2006 Rockefeller Institute Reports on State and Local Government Finances

The 2001 Recession Continues to Affect State Budgets

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April 2006

This is the second in a series of three reports by the Rockefeller Institute of Government on current financial challenges and issues facing state and local governments. It is based on Donald Boyd's article "State Finances: Solid Recovery But Challenges Ahead," from the 2006 edition of *The Book of the States*, scheduled to be released in June 2006 by the Council of State Governments.

State Revenues Have Only Partially Recovered

State tax collections dropped sharply after the recession, but have made up significant ground since then, in most circumstances.

State Budget Conditions Have Improved Dramatically

Rapid state tax growth has been driven by a rebound in financial markets and moderate economic recovery, with an assist from state tax increases. State tax revenue grew 8.2 percent in fiscal year 2004 and 11 percent in 2005. Personal income taxes were up 12 percent in 2005, the sales tax was up 7 percent, and corporate income taxes were up an astounding 33 percent.[1] Strong growth continued at the start of fiscal year 2006, with 9.2 percent growth in the initial quarter.[2]

Most states have participated in this good news. Those that rely heavily on income taxes benefitted from a surge early in 2005 when taxpayers filed tax returns reflecting stock market gains in 2004. The few states that rely on corporate income taxes benefitted from double-digit growth in 11 out of 12 recent quarters.[3] States that rely on oil and natural gas taxes — especially Alaska, New Mexico, North Dakota, Oklahoma, and Wyoming — experienced a surge due to rising energy prices.[4] Partway through fiscal year 2006, 42 states reported revenue collections were above forecast.[5] Even California, which has deep structural problems, is getting a boost from rapid revenue growth, with revenue that may exceed the governor's budgeted amounts by more than $2 billion over two years.[6]

There are relatively few significant exceptions. Michigan and Ohio have suffered from auto manufacturing weakness. More recently, Louisiana revenue has been devastated by hurricanes; Mississippi has been hurt to a lesser extent. Rhode Island has experienced revenue shortfalls and structural budget difficulties. New Jersey, while seeing strong revenue growth, is still working its way out of budget problems.

The positive revenue trend has been abetted by easing spending pressures, with only 19 states reporting spending overruns in 2006, down from 23 in 2005. As happens almost every year, Medicaid was the program most frequently over budget.[7]

As a result, only six states made midyear budget cuts in 2005, down from 37 in 2003. After drawing year-end fund balances down from 10.4 percent of expenditures in 2000 to 3.2 percent in 2003, states rebuilt them to 6.9 percent at the end of 2005 — not enough to cushion a modest recession, but an improvement nonetheless. The number of states with fund balances of at least five percent rose from 12 at the end of 2003 to 33 two years later.[8] Finally, states have begun to cut taxes again; fiscal year 2005 was the first year of net tax cuts since 2000.[9]

State Tax Revenue Is Still Below the Pre-Crisis Peak

Despite rapid growth, state tax revenue in 2005 remained below the pre-recession peak, adjusting for inflation and population growth. In other words, state taxes still cannot finance the level of services they could before the fiscal crisis. As Figure 1 shows, this is a marked difference from the previous recovery.

This phenomenon is common — by fiscal year 2005, real per-capita tax revenue was below the 2000 peak in 25 states (Figure 2).

This reflects three factors. First, tax revenue fell far more sharply in the recent crisis than in the previous one, as Figure 2 shows, so that more growth is required to reach the prior peak. Second, the economic recovery has been modest. Finally, states enacted smaller tax increases in this recession, as shown in Figure 3.

State Spending Restraint

Instead of raising taxes significantly, states trimmed payrolls and cut spending more deeply.

Employment Cuts

Private sector employment usually contracts sharply during recessions, while state and local government employment is stable, partly because demand for government services rarely diminishes and often increases during recessions. In the three recessions before 2001, state government employment either did not decline, or declined only briefly.

Figure 1

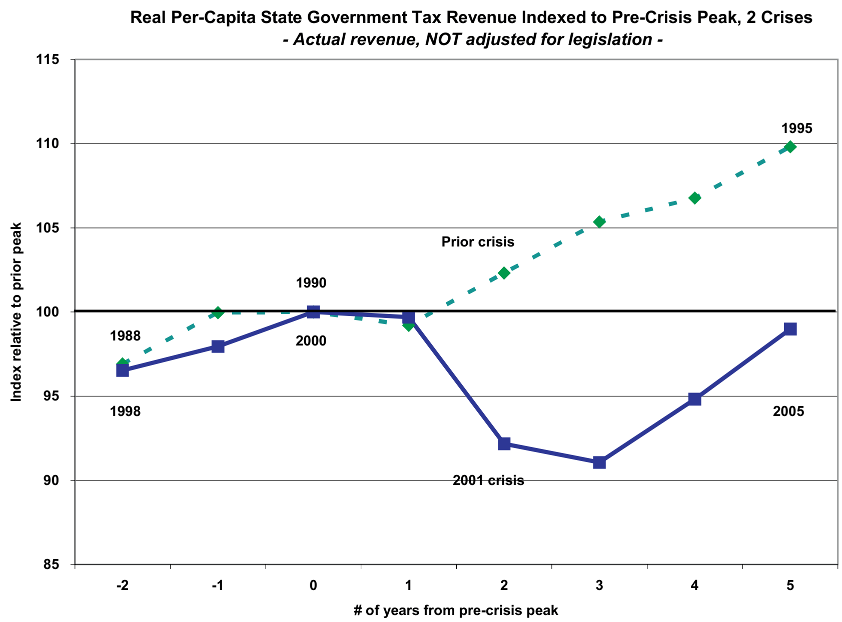


Figure 2

Real Per Capita State Tax Revenue
% Change FY 2000 to FY 2005

United States: -1.0%

Colorado	-14.5%	South Dakota	0.1%
Wisconsin	-11.5%	Alabama	0.4%
Iowa	-11.1%	New Hampshire	0.9%
Oregon	-10.3%	Pennsylvania	2.6%
Georgia	-9.5%	New York	2.9%
Michigan	-9.1%	Arkansas	3.1%
Connecticut	-7.3%	Ohio	4.1%
Missouri	-7.1%	Alaska	4.3%
Utah	-7.0%	Virginia	4.6%
South Carolina	-6.7%	North Dakota	5.4%
Massachusetts	-6.2%	Indiana	5.8%
Maine	-5.9%	Tennessee	6.0%
Texas	-5.1%	Arizona	6.1%
Washington	-5.0%	Nevada	6.3%
North Carolina	-4.7%	Montana	6.3%
California	-4.2%	Rhode Island	7.4%
Mississippi	-4.1%	New Jersey	8.5%
Oklahoma	-4.1%	West Virginia	8.6%
Delaware	-2.8%	Maryland	9.3%
Idaho	-2.7%	Hawaii	9.9%
Minnesota	-2.6%	Florida	10.3%
Illinois	-1.4%	Nebraska	14.0%
Kansas	-1.4%	Louisiana	17.0%
Kentucky	-0.8%	Vermont	19.0%
New Mexico	-0.2%	Wyoming	51.2%

SOURCES: Census Bureau: tax revenue through 2004, and population; Rockefeller Institute: tax growth to 2005. BEA: state & local government chain-weighted price index.

Figure 3

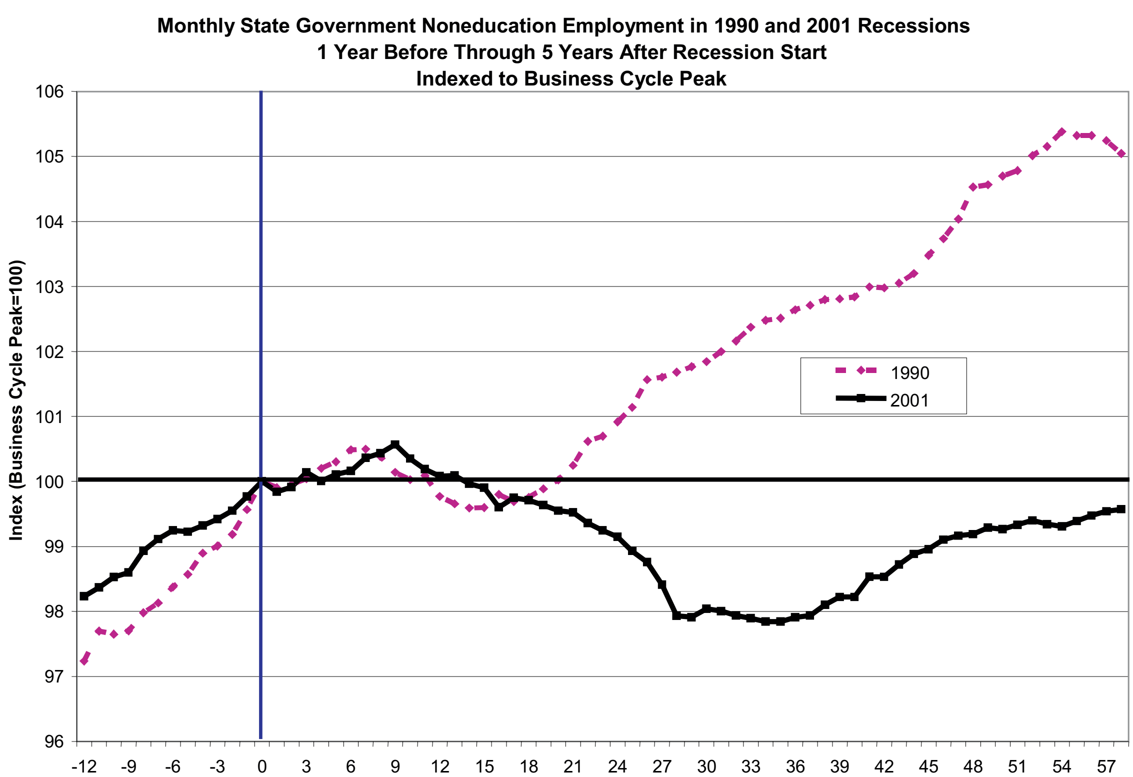
State tax increases in 3 recessions

	Cumulative tax increases as a percent of tax revenue
1980-82 recessions	9.9%
1990-91 recession	9.8%
2001 recession	3.7%

Tax increases are from Fiscal Survey of the States, December 2005.
Tax revenue is from the Bureau of the Census.

Responses to the 2001 recession have been different. While state government *education* employment has increased (largely in institutions of higher education), non-education employment declined more than 2 percentage points before resuming its rise. As Figure 4 shows, nearly six years after the recession began, state government non-education employment remained below its pre-recession level.

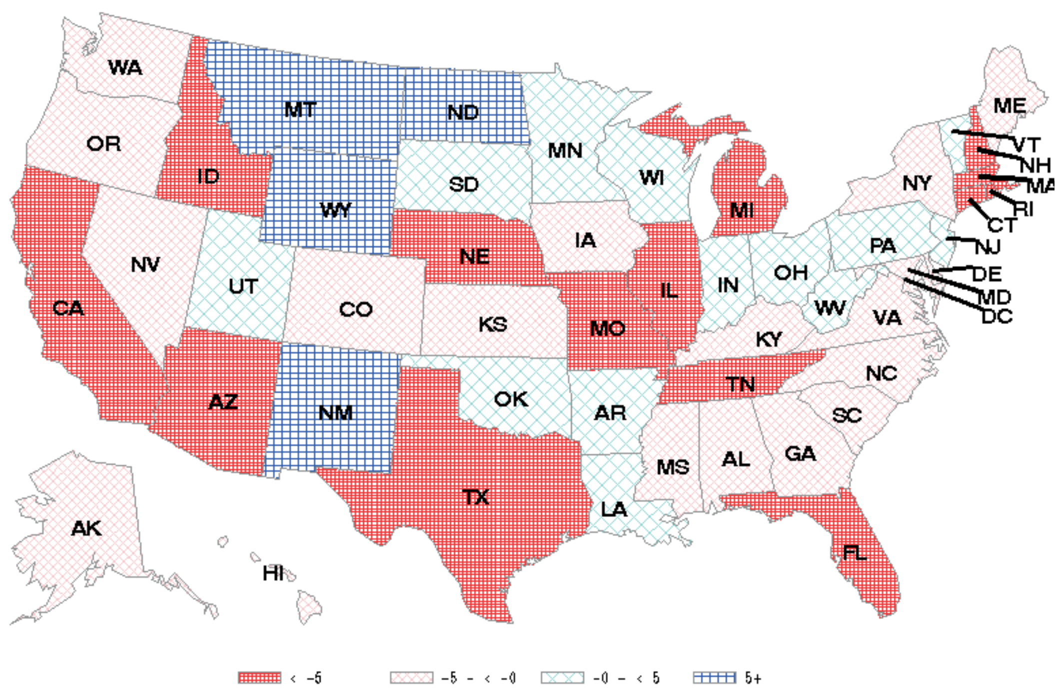
Figure 4



State government employment declines have been widespread. Figure 5 shows the percentage change in state government employment per 1,000 population from the final quarter of 2001 to the final quarter of 2005. For the nation as a whole, this share declined by one percent. It fell in 33 states, declining by more than 5 percent in 15 states. It rose by more than 5 percent in only four. Most of the states that increased government employment had strong tax revenue growth.

Figure 5

Percent Change in State Government Employment Per 1,000 Population, 2001 to 2005
October-December Quarter



Sources: Rockefeller Institute analysis of data from Census Bureau and Bureau of Labor Statistics

Spending Reductions

Recently released state fiscal data show state efforts at restraining spending. Between fiscal year 2002 when states began responding to recession-induced tax revenue declines and 2004, state real per capita spending rose by only 1.2 percent, a sharp slowdown from earlier years.[10] More telling was the way spending was distributed: After adjusting for inflation and population growth, medical vendor payments (which correspond closely to Medicaid) rose 16.5 percent while all other state government spending actually fell 2 percent, suggesting that Medicaid spending "crowded out" other spending.[11]

Elementary and secondary education rose the fastest of the large spending categories. Higher education spending also rose, supported by substantial tuition increases that offset cuts in state appropriations.[12] (See Figure 6.) All other spending in aggregate declined.

Figure 6

State Government Expenditures in 2002 and 2004 Fiscal Years, Real Per Capita

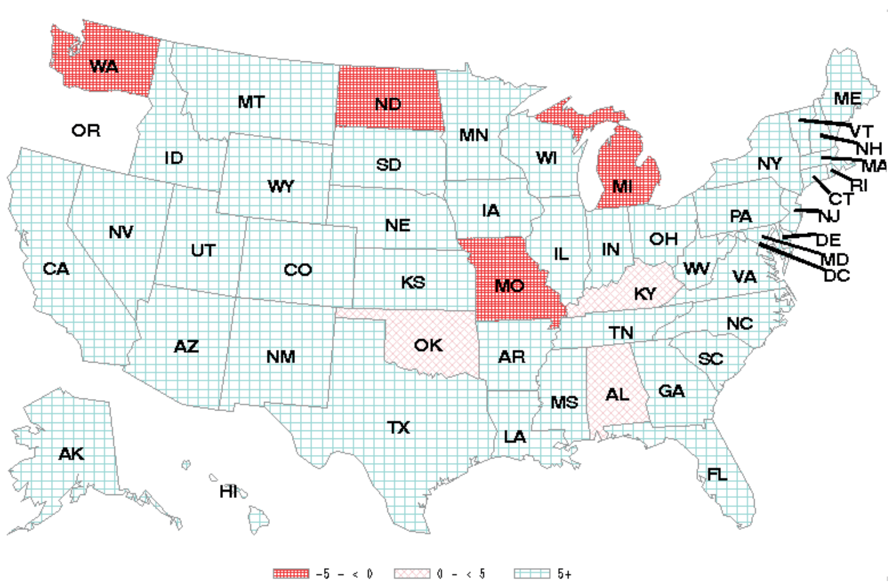
	2002	2004	Change	% Change
	(real per capita, 2004 dollars)			
General expenditures	$ 4,119.8	$ 4,167.5	$ 47.7	1.2%
Medical vendor payments (mostly Medicaid)	704.4	820.9	116.5	16.5%
Other state government expenditures (excluding medical vendor payments)	$ 3,415.4	$ 3,346.5	$ (68.8)	-2.0%
Elementary and secondary education	823.0	842.8	19.7	2.4%
Higher education (including tuition-supported spending)	519.0	526.4	7.4	1.4%
Public welfare (excluding medical vendor payments)	361.6	348.5	(13.1)	-3.6%
Highways, and transit subsidies	336.8	319.0	(17.8)	-5.3%
All other state government expenditures	1,375.0	1,309.8	(65.1)	-4.7%

Sources: Census Bureau for finance and population data; Bureau of Economic Analysis for price index.
Inflation measured by the state and local government chain-weighted price index.
Note: Census data on higher education include spending from tuition funds. State government support for higher education actually declined between 2002 and 2004.

Medical vendor payments rose in virtually all states, while 33 states cut other spending, with western states far more likely to cut than eastern states. (See Figures 7 and 8.)

Figure 7

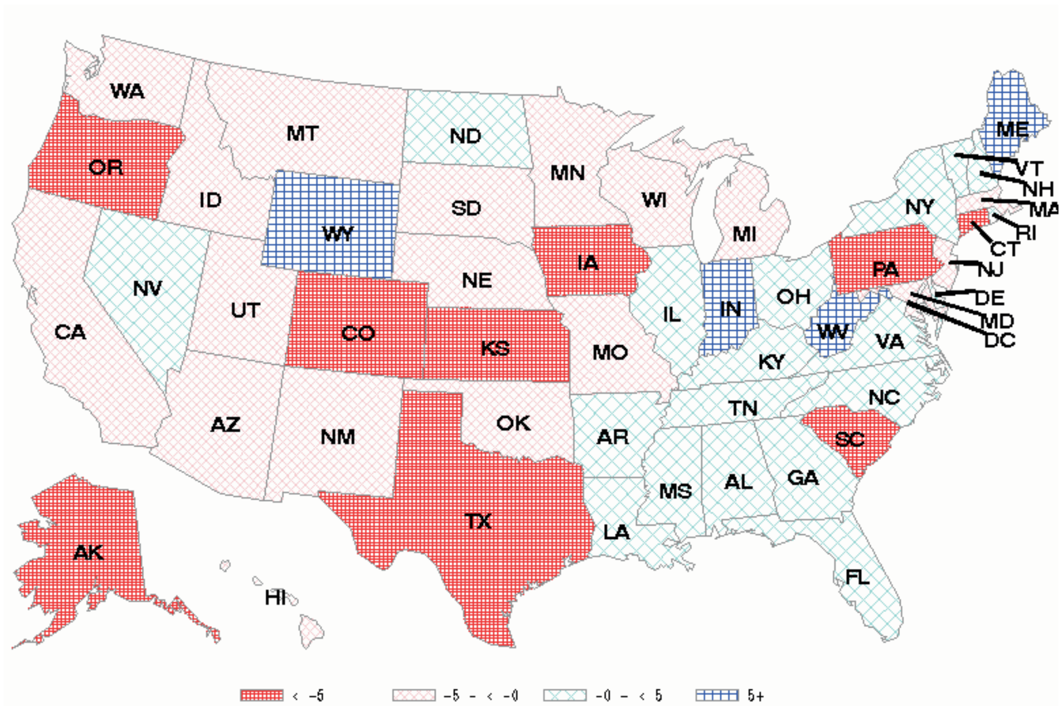
Percent Change in State Government Medical Vendor Payments From 2002 to 2004
Adjusted for Inflation and Population Growth (Oregon Excluded Due to Aberrations)



Sources: Rockefeller Institute analysis of data from Census Bureau and Bureau of Economic Analysis

Figure 8

Percent Change in State Government Expenditures: 2002 to 2004
Excluding Medical Vendor Payments, Adjusted for Inflation and Population Growth



Sources: Rockefeller Institute analysis of data from Census Bureau and Bureau of Economic Analysis

As shown in Figure 9, spending reductions hit many areas of the budget. More than half of the states reduced spending on libraries (a relatively small spending area) by more than 10 percent, and nearly as many significantly reduced spending on legislative operations and staff. Many other areas were reduced by a majority of states, often quite extensively.

Finally, Figure 10 shows how recent changes fit into longer-term trends. When viewed over the period from 1999 to 2004 (the right-most column), state spending in all major categories (and in most smaller functional areas, not shown on the table) has increased, despite the declines between 2002 and 2004, and increases over longer periods are more significant. The table also shows the dominating effect of Medicaid on state budgets over the last 20 years.

In sum, states' initial response to the fiscal crisis of 2001 included widespread cuts throughout the nation and across spending categories. Although aggregate cuts were modest when viewed in historical context, spending on Medicaid soared, and support for many discretionary programs was cut sharply.

Figure 9

State Government Real Per-Capita Spending, Fiscal Year 2002 to 2004
Prevalence of reductions and increases, selected expenditure areas

	Number of States With: Reductions of: More than 10%	Reductions of: 0 to 10%	Increases of: 0 to 10%	Increases of: More than 10%	Median % Change
General expenditures	1	16	31	2	0.7%
Medical vendor payments (mostly Medicaid)	1	4	11	34	16.5%
Other state government expenditures (excluding medical vendor payments)	2	31	16	1	-1.1%
Libraries	26	12	3	8	-11.3%
Legislative	25	18	3	4	-10.3%
Parks	19	14	7	10	-4.2%
General capital outlay	18	15	8	9	-5.0%
Natural resources	17	12	10	11	-3.1%
Health (other than medical vendor payments)	16	13	11	10	-2.2%
Corrections	11	25	10	4	-6.2%
Public welfare (other than medical vendor payments)	11	14	10	15	-0.2%
Elementary and secondary education	2	24	17	7	0.0%
Higher education (including tuition supported spending)	1	16	26	7	2.0%

Sources: Census Bureau for finance and population data; Bureau of Economic Analysis for price index.
Inflation measured by the state and local government chain-weighted price index.
Note: Census data on higher education include spending from tuition funds. State government support for higher education actually declined between 2002 and 2004.

Figure 10

Percentage change in real per-capita state government expenditures

	5-year time periods: 1984 to 1989	1989 to 1994	1994 to 1999	1999 to 2004
General expenditures	22.1%	18.3%	9.7%	10.9%
Elementary and secondary education	24.2%	6.1%	20.8%	6.3%
Medical vendor payments (mostly Medicaid)	29.3%	88.3%	4.6%	40.5%
Higher education	14.6%	10.6%	10.3%	13.4%
All other expenditures	21.9%	11.9%	7.0%	3.1%

Sources: Census Bureau for finance and population data; Bureau of Economic Analysis for price index. Inflation measured by the state and local government chain-weighted price index.
Note: Census data on higher education include spending from tuition funds. State government support for higher education actually declined between 2002 and 2004.

Short-Term Outlook: Tax Cuts and Spending Increases

Even-numbered years often are election years, and gubernatorial seats in 36 states are up for election in 2006, as are more than 80 percent of state legislative seats. Strong revenue growth combined with election-year pressures can create an environment conducive to tax cuts and spending increases.

At this writing, many Republican and Democratic governors alike have proposed or promised tax cuts for their 2006-07 budgets, including the following: Governor Bob Riley (R) of Alabama is again seeking to reduce taxes on low-income families, Arizona's Governor Janet Napolitano (D) proposed $100 million of tax cuts, New York's Governor Pataki (R) proposed a package of individual and business tax cuts, and Wisconsin Governor Jim Doyle (D) is proposing a "living wage" tax credit.[13]

Spending increases also will be common, particularly in elementary and secondary education and in higher education.[14] Governor Napolitano proposed a 17 percent increase for elementary and secondary education, Governor Schwarzenegger (R) in California proposed an 11 percent increase in general fund support for schools, and Governor Ehrlich (R) of Maryland proposed a 12 percent increase. Higher education also is faring well in most states.

Tax increases will be rare, often limited to the recent "go-to" source — cigarette taxes — and in the context of budgets that cut taxes in other areas. Governors Mitch Daniels (R) of Indiana, Thomas Vilsack (D) of Iowa, and George Pataki of New York (R) have all proposed cigarette tax increases.[15]

Widespread tax cuts and some spending increases seem a near certainty for 2006-07. Over the longer term, however, these will have to compete with other challenges states will face.

Challenges Ahead

The initial report in this series focused on government obligations for pension payments and health insurance for retirees. But states face other fiscal challenges, as well.

Medicaid

Medicaid, the federal-state program that finances health care for the poor and medically needy, is the largest item in the majority of state budgets when funding from all sources is considered.[16]

Medicaid will continue to grow rapidly, reflecting expensive new technologies and drugs, the general lack of incentives for consumers to limit care, and the impending growth of the elderly population. Health-finance analysts project that Medicaid spending will grow about 8.6 percent annually over the decade ahead, outpacing population growth plus general price inflation by an average of 5.1 percentage points annually — faster than state tax systems are likely to grow.[17]

The federal government finances about 57 percent of Medicaid costs, although the share varies widely among the states. Congress adopted legislation in early 2006 intended to reduce federal Medicaid spending by $5 billion over five years, and the president's fiscal year 2007 budget would reduce federal spending by $14 billion over five years, in part by shifting some costs to states.[18] To date, federal actions to constrain Medicaid spending growth have been modest relative to the program's size, although some cuts have affected many beneficiaries. Given projected deficits that cumulatively exceed $1 trillion over the next five years, pressure for more and deeper federal cuts is likely.

Other Issues

States face many other issues that will place pressure on budgets, including:

- ❖ The general long-term decline in state sales tax bases. This may be mitigated eventually if Congress adopts legislation to give states greater authority to collect taxes from out-of-state vendors, in response to state streamlining of sales tax systems.

- ❖ Litigation that requires states to increase funding in low-spending school districts, or creates pressures for them to do so. At least eight states are in the midst of complying with or responding to recent successful challenges.[19]
- ❖ Property tax revolts in New Jersey and some other states, which can create pressure for state-financed property tax relief.
- ❖ Continuing efforts in some states to impose constitutional tax and expenditure limitations on legislators and governors. These efforts largely have been unsuccessful in recent years, but remain a potential source of fiscal tension.

Conclusions

The recovery in state finances has been solid and widespread, with only a few exceptions. Most states raised taxes by very little in the recent fiscal crisis, and have cut employment and spending relative to their economies. Most state budgets were in good shape at the end of fiscal year 2006, and election-year budgets for 2007 will lead to tax cuts. But beyond 2007 states will face challenges, including the need to fund or constrain rapid Medicaid growth, pressures to strengthen pension funding and begin financing newly disclosed liabilities for retiree health care, and the likely need to respond to large cuts in federal grants.

Endnotes

1 Jenny, Nicholas W., "Strong Revenue Growth Continues in Most States," *State Revenue Report* No. 61, Rockefeller Institute of Government, September 2005.

2 Jenny, Nicholas W., "State Tax Revenue Off to a Flying Start for Fiscal Year 2006," *State Revenue Report* No. 62, Rockefeller Institute of Government, December 2005.

3 Jenny, *State Revenue Report* No. 62.

4 Zelio, Judy, *State Energy Revenues Gushing*, National Conference of State Legislatures, January 2006.

5 Out of 49 that reported results — State Budget Update: November 2005, National Conference of State Legislatures, Washington, DC.

6 California Legislative Analyst's Office, Analysis of the 2006-07 Budget Bill: Perspectives and Issues, February 22, 2006.

7 National Conference of State Legislatures, *State Budget Update: November 2005*, p.2

8 *The Fiscal Survey of the States*, National Governors Association and National Association of State Budget Officers, Washington DC, December 2005 and April 2004 editions.

9 Jenny, Nicholas W., "2005 Tax and Budget Review," *State Fiscal Brief* No. 74, Rockefeller Institute of Government, January 2006.

10 It would be preferable to examine combined state and local spending over this time period, because it is possible that some changes in state government spending reflect shifts in responsibilities between state and local spending, but at this writing, local government finance data for 2004 are not yet available from the Bureau of the Census.

11 See Kane, Thomas, Peter Orszag, and David Gunter, *State Fiscal Constraints and Higher Education Spending: The Role of Medicaid and the Business Cycle*. The Urban-Brookings Tax Policy Center, Discussion Paper No. 11. May 2003, for an analysis of the tendency of Medicaid to crowd out spending on higher education and other areas.

12 The Census Bureau data used here do not allow us to look easily at net state support for higher education (excluding tuition funds).

13 See Stenson, Brian T., *Governors' Budgets Reflect Strong Revenue Growth*, Rockefeller Institute of Government, February 2006.

14 See Stenson, Brian T. *Governors' Budgets Reflect Strong Revenue Growth*, Rockefeller Institute of Government, February 2006; and Peterson, Kavan, "State surpluses a boon to education," *Stateline.org*, February 22, 2006.

15 Hunter, Kathleen, "Rising revenues spur tax cuts, spending," *Stateline.org,* January 31, 2006, plus individual state budget documents.

16 *State Expenditure Report 2004*, National Association of State Budget Officers, December 2005, Table 5.

17 Borger, Christin, Sheila Smith, Christopher Truffer, Sean Keehan, Andrea Sisko, John Poisal, and M. Kent Clemens, "Health Spending Projections Through 2015: Changes On The Horizon," Health Affairs – Web Exclusive, 22 February 2006.

18 See Schneider, Andy, Leighton Ku, and Judith Solomon*, The Administration's Medicaid Proposals Would Shift Federal Costs to States*, Center on Budget and Policy Priorities, February 14, 2006, for analysis of these cuts. The Center on Budget and Policy Priorities opposes most of these cuts.

19 Based on information provided at www.schoolfunding.info/litigation/litigation.php3.