

State Finances: Not Out of the Woods Yet

Federation of Tax Administrators

Burlington, VT
September 20, 2004

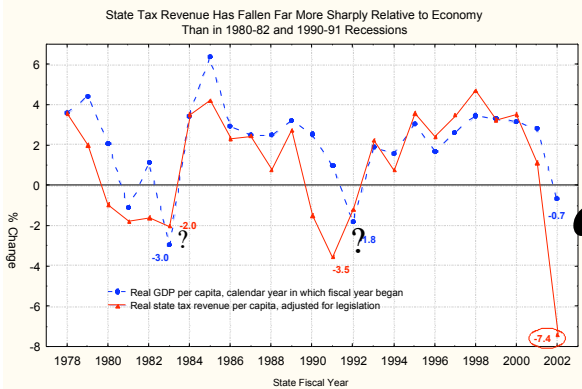
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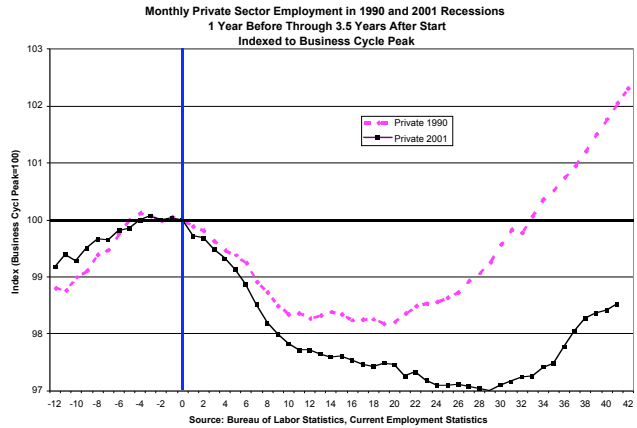


Tax Revenue Decline Was Much Worse Than Economy Might Suggest



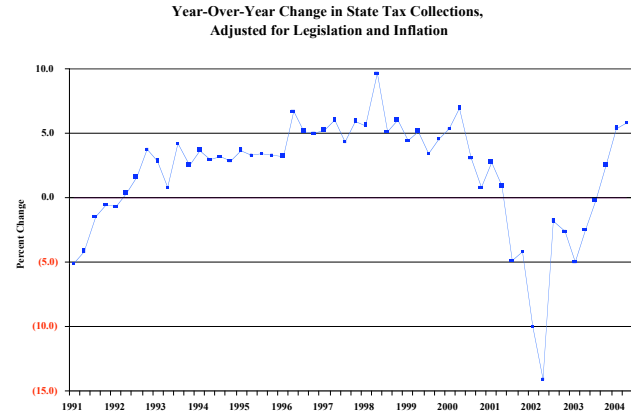
Sources: U.S. Bureau of Economic Analysis, U.S. Bureau of the Census. Significant Features of Fiscal Federalism - 1984 (ACIR), Fiscal Survey of the States (NGA), Rockefeller Institute of Government

Economy Recovering But Weak Relative To Past Recoveries



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Underlying Tax Revenue Now Recovering



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

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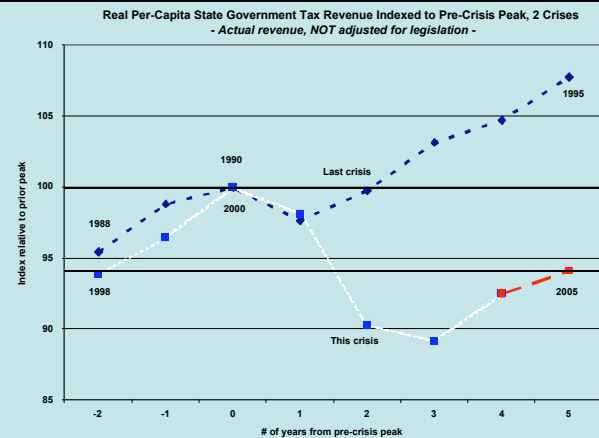
April-June Quarter Was Best Since Early 2000

- 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

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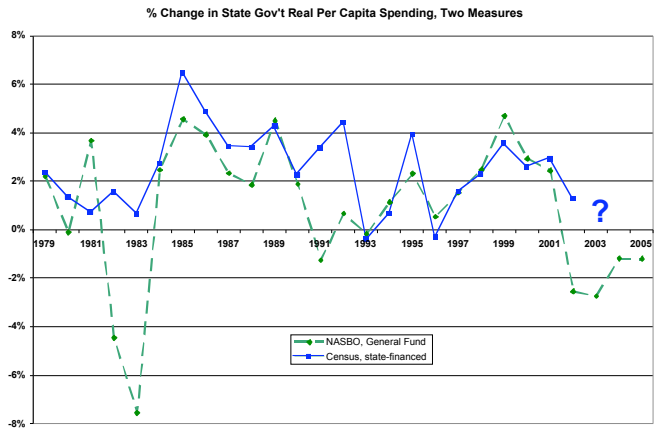
But Tax Revenue Is Still Well Below Prior Peak – Now At 1998 Level



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.

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



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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

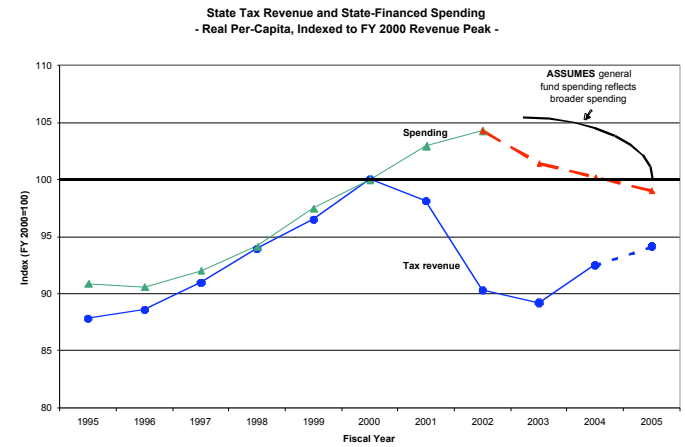
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Even Census Data Do Not Fully Reflect Underlying Budget Trends Over The Short Term

- 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

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



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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

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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

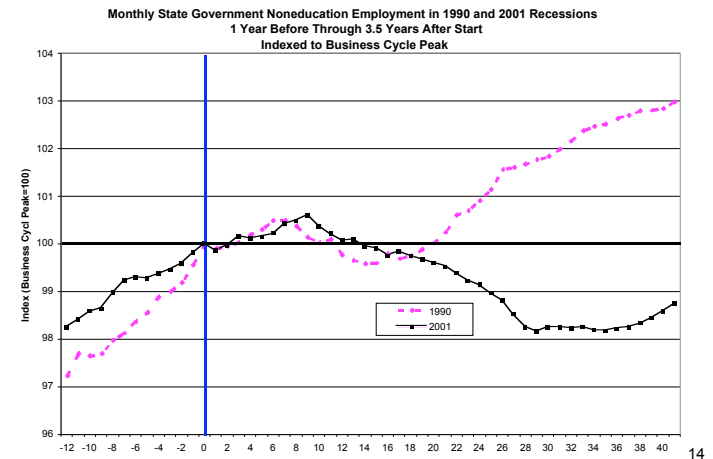
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State Cuts In Employment

- 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

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



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

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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

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