State Finances:
Not Out of the Woods Yet

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Tax Revenue Decline Was Much Worse Than Economy Might Suggest

Economy Recovering But Weak Relative To Past Recoveries

Monthly Private Sector Employment in 1990 and 2001 Recessions
1 Year Before Through 3.5 Years After Start
Indexed to Business Cycle Peak

Underlying Tax Revenue Now Recovering
Year-Over-Year Change in State Tax Collections,
Adjusted for Legislation and Inflation

SOURCE: Nicholas W. Jenny, State Revenue Report #57, Rockefeller Institute of Government, September 2004
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:
  - 12.5% New England
  - 16.5% Mid-Atlantic
  - 5.3% Great Lakes
  - 8.3% Plains
  - 8.9% Southwest
  - 12.0% Southeast
  - 10.7% Rocky Mountain
  - 14.8% Far West

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

But 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

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

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
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.

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

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
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

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

Monthly State Government Noneducation Employment in 1990 and 2001 Recessions
1 Year Before Through 3.5 Years After Start
Indexed to Business Cycle Peak
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

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