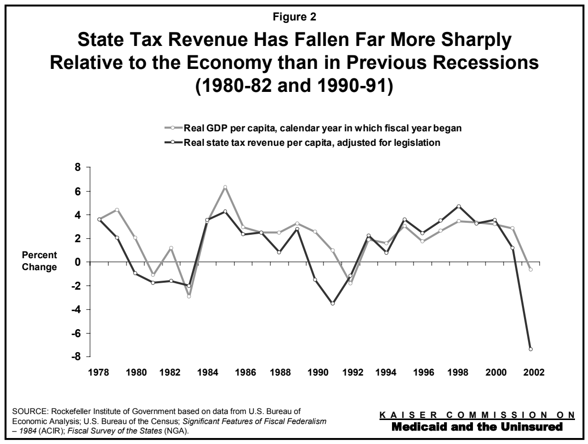
The Not-So-Good News: Recent Economic and State Revenue Growth is Not Enough to Pull States Out of a Big Slump

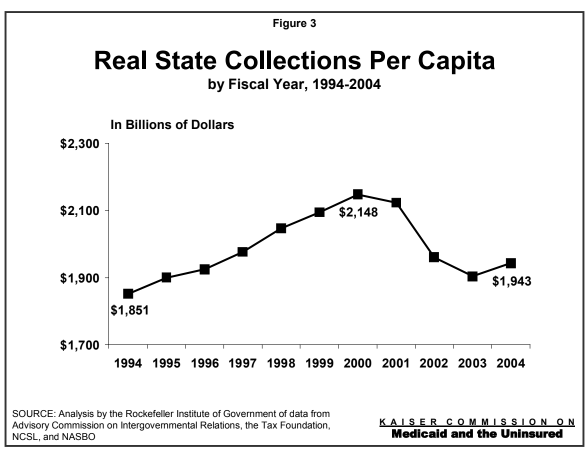
- **The state fiscal situation was very bad to begin with**. Recent improvement in the state economic and revenue situation needs to be compared to the extent of the fiscal problems states have faced since early 2001. In fiscal year 2002, real per-capita tax revenue dropped by 7.4 percent – more than twice as steep as the state revenue declines of either of the two previous recessions (Figure 2).[9] While the national recession was fairly mild, the falloff in state tax revenues was severe and led to daunting state budget shortfalls, which approached $80 billion across all states in FY 2003.[10] This occurred because state tax revenue had been propped up in the late 1990s by unsustainable forces, especially the unprecedented growth in the stock

[5] National Conference of State Legislatures, State Budget Update: November 2003, www.ncsl.org.
[6] Nicholas Jenny, *State Tax Revenue Grows Slightly,* Rockefeller Institute of Government, State Revenue Report #54, December 2003.
[7] National Governors Association/National Association of State Budget Officers, *Fiscal Survey of States*, December 2003, http://www.nasbo.org/Publications/fiscsurv/fsfall2003.pdf
[8] NCSL, November 2003.
[9] Boyd, The Current State Fiscal Crisis and its Aftermath, p. 7.
[10] NCSL, November 2003.

market. When the stock market fell, state budgets fell with it. Capital gains declined about 48 percent in 2001 and preliminary evidence suggests they fell again in 2002, creating the worst cumulative decline in history. The big falloff in state tax revenue in 2002 means that it will take states some time to return to pre-2002 tax levels, and the recent modest growth in state tax revenues is far from sufficient to do that (Figure 3).



- **Looking behind the numbers, the recent economic recovery may not offer much immediate good news for states.** Although real GDP in the U.S. increased a very healthy 8.2 percent in the third quarter of 2003, this rate will not be sustained. More important to state budgets is the recent and persistent weakness of employment. Private employment continued to fall after the end of the recession in November 2001, and at its lowest was 2.9 percent below the recession's start. This decline is substantially greater than the 1.8 percent fall off associated with the last recession, in 1990-1991.[11]



Moreover, despite the recent economic improvement, private sector employment in December 2003 was still 2.6 percent below its level at the start of the recession.

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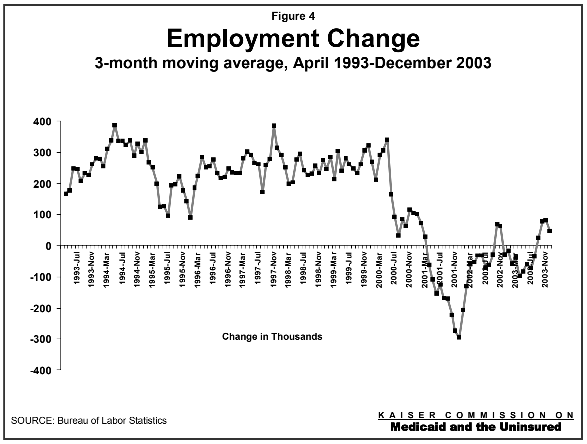
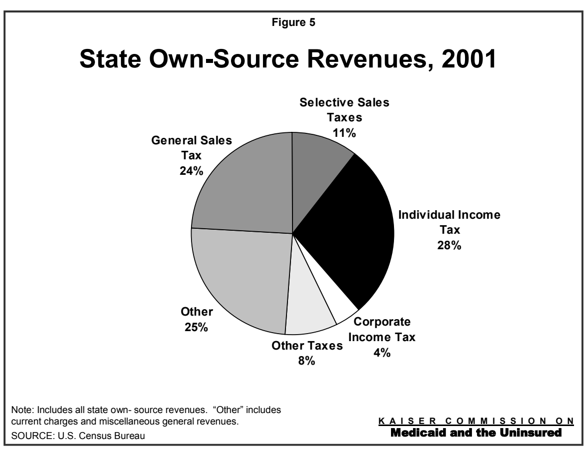
[11] (www.bls.gov, Jan 2004 release)

Although the unemployment rate fell from 5.9 percent in November 2003 to 5.7 percent in December, most of the fall in the rate was the result of peoples' decisions to no longer seek employment, with a larger drop in the labor force than in the number of unemployed.

Overall, employment during the recent recovery remains much lower than it had been at this point in the last recovery. Although employment has begun growing again, with average monthly gains of 48 thousand jobs in the most recent three months, this remains well below the average gains of 200 to 300 thousand jobs during the late1990s (Figure 4). And even with the recent drop in the unemployment rate, the 5.7 percent rate remains well above the 4-5 percent average of the preceding few years.



Why does the employment situation matter to state budgets? For several reasons. First, most state budgets rely heavily on income taxes, and earnings from employment are a major contributor to income. In 2001, personal income taxes were the single largest source of state tax revenues, accounting for about 28 percent of state own-source revenues [12] (Figure 5).



[12] NGA/NASBO, Fiscal Survey of States, November 2003. States vary widely on the extent to which they rely on personal income tax revenue. While in some states, such as New York, personal income taxes account for a majority of state general fund revenue, other states, such as Florida, have no personal income tax.

Personal income taxes are based heavily on wages, and the weak employment in this recovery has held back wage and income growth, and consequently has held back state income tax revenue. Employment contributes to state tax revenue in other important ways as well. Sales taxes depend heavily on consumer spending. Some of the recent growth in spending has been driven by rising debt, but without employment and income growth, spending gains won't be sustained. Until employment rises, state budgets will not experience significant improvement.

Finally, in recent years, capital gains realizations have also contributed substantially to state personal income tax collections, but they are unlikely to do so now. Although the financial markets have risen significantly, they remain well below the historic levels of 2000. Even after last year's 26 percent increase in the Standard and Poor's index, the market would have to rise about another 35 percent to return to its peak level of March 2000. At the same time, some taxpayers will claim substantial capital losses from the recently-passed drop in the markets, and these capital losses will depress personal income tax collections for several years.

- **Even after employment recovers, economic growth will not translate directly and rapidly into state tax revenue growth.** There are some built-in lags between economic growth and state tax collections. Individuals and corporations making "estimated payments" often can base those payments at least in part on prior-year tax liabilities, so that tax collections do not catch up with underlying economic growth until tax returns are filed. Perhaps most important in the current environment, although the economy is recovering and the stock market has begun to recover, tax payments related to financial markets are likely to continue to be well below their earlier levels for several years. Finally, sales taxes typically are collected with a lag of one to three months, which leads to slight delays between economic growth and revenue growth.

More Not-So-Good News: Mounting Spending Pressures, Reluctance to Increase Taxes, and "One-Time" Budget Balancers Point to Continued State Fiscal Stress

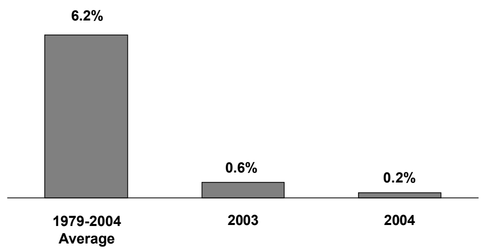
- **Present state budget stability is driven in large part by decisions states have made to increase taxes and restrain spending.** To the extent states have recently achieved a degree of budget stability, they have done so by making difficult fiscal choices. NASBO estimates that general fund spending grew only 0.6 percent in nominal terms in FY 2003 and is forecasted to grow 0.2 percent in 2004. This is far below the 6.2 percent average nominal growth rate for state spending between 1979 and 2004 (Figure 6). And in real terms, taking into account the effect of inflation, estimated state spending actually decreased by 1.6 percent in FY 2003 and 2 percent in FY 2004. At the same time, some states also raised taxes. NASBO estimates that for FY 2004, 36 states raised taxes or fees, totaling $9.6 billion in additional revenue that year.[13] Similarly, the Rockefeller Institute has estimated that tax increases played a significant role in increasing state tax revenues in FY 2003. For example, they

[13] NASBO also estimates that two states cut taxes.

estimated that nominal state tax revenue grew by 4.5 percent in the July-September period, compared to the same time period in the previous year. About 1.9 percentage points of this overall revenue growth was driven by states that increased taxes.[14]

Figure 6

Annual Change in Nominal State General Fund Spending, FY 1979-2004



SOURCE: NGA/NASBO Fiscal survey of States, December 2003

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- **Although some states have raised taxes, the increases are low from the standpoint of recent recessions.** Although tax increases have played a big role in stabilizing the state budget situation, they are smaller than the tax increases states made during the last recession. NCSL has estimated that states have raised taxes by about $7.8 billion, or 1.5 percent of state revenues, in 2003. This contrasts with the $15.4 billion in tax increases, which equaled 5.4 percent of state revenues, that states put in place in 1991.[15] The Center on Budget and Policy Priorities has estimated that recent tax increases have not restored state tax collections to their previous levels and are smaller than recent spending cuts.[16] These analyses support recent evidence indicating that in many states opposition to tax increases remains very strong.[17]

- **Additional decisions to constrain spending may be harder this year.** Although some states will continue to raise taxes and reduce spending, it could be difficult for many states to continue to do so. States are likely to face continued spending pressures from a number of sources. In states' largest budget item, elementary and secondary education, states face significant pressure to increase spending to help meet new school testing and standards requirements, which will require additional resources. States' short-term response to the recession has been to reduce real state aid per pupil by 3.6 percent between fiscal years 2002 and

[14] About 2.2 percent of the 4.5 percent increase reflected inflation; adjusted for the effects of legislation and inflation, the state tax revenue increase was only 0.4 percent. (Jenny, December 2003)
[15] Arturo Perez, Program Principal Fiscal Affairs Program, National Conference of State Legislatures, calculations conveyed in personal communication January 20, 2004 based on *State Budget and Tax Actions 2003, National Conference of State Legislatures*, November 2003, and *State Tax Actions 1997*, National Conference of State Legislatures, February 1998.
[16] Nicholas Johnson, *Despite Major Spending Cuts and Tax Increases, States are Likely to Face Large Deficits for Next Year*, Center on Budget and Policy Priorities, October 22, 2003.
[17] John Holahan, et al., State Responses to Budget Crises in Fiscal Year 2004, Kaiser Commission on Medicaid and the Uninsured, January 2004.

2004, but this approach will be hard to sustain over a longer period, as underlying cost pressures are not subsiding.[18] At the same time, state Medicaid spending continues to grow, albeit at a slower rate in FY 2003 than it had been. While total Medicaid spending grew 14 percent in FY 2002, that growth rate dropped to 7.5 percent in FY 2003. As a result of the federal fiscal relief to states, which temporarily increased the federal Medicaid matching rate, the rate of growth in the state share of Medicaid spending was significantly lower – about 5.5 percent.[19]

In other categories of spending, states have made significant reductions. State government employment historically has been hard to cut – many of the services supported by this employment, such as higher education, elementary and secondary education, prisons and other public safety, public hospitals, and transportation have strong public support. Despite this, and in contrast to past fiscal crises, states reduced the number of state workers substantially over the last year, but the cuts appear to have ended and employment is once again rising. It would be a major departure from the experience of other recessions if states make substantial additional cuts in employment.

- **One-time measures states have used to balance their budgets will compound next year's problems.** Many states have used temporary measures to patch holes in 2003 and 2004 budgets. States have turned to issuing new bonds, spending tobacco settlement funds, and drawing down reserve funds. As these one-time measures expire, the holes they filled in state's budgets will reemerge. Many states facing budget gaps in 2005 do so in large part because of these actions. California is the most well-known example of this, where the adopted fiscal year 2004 budget assumed the issuance of $14.5 billion in deficit bonds and at least $6 billion in other nonrecurring resources,[20] but Florida, Michigan, New Jersey, New York, and other states all face the loss of nonrecurring resources in 2005.

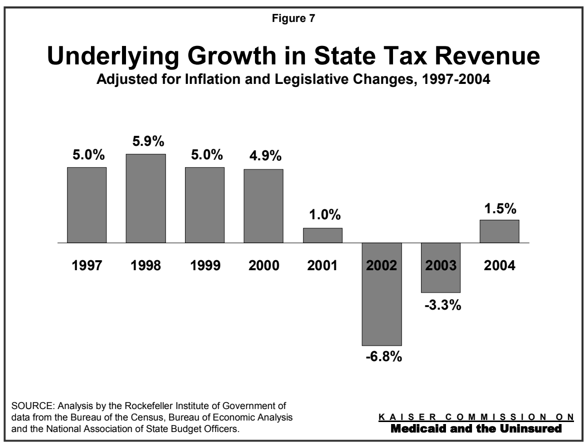
- **The federal fiscal relief, which many states used to fill their FY 2003 and 2004 budget gaps, will expire in June.** Last year, Congress provided $20 billion in temporary fiscal relief to states as part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (TRRA). States have used that fiscal relief to

[18] Reduction in real state aid per pupil spending as reported in "The Impact of State Government Fiscal Crises on Local Governments and Schools," a December 2003 draft paper provided by Andrew Reschovsky of the Robert M. La Follette School of Public Affairs at the University of Wisconsin-Madison. Cited with permission.
[19] See Holahan and Bruen, *Medicaid Spending: What Factors Contributed to the Growth Between 2000 and 2002?*, Kaiser Commission on Medicaid and the Uninsured, September 2003. Estimates of Medicaid spending growth for FY 2003 calculated by Brian Bruen based on preliminary data for that year from the U.S. Department of the Treasury. Other estimates for FY 2003 vary slightly, see Smith, et al., *States Respond to Fiscal Pressure: A 50-State Update of Medicaid Spending Growth and Cost Containment Actions*, Kaiser Commission on Medicaid and the Uninsured, January 2004.
[20] See, for example, Moody's Investors Services, Opinion Released With Downgrade of California General Obligation Bonds, August 2003.

balance their FY 2003 and FY 2004 budgets, forestalling the need for additional spending reductions or tax increases. However, the fiscal relief will expire June 30, 2004, as most states are beginning their 2005 fiscal years. This will leave states with significant gaps in their FY 2005 budgets. If states do not experience significant revenue growth this year, they will have to address these gaps with spending cuts or tax increases (or, perhaps, further one-time actions).

Outlook for FY 2005 and Beyond

Although the state fiscal situation has stabilized, states are not out of the woods yet. Fiscal year 2005 will be a difficult year for most states, as they grapple with revenues that have not yet grown substantially, and that still remain significantly below the levels of just two years ago. Although states expect 2004 to be a much better year than 2003 and 2002, they have not regained the ground they lost in 2001, and revenue growth is likely to be nowhere near as strong as the growth states experienced in the late 1990s (Figure 7).



States will face spending pressures from education, Medicaid, and other programs, and very few states have an appetite for raising taxes. Moreover, states have exhausted many one-time measures, such as use of trust funds, that they have used to balance their budgets over the past several years. Finally, states will confront these difficulties without the federal fiscal relief that helped them balance their budgets over the past two fiscal years. As the Rockefeller Institute recently observed, "States will probably have to cut spending and/or raise taxes in order to balance the fiscal year 2005 budgets they will begin to consider in a few months."[21] And unless the national economic picture, and especially employment, picks up significantly, states may face these conditions for some time to come.

[21] Nicholas Jenny, "State Tax Revenue Shows Slight Improvement," Rockefeller Institute, November 2003.

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