The State Fiscal Crisis

Why it happened and what to do about it

by Peter R. Orszag

TOM NICK COCOTOS (ALL)

State governments play a critical role in the nation's fiscal and economic system. They collect revenues on the order of 6 percent of GDP, or roughly a third as much as the federal government. They have long been responsible for key government functions that affect long-term economic growth as well as everyday life – notably, education and law enforcement. What's more, over the past two decades, devolution has given them expanded responsibilities in core areas like health care and welfare.

STATE GOVERNMENT CURRENT RECEIPTS PER PERSON

	1990	2000	CHANGE
Personal income taxes	$495	$724	$229
Sales taxes	$766	$928	$162
Corporate taxes	$103	$117	$14
Other	$271	$357	$86
TOTAL	**$1,635**	**$2,126**	**$491**

STATE GOVERNMENT CURRENT EXPENDITURES PER PERSON

	1990	2000	CHANGE
General government	$98	$126	$28
Public order and safety	$137	$205	$68
Health	$481	$791	$310
Education	$275	$314	$38
Income security	$226	$258	$32
Other	$183	$212	$29
TOTAL	**$1,400**	**$1,906**	**$506**

NOTE: All figures are in 2001 dollars, using the GDP price index. Figures exclude grants from other layers of government.
SOURCE: Bureau of Economic Analysis and author's calculations.

The ability of state governments to meet their obligations is now threatened by yawning budget deficits. According to the National Conference on State Legislatures, projected deficits total $80 billion – about 15 percent of expenditures – for the fiscal year that began in July in most states. And after two years of budget nips and tucks, states have largely run out of easy options. They are now cutting health care for the poor, slashing higher education spending, releasing prisoners early and even unscrewing light bulbs to save on utility bills. These actions are harmful not only from a social perspective, but from a macroeconomic one. They are a sort of "anti-stimulus," reducing demand for goods and services just when the economy has capacity to burn.

The states' responses to this most-recent fiscal crisis differ from past efforts to close budget gaps. In the early 1990s, for example, states aggressively raised taxes to mop up the red ink. This time around, however, they have relied much more on spending reductions – with troubling implications for the ability of state governments to deliver crucial services like higher education. The $20 billion in emergency relief that was part of the recently enacted federal tax cut package will close only a modest portion of the states' fiscal gap.

The proximate cause of the state budget crisis is easy to pinpoint. The sluggish performance of the economy, combined with the bursting of the stock market bubble, significantly reduced state government revenue even as state outlays for Medicaid soared. But that is not the whole story. The states failed in their duty to accumulate adequate reserves during the boom of the 1990s, and Washington has no general countercyclical revenue-sharing program to help the states help themselves. Because of both what it has done and what it hasn't, Congress has shifted more costs to states – notably, through the Medicaid program.

THE BOOM

The stock market bubble and economic boom of the 1990s filled state coffers, just as they generated windfall revenues for the federal government. State income tax receipts rose particularly rapidly, driven by capital gains income and rapid growth in compensation among higher earners.

The states responded with a combination of tax-rate cuts, expenditure increases and reserve buildups. The Center on Budget and Policy Priorities calculates that state tax cuts enacted from 1994 through 2001 amounted to about 8 percent of state revenues, or about $40 billion annually. In other words, were it

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not for the tax reductions adopted during the 1990s, the state budget gap for this upcoming fiscal year would be roughly half its actual size.

Meanwhile, state spending per person rose from about $1,400 in 1990 to slightly more than $1,900 in 2000. But this was a slower rate of growth than during previous decades, while spending increases were concentrated in health care and prisons. Indeed, much of the increase was associated with Medicaid, which provides medical assistance to the low-income elderly and disabled, as well as to low-income families and pregnant women.

Medicaid cost increases during the 1990s reflected both general health care inflation and expansion in Medicaid enrollment. Expanded enrollment among the low-income elderly and disabled is particularly noteworthy, since these beneficiaries have relatively high health care costs and are typically also covered under the federal Medicare program. More than one-third of Medicaid outlays now pay bills for people covered under both Medicaid and Medicare.

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Medicaid finances items for these beneficiaries that are not covered under Medicare – in particular, prescription drugs along with a variety of deductibles and co-payments that are used to contain the cost of the Medicare program. As medical services have shifted toward outpatient, drug-based therapies and as the cost of prescription drugs has risen faster than the overall cost of medical care, costs have effectively been shifted from the fully federally financed Medicare program to the partially state-financed Medicaid program – and therefore from the federal budget to state budgets.

The states did use part of the revenue gains from the 1990s to add to rainy day funds and other reserves. These reserves are meant to smooth state expenditures and revenue over the business cycle, with money accumulating during booms and depleting during recessions. By the beginning of the 2001 fiscal year, states had accumulated almost $50 billion (or about 10 percent of one year's expenditures) in reserve funds.

Measured as a percentage of annual spending, these reserves amounted to about twice what had been accumulated before the 1990-1991 downturn. But they still weren't enough. One reason: many states set low limits on the size of their rainy day funds. Another reason was simply that the desire to cut taxes often trumped the virtue of saving for the future.

THE CRASH

Although they failed to prepare adequately for the downturn, state policymakers of the late 1990s could perhaps be forgiven for not foreseeing the magnitude or timing of the crash. After all, few leaders in business or the federal government did. State revenue was growing briskly. And while Medicaid costs continued to escalate more rapidly than population and inflation, they were increasing less rapidly than in the late 1980s and early 1990s.

But when it did come, the fiscal reversal proved particularly traumatic. Elaine Maag of the Urban Institute and David Merriman of Loyola University estimate that state revenue in the 2002 fiscal year was roughly $60 billion lower than a simple projection of previous growth would suggest. The decline was especially pronounced in income tax revenue, but sales tax revenue fell significantly, too.

Most of the decline in state revenue reflects the deterioration in both economic conditions and financial markets. Part, however, was driven by federal tax cuts. For example, the federal estate tax provides a credit against state estate and inheritance tax liabilities up to a limit, which varies with the size of the estate. Not surprisingly, every state imposes a "pickup" estate tax that is at least equal to this federal credit.

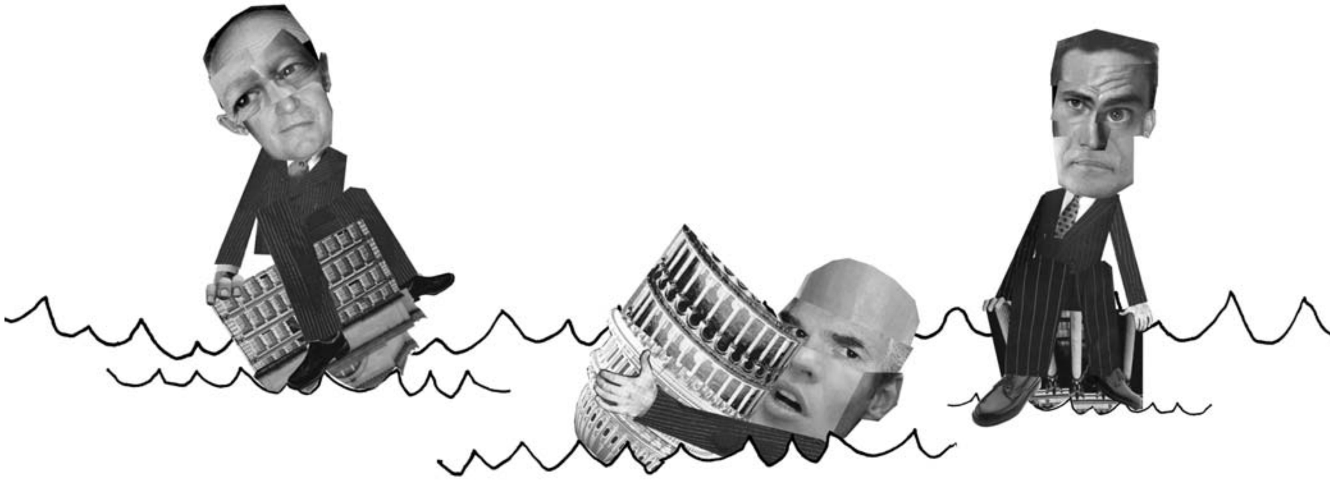
The credit had been transferring $5 billion or more per year from the federal government to the states without imposing additional tax burdens on estates. The 2001 tax cut, however, phases out the state estate tax credit between 2002 and 2005. Some states have "decoupled" their own estate taxes from the federal tax to preserve this source of revenue. But many others have not. Similarly, more generous corporate depreciation schedules and other tax cuts at the federal level will reduce state revenue unless states act to decouple from them.

Spending pressures intensified at approximately the same time that revenue dropped precipitously. The acceleration of health care costs, in particular drug expenditures, raised state Medicaid expenses substantially in 2002 and 2003. The National Association of State Budget Officers estimates that total state Medicaid spending rose by almost 12 percent in both 2001 and 2002 – about twice the growth in total state spending in those years and more than twice as fast as Medicaid spending had been rising in the late 1990s. General-fund deficits amounted to almost $40 billion in the 2002 fiscal year and about $80 billion in the 2003 fiscal year, and they are projected to reach $80 billion again in the 2004 fiscal year.

THE RESPONSE

The rapid appearance of deficits poses obvious problems for the states. Every state except Vermont has some sort of balanced budget requirement, though these requirements do differ in stringency. Some, for example, merely require that the proposed budget (as opposed to the implemented one) be balanced. States also employ various budget gimmicks, such as shifting the timing of payments from one fiscal year to the next, to skirt the balanced budget rules. Furthermore, most states have reserves that they can use to cover budget gaps.

When the state budget gaps first appeared, many states understandably tried to avoid immediate tax and spending changes. For example, 16 states closed at least a third of their 2002 deficits by drawing down reserve funds. Many also shifted significant revenue from the future – through securitization of payments they will receive from the legal settlement with tobacco companies – to help close current budget deficits. In other words,



these states have effectively sold their rights to the future tobacco revenue in order to generate revenue today.

Continuing deficits, however, are increasingly eliminating the easier options available to state policymakers. In all but a handful of states, reserve funds have largely been exhausted. Moreover, when deficits persist over multiple years, accounting gimmicks that depend on shifting income or expenditures cease to work. Having largely exhausted their reserve funds and run out of loopholes in their balanced budget requirements, states are increasingly forced to take steps that impose political and economic costs.

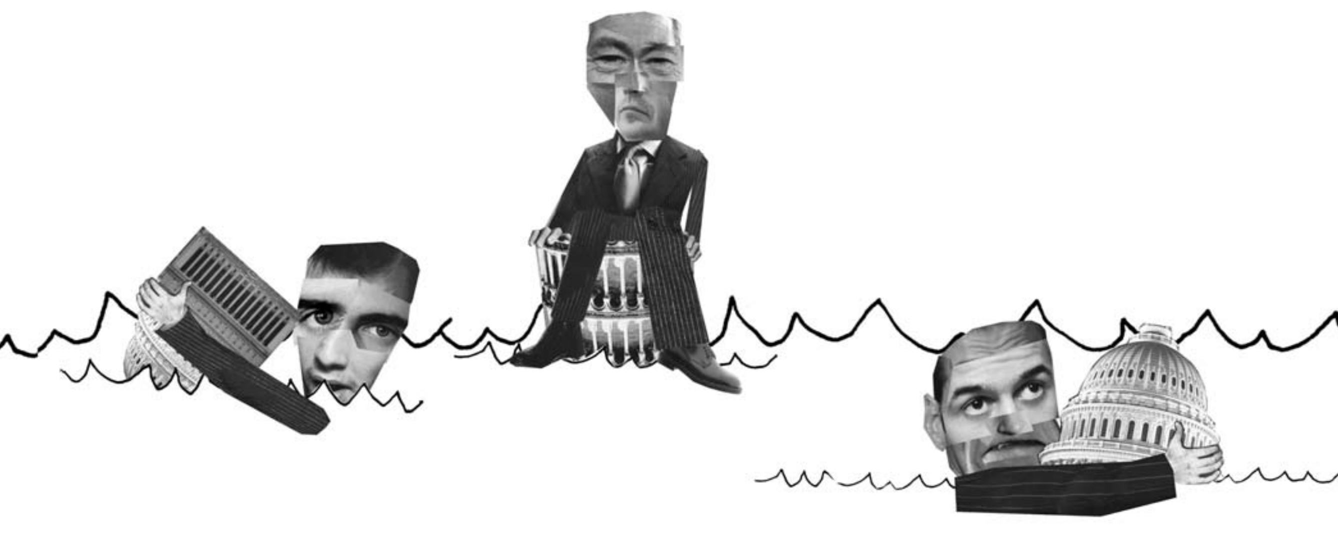
Data from the National Association of State Budget Officers suggest that real per person general fund spending fell by 1 percent in 2002 and by an estimated 2.3 percent in 2003. Several states have recently taken the unusual step of cutting spending for education in the middle of the school year, disrupting school plans. In most states, tuition for public universities and colleges has been raised substantially. Many states have slashed aid to local governments.

States have also begun raising taxes to help close the budget gap. But taxes are playing a much smaller role in addressing the current round of budget deficits than they did during the fiscal difficulties of the early 1990s. Maag and Merriman point out that if states had raised taxes as aggressively in 2002 and 2003 as they did in 1991 and 1992, they would have raised more than $30 billion in additional tax revenue in 2003. One reason for the difference is that more states now require more than a simple majority of legislators to approve tax increases. Arizona, Colorado, Nevada, Oklahoma, Oregon and Washington all added such supermajority requirements in the 1990s.

PAYING THE PIPER

The only real choices left to states at this point are cutting spending or raising taxes. Both are problematic in a sluggish economy, since both spending reductions and tax increases further reduce aggregate demand. In effect, the states are forced to exacerbate the economic downturn.

Contrary to the claims of some politicians, state tax increases are not more damaging in the short term than state spending cuts. Indeed, from a short-term macroeconomic



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perspective, tax increases geared to high-income households are the least harmful option. That's because taxing the affluent tends to reduce savings more than consumption. Note, too, that state income and property tax increases are partially offset by reductions in federal taxes, because state tax payments are generally deductible from federal taxable income.

By contrast, reductions in state government purchases or transfer payments to lower-income families living from payday to payday are likely to drill a bigger hole in total spending. And spending, public and private, is the key to short-term growth in an economy with excess productive capacity.

Whatever their short-run economic effects, spending reductions and tax increases intended to meet immediate fiscal challenges may play out in unexpected ways. A good example involves higher education, which has historically tended to be among the most cyclical of state budget categories.

As the economy entered a recession in the early 1980s, appropriations for higher education declined in real terms. Then during the recovery of the mid-1980s, appropriations recovered and ultimately exceeded their pre-recession peak. However, something was quite different during the economic cycle of the 1990s. As the economy slid into recession in the early 1990s, real appropriations per person again declined. But during the boom of the 1990s, appropriations for higher education rose only slightly and never reached their prerecession levels.

Moreover, the decline in state appropriations for higher education has been offset only partially by increases in tuition. As a result, spending per student at public universities has plummeted compared to spending per student at private universities.

My own research in collaboration with Thomas Kane of UCLA shows that, across

states, Medicaid plays an important role in explaining the difference in higher education financing between the 1980s and the 1990s. Our results suggest that the current round of reductions may prove to be a permanent ratcheting down in state support for higher education rather than a temporary adjustment in response to cyclical fiscal problems.

After a protracted political tussle, Congress decided to offer the states some help. The 2003 tax cut included $20 billion in state fiscal relief, half of which is effectively allocated on a per capita basis and half as a temporary increase in the federal share of Medicaid costs. It's worth noting, though, that Congress is also undermining the states' revenue base; the 2003 tax cut included provisions that will reduce state revenue unless the states decouple their tax codes from the federal statute.

Federal assistance is, of course, welcome, but the initiative won't solve either the immediate problem or the longer-term one. To avoid future fiscal crises, states need to explore ways of minimizing the variability of their budgets over the business cycle and to address structural imbalances between expenditures and revenue.

SMOOTHING THE FISCAL CYCLE

Three steps would help states better smooth their budgets over the business cycle. First, they need to put away more cash in good times. Policymakers must keep rainy day savings high on the agenda, which won't be easy once the sense of crisis fades.

The rules governing reserve funds should also be changed. In 19 states, money added to rainy day funds cannot exceed 5 percent of annual state spending. That is clearly inadequate to meet a sustained fiscal crisis. States have the option of saving money outside their rainy day funds – but that hardly justifies retention of the caps on the rainy day funds themselves.

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In addition, in most states the rules requiring contributions to reserve funds are not adequate to inhibit politicians' natural proclivity to dissipate funds immediately. Such institutional barriers to the accumulation of reserve funds should be changed.

Second, states need to redesign their tax systems with an eye toward minimizing revenue volatility. For example, if income and sales are not perfectly correlated across the business cycle, taxing both can reduce the variability of the total take. Unfortunately, given the relatively high correlation in the relevant tax bases, the gains from such diversification are modest.

Adjusting the tax system to reduce variability in revenues may also conflict with the goal of fairness. A less progressive income tax, for example, tends to be less sensitive to changes in income. By the same token, a sales tax that does not exempt food tends to be less variable over the business cycle, but is more regressive than a narrowly based sales tax.

Third, in light of the practical limits to diversifying state revenue bases, Washington should lend a hand in more systematic fashion. Alice Rivlin of Brookings has proposed automatic federal grants based on national or state economic indicators during recessions. The danger with such a program is that it may discourage states from building up their own reserve funds; hence the revenue-sharing formula should be designed with the states' incentives in mind.

For example, the federal program should cover only a limited share of budget gaps, leaving states with very good reasons to make their own rainy day plans. The program could also be limited to states that have adopted a model set of rules for their reserve funds. And carrots could work along with sticks; the federal formula could include matching funds for state reserve fund accumulations.

The formula for disbursing funds could also reflect the estimated effect of economic changes on the state's revenue. States that cut tax rates during the boom would then receive less than other states that had not.

STRUCTURAL CHANGES

Even if state budgets were designed for a smoother ride over the business cycle, one big problem would remain: In the absence of policy reform, state budgets are likely to come under continued pressure from increased Medicaid costs and from further erosion of their own tax bases.

The population aged 65 and over is expected to increase from 35 million in 2000 to 70 million by 2030. The low-income elderly are eligible for Medicaid, implying that the number of elderly beneficiaries will rise rapidly in the future. Two components of health care for the elderly loom especially large for Medicaid: long-term care and prescription drugs.

In 2000, Medicaid financed nursing home care for more than two-thirds of nursing home residents; these expenses represented about one-quarter of total Medicaid payments. According to the Urban Institute, Medicaid's long-term care costs are projected to double in real terms over the next two decades. And as noted above, costs are being shifted from Medicare to Medicaid as health care increasingly moves toward outpatient services and prescription drugs.

While the process will be painful, reforms to both Medicaid and Medicare are crucial to the future fiscal soundness of state governments. In designing reforms, moreover, it doesn't make sense to reduce the expected costs for the states while making them responsible for a much larger share of the risks involved. Because of their balanced budget rules, narrower revenue bases and more limited borrowing ability, states are much less able to bear such risks than the federal government.

One way or another, states must also address the ongoing erosion of their revenue bases. William Fox of the University of Tennessee estimates that sales subject to state tax have declined from 51 percent of personal income in 1979 to 42 percent in 2001. The corporate income tax base has also been eroding, with roughly half of the decline at the state level reflecting a narrowing of the federal corporate income tax base.

A LAST WORD

Many of these ideas have been on the table before – and there are good political reasons that constructive changes have rarely been made. One can only hope, though, that the wrenching dislocations now under way will change the political calculus of state budgeting – and that enlightened politicians will seize the day.