

State Finances: Improvement, But Pressures and Risks

*National Federation of Municipal Analysts
Advanced Seminar on Tax-Backed Debt*

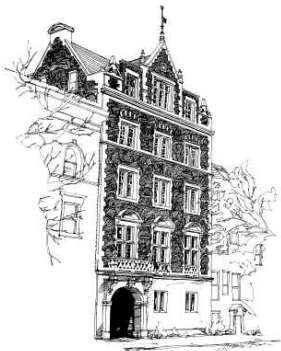
Orlando, FL
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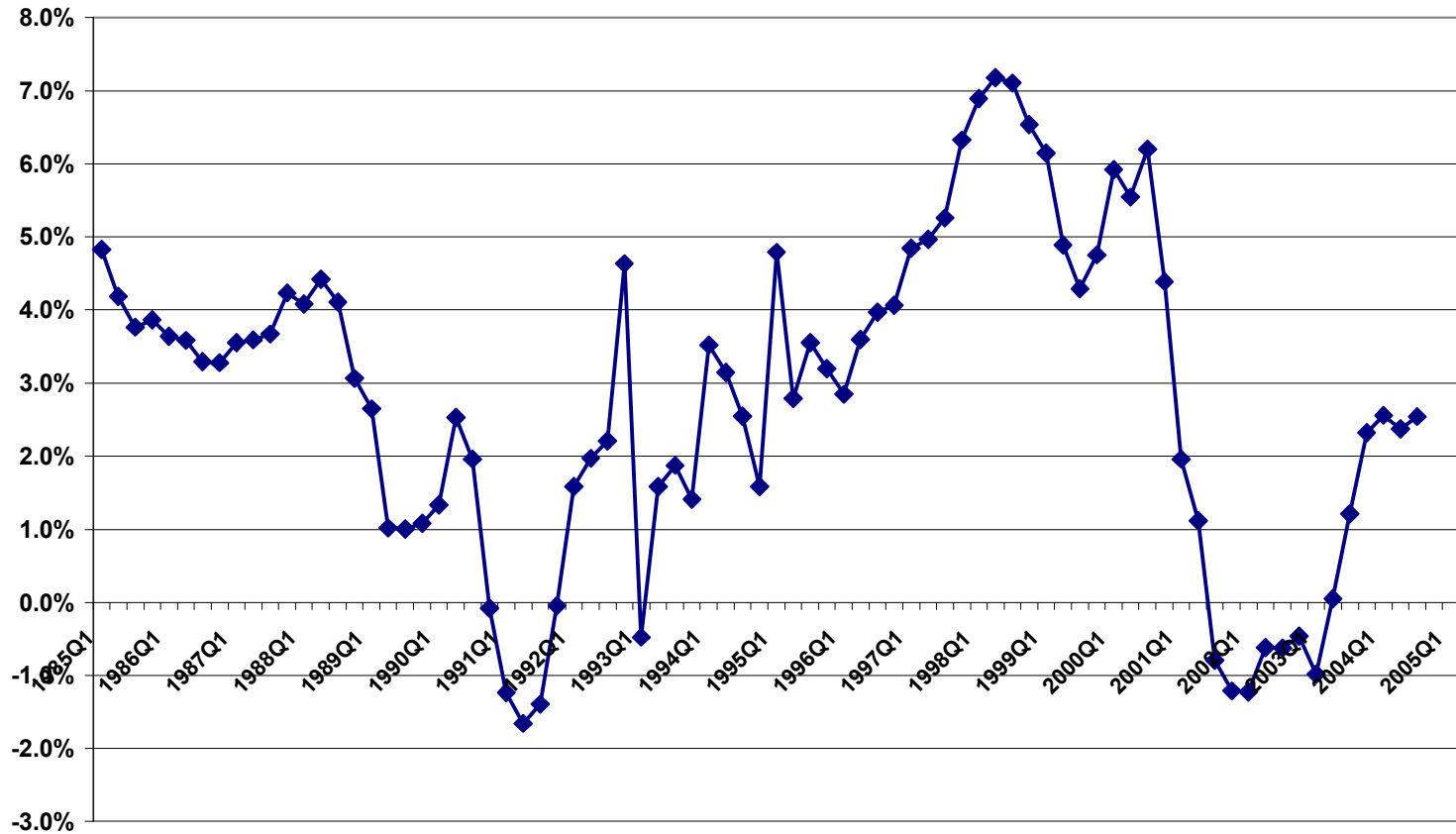
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Wage Growth Has Recovered, Still Below Pre-Recession Rates

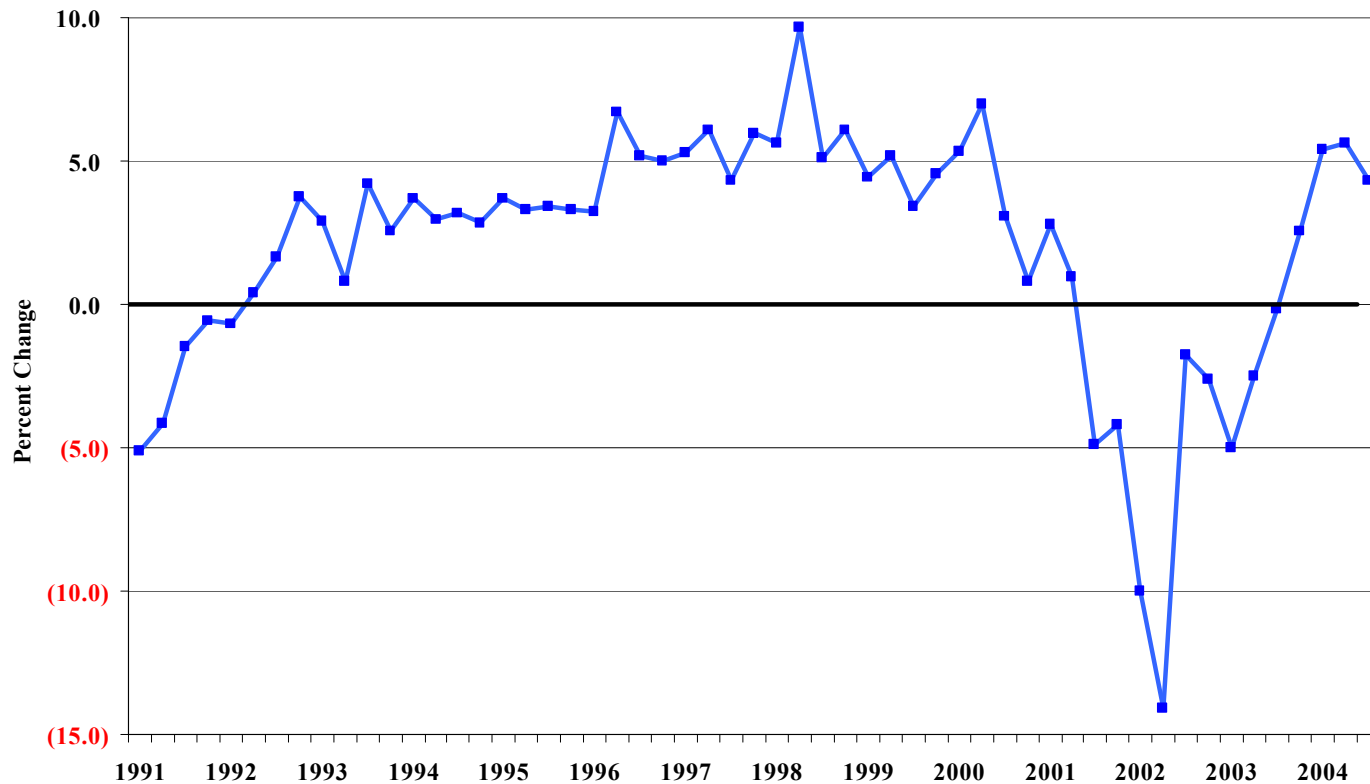
% Change in Real Wages vs. Same Quarter of Prior Year



Source: Bureau of Economic Analysis

Underlying Tax Revenue Continues to Recover

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



July-Sept Quarter Was Healthy

- Tax growth:
 - 8.6% nominal
 - 8.2% nominal, adjusted
 - 4.3% real, adjusted
- Nominal by tax:
 - 8.2% PIT
 - 6.7% withholding
 - 14.3% estimated tax (10.5% median)
 - 5.9% sales
 - 21.7% corporate
- Nominal by region:
 - 7.4% New England
 - 8.8% Mid-Atlantic
 - 6.3% Great Lakes
 - 4.5% Plains
 - 8.7% Southeast
 - 11.6% Southwest
 - 8.3% Rocky Mountain
 - 11.0% Far West

SOURCE: Nicholas W. Jenny, *State Revenue Report #58*, Rockefeller Institute of Government, December 2004

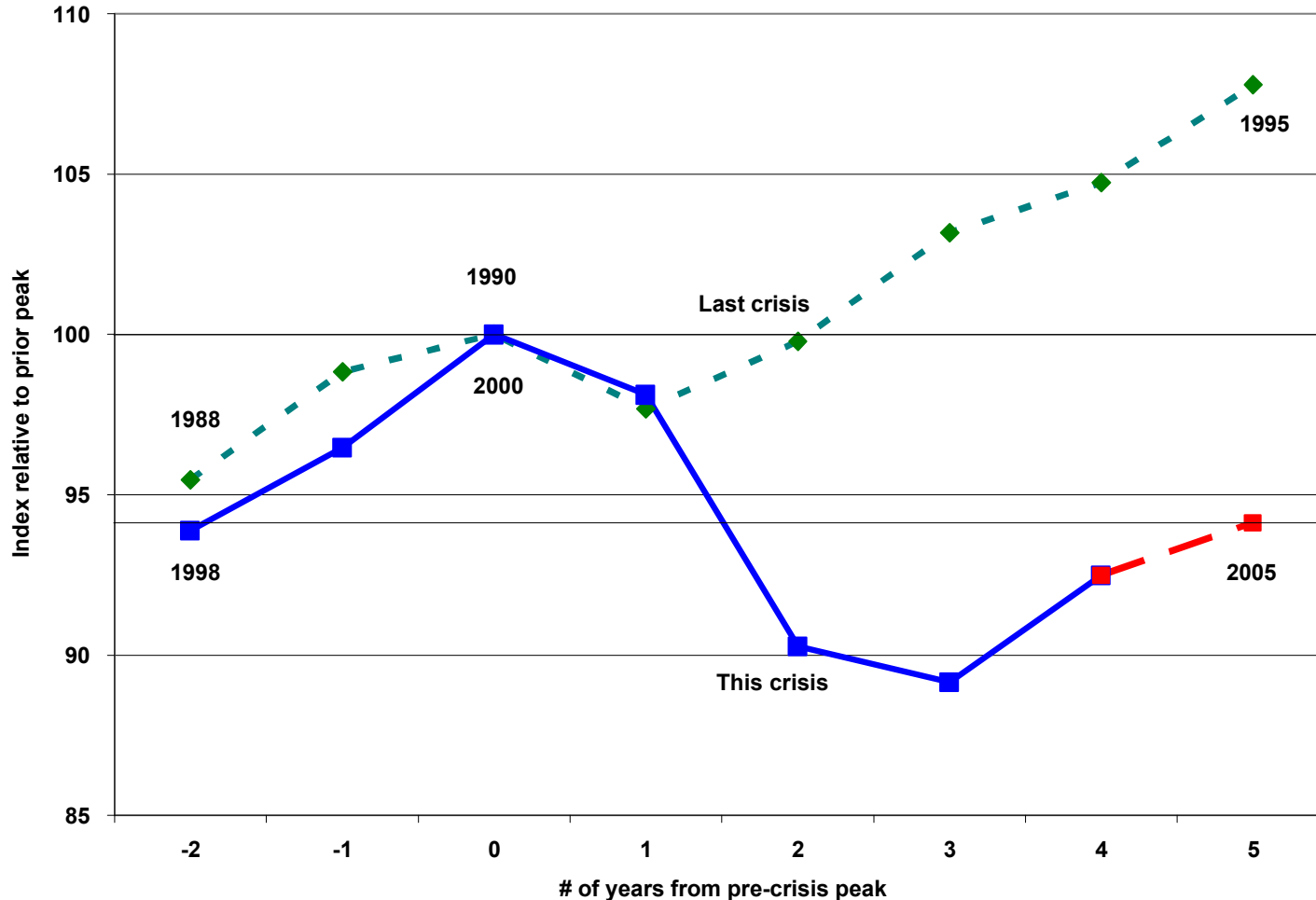
State Fiscal Conditions Have Improved

- Only 3 states reported gaps in 2005 after budget enactment, vs. 10 and 31 in 2 prior years
- Revenue on target, or better, in 46 states
- Spending running ahead of projections in about half of states, but not enough to cause budget gaps. Overages most common in Medicaid
- But states face fiscal pressures and risks...

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.

Sales Tax Base Has Been Declining

Sales Tax Base as a Percent of Personal Income, 1979–2003



- Shift from goods to service consumption
- E-commerce, mail order, cross-border losses
- Exemption creep

Reproduced from Bruce, Donald and William F. Fox, "E-Commerce in the Context of Declining State Sales Tax Bases," *National Tax Journal*, 53(3,4) 2000.

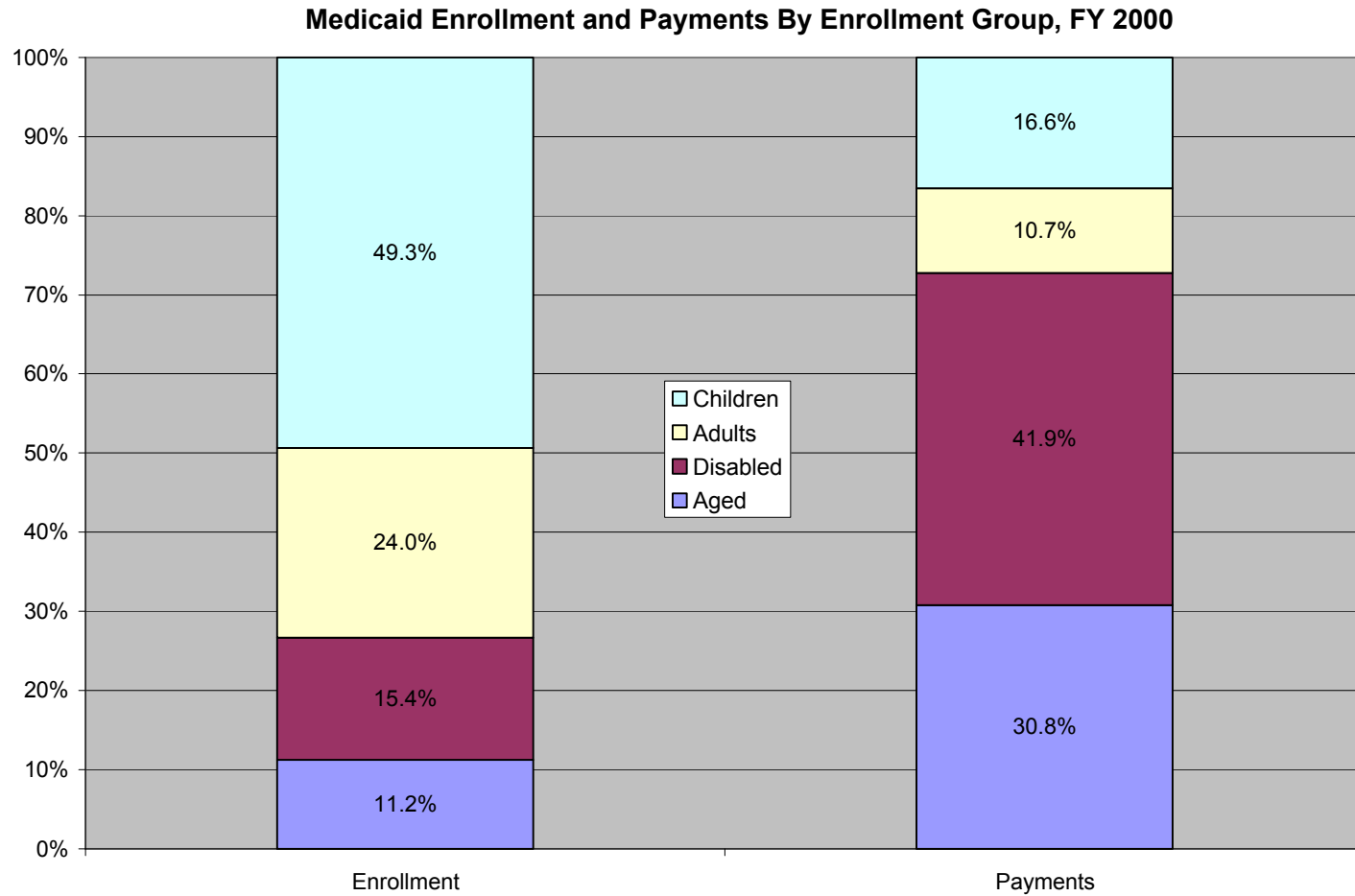
Federal Tax Reform

- Most discussion is about national impacts
- From state-local perspective, potentially big fiscal issues
 - Deductibility of S&L taxes
 - Administrability of income tax
 - Fed intrusion into traditional SL tax area
 - Municipal bond interest exclusion

Medicaid Cost Pressures

- Now #1 area of state spending (#2 of own-source spending, after K12)
- Has resumed rapid growth, after slowing in late 1990s
- Year after year, over budget in many states
- Not just a program for low-income people. Serves many formerly middle class. Difficult for states to control or cut.
- Outyears: CBO expects 7-8% annually
- By contrast, economic forecasters typically expecting 5-6% growth in nominal personal income (a major factor affecting state tax bases)
- Medicaid 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)

Medicaid: More Than 70% is for Elderly and Disabled



Source: Kaiser Commission on Medicaid and the Uninsured, *2000 State and National Medicaid Enrollment and Spending Data (MSIS)*, Tables 1 and 4, www.kff.org/medicaid/kcmu031104bpkg.cfm

K-12 Spending Pressures

- Enrollment will grow relatively slowly in coming years in most states
- But higher standards and court decisions are creating pressures
- No one can estimate costs of higher standards with any certainty, but they could be large
 - Economists Reschovsky and Imazeki estimated that bringing low-performing school districts in Texas up to statewide average would take a doubling of state aid
 - Court-appointed referees in New York lawsuit estimated an increased need of \$5.6 billion annually in New York City, a more-than-40 percent increase.
 - Consultant report in Ohio estimated meeting No Child Left Behind standards would require 11% increase

Other Spending Pressures

- Higher education (#3 spending area):
 - Enrollments are rising as children of baby boomers leave high school and enter college
 - Occupations requiring substantial college are in increasing demand: 43 percent of new jobs in coming years, despite accounting for only 29 percent of current jobs (BLS)
- Corrections
 - Incarceration rate increased by >50% in 1990 to 2002, despite >30% drop in violent crime, driving up spending
 - Many states now reconsidering sentencing policies, in part to help ease prison costs
- Pensions
 - Pension fund earnings more than doubled relative to budgets in 1990s, allowing reduction in contributions
 - Pension contributions now rising significantly in many states and localities

Perspective on TABOR (1)

Long-Term Spending Trends

State and local own-source expenditures - long term Adjusted using CPI-U

Year	Real per-capita expenditures	Average annual growth	Per \$100 GDP	Average annual growth
1950	\$804.4		\$5.4	
1960	1,195.1	4.0%	6.6	1.9%
1970	2,052.7	5.6%	8.5	2.6%
1980	2,466.2	1.9%	9.0	0.6%
1990	3,413.7	3.3%	10.4	1.5%
2000	3,804.9	1.1%	10.2	-0.2%
2003	3,977.9	1.5%	10.5	0.9%

Sources: Federal Budget FFY 2005 Table 15.2 (SLG Own-source expenditures, FFY); Bureau of Economic Analysis (GDP); Bureau of Labor Statistics (CPI-U); Bureau of the Census (Population)

Perspective on TABOR (2)

More-Recent Spending Trends

- From 1980 to 1990
 - Every state increased real per-capita state-local spending from own sources
 - 49 increased by 15% or more
- From 1990 to 2000
 - 48 states increased real per-capita state-local spending from own sources
 - 35 by 15% or more

Recap: Improvement, But Risks and Pressures

- Tax revenue is well below prior peak and recovery is weak by historical standards; spending has not been cut, or taxes increased, commensurately
- Sales tax base erosion still an issue for SLGs
- Federal tax reform creates fiscal risks
- Medicaid costs continue and are hard to stop or slow; reform proposals will create fiscal risks
- Standards movement and NCLB mean pressure to increase K12 spending
- Enrollment growth and labor market demands create pressures for higher education
- Other pressures include corrections and pensions