

How Are States Responding to Fiscal Stress?

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With reserves depleted and postponed costs resurfacing, economic recovery may not be enough to prevent painful state budget cuts in FY 2004.

The current state fiscal crisis provides a new perspective on the devolution of key programs serving low-income families with children from the federal government to the states. The first recession since welfare reform was enacted in 1996, the weak recovery that has followed, and the economic repercussions of September 11 have resulted in a gap between revenue and expenditures in virtually every state.¹ This brief describes how seven states are responding to this gap. More specifically, what is happening to programs such as Temporary Assistance for Needy Families (TANF), Medicaid, and child care?

To learn how states have responded to fiscal stress in FY 2002 and the first half of FY 2003,² we conducted site visits in California, Colorado, Florida, Michigan, Mississippi, New Jersey, and Washington. These seven states were selected because, among the 13 focal states of the Urban Institute's *Assessing the New Federalism* project, they have the largest fiscal problems to date, and they represent a diversity of regions and political traditions. The seven states are not strictly representative of all states, but their experiences may suggest what will happen elsewhere if budget pressures worsen. During our site visits, we interviewed state administrative officials, legislators and legislative staff, and advocacy groups with a variety of viewpoints. We supplemented these interviews by reviewing newspaper articles, state budget documents, and other analyses.

Figure 1 shows the fiscal deterioration experienced by the seven states in FY 2002 and FY 2003. All seven states began their

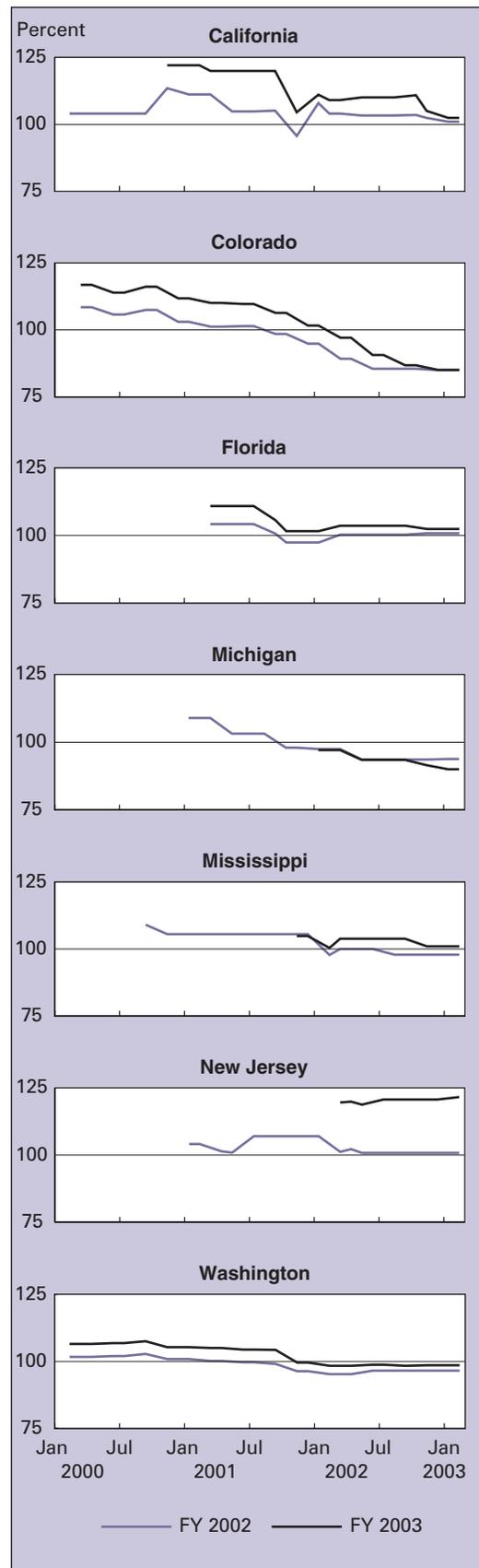
FY 2002 budget cycles expecting more revenue than they had in the prior year. These estimates proved overly optimistic. For FY 2002, three states were able, with policy changes, to take in revenues that were essentially unchanged from the prior year, and four states had revenues below those of the prior year. Midway into FY 2003, revenue estimates have stabilized in some states while they continue to drop in others.

Our research suggests several patterns in state responses to current fiscal stress. All states have drawn down reserves to reduce the size of their budget gaps. Most states have also used strategies that accelerate revenues or delay costs, minimizing budget pressure in the current year, but often increasing the pressure in future fiscal years. States have done little to increase revenue, leaving program cuts as the primary strategy for balancing the budget. Most budget cuts have been "across the board," but primary and secondary education are often protected. Given education's prominence in state budgets, that protection has increased the size of cuts needed in other programs, particularly those serving low-income families. Specific cuts to date have mostly been modest, but deeper cuts are expected in response to the fiscal pressures ahead.

Short-Term Solutions

Whenever possible, states have avoided broad-based tax increases or spending decreases by turning to short-term solutions. All seven states have drawn down

FIGURE 1. FY 2002 and FY 2003 General Revenue Estimates as a Percentage of FY 2001 General Revenue



reserves or trust funds; three of the seven have also securitized at least part of their tobacco settlement payments (table 1). Some states have also responded to fiscal problems by shifting revenues or expenditures across fiscal years. These maneuvers carry less risk of political backlash than increasing taxes or cutting spending, but they can compound fiscal stresses in subsequent years. States have also refinanced debt to take advantage of the current low interest rates.

Reserves

Tapping reserves is a simple solution to budget shortfalls; as one official remarked, “That’s what they’re there for.” Constitutional or statutory provisions, however, affect the size of the reserves available. Whereas some state policies encourage accumulating reserves, others make doing so difficult. Michigan requires that money be paid into its reserve fund when real personal income grows by more than 2 percent in a calendar year. In contrast, Colorado’s 6 percent appropriations growth limit means reserves compete directly against other spending priorities.³

States also differ in their freedom to draw down reserves. Florida is required to keep at least 5 percent of yearly appropriations as reserves, but if used, the fund must be repaid to reach 5 percent of appropriations within five years. Fearing the current recession would persist and make repayment difficult, legislators have not yet tapped the \$941 million fund. By contrast, New Jersey spent its entire \$720 million statutory reserve fund in FY 2002. States also differ in their ability to draw on trust funds other than the designated reserve, and on whether and on what terms these other funds must be repaid.

Tobacco Settlement Securitization

The multistate lawsuit settlement with tobacco companies provided states with an unexpected yearly stream of revenue. Tobacco securitization—the sale of bonds backed by future revenues from the settlement to make money available now—is the short-term response on which our interviewees were most divided. Critics of securitization argue that the tobacco settlement

TABLE 1. State Responses to Fiscal Stress, FY 2002–2003

| Strategy | State | | | | | | |
|----------------------------------|----------------|----|----------------|----------------|----|----------------|----|
| | CA | CO | FL | MI | MS | NJ | WA |
| Short-term solutions | | | | | | | |
| use reserves or rainy day funds | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| securitize tobacco settlement | ■ | | | | | ■ | ■ |
| Revenue solutions | | | | | | | |
| raise cigarette taxes | ● | | | ■ | | ■ | |
| raise personal income taxes | ■ | | | | | | |
| raise sales taxes | | | | | | ● | ■ |
| raise business taxes | ■ | | | ■ ^a | | ■ | |
| raise intangibles/property taxes | | | ■ ^a | | | ■ ^a | |
| raise fuel taxes | | | | ● | | | ● |
| increase gambling revenues | | | | ■ | ■ | | ■ |
| Spending solutions | | | | | | | |
| cut across the board | ■ | ■ | | ■ | ■ | ■ | ■ |
| expand early retirement options | ■ | | | ■ | | | ■ |
| lay off state workers | | ■ | ■ | ■ | | ■ | ■ |
| cut Medicaid | ■ | ■ | ■ | ■ | ■ | ● ^b | ■ |
| cut SCHIP | ■ ^b | ■ | | ■ ^b | | ■ | |
| cut TANF | ■ ^b | | | ■ | ■ | | |
| cut child care | ● | ■ | | | ■ | | |
| cut child welfare | ■ | | | ■ | | | ■ |
| cut K–12 education | ■ | | ■ | | ■ | ■ | ■ |
| cut higher education | ■ | ■ | | | ■ | ■ | ■ |
| cut local aid | ■ | | ■ | ● | | ■ | ■ |

Key: ■ = Enacted; ● = Proposed by governor and rejected.
 Notes:
 a. Postponed planned tax cut.
 b. Postponed planned spending increase.

should be used for antitobacco or health programs, that the financial terms of securitization are unfavorable, and that it can lower a state’s bond rating. Nationally, at least 17 states or counties have securitized part or all of their tobacco payments (Queary 2002). Three of the states we studied securitized their tobacco payments to obtain revenues: California raised \$4.5 billion, New Jersey \$1 billion, and Washington \$450 million. Officials in these states described securitization as the least of many evils, and sometimes the only alternative to cutting programs.

Tax Solutions

In a departure from states’ responses to previous downturns, elected officials in six of the seven states have made little effort to raise taxes, although some states postponed planned tax cuts. While some research suggests that the electoral penalty

for raising taxes is small (Winters 1999), politicians are reluctant to raise taxes lest they suffer the fate of defeated incumbents.

Many states, moreover, make raising taxes more difficult than reducing spending. Tax increases require two-thirds legislative approval in California and Florida, and three-fifths in Mississippi. Michigan’s constitution sets the maximum sales tax rate and prohibits a graduated personal income tax; Washington’s constitution prohibits any personal or corporate income tax. Colorado tax increases must be approved by the voters. New Jersey, the only state of the seven without special constraints on taxation, is also one of only six states in the nation that raised taxes by more than 3 percent of total tax revenue in FY 2002 (Johnson 2002).

While wholesale changes in tax rates or the tax structure have not even been discussed in most states, many states took modest steps designed to increase tax revenue.

Cigarette Taxes

Nationally, the most commonly increased tax was that on cigarettes (NGA and NASBO 2002). In FY 2003, New Jersey's cigarette tax increased from \$0.80 to \$1.50 per pack; Michigan's increased from \$0.75 to \$1.25 per pack. Cigarette tax increases are often seen as more palatable than others because they deter cigarette consumption. However, they fall disproportionately on low-income individuals (Lav 2002).

Income Taxes

None of the states studied changed their basic income tax rates, but California changed the rate of withholding on stock options and bonuses from 6 to 9.3 percent for a one-time revenue boost. To enhance current-year revenue, California also expanded withholding on commercial real estate sales, which formerly applied only to nonresidents, to apply to residents as well. Michigan, notably, is implementing a personal income tax cut enacted before the downturn.

Sales Taxes

As with the income tax, none of the states studied changed their general sales tax rate. However, California and Florida canceled planned back-to-school sales tax holidays. Officials noted that eliminating these holidays, which had never been enacted into law, was a relatively easy way to increase revenues. Washington imposed use taxes on out-of-state shipping, advertising, and repair services to match in-state sales tax levels.

Business Taxes

Reforming corporate income taxes was an important part of New Jersey's response to fiscal stress in FY 2002. Statutory changes closed

loopholes and established an alternative minimum measure of tax liability that is expected to increase state revenues by over \$800 million. New Jersey also decoupled its corporate tax from the federal tax (that is, changed provisions that linked state tax rates to federal rates) to avoid implementing the federal "bonus depreciation" cut, which awards tax breaks to firms making investments before September 10, 2004. Florida, in contrast, passed legislation to conform to the federal cut.

Other Revenue Enhancements

States enhanced revenues in ways other than those discussed above. Florida postponed increasing the exemption level of its intangibles tax on investments for two years. New Jersey decoupled from the federal estate tax, which is being phased out over 10 years. Washington added auditors at the Department of Revenue to collect owed taxes. Gubernatorial proposals to increase fuel taxes, however, were rejected by the legislature in Michigan and by the voters in Washington.

Some states looked to gambling for added revenues. Washington joined the "Big Game" multistate lottery. Michigan added a Sunday drawing to its lottery despite objections from some Republicans. Mississippi implemented an automatic 3 percent tax on casino winnings rather than wait for out-of-state bettors to file returns.

Spending Solutions

Most states have emphasized reducing spending over increasing taxes in response to current fiscal problems. Both across-the-board and targeted cuts have been made (see table 1).

Across-the-Board Cuts

Six of the states made across-the-board budget cuts. New Jersey, for

example, reduced the budgets of all agencies by 5 percent in FY 2002. However, "across the board" can be a misleading label. Each of the six states protected funding for K-12 education to some extent, for reasons including public support, strong unions, perceived relation to state economic development, and constitutionally mandated funding levels. The protected status of K-12 education, which represents 22 percent of state spending nationally (NASBO 2002), leaves other budget lines more vulnerable.

State Employees

State workers were often among the first to be affected by budget reductions. Agencies commonly responded to cuts by eliminating vacant positions and limiting administrative travel and equipment purchases. Colorado implemented a hiring freeze. Michigan offered a generous early retirement incentive and replaced only one in four retirees. California and Mississippi reduced funding for vacant positions, and Mississippi eliminated positions unoccupied for more than 60 days. Colorado, Florida, Michigan, New Jersey, and Washington laid off state workers. Washington state workers also paid higher insurance premiums and were denied a scheduled cost-of-living adjustment.

Most of these measures affected state employees in all agencies, but they seem to have had particular impact on social service and health programs. In Michigan, for example, 12 percent of all state employees, but 21 percent of the Family Independence Agency and 18 percent of Community Health, took early retirement (Durbin 2002). And 293 of the 419 Washington employees laid off at the end of FY 2002 were in the Department of Social and Health Services (Condon 2002).

Health Programs

State health programs are typically the second largest component of state budgets. In FY 2001, Medicaid alone comprised about 20 percent of state spending (NASBO 2002), making state health programs logical targets for cost savings. Cuts in provider reimbursements, or elimination of planned increases, have been the most common means of achieving savings in state health programs (Holahan et al. 2003). New Jersey physicians were denied a planned fee increase. Colorado made 5 percent cuts in provider reimbursement rates for emergency and county transportation, lab and x-ray services, home health care, private duty nursing, durable medical equipment, and some psychotherapy claims. Mississippi, already one of the states with the fewest doctors per capita, cut Medicaid provider reimbursements by 5 percent, and cut pharmacist fees as well (Goodman 2002). Washington's reduction in pharmacy reimbursement rates resulted in decreased participation by non-chain pharmacies. The state created a mail-order prescription system to serve rural recipients who were left without Medicaid-accepting pharmacies nearby. Michigan and Florida designated particular medicines as preferred in efforts to extract lower prices from drug manufacturers.

Reductions in health benefits and eligibility have thus far been at the margins. Mississippi raised Medicaid prescription drug copayments and reduced prescription and eyeglass benefits (Goodman 2002). Medicaid dental services for adults were reduced in California and Florida. In Washington, about 26,000 immigrant children, most of them undocumented, became ineligible for state-funded health benefits equivalent to Medicaid, and became eligible for (but not automatically enrolled in) the state's Basic Health Plan, which provides fewer benefits than Medicaid and requires recipient cost-

sharing. The eligibility limit for Florida Medicaid's elderly and disabled program was reduced slightly, from 90 to 88 percent of the federal poverty guidelines. California and Michigan postponed plans to expand eligibility for the State Children's Health Insurance Program (SCHIP) to parents.

Social Services

Five of the seven states we studied made reductions in social service programs. When considering TANF program reductions, these states have generally tried to maintain cash assistance. Most of Michigan's TANF program cuts, for example, were restored to fund growing cash assistance caseloads. TANF cuts have had greater impact on job-related services and supports. In California's FY 2003 budget, county TANF offices were cut by 12 percent of FY 2002 funding levels. With less money to fund cash assistance and other TANF programs, innovative services, such as Los Angeles County's program to help welfare families achieve long-term self-sufficiency, were eliminated.

Child care, a crucial work support, is popular among participants and voters, but significant waiting lists exist in 19 states, including California, Colorado, and Florida (Children's Defense Fund 2002). Florida's FY 2003 child care funding remains at FY 2002 levels with over 47,000 children on the waiting list. Five Colorado counties closed enrollment and created waiting lists. Eligibility for Washington's child care was reduced from 225 to 200 percent of federal poverty guidelines and copayments were increased for those who remained eligible.

Local Financing

Some states have cut local financing, leaving counties with difficult decisions of their own.⁴ Cuts in local

funding may have substantial consequences for programs that serve low-income families, as programs such as TANF, child care assistance, and Medicaid are often administered, and to some degree funded, by counties. In addition to making the cuts listed above, for example, California reduced funding for county administration of Medicaid and food stamps, delayed payments for state-mandated programs, reduced county social service performance incentives, and took back previously awarded incentive funds that had not yet been spent. Washington stopped back-filling revenues lost from changes in the motor vehicle tax, shifting \$59 million in costs to localities. New Jersey froze aid to local school districts. Almost 65 percent of Florida's FY 2002 budget cuts resulted from reduced aid to local governments.

The Role of Federal Financing

Federal financing arrangements have played a role in determining what gets cut. Federal financing of Medicaid and SCHIP provides incentives to maintain funding levels, particularly in states that enjoy the highest match rates. State officials reported that they take federal matches into consideration when they debate cuts in health programs: They know that they have to cut Medicaid by two to four dollars, and SCHIP by even more, to save a dollar of state money.

Yet the loss of matching funds does not always prevent program reductions. Medicaid in particular, our interviewees suggested, is simply too big to be ignored in any package of spending reductions. In Mississippi, which has the highest Medicaid and SCHIP match rates of any state, the governor and legislature worked hard to minimize health care cuts, and limited the loss of federal funds by covering roughly two-thirds of the Medicaid shortfall with tobacco settlement payments

(Goodman 2002). Florida expanded its SCHIP program, which has a matching rate of about 70 percent, while many Medicaid programs, with a federal rate of about 56 percent, were cut. Among states with lower federal matching rates, Colorado insulated its Medicaid program from the first rounds of state budget cuts, but included Medicaid in later reductions because of the sheer size of the shortfall.

The matching requirements attached to federal Title IV grants, which fund child welfare, foster care, and adoption assistance, have protected these programs in many states. In California, the fact that counties share the cost of Title IV-E foster care and adoption programs with state and federal governments was a factor limiting state-level cuts in these programs.

Federal maintenance of effort (MOE) requirements protected TANF from budget reductions. Many officials we spoke with cited MOE requirements in explaining why TANF had not suffered direct cuts in their states. MOE levels create a minimum TANF funding level in each state, but some states, including California and Mississippi, have treated them as maximum levels as well. Often, TANF could not sustain large cuts without loss of federal funding because states already funded TANF at or only slightly above MOE levels.

States have found creative ways to meet MOE requirements despite strained budgets. To prevent the loss of federal funds, Mississippi included previously uncounted programs, such as educational assistance to TANF recipients, toward MOE requirements. New Jersey counts the post-1996 portion of court-ordered spending on select low-income school districts toward its TANF MOE.

Looking Ahead

The magnitude of shortfalls expected in the current fiscal year varies among the seven states. Florida's Republican governor currently projects no additional shortfall, though

Democrats dispute this. Estimates of California's FY 2003 shortfall, in contrast, range from \$6 to \$10 billion, representing 8 to 14 percent of the state's general fund (Hill 2002; NCSL 2003).

One official told us, "You are doing these interviews too early," suggesting that the worst is yet to come. Estimates of the FY 2004 shortfall in the states we studied range from 8.9 percent of the budget in Washington to 33.8 percent in California (Lav and Johnson 2003).⁵ With reserves depleted and postponed costs resurfacing, economic recovery may not be enough to prevent painful budget cuts in FY 2004, particularly if state revenues follow the usual pattern of lagging behind other economic indicators.

Nonessential programs, described by some interviewees as "low-hanging fruit," will already have been cut, leaving only difficult choices. Medicaid costs are rising while states are becoming less able to shift program costs to the federal government due to the phase-in of restrictions on use of special financing under the disproportionate share hospital (DSH) and upper payment limit (UPL) programs. States must also deal with the "SCHIP dip" in the years ahead: as specified in the 1997 legislation that created the program, federal funding dropped from \$4.275 billion to \$3.15 billion, a decrease of 26 percent, in FFY 2002, and will remain at the lower level through FFY 2004. President Bush, moreover, has proposed reauthorizing the TANF program with tougher work standards for states to meet, but no additional funding to pay for programs to help them meet these goals or to adjust for changes in the cost of living since 1996.

Conclusion

States responded to the current fiscal crisis by turning first to reserves and other one-time revenue sources, often postponing fiscal troubles. Tax solutions, which helped states out of the last fiscal downturn, have been limited. This is partly due to current

political preferences, but state laws also severely restricted some states' abilities to increase taxes, prompting one interviewee to say that states "tied their own hands." The heavy reliance on one-time revenue shifts and short-term solutions suggest states' most difficult fiscal choices are yet to come.

When spending cuts were necessary, states generally tried to delay planned expansions rather than make current participants ineligible, and to implement across-the-board cuts rather than single out particular programs. Personnel often felt reductions first, and as a result many agencies are currently understaffed. Service providers, state workers, and program recipients all felt reductions.

Strong interest groups and constitutional provisions protected funding for education in some states. This left such other programs as TANF, Medicaid, and child care to bear the burden of spending reductions.

The prosperity of the late 1990s seems to have masked serious structural problems in the financing of state governments. The sales tax base is being eroded by untaxed services and Internet, catalog, and cross-border sales (Bruce and Fox 2000). Greater dependence on income taxes implies greater volatility in tax collections because income tax revenues vary more from year to year than revenues from sales or property taxes do; revenues from taxing capital gains, stock options, and bonuses are especially unstable. Many states adopted permanent restrictions on revenue and/or spending growth pegged to levels that do not reflect the anticipated cost of programs state residents have come to expect their governments to operate.

The federal government's role in state budgets is mixed. On the one hand, MOE requirements and high matching rates have protected some national priorities. On the other hand, devolution of responsibility for social programs increases the demand on state budgets at precisely the time when resources are most limited.

While most of their focus is on immediate pressures, ultimately

states should examine long-term solutions to fiscal stress and enact policies that work in expansions and recessions. Part of that calculus needs to be a recognition that devolution changes the fiscal needs and cycles of states. Whether states can and will modify their tax structures and levels to account for this change has implications for an assessment of current efforts at devolution and the likely effects of additional movement in this direction.

Notes

1. A handful of states have not yet experienced large shortfalls. Every state except Wyoming, which has benefited from an increase in natural gas prices, either has had a shortfall in the current fiscal year or expects one in the next fiscal year (NCSL 2003; Reid 2003).
2. The fiscal year begins on October 1 in Michigan and on July 1 in the other six states. States name their fiscal periods in different ways: what New Jersey calls the FY 2002 budget would be the FY 2001–02 budget in California and the 2002 supplemental to the 2001–03 biennial budget in Washington. For simplicity, we use “FY 2002” for all states and use “FFY” to refer to the federal fiscal year, which starts on October 1.
3. Since its enactment in 1991, the Bird-Arveschoug constitutional amendment has limited Colorado’s annual appropriations growth to the lesser of 5 percent of state personal income or 6 percent of total previous-year general fund appropriations. The 6 percent limit has been the effective constraint in each year since 1991.
4. Because our study design emphasized state-level policy decisions, we do not fully capture the consequences of local budget cuts.
5. FY 2004 estimates were not available for Mississippi.

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