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STATE AND LOCAL GOVERNMENTS FACE CONTINUED FISCAL PRESSURE

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Tax revenue has stopped plummeting and has resumed growth. Unfortunately, the fiscal outlook for state and local governments in the new year is not rosy.

Even with the improved economy and legislated tax increases, state tax revenue remains about 8 percent below its 2000 peak after adjusting for inflation and population growth. Many states used one-shots and other nonrecurring resources to put off the policy choices that lower revenue requires. Many states will have to make difficult choices — further spending cuts or further tax increases — in the next 2-3 years. On top of this, state and local governments face fiscal risks and continued spending pressures.

Fiscal Risks From Federal Policy

Perhaps the largest risk is the possibility that the federal government will enact a major overhaul of the federal tax system by adopting a retail sales tax, a consumption tax, or a value-added tax. Whatever the pros and cons from the perspective of the federal tax system and the nation's economy, all of these approaches could create major — and largely undiscussed — problems for state and local government finances.

Depending on important details, these proposals could:

(a) Eliminate the deductibility of state and local income and property taxes, raising the effective cost of state and local services and having dramatically different impacts across states;

(b) Tread on the traditional state-local terrain of sales taxes, making it difficult for state and local governments to raise revenue from these taxes;

(c) Make it impractically expensive for states to have their own income taxes if federal tax changes are in place of the existing federal income tax; and/or

(d) Raise the costs to states of maintaining and improving infrastructure, if municipal bond interest is no longer tax-exempt.

Another major policy risk is the possibility that the federal government will convert Medicaid into a near-block-grant that caps federal spending or its growth in a way that requires cutbacks in services or an increase in the state share of Medicaid spending. As with federal tax reform, some variants of Medicaid reform could have adverse fiscal impacts on all states and others could create significant winners and losers among states.

Spending Pressures

Medicaid: After a brief slowdown in the late 1990s, Medicaid has returned to annual double-digit growth rates. The National Association of State Budget Officers estimated that Medicaid is now the single-largest area of state government spending, ahead of elementary and secondary education. The rapid growth results from many factors that are difficult or impossible for states to control, including rapidly evolving and expensive technologies and prescription drugs, and rapid growth in enrollment of expensive-to-care-for disabled and "dual eligible" populations (individuals eligible both for Medicare and for Medicaid). In addition, state and federal policy choices to expand Medicaid's coverage to more low-income children and pregnant women and to reach out to potentially eligible populations and enroll them in Medicaid have contributed to spending increases.

Many of these forces are likely to continue driving Medicaid costs upward in coming years. In addition, the aging of the population will have a significant impact on Medicaid. Between 2005 and 2015, the U.S. Bureau of the Census expects the population aged 65 and over to grow by 26 percent, while the under-65 population will grow by only 6 percent.[1] As the population ages, states may find it difficult to finance rapidly increasing demand for Medicaid-financed prescription drugs and expensive long-term care services. Forecasters at the Center for Medicare and Medicaid Services in the U.S. Department of Health and Human Services and at the Congressional Budget Office expect Medicaid spending to grow considerably faster than the economy in the coming decade. It will continue to strain state finances even without major changes in federal participation.

Elementary and secondary education: The good fiscal news for state and local governments is that K-12 enrollment growth is slowing throughout most of the nation, although there will be pockets of rapid growth, particularly in western states and some mountain states. However, the pressures to increase spending per pupil are larger than ever. Even before the *No Child Left Behind Act* (NCLB), states were raising graduation and learning standards and creating demand for updated textbooks and curricula, smaller class sizes, more highly qualified teachers, more academic intervention services, enhanced summer learning opportunities, and other supports, all of which cost money. NCLB intensifies these demands. In addition, almost every state has had its system of financing education challenged in court. About two-thirds of challenges in the past 15 years have been successful, creating additional pressure to spend more.

The costs of meeting higher standards and responding to court challenges cannot be estimated precisely, but it is clear they will be very large. One recent study estimated statistically the costs of bringing low-performing school districts in Texas up to the statewide average on certain exams, and concluded that it would take a doubling of state aid to school districts in Texas to accomplish this.[2] The court-appointed referees in a New York lawsuit recently issued a report estimating an increased need of $5.6 billion annually in New York City, a more-than-40 percent increase.[3] Cost studies associated with litigation in other states also have concluded that spending increases would need to be large.

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1 Based on the middle projections from the Population Projections Program, Population Division, U.S. Census Bureau, data files NP-T3-A through NP-T3-E, Internet release date January 13, 2000.

2 Reschovsky, Andrew and Jennifer Imazeki, "Financing Education So That No Child Is Left Behind: Determining the Costs of Improving Student Performance," *Developments in School Finance 2003*, National Center for Education Statistics, 2004.

3 Feerick, John D., E. Leo Milonas, and William C. Thompson, *Report and Recommendations of the Judicial Referees*, Supreme Court of the State of New York, *Campaign for Fiscal Equity, Inc., et al.,* vs. *The State of New York et al.,* Index No. 111070/93, Honorable Leland DeGrasse, November 30, 2004.

Higher education: Higher education is the third-largest spending category for the state-local sector. Public colleges and universities enroll more than 12 million students and account for more than 77 percent of all higher education enrollment. State expenditures on higher education as a share of gross domestic product have fallen almost continuously since 1976, in part reflecting graduation of baby boomers from the higher education system and in part reflecting lower priority for higher education than for other services. State contributions to public higher education institutions were battered in the recent fiscal crisis — real state appropriations for public higher education institutions fell 7.8 percent between fiscal year 2002 and fiscal year 2004, and declined in 36 states, contributing to widespread double-digit increases in tuition.

Baby boomers' children are now exiting high school and entering college, driving up enrollments. In addition, labor markets are demanding more and more higher education — the U.S. Department of Labor estimates that occupations in which three-quarters or more of workers have at least some college education will constitute 43 percent of the new jobs in the decade from 2002 to 2012, despite accounting for only 29 percent of current jobs.[4] This labor market demand is likely to drive up college participation rates among people in the labor force of all ages.

Other important areas of state and local finance: Transportation and corrections are the next largest areas of state government spending. The fringe-benefit costs of state and local government employees also are an important source of fiscal pressure, especially for local governments because they employ nearly three times as many workers as states.

- **Transportation:** The federal government plays a larger role in financing transportation than in most other areas (except Medicaid and TANF), financing 30 percent of all transportation spending in 2000.[5] The federal government's primary transportation program is the Transportation Equity Act for the 21st Century (TEA-21), which authorized more than $200 billion of federal funding from 1998 through 2003. The federal government has been extending TEA-21 for a few months at a time. Currently it expires May 31, 2005. The eventual reauthorization will raise major issues for state and local governments, including questions about the overall level of federal funding and how it is allocated across states.

- **Corrections:** Between 1990 and 2002 the incarceration rate — prisoners as a percentage of the population — increased by more than 50 percent despite a drop of more than 30 percent in the violent crime rate, driven in part by tougher sentencing and probation policies. This led to a massive prison-building boom and a rapid rise in prison operating costs. While growth in the number of prisoners has slowed recently in most states, many states are still grappling with growing populations and most are faced with far higher costs than a decade ago. More than half of the states have loosened sentencing rules in the last few years and many more are considering doing so. It might be better if states

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4 Author's analysis of data underlying Hecker, Daniel E., "Occupational Employment Projections to 2012," *Monthly Labor Review*, U.S. Bureau of Labor Statistics, February 2004.

5 *Transportation Statistics Annual Report 2004*, U.S. Department of Transportation, Bureau of Transportation Statistics, Washington D.C.

considered these kinds of policy changes primarily for nonfiscal reasons, rather than because finances are strained.

- **Fringe benefits:** State and local government pension fund earnings more than doubled relative to state and local budgets between 1990 and 2000, allowing them to scale back contributions (with a lag) by more than 30 percent despite rising pension obligations. That trend has since reversed and many state and local governments now face rapidly rising pension contributions that in some cases are quite significant relative to their budgets.

Conclusion

State and local governments are now recovering from the fiscal crisis, but unfortunately they can only be moved off the critical list into intensive care. Continued spending pressures and the risk of federal policy changes that will strain their finances mean state and local government finances need continued monitoring. Effective leadership and performance management systems can help, but they can only go so far. Many states undoubtedly will need to make hard choices.