

State Finances: Not Out of the Woods Yet

Federation of Tax Administrators

Burlington, VT
September 20, 2004

Donald J. Boyd, Director of Fiscal Studies
Assistance of Nicholas Jenny gratefully acknowledged

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

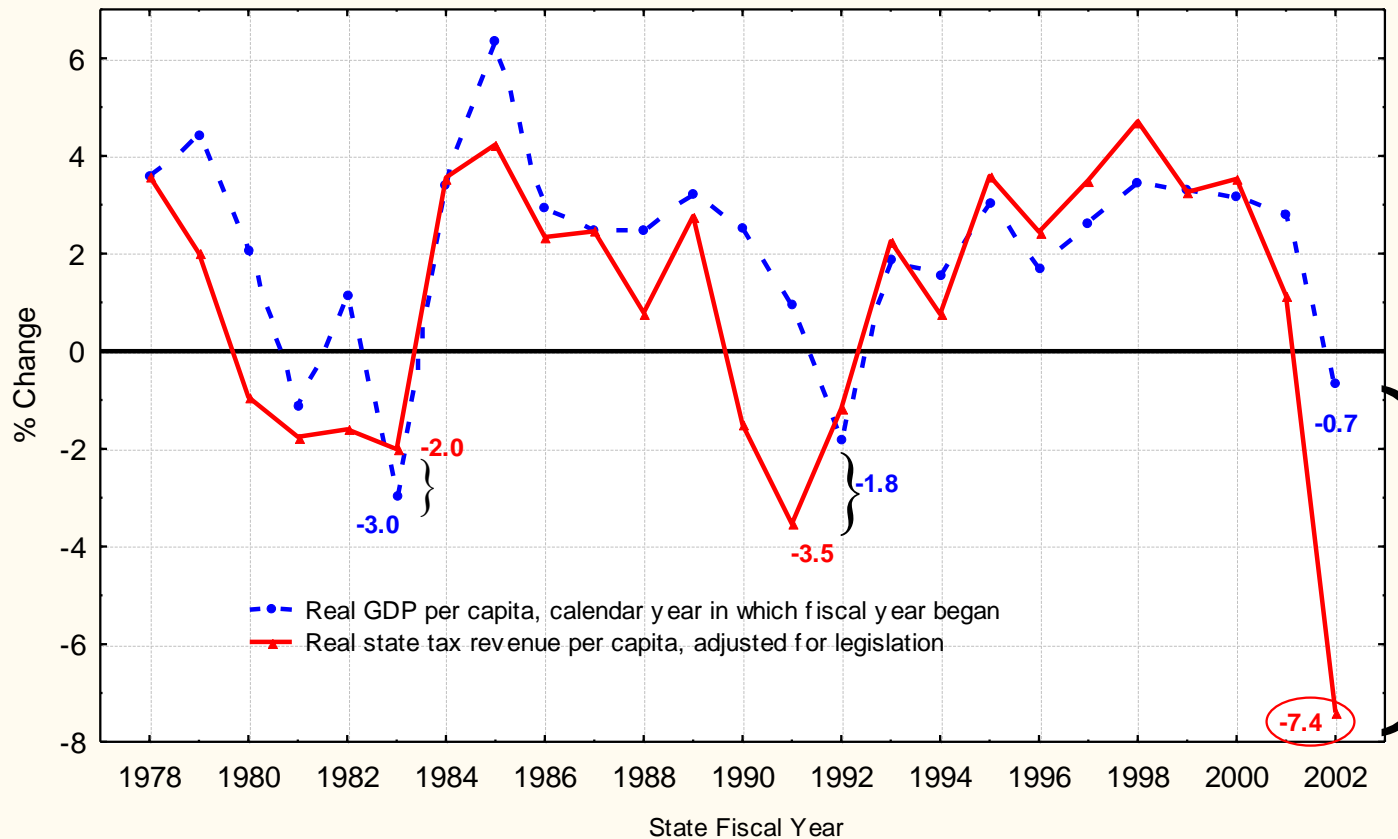
boydd@rockinst.org • 518-443-5284

www.StateAndLocalGateway.rockinst.org



Tax Revenue Decline Was Much Worse Than Economy Might Suggest

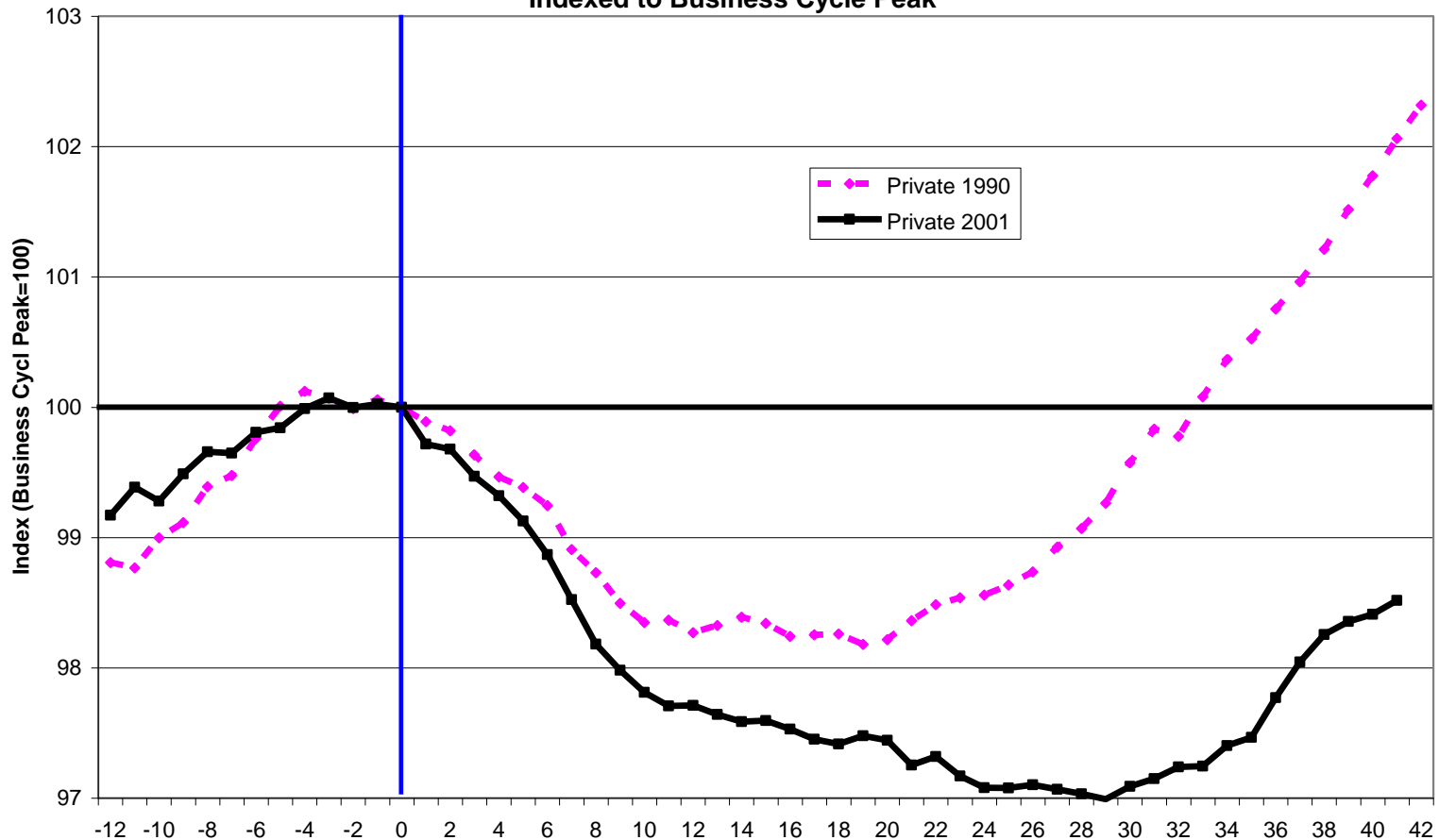
State Tax Revenue Has Fallen Far More Sharply Relative to Economy Than in 1980-82 and 1990-91 Recessions



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

Economy Recovering But Weak Relative To Past Recoveries

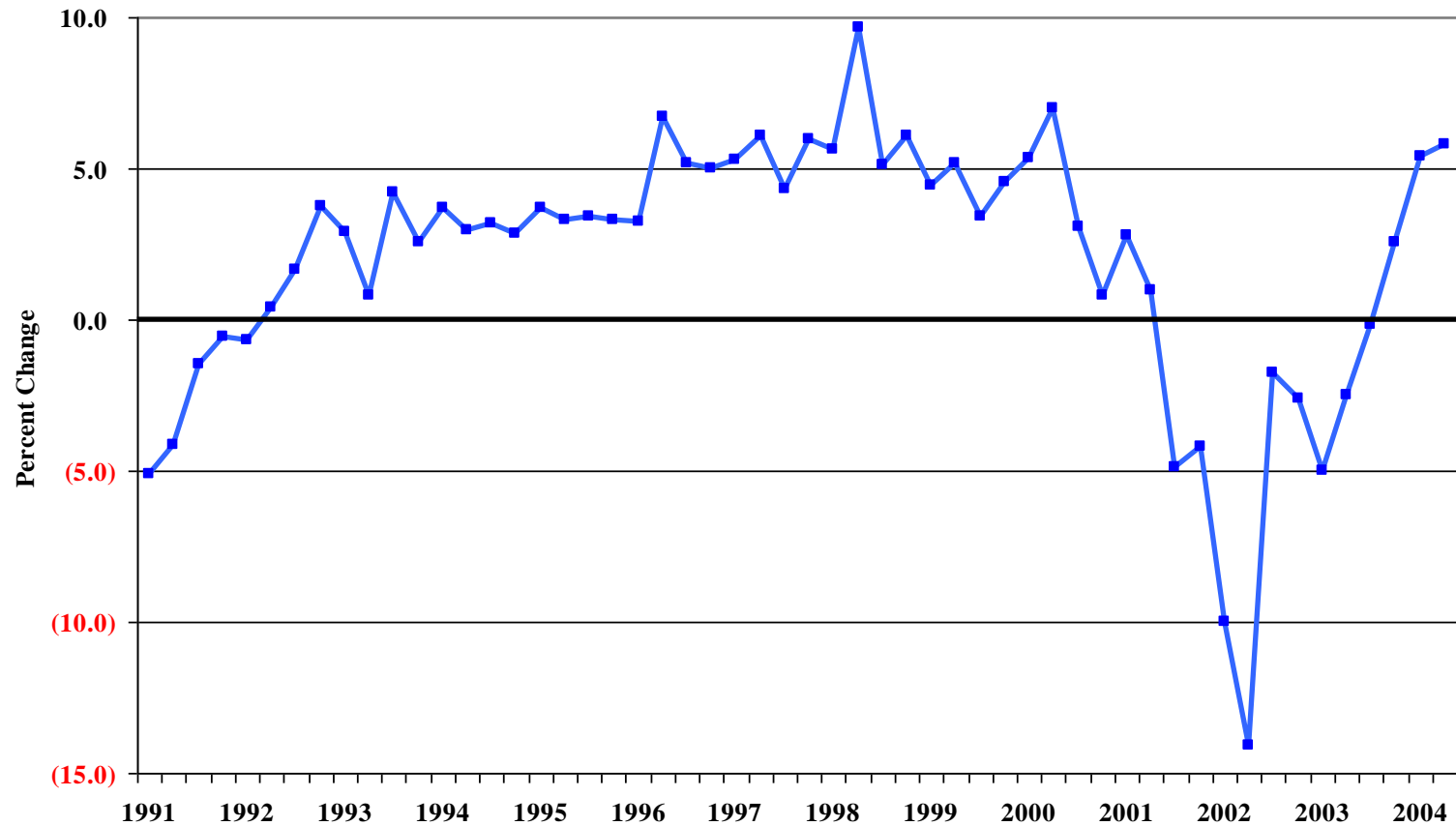
Monthly Private Sector Employment in 1990 and 2001 Recessions
1 Year Before Through 3.5 Years After Start
Indexed to Business Cycle Peak



Source: Bureau of Labor Statistics, Current Employment Statistics

Underlying Tax Revenue Now Recovering

Year-Over-Year Change in State Tax Collections,
Adjusted for Legislation and Inflation



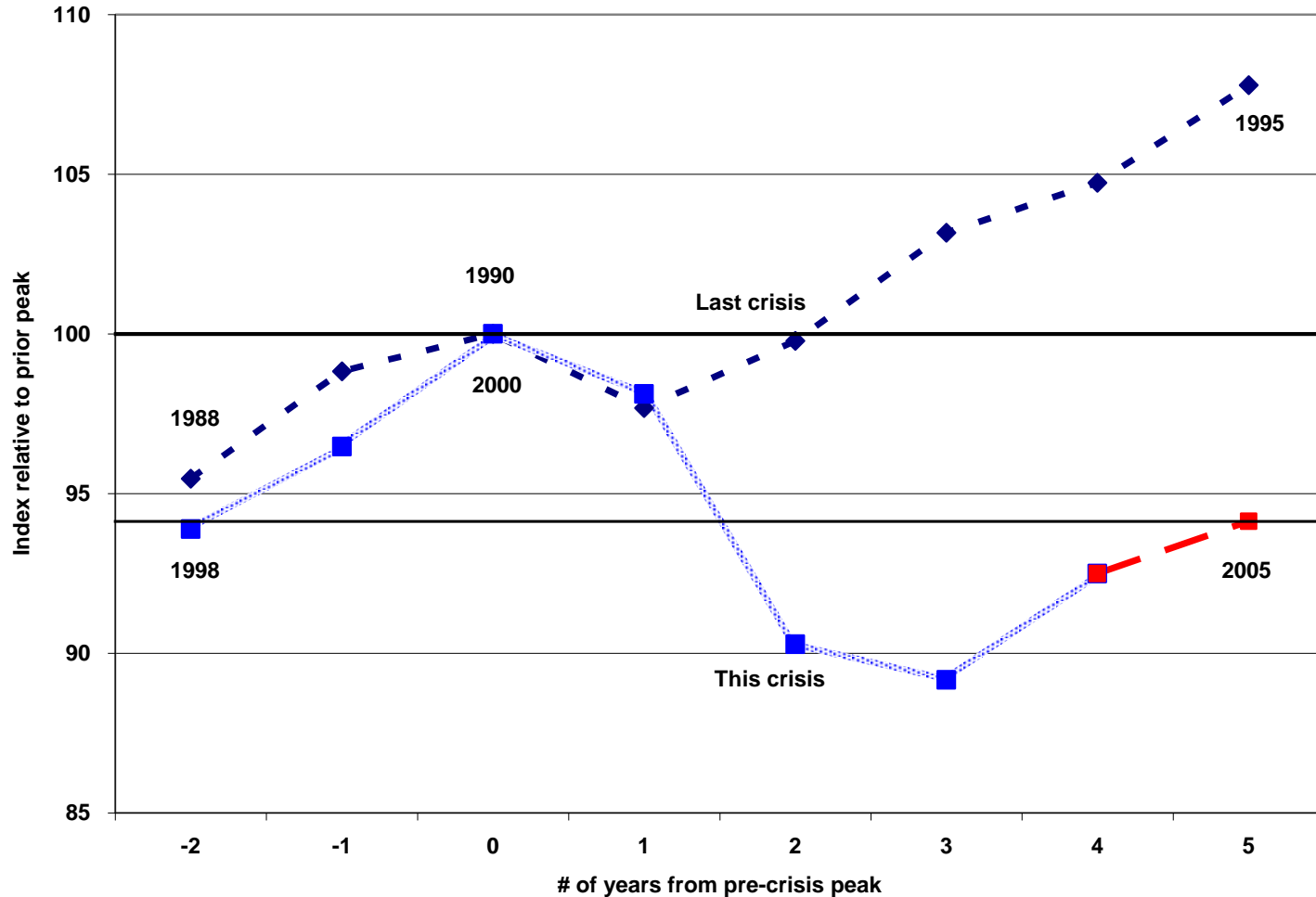
April-June Quarter Was Best Since Early 2000

- Tax growth:
 - 11.3% nominal
 - 9.2% nominal, adjusted
 - 5.8% real, adjusted
- Nominal by tax:
 - 15.6% PIT
 - 5.6% withholding
 - 21.2% estimated tax, 36 states (16.9% median)
 - 7.1% sales
 - 13.6% corporate
- Nominal by region:
 - 12.0% New England
 - 16.5% Mid-Atlantic
 - 5.3% Great Lakes
 - 8.3% Plains
 - 8.9% Southeast
 - 12.0% Southwest
 - 10.7% Rocky Mountain
 - 14.8% Far West

SOURCE: Nicholas W. Jenny, *State Revenue Report #57*, Rockefeller Institute of Government, September 2004

But Tax Revenue Is Still Well Below Prior Peak – Now At 1998 Level

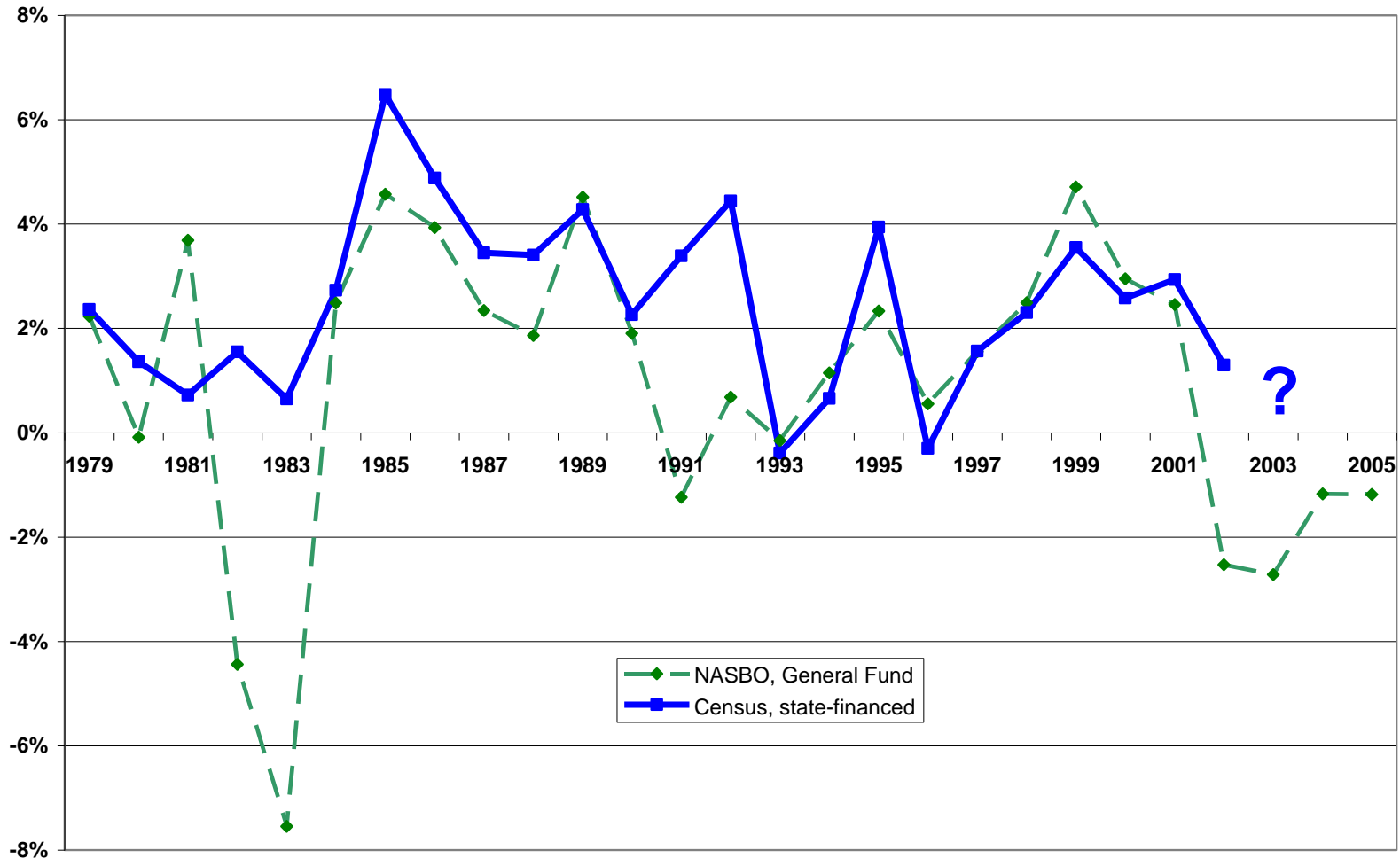
Real Per-Capita State Government Tax Revenue Indexed to Pre-Crisis Peak, 2 Crises
 - Actual revenue, NOT adjusted for legislation -



SOURCES: Census Bureau for tax revenue through 2003, and population. Rockefeller Institute for tax growth to 2004. State estimates from NASBO for growth to 2005. BEA for state & local government chain-weighted price index.

Are Spending Cuts As Deep As Budgets Portray? Hard to Know...Yet

% Change in State Gov't Real Per Capita Spending, Two Measures



Why Might Census And General Fund Spending Measures Diverge, Especially During Crises?

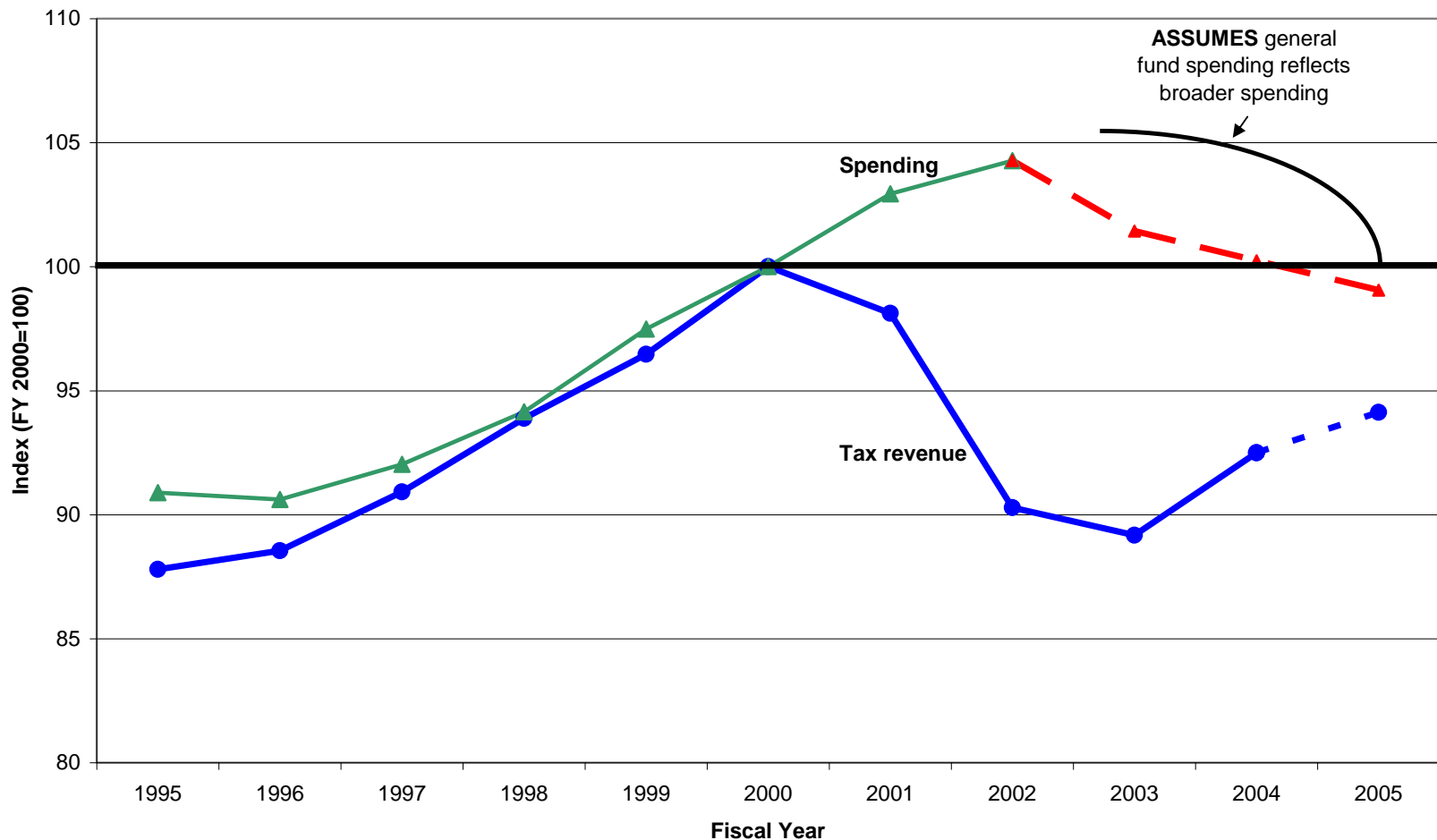
- Census attempts to count all spending, regardless of how funded
- General fund is a far more limited part of budget:
 - Spending funded by dedicated revenue sources such as lottery (often for education) and special taxes (e.g., highway taxes) usually not included in general fund
 - In crisis periods these dedicated sources often become more attractive and easier to increase than general taxes
- States generally decide what to count in the general fund. May have incentive and opportunity to “manage” the apparent general fund growth
 - In crisis periods it may be attractive to have larger spending cuts in the general fund, and to fund more spending from other funds
- So...
 - Census data generally a better indicator of whether and how much states have cut spending
 - We won't know FY 2003 – first real crisis-response year - for another few months

Even Census Data Do Not Fully Reflect Underlying Budget Trends Over The Short Term

- Many “tools” and gimmicks states use to get through a crisis reduce Census spending as well as general fund spending, without reducing longer-term spending pressures:
 - Deferring payroll and other bills from one period to the next (Note: generally will not reduce spending as reported in CAFRs)
 - Deferring construction projects and associated spending
 - Delaying hiring, startup of new programs, etc., until late in fiscal year
 - Reduced pension contributions via pension obligation bonds
- In addition, one-shot revenue sources and temporary taxes not easy to distinguish from recurring revenue
- In the other direction – total spending can rise even as many individual agencies may suffer spending cuts (e.g., when Medicaid growth crowds out other spending).
- On balance...state crisis responses often do less to reduce longer-term budget pressures than budget and Census data suggest

Even IF NASBO General Fund Spending Reflects Broader Spending, More Realignment Probably Needed

State Tax Revenue and State-Financed Spending
- Real Per-Capita, Indexed to FY 2000 Revenue Peak -



What Have States Done?

- Large and widespread cuts in higher education spending
- Surprisingly large cuts in state agency employment
- Mostly targeted tax and fee increases, smaller than last recession
- Some cuts in K-12 education (Nominal state K-12 education aid has been flat, but real per-pupil aid decreased 3.6% between FY 2002 and FY 2004)
- Widespread cuts in Medicaid, but budget savings often not large
- Widespread cuts in smaller agencies and functions of government
- Widespread use of fund balances, tobacco settlements, other one-shots, pension obligation bonds, various gimmicks

Higher Education Has Been Hit Hard

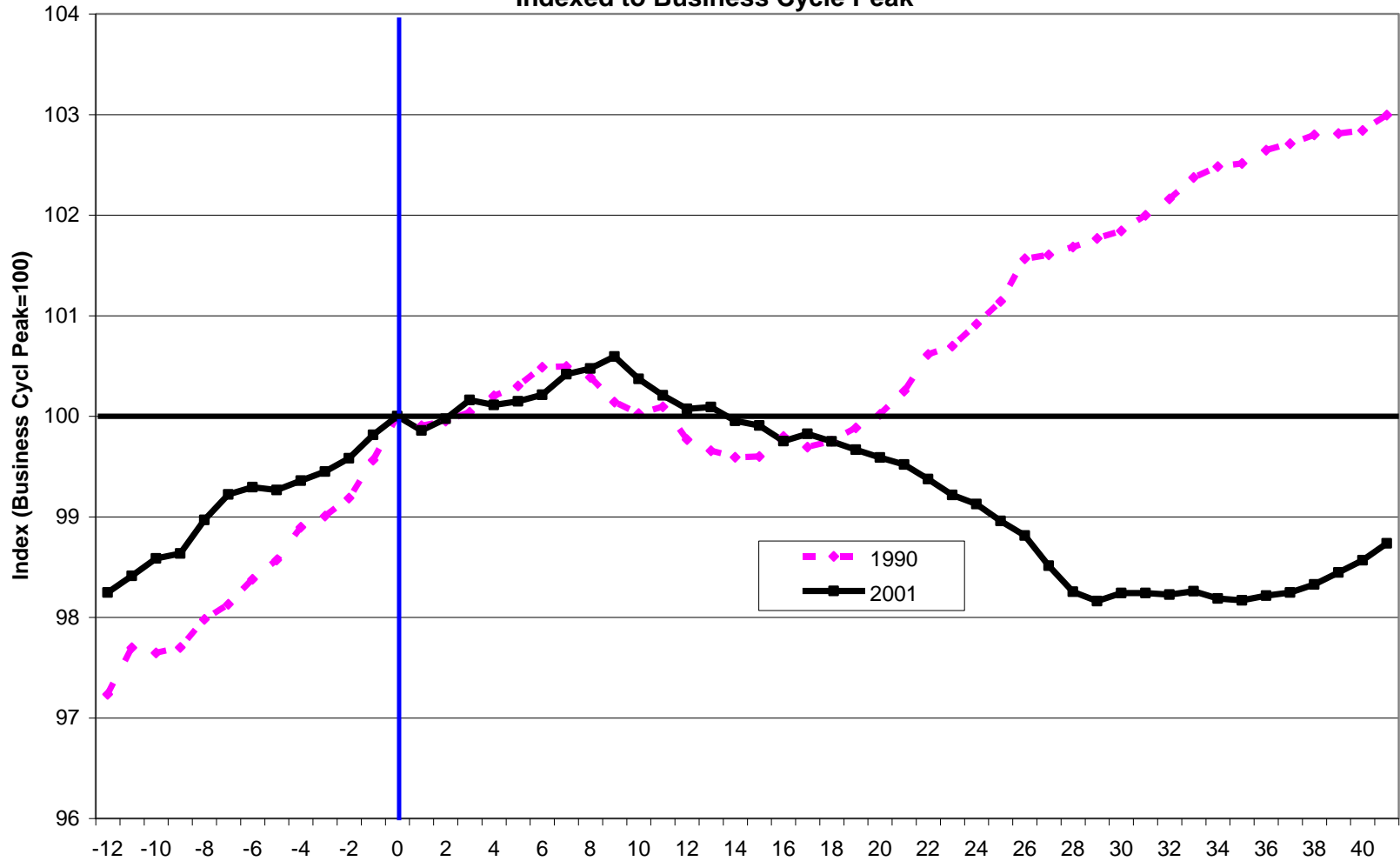
- State appropriations down 4% in aggregate between FY 2002 and FY 2004, in nominal terms
- Down in 30 states
- Resident undergraduate tuition and fees up more than 20% on average; up significantly in most states

State Cuts In Employment

- Surprisingly large cuts in state agency employment compared with prior recessions (see next graph):
 - more than 1% below peak for U.S. as a whole
 - furloughs, layoffs, freezes, early retirement
- But opportunity for significant budget savings from employment cuts are limited. Two largest state spending areas have relatively few employees:
 - K-12 education is mostly aid to local districts, not pay to state employees
 - Medicaid is mostly payments to medical vendors

State Agency Employment Has Been Hit Much Harder Than In Prior Recessions

Monthly State Government Noneducation Employment in 1990 and 2001 Recessions
1 Year Before Through 3.5 Years After Start
Indexed to Business Cycle Peak



Medicaid Is Huge, But It Is Still Hard For States To Obtain Large Budget Savings

- Many states have cut Medicaid at least somewhat:
 - Almost all froze or reduced at least some provider payments in last 2 years
 - Actions to control drug costs in 45+ states in last 2 years
 - Actions to reduce or restrict eligibility in about half of states, potentially affecting 1-2 million people
- But budget savings often not large:
 - In Rockefeller Institute study of 10 states, all 10 cut Medicaid in some fashion, but only 2 states had cuts of more than 4% of the program (OR was 13%, TX was 14%)
 - See James Fossett and Courtney Burke, *Medicaid and State Budgets in FY 2004: Why Medicaid Is So Hard To Cut*, Rockefeller Institute of Government, July 2004
- Significant Medicaid savings are hard to obtain
 - Many of the cuts reduced enrollment of children and low-income adults, but these are the least expensive populations to care for
 - Elderly and disabled are far more expensive to care for but often have significant support among elected officials
 - Strong political support for Medicaid in the health care industry
 - Aging of the population will be driving costs upward
 - Cuts in Medicaid are “shared” with federal government – to save \$1 in state money, a state will have to cut services by \$2 to \$4+, depending on the state’s federal reimbursement rate

States Face Continued Near-Term Challenges

- Need to replace revenue or cut spending as one-shots disappear, continue to bring revenue and spending into line
- Need/desire to replenish reserve funds
- Medicaid pressures:
 - increases in prescription drug costs (double-digit annual increases)
 - increasing costs of long-term care and aging of the population
 - enrollment increases
 - over the longer term, CBO expects 8-9% annual growth in Medicaid
- K-12 education:
 - enrollment pressures have eased, but continued pressure from the standards movement and NCLB
 - Continued strong political support for K-12 spending
- Higher education: baby boomer echo moving into college years; labor market “pull” requires more higher education
- Continued difficulty collecting tax on Internet and mail order transactions