

The State Fiscal Crisis – How We Got Here, Where We May Be Going

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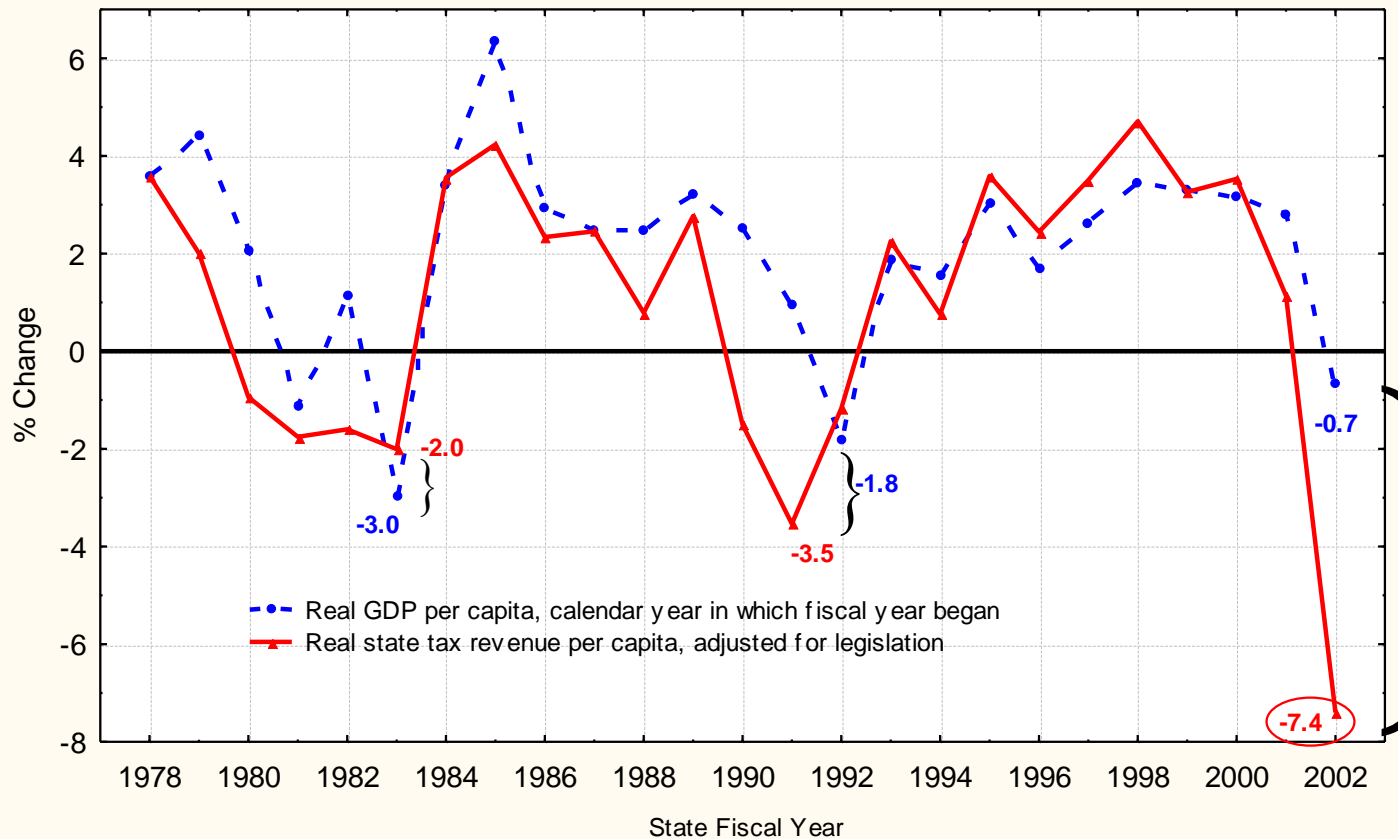
A Two-Pronged Crisis

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

Capital Gains Plummeted, Wages and Other Income Slowed Sharply

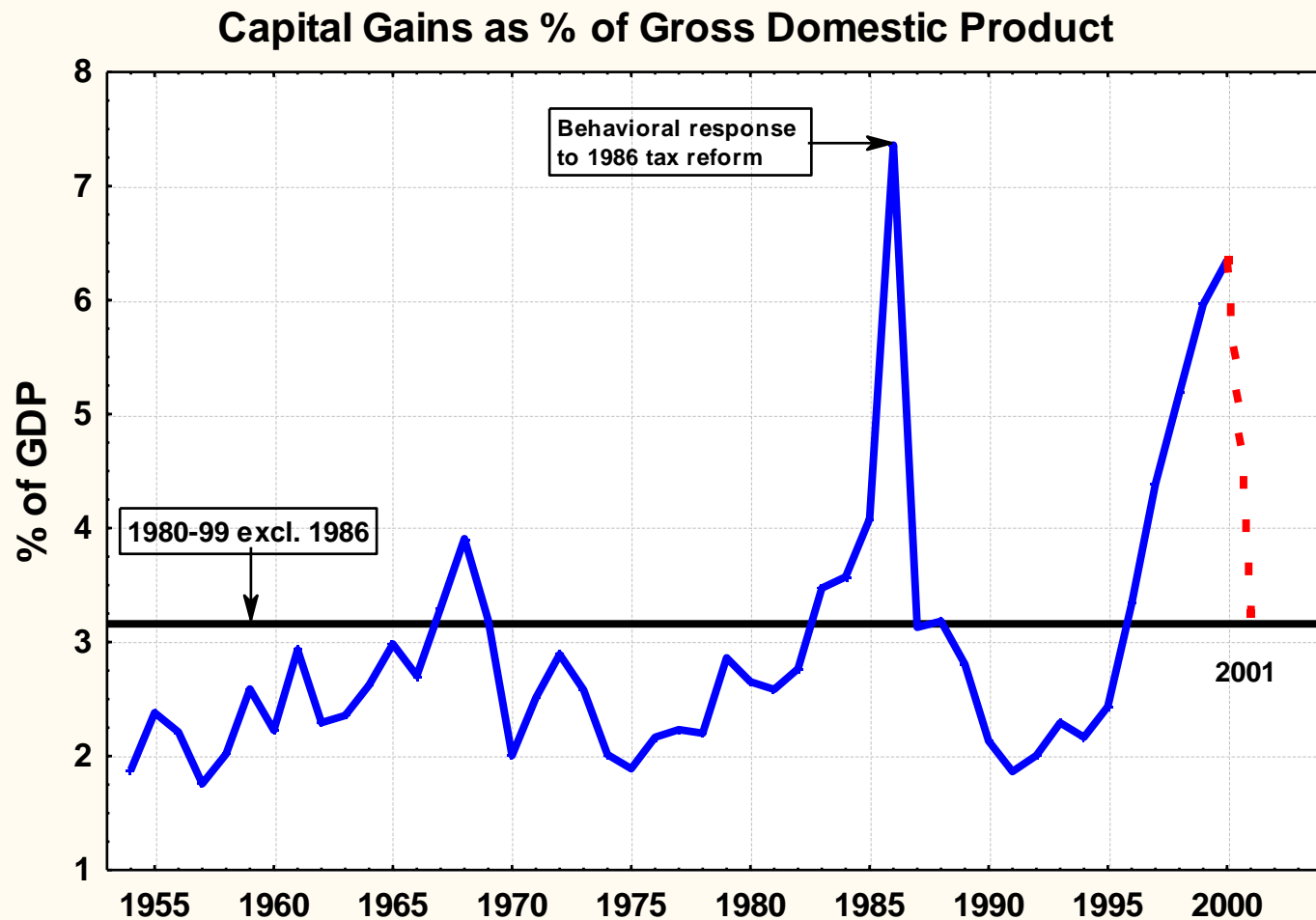
Percentage Change in Major Elements of the Income Tax

	1998	1999	2000	2001
Wages	7.5	6.5	7.8	2.5
Capital gains	23.8	21.7	13.4	(47.8)
Other income	7.8	8.3	8.7	0.6
Adjusted gross income	7.5	6.5	7.8	2.5
Taxable income (federal)	10.1	9.3	9.5	(5.6)

Note: Progressive income tax structures magnified the drop in taxable income. Income tax revenue in FY 2002 fell by 12%.

Source: IRS Statistics of Income data

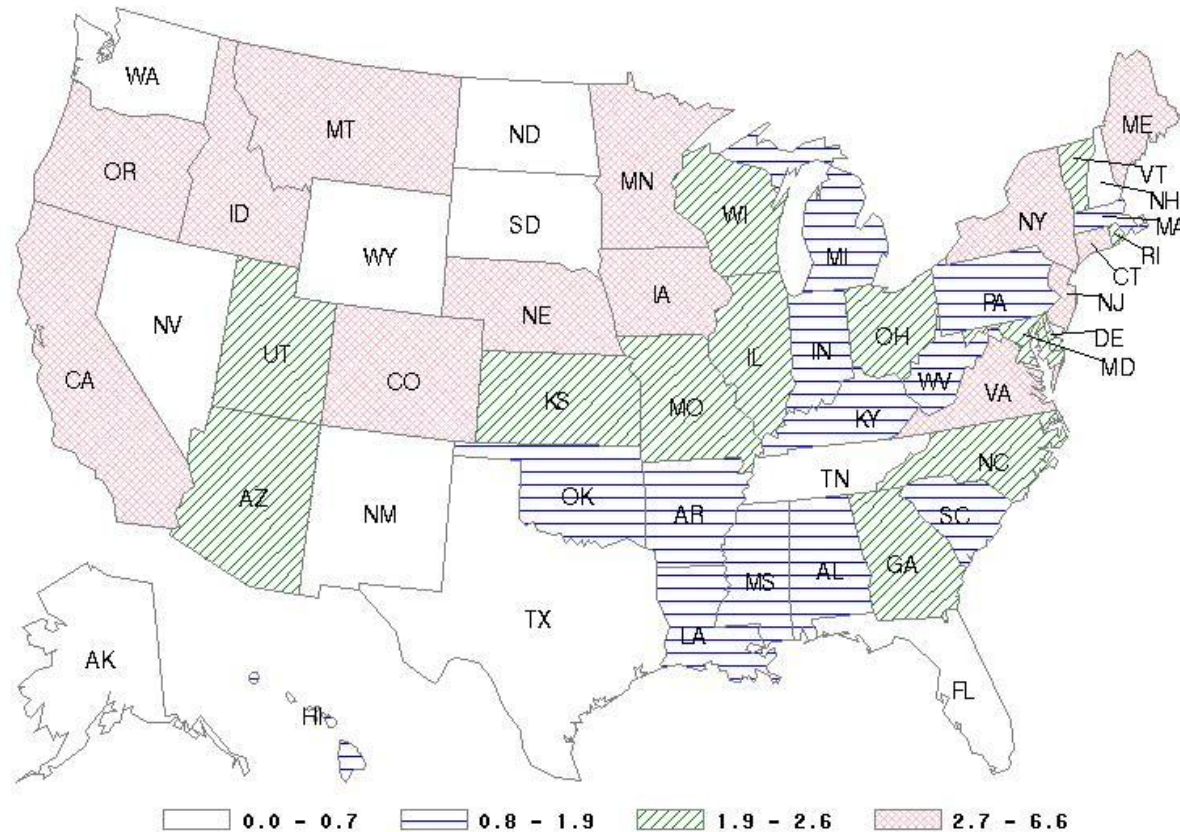
1990s Runup in Gains and 2001 Plunge Were Outside “Normal” Experience (1986 was special)



SOURCE: Internal Revenue Service, Statistics of Income Branch

Capital gains decline had widely varying impacts on states

Capital gains tax loss in tax year 2001 as % of state tax revenue



NOTE: This reflects the direct loss only. Stock options and other related effects made things worse still.

Estimated Direct Loss to States (Total loss, including options and related effects, would be larger)

Direct Impact of Decline in Capital Gains in Tax Year 2001 As % of State Tax Revenue

California	(6.6)	Missouri	(2.2)
Oregon	(5.1)	Georgia	(2.1)
New Jersey	(4.1)	Kansas	(2.1)
Maine	(4.0)	Vermont	(2.0)
New York	(3.7)	Delaware	(2.0)
Montana	(3.7)	Illinois	(1.9)
Idaho	(3.7)	South Carolina	(1.9)
Colorado	(3.6)	Massachusetts	(1.8)
Nebraska	(3.2)	Hawaii	(1.7)
Minnesota	(2.8)	Michigan	(1.4)
Virginia	(2.8)	Louisiana	(1.4)
Connecticut	(2.8)	Alabama	(1.4)
Iowa	(2.7)	Oklahoma	(1.3)
Maryland	(2.6)	Arkansas	(1.3)
Utah	(2.5)	Pennsylvania	(1.3)
North Carolina	(2.5)	West Virginia	(1.0)
Arizona	(2.4)	Kentucky	(0.9)
Wisconsin	(2.4)	Indiana	(0.8)
Rhode Island	(2.3)	Mississippi	(0.8)
Ohio	(2.3)	North Dakota	(0.7)
United States median	(2.3)		

NOTE: Excludes non-income tax states of Alaska, Florida, New Hampshire, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming. New Mexico excluded due to suspect data.

Source: IRS Statistics of Income data files 00in54cm.xls and 01in54cm.xls, plus state capital gains tax rules.

Far West, Northeast Hit Hard in FY 2002, (Partly Due To Capital Gains Impact)

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

PIT Shortfalls Far Larger Than Corporate or Sales Tax (in Dollars)

State Tax Revenue Shortfalls (Amounts in \$ millions)

	<i>Fiscal Year 2002</i>			<i>Fiscal Year 2003 (Estimate)</i>		
	Shortfall	% Share of Total Shortfall	Shortfall as % of Estimate	Shortfall	% Share of Total Shortfall	% Shortfall
Personal income tax	\$ 27,508	71.9%	12.8%	\$ 17,173	72.5%	8.6%
Sales tax	4,810	12.6%	3.2%	4,235	17.9%	2.5%
Corporate income tax	5,921	15.5%	21.5%	2,289	9.7%	8.3%
Sum of 3 main taxes	\$ 38,239	100.0%	9.7%	\$ 23,697	100.0%	5.9%

Source:

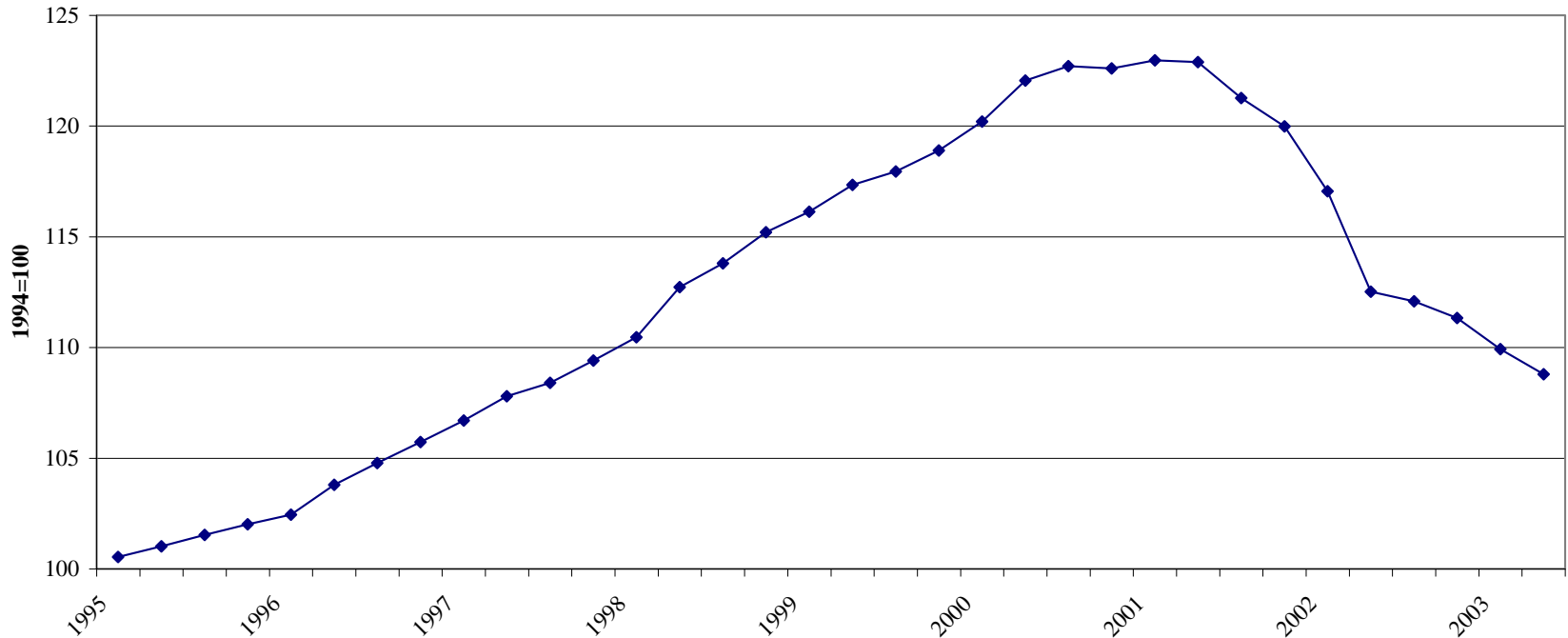
National Association of State Budget Officers, Fiscal Survey of the States, November 2002, Table A-9 and June 2003, Table A-6

Revenue Remains Weak

- Tax revenue declined sharply at end of FY 2002, straining policymaking process
- Revenue weakness continued in FY 2003.
Adjusted for inflation and legislation:
 - Revenue for April-June quarter declined 0.8% - income tax returns on 2002 tax year apparently did not improve
 - Revenue for FY 2003 declined 0.2%
- Even with recovery, stock markets unlikely to generate gains close to those realized in 2000 for many years
- Carryover of capital losses could depress capital gains in 2003 and later years

Tax Revenue: No Longer Plummeting But Remains Weak

State Tax Revenue Adjusted for Legislation and Inflation
Four-Quarter Moving Average, Indexed to 1994



Source: Nicholas W. Jenny, Rockefeller Institute of Government, Underlying State Revenue Picture Remains Bleak, August 2003

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
- FY 2003: somewhat slower, at 8% (state share), but still far faster than revenue
- 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,
National Association of State Budget Officers

Tax Revenue Declines Played Far Bigger Role In Budget Problems Than Medicaid Acceleration

What Caused State Fiscal Problems - - Tax Revenue Declines or Medicaid Spending Increases?

	State Spending From Own Sources on Medicaid	State Tax Revenue
Fiscal year 2001 actual (millions of dollars)	\$ 85,141	\$ 528,169
Actual growth rate	13.2%	(5.7%)
"Normal" growth rate (illustrative)	5.0%	6.0%
Actual fiscal year 2002 amount (estimated - millions of dollars)	\$ 96,380	\$ 498,064
Potential fiscal year 2002 amount at "normal" growth rate (millions of dollars)	<u>89,398</u>	<u>559,860</u>
Estimated contribution to state budget gaps (millions of dollars)	\$ 6,982	\$ 61,796
Ratio of tax gap to Medicaid gap		9 : 1

Sources:

Medicaid expenditures: State Expenditure Report, National Association of State Budget Officers, Summer 2002
Fiscal Survey of the States, November 2002

Tax revenue, U.S. Bureau of the Census, adjusted by Rockefeller Institute of Government to remove impact of tax legislation

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 So Far

- **Fund balances:** drawn down from more than 10% of expenditures in FY 2001 to 1.3% of expenditures at end of FY 2003; 16 states now have balances of <1%
- **Special funds:** At least 23 states tapped capital, highway, other funds for FY 2003, and 29 for FY 2004; at least 16 have used tobacco settlement money
- **Spending cuts:** 31 states cut for FY 2004 in some fashion; Medicaid cost containment planned in many states (but how real?)
- **Tax increases:**
 - FY 2003: $\geq 1\%$ in 16+ states, for \$6.7 billion, 40% of \$ was cigarette taxes; a few large or broad-based tax increases – KS, IN, MA, NJ, TN – but these were exceptions, not the rule
 - FY 2004: more income and sales tax increases, \$6.9 billion tax increase in total (see next page)

CAUTION: tax and spending changes not always as large as they sound

SOURCE: mostly NCSL

FY 2004 Revenue Increases

FY 2004 Net State Tax and Revenue Increases (Billions of Dollars)

Sales and Use	\$	2.8
Personal Income		1.8
Tobacco		0.6
Corporate Income		0.5
Other taxes		1.2
		<hr/>
Total taxes		6.9
Fees		2.6
Other revenue		1.1
		<hr/>
Total Revenue	\$	10.6
		<hr/>

Source: National Conference of State Legislatures, State Tax Actions 2003: Preliminary Report, as reported in Jenny, Nicholas and James Orsi, "Budget Balancing Tactics", Rockefeller Institute of Government, August 2003

Spending 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 now estimated at 0.3% so spending by function (when available) will be lower than shown above
- FY 2004 spending estimated to decline by 0.1%

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
- Medicaid and K-12 education spending pressures
- Many states solved 2003-04 problems in ways that make 2004-05 and 2005-06 much worse
- → Good times for most states probably at least 2-3 years away

Appendix:

Factors Affecting Outlook For Spending Cuts

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

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

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

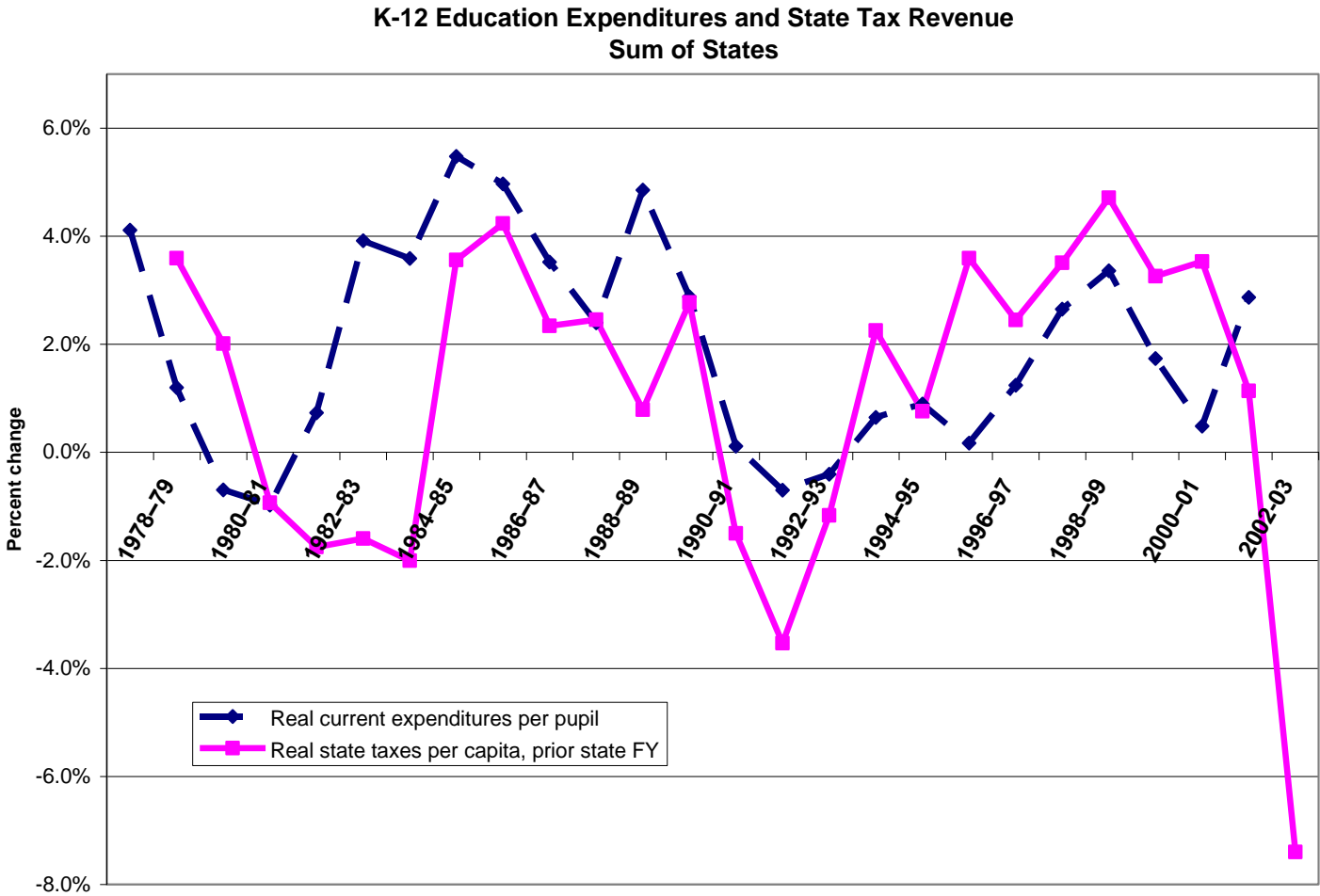
	Amount of Aid (Billions of dollars)	% Share
Local government general revenue, total	\$ 888.9	
Local government revenue from state governments	<u>317.1</u>	<u>100.0</u>
Education (K-12 and higher education)	209.4	66.1
Public welfare	29.5	9.3
General support	24.3	7.7
Health & hospitals	13.5	4.2
Highways	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...



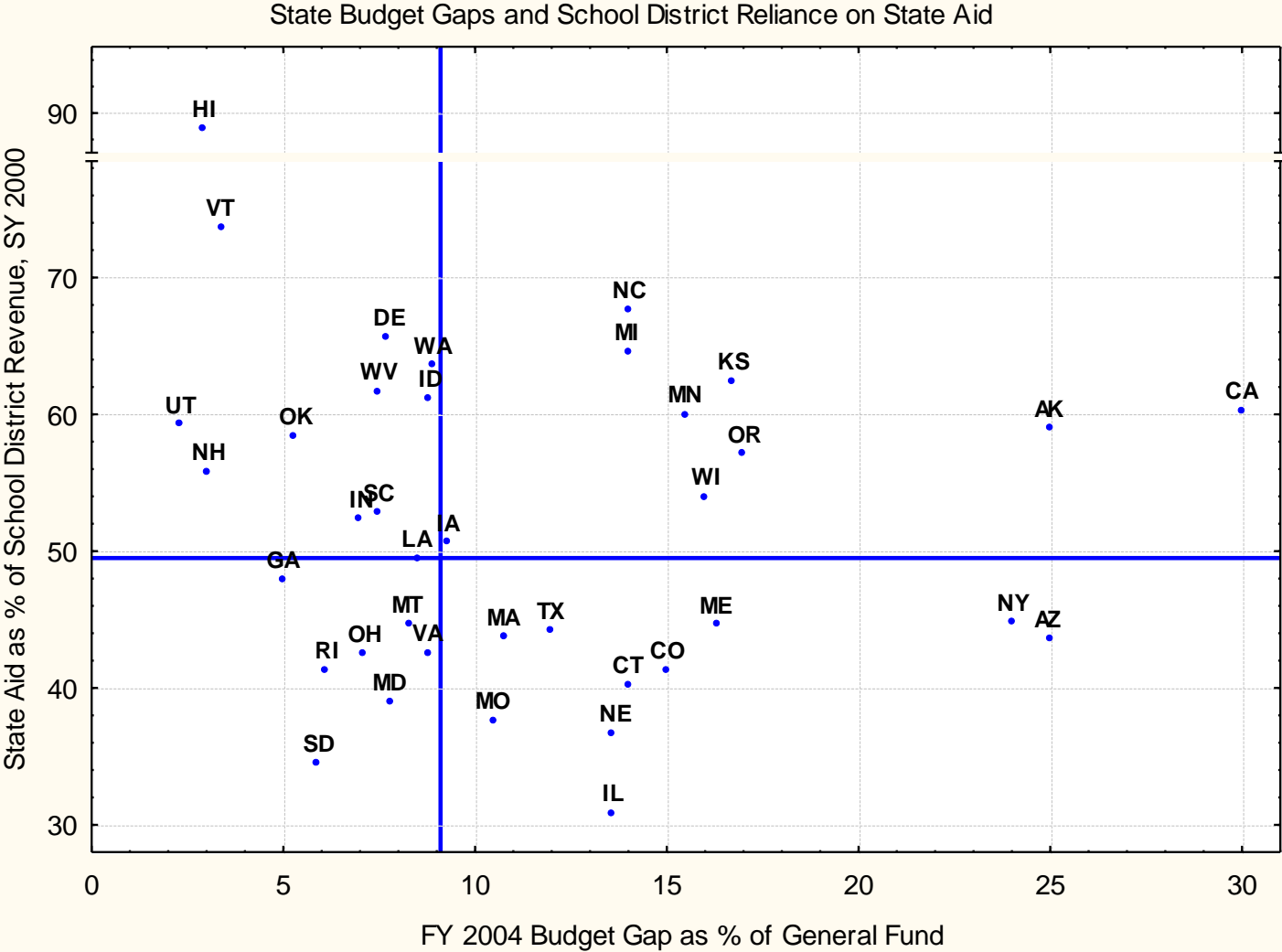
In Which States Do School Districts Rely Heavily On State Aid?

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

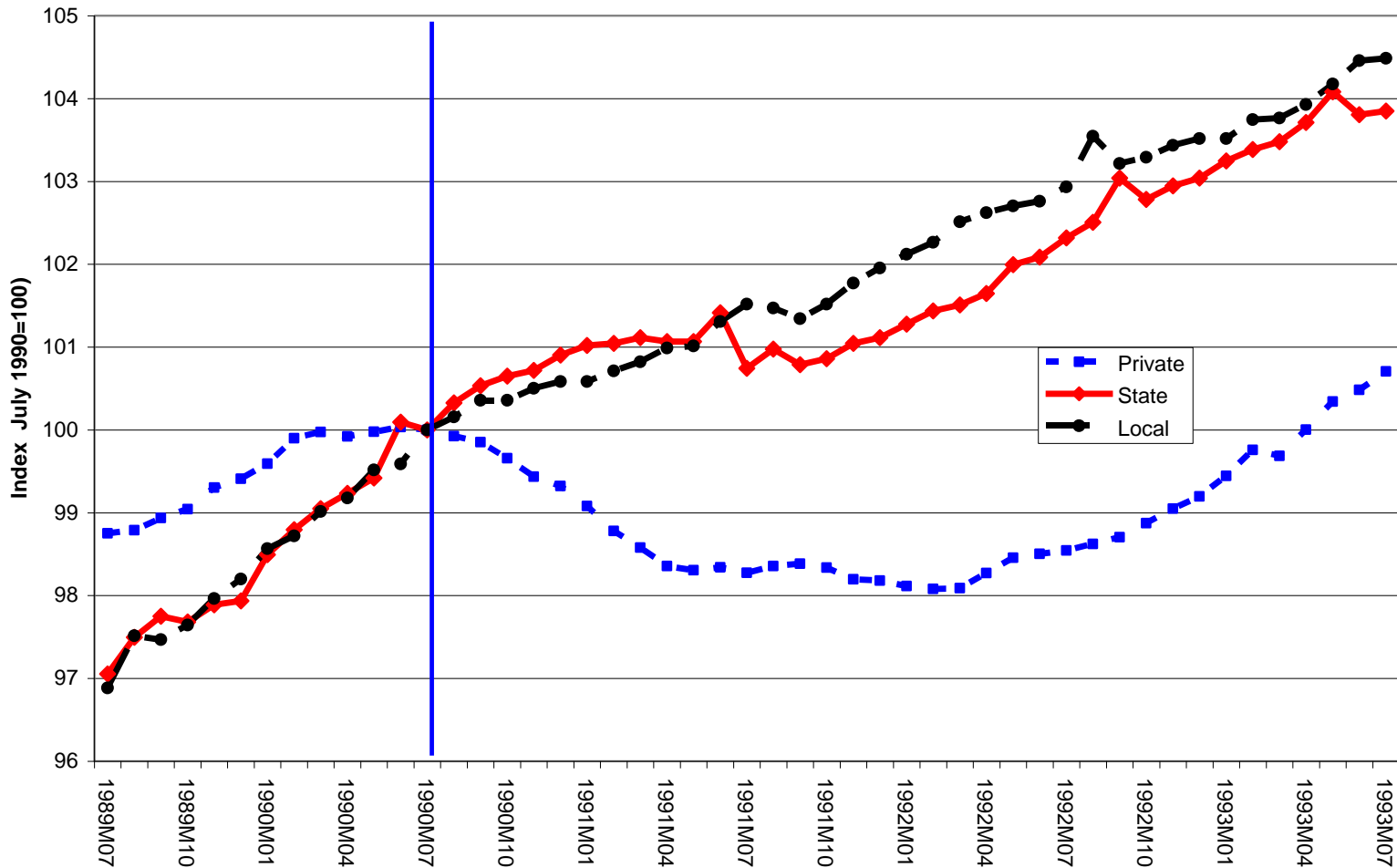
Source: National Center for Education Statistics, National Public Education Financial Survey, 1999–2000

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

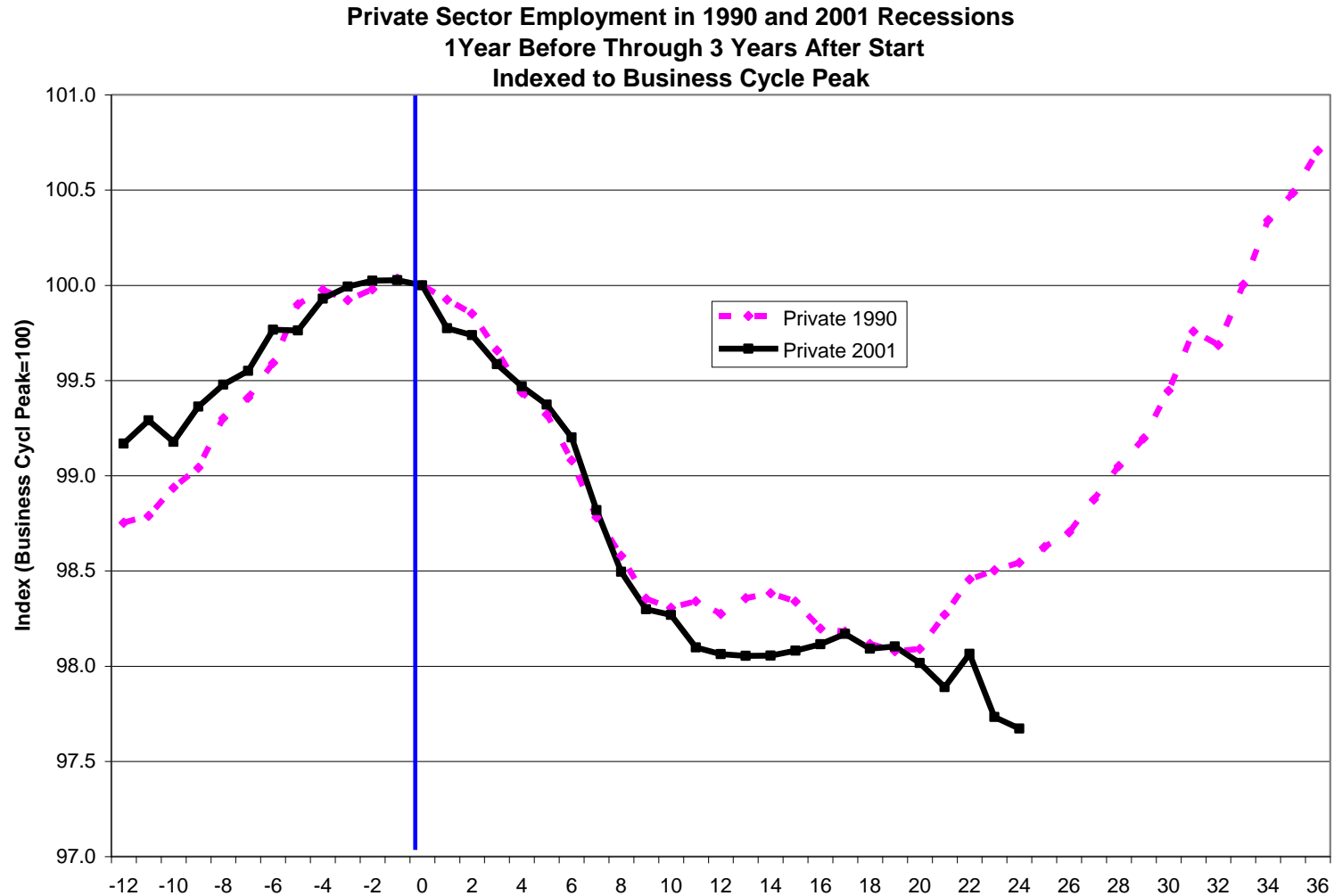


Governments, In Aggregate, Generally Don't Reduce Employment in Recessions – 1990 Fairly Typical

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

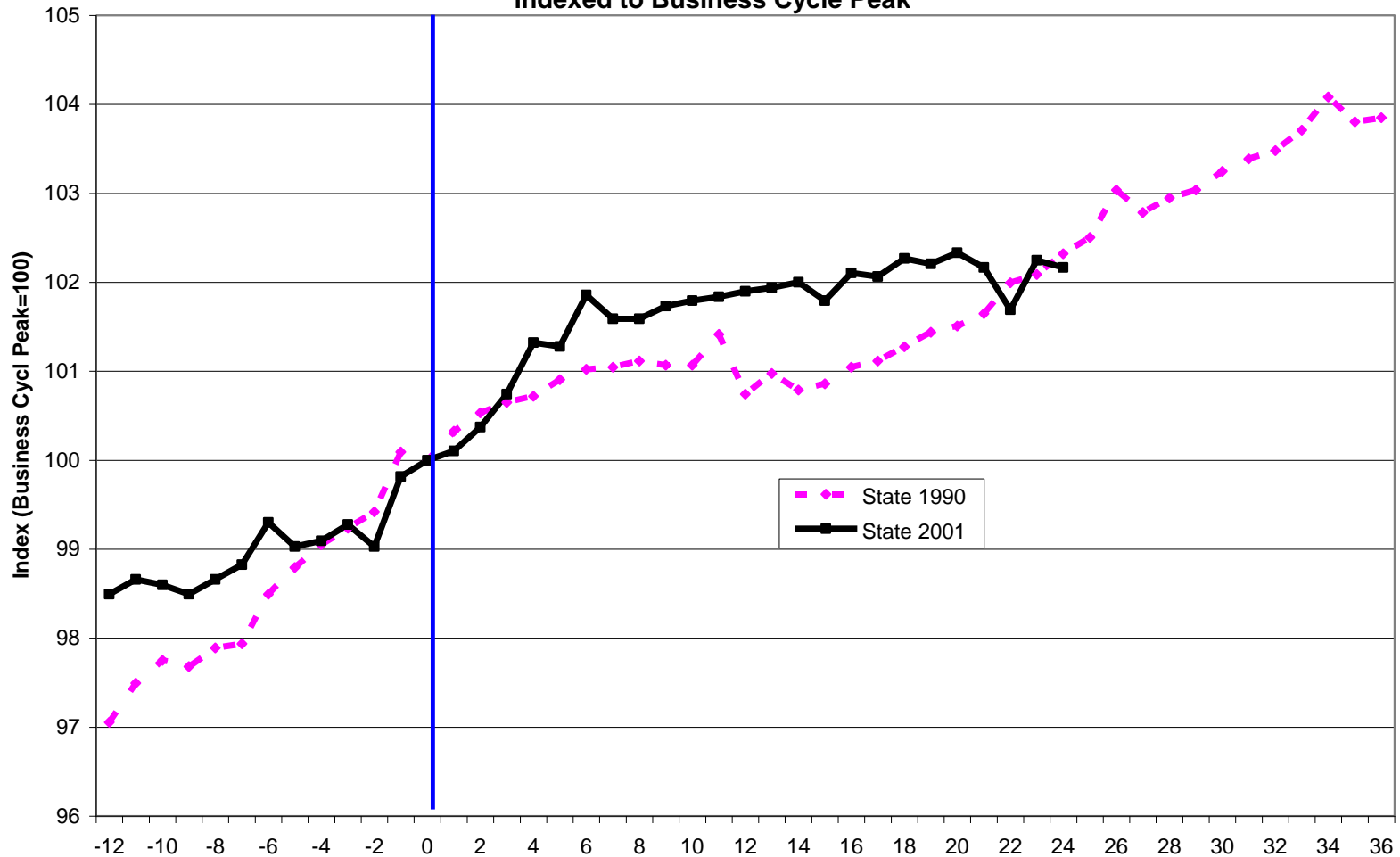


Current Recession - Private Sector: Recently Somewhat Worse Than 1990 Recession



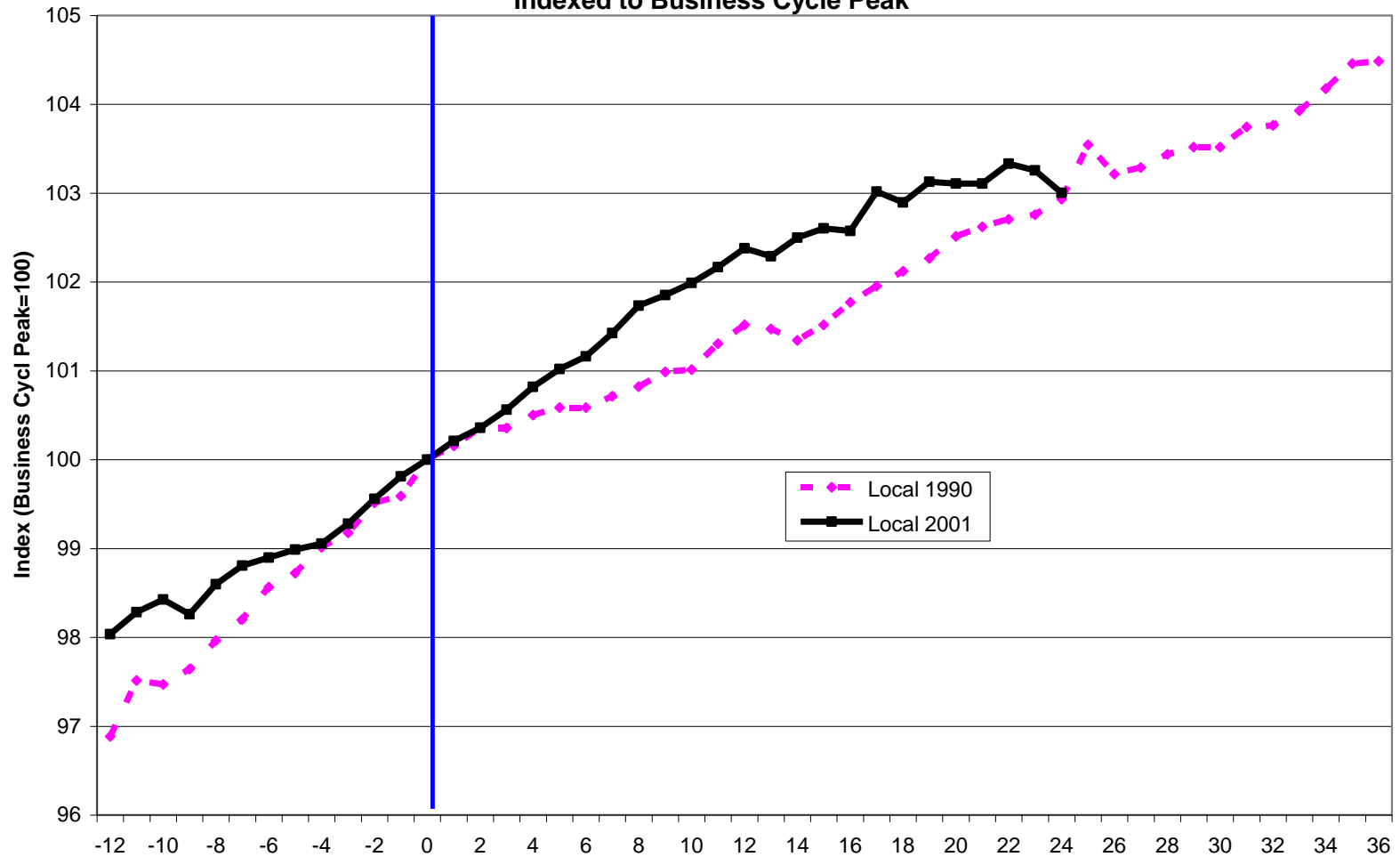
Current Recession – State Gov't: Similar To 1990 Recession, But May Be Some Weakening

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 (see appendix) – but some evidence it is happening

How Will It All Play Out? (2)

- Anti-tax sentiment remains strong
- Some tax increases:
 - mostly cigarette, nuisance taxes in FY 2003
 - more sales and income tax increases for FY 2004, but still limited
- Gambling/lottery revenue potential is limited
- Lots of one shots already, but more likely:
 - tobacco funds
 - reserve funds
 - off-budget funds
 - accelerations; etc.
- I don't envy legislators and their staffs