Social Program Spending and State Fiscal Crises

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Occasional Paper Number 70

Assessing the New Federalism

An Urban Institute Program to Assess Changing Social Policies

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This report is part of the Urban Institute's *Assessing the New Federalism* project, a multiyear effort to monitor and assess the devolution of social programs from the federal to the state and local levels. Alan Weil is the project director. The project analyzes changes in income support, social services, and health programs. In collaboration with Child Trends, the project studies child and family well-being.

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About the Series

Assessing the New Federalism is a multiyear Urban Institute project designed to analyze the devolution of responsibility for social programs from the federal government to the states, focusing primarily on health care, income security, employment and training programs, and social services. Researchers monitor program changes and fiscal developments. In collaboration with Child Trends, the project studies changes in family well-being. The project aims to provide timely, nonpartisan information to inform public debate and to help state and local decisionmakers carry out their new responsibilities more effectively.

Key components of the project include a household survey, studies of policies in 13 states, and a database with information on all states and the District of Columbia, available at the Urban Institute's web site. This paper is one in a series of occasional papers analyzing information from these and other sources.

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Social Program Spending and State Fiscal Crises

In recent fiscal years, states have endured severe fiscal stress, triggered by the recession that began in March 2001 and exacerbated by the terrorist attacks of September 11. This stress represents a rapid reversal from the late 1990s—a period of prosperity during which states expanded health insurance coverage and provided new services using their welfare block grants, while also cutting taxes and increasing spending in other areas such as education and corrections. In the past few years, by contrast, virtually every state has had trouble raising enough revenue to cover expenditures. The new state fiscal crisis has forced states to make choices they were previously able to avoid.

The welfare reforms of the 1990s, culminating in the 1996 creation of the Temporary Assistance for Needy Families (TANF) block grant, shifted authority for traditional welfare programs from the national government to the states. With this devolution of responsibility, key social programs—and the well-being of those most frequently targeted by them, low-income families with children—have become more dependent on the fiscal health of the states. In the absence of major changes in national health policies, it has also been up to the states to provide coverage for the uninsured. Current proposals by the Bush administration would give states more authority in such other policy areas as housing assistance and preschool education.

To understand what choices states have been making in funding social programs, we conducted research on seven states: California, Colorado, Florida, Michigan, Mississippi, New Jersey, and Washington. These were selected from the 13 focal states of the Urban Institute's *Assessing the New Federalism* project because they had the largest fiscal problems when we began our research in mid-2002, and because they represent diverse regions and political traditions. We conducted site visits to each state in the fall of 2002 to meet with executive and legislative officials, their staff members, and state-level advocacy groups. We supplemented and updated what we learned in our interviews with information from state budget documents, newspaper articles, and other published analyses.[1]

We summarized what the seven states have done in an earlier brief (Finegold, Schardin, and Steinbach 2003). This paper includes summaries of each state's response to fiscal stress that are more detailed and current than what we could present in the brief. An introductory overview draws on the state summaries to examine why states made the policy choices we identify and suggests some lessons from the unhappy experiences of these states.

Economic Downturn and Revenue Disaster

The current economic downturn is among the mildest experienced since World War II. Table 1 compares peak unemployment rates and real percentage gross domestic product (GDP) declines in each recession since World War II. In the current recession, real GDP actually rose 0.2 percent, making it the only postwar recession in which GDP did not decline. Unemployment reached 6.4 percent in June 2003, which is lower than the peak unemployment rate in all but two postwar recessions.

Yet the current state revenue shortfall has been deeper and more prolonged than in any other recession since World War II (National Association of State Budget Officers [NASBO] 2002b). Figure 1 illustrates real annual percentage change in state government tax collections from FY 1953 to FY 2002.[2] Following fairly stable revenue growth from FY 1992 to FY 2001, state tax collections plummeted in FY 2002. California's revenue decline in FY 2002 was its greatest since the Great Depression, and Michigan's FY 2003 general fund revenue is expected to be its smallest since FY 1996 (E. Hill 2002; Michigan Office of the State Budget 2002). FY 2002 was the only year of nominal state revenue collections decline since World War II, and the year's real decline of 6 percent was far greater than in any other recession of the period.

Figure 2 presents a picture of the current revenue crisis in each of this paper's seven focal states in relation to their actual FY 2001 revenue. A value of 100 percent indicates real revenue equal to FY 2001 collections, while values below 100 percent represent real revenue below FY 2001 collections. Real FY 2004 revenues are expected to fall short of FY 2001 revenues in all seven states except New Jersey, where raising tax revenue was a cornerstone of their response to fiscal stress. (Florida is projected to barely miss, with FY 2004 revenues at 99.85% of FY 2001 revenue levels.) Colorado's

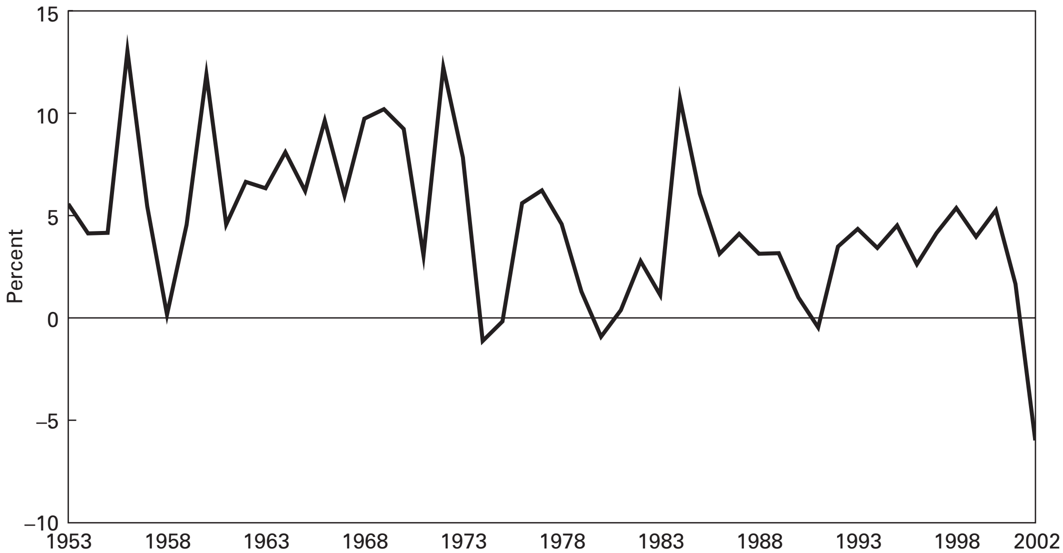
Table 1. Real GDP Changes and Peak Unemployment Rates in Recessions since 1948

Recession	Percent change in GDP	Peak unemployment percentage
1948–49	–1.67	7.9
1953–54	–2.57	6.1
1957–58	–3.15	7.5
1960–61	–0.53	7.1
1969–70	–0.14	6.1
1973–75	–3.40	9.0
1980	–2.19	7.8
1981–82	–2.79	10.8
1990–91	–1.31	7.8
2001	0.20	6.4

Sources: Bureau of Economic Analysis, http://www.bea.gov/bea/dn1.htm; National Bureau of Economic Research, Business Cycle Expansions and Contractions, http://www.nber.org/cycles/; Bureau of Labor Statistics, National Unemployment Rate, http://www.bls.gov.

Notes: Real GDP decline represents NBER-defined peak to trough change. Because changes in unemployment typically lag behind changes in GDP, peak unemployment may occur slightly after the end of a recession period.

Figure 1. Real Annual Percent Change in State Tax Collections, Fiscal Years 1953–2002



Sources: U.S. Census Bureau, *Annual Survey of State and Local Government Finances and Census of Governments,* 1953–2002; National Income and Product Accounts, table 7.1, line 8.

official revenue estimates project that nominal revenues will not surpass those of FY 2001 until FY 2007 (Colorado Legislative Council 2003).

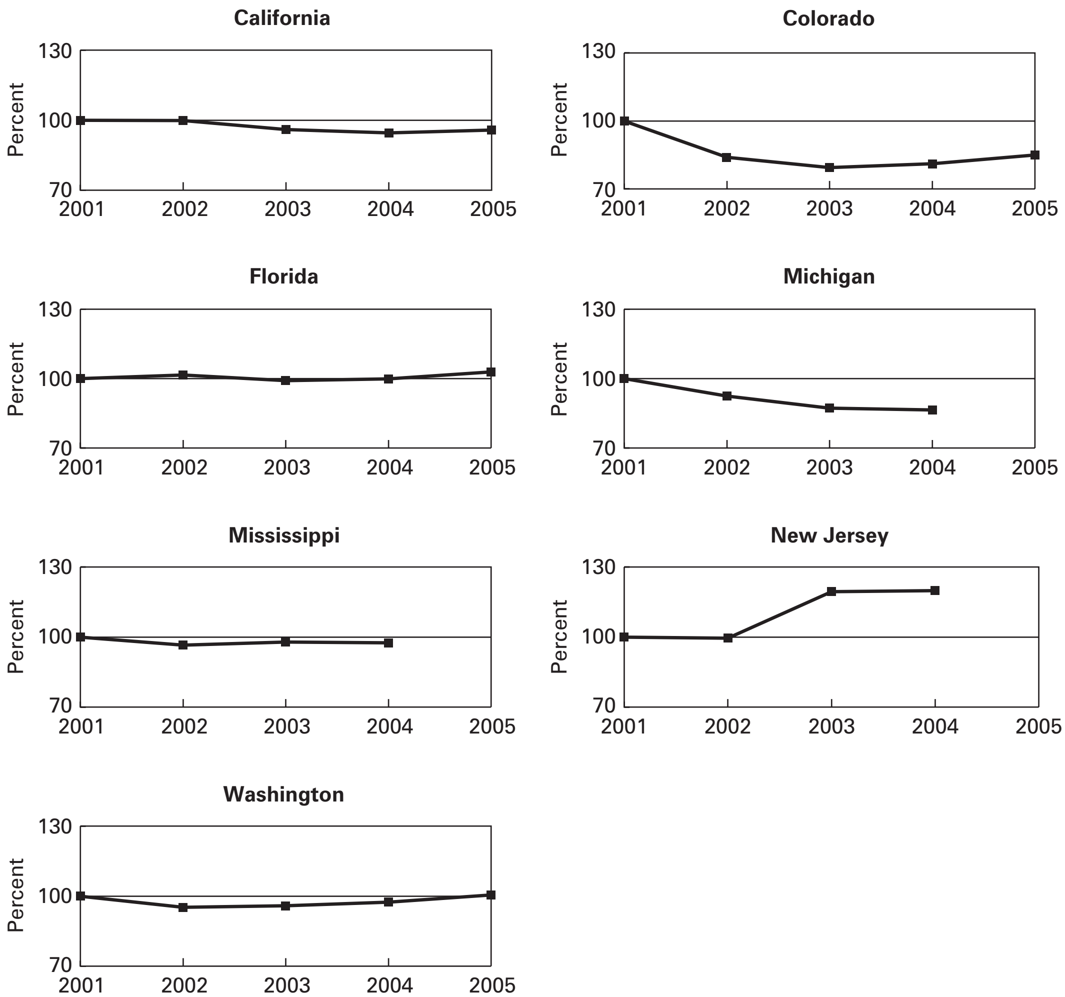
The severity of the current revenue crisis far exceeds that of the recession that triggered it because of policy choices made in the late 1990s. During the boom years state officials cut taxes and expanded programs based on unsustainable revenue growth. The states enacted net tax cuts every year from FY 1995 to FY 2002 (Maag and Merriman 2003). At the same time, they expanded health insurance coverage, reduced class sizes, and put more people in prison. In some states, where the power to make important fiscal choices has shifted away from elected officials and toward voter initiatives, voters have mandated spending increases and tax cuts. One interviewee described this process as "hyper-democracy."

When the unprecedented revenue growth of the late 1990s subsided, it became evident that state policy choices had produced structural deficits. Structural deficits, in which expenditures exceed taxes during normal economic activity, differ from cyclical deficits, in which revenues are expected to decline in proportion to an economic downturn. Economic recovery can erase a cyclical deficit, but erasing structural deficits requires realigning spending and revenue policies to achieve balance between the two.

State Responses

In each of the seven states, FY 2002 and FY 2003 general-fund revenues fell below baseline, the levels that would have been necessary to maintain real spending at

Figure 2. Real General Revenue Estimates as a Percentage of FY 2001 General Revenue, FY 2001–05



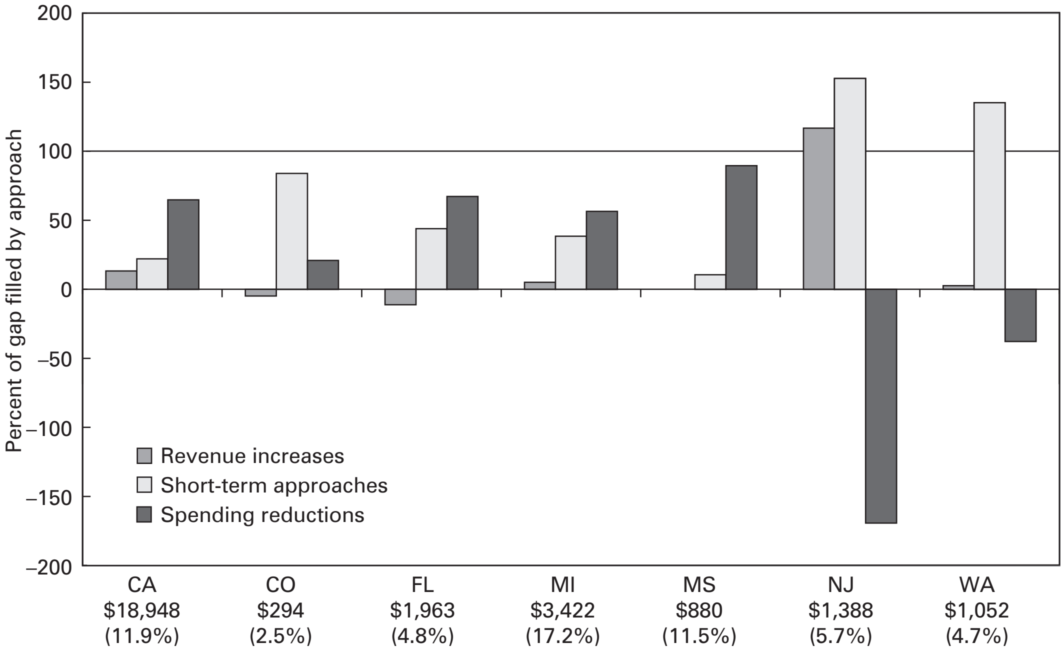
Sources: Revenue estimates gathered from each state's official forecasting agency.
Notes: Revenue estimates extend as far into the future as published as of June 2003. Real revenue is estimated using Global Insights Inc., projections for the Implicit Price Deflator for Personal Consumption Expenditures.

FY 2001 levels. The size of the gap varied from 2.5 percent of real FY 2001 spending in Colorado to 17.2 percent in Michigan. Figure 3 shows how each state relied on revenues, spending, and short-term solutions to close budget gaps. Positive percentages indicate reliance on a particular solution, whereas negative percentages indicate that a state enlarged its shortfall with a particular solution.

Short-Term

Each state has relied on short-term solutions to deal with its current problems. Short-term solutions include using reserves, transferring other state funds to the general

Figure 3. State Responses to Close Budget Gaps, FY 2002 and 2003



Sources: Based on NASBO (2002c), updated with state budget documents.
Notes: Dollar values under state abbreviations denote dollar value in millions of budget shortfall in FY 2001 dollars. Percentages denote gap as a percentage of real FY 2001 expenditures.

fund, and shifting expenditures or revenues across fiscal years to achieve nominal fiscal balance. These solutions help to get a state through its immediate crisis without addressing the structural deficit discussed above.

State reserves at the beginning of the 2001 recession were proportionally larger than before either of the two previous recessions: The combined reserves of the 50 states totaled 10.4 percent of expenditures at the end of FY 2000, compared with prerecession peaks of 9.0 percent in 1980 and 4.8 percent in 1989 (NASBO 2002b). In our seven focal states, FY 2000 reserves ranged from 7.8 percent in Mississippi to 15.4 percent in Michigan, where state law requires transfers into the Budget Stabilization Fund when real annual personal income increases by more than 2 percent (NASBO 2001).

The reserves built up in the late 1990s generally allowed the states to get through the first year of revenue shortfalls relatively painlessly. But as the crisis continued, the states had less to fall back on. Each state relied more heavily on short-term solutions in FY 2001 than in FY 2002.

Another short-term solution is debt refinancing. Low interest rates, among the few positive aspects of the current economy, have allowed states to reduce their debt service costs, and thus their budget shortfalls, through refinancing. Michigan was able to save $41 million by restructuring its general fund/general purpose debt. Michigan also saved money—but incurred added risk—by issuing variable-rate bonds backed by future federal transportation funds to finance a major capital project

(Carvlin 2002; Michigan House Fiscal Agency 2002; Thiel 2001). New Jersey and Mississippi saved $68 million and $12.3 million, respectively, through refinancing.

California, New Jersey, and Washington have generated some current revenues by issuing bonds backed by future payments from the settlement of the multistate lawsuit against tobacco companies. Other states may also turn to tobacco securitization as one of the few short-term solutions still available. A March 2003 Illinois court ruling awarding $10.1 billion against Philip Morris, however, raised questions about the ability of the companies to meet the settlement terms, increasing the perceived risk of the bonds and thus the interest rates that states have to pay to market them. The ruling stalled movement toward securitization in Colorado, and led California to cancel its second bond sale, which had been expected to raise $2 billion. Tobacco securitization may resume if a higher court overturns the Illinois ruling.

Taxes

State reluctance to raise taxes is evident in figure 3. New Jersey, which raised corporate business and cigarette taxes, was the only one of the seven states to rely primarily on tax increases in its response to revenue problems. Michigan raised cigarette taxes by 50 cents per pack and suspended a scheduled reduction in its single business tax. Washington imposed a use tax on out-of-state shipping, advertising, and repair services. California increased withholding of certain taxes and suspended for two years the net operating loss provision, which allows individuals or businesses to apply losses in one fiscal year against income in another. Mississippi enacted no revenue measures for FY 2002 or FY 2003; Colorado and Florida increased revenue shortfalls with new tax cuts. None of the states increased income or sales tax rates, and Florida and Washington, which have no income taxes, did not take any steps toward adopting one.

Figure 3, moreover, may overstate states' reliance on raising tax revenue as a response to fiscal stress because some recent tax changes give up more revenue tomorrow than they generate today. California suspended its net operating loss provision, but raised the proportion of losses that will be deductible when the provision goes back into effect (in January 2004) from 65 to 100 percent. Similarly, Michigan postponed its previously enacted annual 0.1 percent cut in the single business tax for two years, but accelerated the date when the tax will be completely phased out from FY 2020 to FY 2009. Michigan also shifted $728 million between fiscal years by moving up the date when state property taxes are due, but eased the burden with a one-time cut in the same tax worth $266 million.[3]

The current resistance to tax increases provides a contrast with the state and local policy decisions of the late 1970s and early 1980s, in which Wolman and Peterson (1981) found "a bias toward responding to fiscal pressure by increasing revenues to maintain services rather than by reducing expenditures." As Maag and Merriman (2003) point out, states were also willing to raise taxes during the revenue crisis triggered by the recession in 1990. States enacted tax increases totaling 3.4 and 4.6 percent of total revenues in FY 1991 and FY 1992, respectively. In contrast, state tax increases totaled 0.3 percent in FY 2002 and 1.6 percent in FY 2003. If states had increased revenue by the same proportions in FY 2002 and FY 2003 as in the two earlier years, the cumulative FY 2003 shortfall would be one-third its current size.

Why have officials become more reluctant to raise taxes? The political consequences of the earlier tax increases may affect their decisions. Michigan officials remember that John Engler, a Republican, used the tax issue to defeat the incumbent Democratic governor, James Blanchard, in 1990, and that Engler subsequently retained the governorship until he was forced out by term limits this past year. Taxes also played a big role in New Jersey, where the Republican, Christine Todd Whitman, defeated the Democratic incumbent, James Florio, in 1993. This time around, Democratic governors Gary Locke (Washington), Gray Davis (California), and Jennifer Granholm (Michigan) have all emphasized expenditure cuts over tax increases. Another Democratic governor, New Jersey's James McGreevey, proposed, and got the legislature to approve, corporate tax increases last year, when there were no state elections, but is forswearing further increases in the state's three biggest taxes (personal income, sales, and corporate income) this year, when control of the legislature is at stake.

Republicans, for their part, appear to be divided between those who reject any tax increase and those who would accept some increase, typically in sales or cigarette taxes rather than income or business taxes, as part of a budget package that also includes substantial spending cuts. This division produced bitter conflict between the House and Senate in Florida, where Republicans control both chambers as well as the governorship. Democrats controlled California's governorship and legislature, but the two-thirds vote required in each house to raise taxes gave Republicans leverage as long as they could maintain party unity in at least one chamber.

In several of the states we studied, moreover, legislators or voters responded to the tax increases of the early 1990s by enacting new statutory or constitutional provisions that make it more difficult to raise taxes. In 1992, for example, Colorado's Taxpayer's Bill of Rights inserted strict revenue limits into the state constitution, with amounts collected above the limits to be refunded to taxpayers the following year. Washington voters have approved a series of initiatives limiting taxes and spending.

Some governors have found ways to increase revenues without the changes in tax rates that formal requirements and political alignments effectively preclude. Washington increased tax enforcement, increasing yields by more than it costs to hire additional auditors. This approach might work best in a state that, like Washington, has no income tax: firms, rather than individual taxpayers, will experience the stricter enforcement of business and sales taxes. Michigan has gone in the other direction: at the end of 2002, the legislature voted to reduce penalties for cheating on taxes or failing to file returns. Governor Granholm has sought to frame her proposal for reversion to the larger penalties as "closing tax loopholes," a formulation that may be more acceptable to the public than "raising taxes." New Jersey Governor McGreevey supported increasing the corporate tax with an ad campaign emphasizing that some large corporations were paying less tax than families leaving welfare. Finally, in Republican-dominated Colorado and Florida, passage of FY 2004 budgets relied partially on several fee increases, which legislators claim are fairer than tax increases because they are levied on those using particular government services.

Looking beyond our seven states, Kansas increased its sales tax rate, and Nebraska increased rates for its sales and income taxes, but both states made the increases temporary by setting statutory dates to fully or partially eliminate the increases (Fulwinder 2002; McLean 2002).

Spending

The limited availability of short-term solutions and the political constraints on tax increases left spending cuts as the primary mechanism for closing budget gaps in all of our focal states except New Jersey and Washington (figure 3). Real general-fund spending in FY 2002 and FY 2003 was below the FY 2001 level by 7.7 percentage points in California, 0.9 percentage points in Colorado, 3.2 percentage points in Florida, 9.7 percentage points in Michigan, and 10.3 percentage points in Mississippi.[4] State spending in FY 2002 and FY 2003, adjusted for inflation, exceeded FY 2001 spending in New Jersey, which increased taxes, and in Washington, which relied on tobacco securitization and other short-term measures.

Policymakers in Colorado and Mississippi perceived across-the-board cuts as the fairest or best solution, although certain budget areas were usually protected from the cuts because of mandates or preferences. Mississippi law requires an across-the-board approach: The governor cannot cut any agency's budget by more than 5 percent unless all agencies are cut by 5 percent, and any cuts above 5 percent must be applied uniformly. Some of Florida's elected officials, in contrast, felt that their purpose in the cutting process was to identify better ways to direct cuts than across the board.

Like across-the-board percentage cuts, personnel reductions through attrition, early retirements, or layoffs reach across departments. Reductions or freezes in employee compensation also reach across departments. Michigan's FY 2004 budget, for example, assumes that state workers will agree to give up $250 million in salary and benefits due under existing labor contracts.

Spending reductions have affected each major category of state spending. Federal matching subsidizes state spending on Medicaid (19.6 percent of state expenditures in FY 2001) and SCHIP.[5] Yet states have been willing to give up some of the federal money to achieve current budgetary savings. Medicaid, in particular, accounts for such a large proportion of state spending that it is difficult to reduce overall spending without cutting the program. States have tried to shift as much of the burden onto providers by freezing or even rolling back reimbursement rates, but this tactic is limited by the ability of providers to stop participating in programs when their fees are unacceptably low. Cutbacks in eligibility are becoming more frequent: Colorado, for example, is eliminating SCHIP coverage of prenatal care and capping child enrollment in the program (Austin 2003).

Most of the 2.2 percent of state expenditures that goes to public assistance is spent under the TANF program. Many interviewees noted the need to meet maintenance-of-effort (MOE) requirements to avoid losing TANF funding. These requirements set a floor on the TANF-funded portion of human services spending, which can include child care and other work supports as well as cash assistance. Because most states have been spending their own money at, or only slightly above, MOE levels, the MOE requirements have been effective constraints on the ability of state officials to concentrate spending reductions on human services.

Primary and secondary education (22.2 percent of total state expenditures), like health care, is too big for states to ignore when they cut spending. Popular support for K–12 education, effective teacher organizations, and constitutional provisions that set floors for school spending in some states have not provided full protection against cuts.

Higher education (11.3 percent of state expenditures) is not protected by constitutional guarantees, maintenance-of-effort requirements, or federal matching formulas. FY 2004 looms as a particularly bad year for higher education in several of the states we studied. Colorado has already adopted a budget that reduces higher education funding by more than one-third.

One factor that may make state officials feel better about cutting higher education spending is that colleges and universities can absorb the loss of state support by raising tuition. Similarly, local school districts can, if they choose, raise their own taxes to make up for the loss of state aid. Reductions in state aid to local governments have occurred, or been proposed, in areas besides education. California has stopped rewarding county TANF agencies with performance bonuses, and taken back bonuses that had already been rewarded but had not yet been spent. Two governors have targeted Michigan's local revenue sharing for cuts. To the extent that state spending cuts lead to increases in local taxes and in-state tuition, data on state tax changes understate the full costs imposed on residents during an economic downturn.

Variations in State Budget Processes

Through our interviews, we saw that the political process in each state varied greatly given distinct laws, histories, and political characteristics. Variables that influenced states' responses to fiscal stress included revenue forecasting procedures, the institutional separation of powers, and legal constraints on spending and revenue decisions.

Several methods of revenue forecasting exist in the seven states we studied. Florida and Michigan use consensus forecasting, which depoliticizes the revenue estimating process and may allow elected officials to respond to crisis more quickly. In contrast, officials in Mississippi and New Jersey have no formal consensus process. In these states revenue estimates were the subject of political tension that may have delayed action. Washington's Office of the Forecast Council, headed by a professional economist appointed for a fixed term, develops revenue estimates that all participants in the budget process accept. Finally, California and Colorado's estimates are made separately by the legislature and executive office. In recent years, these estimates have tended to be similar, and some believe this process is an incentive for officials to be realistic and accountable.

Each state's legislative and executive branches share responsibility of the budget process differently. Michigan's constitution requires the governor to respond to revenue shortfalls, and provides that executive orders issued in these circumstances take effect after the House and Senate appropriations committees approve them in up-or-down votes. In contrast, Colorado's executive budget is all but ignored by the legislative joint budget committee, which crafts proposals for the entire legislature to debate. Mississippi's governor is relatively powerless in the budget-writing process, but is required to take action to balance the legislature's budget when revenues fall more than 2 percent below projections.

After the recession of the early 1990s, legislatures and voters passed several measures to encourage fiscal responsibility and protect certain spending areas. The recent revenue crisis exposed unanticipated side effects of these policies, and in some cases these side effects steered the political process. For example, Colorado's voters mandated increased education spending each year, but in the face of budget cuts, this mandate positioned other areas of spending closer to the budget ax.

Lessons

California, Colorado, Florida, Michigan, Mississippi, New Jersey, and Washington have distinctive economic and political characteristics that we highlight in the following state summaries. Despite these differences, the story for each state is much the same, with a mild recession leading to revenue declines that force public officials to choose among a limited number of unpleasant options. These states, except for New Jersey, have also made similar policy decisions, relying on short-term solutions when possible and choosing to cut spending rather than increase taxes when they have to do one or the other. What lessons do the common experiences of the seven states suggest?

- **Be realistic about the sustainability of revenue trends.** Warnings about the fragility of state finances went unheeded by elected officials in several states. In 1999, for example, Florida's well-respected former chief tax collector, Larry Fuchs, warned that another recession like that of the early 1990s would necessitate $1.5 billion more than the state's reserves could cover. Fuchs cited Florida's eroding sales tax as the main problem, and advocated preventive reforms. In New Jersey, revenue estimators at legislative and executive budget offices began warning the governor and legislature in 1998 and 1999. There, stock options, bonuses, and capital gains revenues were seen as the largest threats to stability.

  We know now that the business cycle will continue, that unpredictable events can have effects at the state and national levels, and that what goes up can also come down. States should adopt policies that work in good and bad times: elected officials ought to be realistic when planning for the fiscal future, resisting permanent tax cuts and spending increases that may not be sustainable. The states might not be able to prevent future revenue crises, for macroeconomic conditions and national policies are beyond their control. But they can act to make crises more manageable when they occur.

- **Don't count on federal help.** Through the National Governors Association, the National Conference of State Legislatures, and other intergovernmental organizations, state officials have sought temporary federal assistance in the form of an enhanced Medicaid match rate or a revival of unrestricted state and local revenue sharing. They have also advocated long-term solutions to their revenue problems, such as shifting the costs of prescription drugs from Medicaid to Medicare for those eligible for both programs.

The compromise tax cut package that Congress approved in May 2003 includes $20 billion in temporary state and local aid. Yet that money covers a fraction of the budget gaps that states are dealing with now and the spending cuts they have already made. By FY 2004, the cumulative budget gap in California alone will exceed this amount.

At the same time that this money is being transferred, other changes in federal policy are adding to state fiscal problems. The same tax legislation that includes the $20 billion will also cost the states $3 billion in FY 2004 and FY 2005 unless they act to change state tax provisions linked to the federal tax code (N. Johnson 2003). Interviewees in Michigan and New Jersey emphasized the impact of tougher federal rules on Medicaid reimbursements to their fiscal problems.

There are good arguments for short-term and long-term realignment of state and national fiscal responsibilities. But state officials should recognize that the national government has changed. The Bush administration has other priorities and the federal budget is in deficit again after a short period of surplus. States should have backup plans to maintain key programs such as Medicaid and child care when federal assistance is inadequate.

- **Build up reserves and be able to draw on them when needed.** Despite reserves proportionally larger than in the previous two recessions, states relying on rainy day funds to balance their budgets found them quickly depleted. Each state faces unique circumstances that encourage or discourage the buildup of reserves and their expenditure, such as caps, repayment requirements, and supermajority votes (Zahradnik and Ribeiro 2003). For example, Colorado's TABOR amendment requires a reserve, but it may only be used for natural disasters; Colorado accumulates no true rainy day fund, since each dollar put into it would compete with other programs under strict spending limits. Florida's budget stabilization fund may be used for either economic downturns or natural disasters, but a requirement to repay the fund within five years to reach 5 percent of appropriations in the year of repayment has prevented cautious politicians from tapping the $959 million fund.

  Many of these provisions prevent states from building up reserves when revenues are expanding—reserves that states could use to bridge revenue contractions. States ought to reduce barriers to the accumulation of reserves, remove limitations that interfere with the best allocation of reserves, and reexamine the size of reserve funds necessary to successfully weather the next fiscal storm. If the structural problems in state finances are not corrected in time for the next crisis, states can expect to need large reserves.

- **Make tax policies symmetrical.** States have made it hard to raise taxes. Tax increases require approval by two-thirds of each chamber in California and Florida, and three-fifths of each house in Mississippi. The Colorado constitution requires that the voters approve any tax increase. The Washington constitution does not explicitly require voter approval of tax increases, but the ease with which opponents can put a repeal referendum on the ballot has a similar effect. Some of these constraints predate the fiscal crises and tax increases of the early 1990s, but Colorado, Florida, New Jersey, and Washington have enacted provisions that limit revenues and/or expenditures since that time (NASBO 2002a; Poterba and Rueben 1999).

All these provisions operate in one direction only: requirements of legislative supermajorities or popular approval apply to tax increases, but not to tax reductions. Because it is easier for states to cut taxes in prosperity than to raise them in recession, state budgets may be ratcheted downward over time. Similarly, overall revenue (or spending) is subject to ceilings, but not floors. The falling tax yields of the past few years have put states far enough below these ceilings that policymakers see no danger of exceeding them. In the long run, however, the risk of raising money that cannot be legally spent may discourage tax increases, resulting in rates that are too low to yield adequate revenues during economic downturns.

The summaries that follow show how the current crisis has played out within each state's specific economic and political context, and how it has affected the programs most important for low-income families with children. The summaries do not, unfortunately, suggest that any one state has discovered a formula for solving fiscal problems without tax increases or spending cuts. They do, however, demonstrate the need for policymakers in each state to make decisions, now and when things get better, with the next fiscal crisis in their minds.

California

While most states are facing substantial fiscal pressure, several factors make California's situation unique. It has many large cities, the largest population of any state, the largest proportion of legal and undocumented immigrants, and one of the largest proportions of residents on welfare (Hovey and Hovey 1999; Tumlin, Zimmerman, and Ost 1999). It is also home to the center of the high-tech boom of the 1990s, Silicon Valley. State revenues soared with increases in capital gains, bonuses, and stock options during the boom and collapsed with the sudden disappearance of these sources of income.

The size of California's budget immediately sets it apart from other states. Governor Davis budgeted $100.4 billion for expenditures in fiscal year 2004 (J. Hill 2003d). California's size has advantages and disadvantages. On one hand, a revenue gap of $318 million, which the state experienced in FY 2001, was small relative to the overall state budget (California Legislative Analyst's Office 2001a). On the other hand, large dollar figures capture voters' attention. Large surpluses made the state budget a political target in the late 1990s. Consequently, public officials felt pressure to expand programs and cut taxes.

Reduced income tax revenues produced a small shortfall in FY 2001 and big shortfalls for each subsequent fiscal year to date. The state has used its reserves, securitized its entire tobacco settlement, and reduced spending. Yet by early 2003, the nonpartisan Legislative Analyst's Office (LAO) projected that under current law, the state would run a $26.1 billion deficit in FY 2004, including the carryover from FY 2003 (J. Hill 2003a). Governor Gray Davis, citing projections that were even worse, proposed further spending reductions and tax increases to address the gap between expenditures and revenues in FY 2004. Although the legislature approved an FY 2004 budget closing the gap, the budget crisis contributed to the recall campaign against Governor Davis. Recall advocates met the requirements to place the question on the ballot, and in October 2003 Davis became the second governor of any state to be recalled by the voters.

Political and Legal Context

Governor Davis, a Democrat, was elected in 1998 and reelected in 2002. He is known for his commitment to public education, health care, transportation, and tax relief. The governor is limited to two four-year terms, as are state senators. Assembly members can serve three two-year terms.

Voting, especially on budget issues, usually takes place along party lines. In recent years, Democrats have enjoyed large majorities in both chambers of the legislature. However, both chambers must approve the budget by two-thirds majorities.

During the 2001–02 legislative session, a unified Democratic Party needed one Republican in the Senate, and four in the Assembly, to pass a budget. Therefore votes are often "bargained" for. In addition, under Proposition 13, approved in 1978, tax rate increases must be approved by two-thirds majorities in each chamber. This requirement hinders any attempt by the Democratic majority to increase tax rates or close tax loopholes in response to fiscal crises. Tax cuts are not subjected to the two-thirds majority provision.

The California state constitution requires that the governor submit a budget bill each January 10th enumerating expenditures, which must be offset by revenues. The governor generally adopts the current level of funding for a department, modified according to the Budget Change proposals submitted by departments. The legislature must pass the Budget Bill by June 15. The Assembly and Senate usually begin their separate reviews in late February after considering the analysis of the executive budget by the LAO.

The governor updates the revenue and expenditure projections in a May budget revision. Consequently the legislature usually waits for the May revision before making final decisions on major programs. A budget conference committee works out differences between the Assembly and Senate versions of the budget bill and sends its version back to each chamber for approval by the necessary two-thirds. The governor is constitutionally permitted to veto or lessen items of appropriation (California Department of Finance 2000). The governor cannot, however, make mid-year adjustments to the budget without going back to the legislature.

Initiatives and statutes approved in the past constrain budgetmaking. For example, Proposition 4, approved by voters in 1979, added an appropriations limit to the state constitution. As modified in 1988 and 1990, Article XIIIB limits annual appropriations to FY 1979 levels, adjusted for growth in population, school enrollment, and per capita personal income. Revenues above the limit, for two consecutive years, are to be divided between education spending and tax rebates. Proposition 98, approved in 1988, established a minimum level of funding, based on economic and fiscal conditions, for K–12 education and community colleges (California Legislative Analyst's Office 2000; Doerr 2000).

Revenue is estimated by both the Department of Finance and the LAO. The Department of Finance estimates revenue in January for the governor's January budget, and in May for the governor's May revision. The LAO estimates revenue for the legislature in February and November. The two sets of estimates differ because they are done at different times, but the trends they suggest are usually similar.

Fiscal Pressures and Policy Responses

FY 2001

Reflecting declines in all major taxes during May and June 2001, FY 2001 revenues came in $318 million below LAO projections (California Legislative Analyst's Office 2001a). On the scale of the California budget, the problem was small: $318 million represented less than 0.5 percent of general-fund revenues. A prior-year fund balance of over $9 billion allowed the state to absorb the decrease without any mid-year adjustments in spending or revenues. At the end of FY 2001, California still had almost $7 billion in its various reserves (E. Hill 2002).

California's sales tax rate was reduced temporarily in FY 2001 under the terms of a law enacted in 1991. According to that law, the state sales tax for a calendar year would be reduced by 0.25 percentage points if the balance in the Special Fund for Economic Uncertainties (SFEU) reserve at the end of the previous fiscal year was greater than 4 percent of general-fund revenues in that year, and the expected balance in this fund at the end of the current fiscal year was greater than 4 percent of general-fund revenues in the current fiscal year. These conditions were met, for the first and only time so far, in FY 2000 and FY 2001. The large balance in the SFEU reserve triggered the 0.25 percentage point sales tax cut for calendar year 2001, encompassing the second half of FY 2001 and the first half of FY 2002.

FY 2002

In FY 2002, California had an operating shortfall of $13 billion caused by a decline of over $10 billion in revenue and an increase of about $3 billion in expenditures. The governor's initial January budget estimated FY 2002 general-fund revenue at $79.4 billion and general-fund expenditures at $82.9 billion. January expenditure estimates were $8 billion above current law requirements and included $5.5 billion in new spending initiatives, $1.9 billion for reserves, and $108 million in tax relief measures including an August sales tax holiday and an increase in the investment credit for manufacturers (California Legislative Analyst's Office 2001b). The January budget included funding for the expansion of California's SCHIP program, Healthy Families, to cover low-income parents as well as their children.

In May 2001, the governor estimated that the January budget revenue projections for FY 2002 were $4.2 billion too high and estimated expenditures were $1.5 billion too low (E. Hill 2001b). Governor Davis proposed a number of solutions in the May revision, including reducing the amount held in the state reserve funds, postponing the shift of gasoline sales tax revenue from the general fund to transportation, reducing one-time spending proposals, transferring special fund money into the general fund, and reducing Proposition 98 education spending.

The enacted FY 2002 budget assumed revenues of $75.1 billion. Health programs were fully funded with the help of tobacco settlement money. Social services were fully funded, including cost-of-living adjustments (COLAs) for recipients of CalWORKs (the state's TANF program), Supplemental Security Income/State Supplementary Program (SSI/SSP) grants, and foster care. CalWORKs county performance incentives were reduced, however, and child support county incentives were delayed (E. Hill 2001b).

Even after May revisions reduced the original January revenue estimate to $74.8 billion (E. Hill 2001c), a decrease of 3.7 percent from FY 2001 revenue levels, revenue continued to fall short of projections. By fall 2001 it was clear that revenue would not meet even the decreased projection. The LAO estimated in November 2001 that revenue would be $6.8 billion below the enacted budget projection, a 12 percent decline from FY 2001 levels.

Falling income tax revenues were the major source of California's budget woes. In particular, revenues received from stock options and capital gains fell from $17 billion in FY 2001 to $6 billion in FY 2002. California's estate taxes declined by $100 million due to the removal of the federal estate tax, to which the state tax is linked (E. Hill 2002). The continuation of the triggered sales tax reduction through the end of CY 2002 reduced July–December revenues by an estimated $550 million. As part of the series of compromises around the FY 2002 budget, the sales tax trigger was restructured. Sales tax rates will now be decreased by 0.25 percent when the SFEU reaches 3 percent of general-fund revenues in the previous year and general-fund revenues collected from May 1 to September 30 are greater than or equal to revenue projections in the May revision.

Reserves were used to cover $7 billion of the $13 billion shortfall (E. Hill 2002). FY 2002's January budget included $2.2 billion in reserves. By May the amount had fallen to $1.1 billion. The state ultimately ended FY 2002 with a $1.4 billion deficit. Tax relief proposals in the January budget were dropped.

The state also cut spending. On October 23, 2001, Governor Davis issued an executive order directing a hiring freeze and a $150 million reduction in operating expenses. He also asked agencies to draw up plans for 15 percent budget cuts for FY 2003.

In January 2002, the legislature voted to decrease expenditures by $2.2 billion in FY 2002 and $589 million in FY 2003. K–12 funding was reduced by $875 million; education cuts included withdrawal of energy cost funds, delays for some teacher incentives, and reductions in some categorical programs (E. Hill 2002). Across-the-board cuts in state operating expenses, a decrease in funding for energy-related costs, and a reduction of Smog Impact Fee refunds accounted for $605 million in general government savings. The Healthy Families parental expansion, which had already received the necessary federal waiver, was postponed.

The state's response to the 2001 energy crisis, it should be noted, has had no direct effect on the budget. The state borrowed $6 billion from the general fund to purchase electricity on behalf of California utilities. State law, however, requires that these loans be repaid, and the Department of Water Resources is marketing electricity revenue bonds to raise the funds to do so. The loans, therefore, do not represent general-fund expenditures, and the $6 billion is not included in estimates of revenue shortfalls (E. Hill 2001a).

FY 2003

As they strove to pass a budget for FY 2003, California lawmakers faced a gap of $23.6 billion between revenue and expenditures. The gap was a result of rising expenditures according to current law, declining revenue projections, carryover from the FY 2002 year-end deficit, and a target reserve balance of $500 million. The gap was closed primarily through program reductions and by securitizing Tobacco Master Settlement funding. The FY 2003 budget was signed 67 days after the fiscal year actually began, making it the latest in the state's history.

The governor's January 2002 budget projected FY 2003 revenue of $79.3 billion. By the May 2002 revision, the executive revenue projection was $78.6 billion, including a reduction of $5.8 billion in the baseline forecast and an increase of $5.1 billion related to policy changes. Major policy changes proposed in the May revision included a cigarette tax increase of 50 cents per pack; a two-year suspension of the net operating loss deduction provision in the state's corporate income tax; restructuring financial institution debt; expanded withholding; and an increase in the vehicle license fee (VLF). The legislature ultimately rejected the cigarette tax and the VLF increase.

California enacted a large number of short-term revenue enhancement measures. Because of poor revenue performance in FY 2002, the state had to focus on funding sources other than the state's reserves. California received $4.5 billion from securitizing the first 25 years of its tobacco settlement, closing 19 percent of the budget gap. Governor Davis's January 2002 budget proposed securitizing only $2.4 billion, 45 percent of the present value of the tobacco settlement revenue stream, but by the May 2002 revision the governor proposed securitizing all of the state tobacco settlement revenues for the next 25 years (E. Hill 2002).

The FY 2003 budget restructured the way California deals with bad debt for banks to conform to federal law. Previously, banks were allowed to deduct debts expected to become worthless from their taxable income. The state increased FY 2003 revenues by an estimated $285 million, and FY 2004 revenues by $15 million, by conforming to federal tax law and allowing the deduction only when the debts were actually written off (E. Hill 2002).

The enacted FY 2003 budget also increased the rate of withholding on stock options and bonuses from 6.0 to 9.3 percent. This produced a one-time revenue acceleration of an estimated $400 million. California also expanded withholding on real estate sales to residents; previously only nonresidents were required to withhold 3.5 percent of the purchase price for commercial property. The withholding expansion increased FY 2003 revenue by an estimated $225 million. The FY 2003 budget increased revenue by an estimated $145 million by collecting delinquent income and sales tax. The Franchise Tax Board and the Board of Equalization now have temporary authority to waive penalties and interest on certain accounts, providing an incentive for payment (E. Hill 2002).

California closed much of the FY 2003 budget gap by delaying tax credits. Net operating loss (NOL) deductions were deferred for two years, increasing revenue by $1.2 billion, 5.1 percent of the budget gap. The NOL suspension will also increase FY 2004 revenue by $800 million. Beginning in FY 2005, however, the proportion of losses that can be carried forward will increase from 65 to 100 percent, costing the state hundreds of millions of dollars each year. California also suspended the Teacher Tax Credit for one year, which saved $170 million, 0.7 percent of the total gap (E. Hill 2002).

To meet the requirement that expenditures be offset by revenues, the FY 2003 budget assumed federal funding increases totaling $1.1 billion, including $400 million from an increased Medicaid matching rate, $350 million from bioterrorism funding and international security, $91 million for child support system penalty relief, $56 million for sundry health and social services programs, and $50 million to reimburse California for imprisoning undocumented immigrant felons (E. Hill 2002). There was widespread skepticism about how much of this money the state would actually receive, and Congress adjourned at the end of 2002 without providing these funds.

California's budgeted general-fund expenditures for FY 2003 were 0.2 percent lower than FY 2002 levels. The enacted budget saved considerable general funding by reducing state operations. The Department of Finance was authorized but not required to reduce state operations by $750 million in FY 2003. In addition, the enacted budget provided early retirement incentives for state employees, which was budgeted to save the general fund an estimated $285 million. An estimated $300 million was saved by the elimination of 6,000 vacant positions; departments retained half of the money saved. An additional 1,000 positions must be eliminated by the end of FY 2004 (E. Hill 2002).

The governor's May 2002 revision proposed FY 2003 reductions in county administration funding for CalWORKs, foster care, food stamps, and in-home supportive services for a total savings of $132.9 million. The May revision also proposed suspending COLAs for Supplemental Security Income/State Supplemental Payment (SSI/SSP) grants for a further savings of $54.3 million. California is now under a federal penalty for failing to implement a statewide automated child support collections system as required by the Personal Responsibility and Work Opportunity Reconciliation Act. The May revision proposed covering half this penalty using general fund money and shifting half of this penalty to counties.

The enacted FY 2003 budget delayed CalWORKs COLAs from October 2002 to June 2003; the one month of higher benefits in FY 2003 raised the base for future percentage increases. Funding for SSI/SSP programs increased by 9 percent or $3.1 million in the enacted FY 2003 budget, but January 2003 COLAs were delayed until June 2003 (E. Hill 2002). The FY 2003 budget does not provide any funds that count toward the welfare-to-work federal match, postponing the state's $60 million obligation to July 2004. Adult education and community college programs for CalWORKs recipients were cut by $56 million. The legislature restored some of this funding, only to have Governor Davis veto the partial restoration.

CalWORKs county administration bore some heavy reductions in the enacted FY 2003 budget. New incentive payments to counties to decrease caseloads were omitted and $317 million in previously issued (but unspent) incentive payments to support core CalWORKs activities such as cash assistance, welfare-to-work services and child care was omitted. CalWORKs county administration was cut by $47.4 million, 12 percent of FY 2002 spending. The governor had proposed cutting CalWORKs county administration by $71.9 million in the May revision; however the legislature restored $24.5 million. Food stamp and foster care county administration funding were reduced by 1.5 percent. Governor Davis had originally proposed cuts of 20 percent but the legislature restored funding; the governor in turn vetoed $6.8 million of general fund support for county food stamps administration (E. Hill 2002). Counties responded to the loss of state money by cutting or eliminating innovative service programs such as Los Angeles County's five-year plan to help welfare families achieve long-term self-sufficiency.

California also changed the frequency of the reports on income and resources that recipients of CalWORKs and Food Stamps are required to submit. The statewide shift from monthly to quarterly reporting was expected to increase CalWORKs program costs by $16.8 million, but to recoup these costs with $2 million in food stamp administrative savings, and larger savings from a reduction in the food stamp error rate that could lead to a negotiated reduction in the state's food stamp penalties, which currently total $100 million.

Overall funding for children's programs in the Department of Social Services increased $30 million, or 2.4 percent. Over the past few fiscal years child welfare has maintained level funding, despite caseload declines. The legislature restored funding for emergency workload relief and for COLAs to the cost-of-doing-business funding that counties receive to cover expenses such as rents or collectively bargained salary increases, but Governor Davis vetoed these restorations. The enacted budget does not provide COLAs for foster care and related services. Basic funding for adoptions was replaced with federal funds.

The Department of Child Support Services was cut by 12 percent, or $50 million (E. Hill 2002). The enacted FY 2003 budget assumed that California would receive some relief from the penalties it has incurred by its failure to meet federal standards for automation of child support enforcement. The LAO estimated that California would have to pay $180 million in penalties in FY 2003; the budget assumed that new federal legislation would reduce this burden by 50 percent.

Governor Davis proposed a major restructuring of California's child care system that he said would save $400 million per year. The governor's plan reduced eligibility limits, implemented family fees, modified waiting list priorities, and phased out CalWORKs Stage 3 child care. Under current law, families are guaranteed subsidized child care for two years after leaving CalWORKs (Stage 2). A family that has exhausted its two years can continue to receive child care under Stage 3 unless its income exceeds 75 percent of the state median. This creates a difference in access between former CalWORKs recipients receiving Stage 3 subsidies and families that have never received cash assistance, who may be denied child care subsidies even though their incomes fall below the 75 percent limit. While the governor's program would have eliminated this inequity, it would have created a new one. In the absence of Stage 3, former CalWORKs families who used up their guaranteed two years would have had to reapply for child care subsidies, which might have meant that they would be placed on a waiting list. Families with similar current incomes that had never been on CalWORKs, in contrast, would not have experienced this interruption (California Budget Project 2002; Davis 2002; Montgomery et al. 2002). The legislature rejected the child care proposal after the women's caucus expressed concerns about it.[6]

General-fund expenditures for health care programs in FY 2003 are 5 percent below FY 2002 estimated expenditures. Spending for some health programs increased modestly while spending for others declined. Medi-Cal expenditures increased by 1 percent to reach $9.8 billion in FY 2003. This figure assumed $400 million from increased federal funds. Though program spending for Medi-Cal increased on the whole, some cost saving measures were implemented. The governor's 2002 January budget and May revision proposed spreading cuts evenly to benefits, provider payments, county funding, eligibility and enrollment, and purchasing and management. Specific changes included delaying "express lane" eligibility for coverage, removing media outreach, eliminating a two-month eligibility bridge for children moving from Medi-Cal to Healthy Families, reducing the number of optional benefits that California currently covers, reducing physician reimbursement rates, and rescinding the 1931(b) expansion of Medi-Cal to cover poor families with incomes up to 100 percent of the federal poverty guidelines that was enacted in 1999.

The legislature rejected most of these measures, instead targeting county funding and purchasing and management for cuts. Appropriations for county administration were reduced by $29 million from FY 2002 levels and no cost-of-doing-business increases were granted for FY 2003. The budget also requires counties to pay 10 percent of the growth in the costs of the Early and Periodic Screening, Diagnosis, and Treatment (EPSDT) program. In program purchasing and management, increased rebates from pharmaceutical companies, improved Medi-Cal anti-fraud efforts, an expanded Medical Case Management Program (MCMP), and additional changes to state purchases of medical supplies and services will save the general fund a total of $570.5 million.

Other areas of Medi-Cal were cut as well. The enacted FY 2003 budget limited adult nonemergency dental benefits, funding one examination and one cleaning per year instead of two. Administrative fees for hospitals that participate in the DSH program were increased, for a general fund savings of $55 million. An additional $12 million general-fund savings resulted from rescinding reimbursement rate increases for prescription drugs by 40 cents per claim.

The FY 2003 budget allocated $672 million for the Healthy Families program, a 22 percent increase over FY 2002 expenditures. The increase was based on anticipated enrollment growth of 12 percent. While the overall Healthy Families budget was increased, the governor vetoed funding for an expansion of the program to cover parents. In January 2002, the federal government approved California's waiver request to expand Healthy Families to parents, but the state originally delayed implementation from FY 2002 to FY 2003, and the program was again postponed in FY 2003 owing to resource constraints.

Counties were greatly affected by budget reductions. In addition to the reductions to local governments mentioned above, payments to local governments for state-mandated programs were delayed. The loss of performance incentives significantly affected counties. Although counties had not spent all of the money received for performance incentives, they generally had plans to do so. Further, the FY 2003 budget passed 90 percent of the state's food stamp penalties to the counties while Governor Davis continued to seek federal relief from these penalties (California Senate Republican Fiscal Office 2002).

Budget cuts were expected to reduce statewide staffing for Child Welfare Services by an estimated 500 workers. County officials expected the reduction in spending to cause substantial delays in investigations of reports of abuse and neglect, family unification efforts, and juvenile court cases. Adoptions staff were to be reduced by an estimated 42 workers. The County Welfare Directors Association of California estimated that 510 children each year will unnecessarily remain in foster care and warned that budget reductions could expose California to federal sanctions for failure to meet national compliance standards. In Medi-Cal, counties expected a staff reduction of 615 workers and delays in determining eligibility. In Food Stamps, counties expected delays in providing food stamp benefits and services for “immediate need” applicants (Mecca 2002).

In the FY 2003 budget, K–12 education was funded at $6.1 million over the estimated Proposition 98 minimum guarantee of $41.6 billion. However, in the FY 2002 budget, K–12 was funded at $5.5 billion above this guarantee. From FY 1999 to FY 2002, funding for higher education increased 26.3 percent. In FY 2003, higher education funding increased 2.5 percent (California Department of Finance 2002).

Despite reductions in expenditures, California continued to experience fiscal troubles. In August 2002, Governor Davis asked state agencies to suggest FY 2003 spending cutbacks of at least 20 percent. In November 2002 Governor Davis implemented a hiring freeze as well as a freeze on all state agency nonessential spending on equipment, travel, and consultants. The hiring freeze remained in effect for all state jobs except those that affect health or public safety and those that bring in revenue. In December 2002 the LAO projected an FY 2003 general fund deficit of $6.1 billion and an FY 2004 shortfall of $21.1 billion, based on the expected carryover from FY 2003, continued poor revenue performance, and the failure of FY 2003’s one-time solutions to address the underlying gap between current law expenditures and revenue.

Budget Outlook

In December 2002, Governor Davis called the legislature into special session to address the expected shortfalls in FY 2003 and FY 2004. In calling the special session, Governor Davis revised his estimate of the FY 2004 shortfall, including the FY 2003 carryover, to $34.8 billion, with the increase due primarily to poor personal income tax performance. Davis proposed $10.2 billion in spending cuts including $3 billion from education and $2 billion from health and human services. Also in December, California’s state bond rating was lowered one notch by Fitch and by Standard and Poor’s.

In January 2003, Governor Davis released his $96.8 billion dollar FY 2004 budget. The governor proposed to bridge the deficit by $26.9 billion in reductions, savings, and shifts to local government, $3.3 billion in loans and borrowing, $2.3 billion in fund shifts, and $2.1 billion in transfers and new revenues. Notably, the governor proposed $8.3 billion in tax increases including a per-pack cigarette tax increase of $1.10, a one cent sales tax increase, and a 1 to 2 percent income tax increase on some of the wealthiest Californians. The budget included $20.7 billion in program reductions, including cuts to SSI/SSP, community colleges, elimination of CalWORKs Stage 3 child care, and a 15 percent reduction to Medi-Cal doctor reimbursement rates. In total, the governor’s budget proposed spending $62.8 billion from the general fund, a decrease of 18.2 percent from FY 2003 (California Budget Project 2003). The budget shifted $8 billion in program costs to counties and proposed to stop backfilling vehicle license revenue to counties. The governor's budget also suggested 1,500 state worker layoffs and a reserve of $531 million.

The LAO estimated that the governor overstated the budget deficit by $8.5 billion in FY 2004. The differing estimates were a result of a more optimistic view of revenue and economic recovery by the LAO, accounting for $3 billion, and different estimates of spending obligations under current law. The governor's estimate of spending obligations was $5.5 billion higher than the LAO, mainly because the governor included spending above the levels mandated by statute. However, the governor proposed not to fund the $5.5 billion in higher spending obligations, narrowing the net difference between the two estimates to $3 billion.

In February 2003, the legislature rejected Governor Davis's proposal to reduce Medi-Cal provider rates and end some optional benefits. The legislature also rejected Davis's plan to stop backfilling vehicle license fee (VLF) revenues to counties. Instead, the legislature approved a bill that would have allowed the VLF to increase to pre-1998 levels. Governor Davis vetoed the bill (J. Hill 2003c).

Later in February, California's state credit was lowered again, this time by Moody's, putting the state in Moody's lowest category with New York and Louisiana (Lawrence 2003). Exacerbating fiscal troubles, California also discovered that Medi-Cal will spend $1 billion more in FY 2003 than anticipated owing to caseload growth (about 100,000 more participants per month than expected, $350 million), provider fees that were never reduced because of lobbying by doctors ($71 million), anti-fraud savings that had not been achieved ($124 million), and a court decision that prevents California from automatically ending coverage for people no longer receiving SSI/SSP cash payments ($85 million) (Weintraub 2003).

In March 2003, Senate Republicans proposed solving California's budget crises by rolling over part of the deficit until 2005 and cutting 7 percent from unspecified programs (Bee Capitol Bureau 2003). Ultimately, the Senate and Assembly passed a budget package of $3.5 billion in mid-year cuts and fund shifts including $2.3 billion in education cuts.

In May 2003, the Senate and Assembly approved another series of budget savings measures, which aimed to reduce the deficit by a further $3.6 billion. Most of the savings, $1.85 billion, came from pension obligation bond sales. However, a number of cost-saving measures in health and education were included in the package (Bluth 2003a). The governor's May revision projected a budget gap over FY 2003 and FY 2004 that was $3.6 billion larger than projected in the January budget. The May 2003 revenue forecast was actually a bit stronger than in January, but the improvement was outweighed by increases in anticipated spending and the cancellation of the second round of tobacco securitization, which had been expected to yield $2 billion in short-term funding (Davis 2003), due to the uncertainties surrounding the tobacco securities after the $10.1 billion Illinois ruling against Phillip Morris.

With Republican legislators refusing to raise taxes and Democratic legislators refusing to cut as deeply as the Republicans or Governor Davis wanted, California again missed the June 15 deadline for an approved budget. The legislature did pass a budget bill on July 29, after a process in which the Senate Republican leader threatened to campaign against members of his party who voted to increase taxes (Hill and Fletcher 2003), the Assembly Speaker refused to let legislators leave the Capitol until they approved a budget (Delsohn 2003), and more than one million Californians signed petitions to recall the governor they had reelected the previous November.

The FY 2004 budget included $70.8 billion in general fund spending, a 9.4 percent decrease from the FY 2003 budget as originally enacted. The budget cut funding for Medi-Cal and child care, but did not include the major changes to these programs the governor had proposed (E. Hill 2003). The Medi-Cal changes did not roll back eligibility expansions or eliminate optional services, but reimbursements to providers were cut by 5 percent and adult participants were required to report income twice rather than once per year. Stage 3 child care survived, but reimbursements to child care providers were reduced. Federal TANF dollars were reallocated to Stage 2 child care. The state funded June 2003 cost-of-living adjustments for SSI/SSP and CalWORKs recipients, but cancelled the COLAs set for October 2003. K–12 spending in FY 2003 and FY 2004 was cut below the level the legislature had originally approved for FY 2003. Higher education spending was reduced 4 percent from FY 2003 levels. Increased student fees made up for most of the lost revenues: the University of California system, which was cut 7.9 percent, raised fees by more than $1,000 per student. The budget committed the administration to eliminating 16,000 jobs, 7.7 percent of the state workforce (Thompson 2003). By mid-August, over 12,000 state workers had been notified they might lose their jobs in the fall. Several of the 21 unions representing state workers agreed to contract concessions to protect at least some of these jobs, but in late September, the state began its first round of layoffs, expected to affect 628 employees (J. Hill 2003e). Some agencies were already understaffed because of a hiring freeze and the elimination of unfilled positions.

The approved budget did not include any tax increases. Before its passage, however, the governor's finance director increased the VLF. The administration claimed the authority to raise the fee without legislative approval under a 1998 provision authorizing increases when the state faced adverse fiscal conditions. Opponents, who argue that the change is a tax increase that requires approval by two-thirds of each legislative chamber, have gone to court to challenge the legality of the move (Howard Jarvis Taxpayers Association 2003). Other revenue sources included $680 million (up from $100 million) from renegotiated tribal gaming contracts and $2.2 billion of additional aid during FY 2003 and 2004 from the federal tax cut legislation.

The combination of expenditure reductions and revenue increases was insufficient to make up the entire budget shortfall. The state therefore borrowed $10.7 billion by issuing deficit-financing bonds. Republicans blocked Governor Davis's proposal to repay the bonds by increasing the state sales tax one-half cent for five years (Bluth 2003b). The state instead enacted what was called the "triple flip." Half a cent of the sales tax was shifted from local governments to a dedicated revenue stream that would assure investors the bonds would be repaid. The state compensated cities and counties by reallocating property tax revenues from the Educational Revenue Augmentation Fund (ERAF) to them. Increased state appropriations, in turn, would compensate school districts for the loss of ERAF revenues. Local officials expressed concerns that the state would renege on its commitments in future years (J. Hill 2003b; Maddaus 2003). The state issued an additional $1.9 billion in bonds to cover its pension fund obligations.

The LAO projects an $8 billion shortfall in FY 2005, when revenues from the triple flip, the new federal aid, and other one-time measures will not be available (E. Hill 2003). After the budget had passed, Moody's lowered the state's bond rating, citing this future gap (Roberts 2003).

Conclusions

California relied on a myriad of one-time solutions to close budget gaps in FY 2002, FY 2003, and FY 2004. The state delayed tax credits and deductions, assumed federal relief, froze hiring across the board, cut administration, and borrowed against future revenues. Yet these measures were not enough to avoid program reductions, through which the state closed 31.5 percent of its $23.6 billion FY 2003 shortfall. To maintain current service levels, California delayed program expansions and cost of living increases, shifted costs from the state to counties, and adopted across-the-board cuts.

The state made many administrative cuts and funding shifts to avoid cutting cash assistance, work supports, or job placement and training. Counties, however, have cut back many "optional" services in response to reduced state funding. Major reductions in eligibility for social programs were avoided, but expansions in eligibility were postponed. Scheduled cost-of-living adjustments for recipients of CalWORKs and SSI/SSP were cancelled, and reimbursement rates were lowered for some health and child care providers. State employees felt spending reductions most heavily. California avoided layoffs for several years, but began issuing them in September 2003.

Variation in the federal match rates had very little effect on the degree to which programs were insulated from budget cuts. Despite federal matching dollars, expansions in Medi-Cal and Healthy Families were delayed and spending reductions occurred. Social Services also fell victim to the budget crunch. Some interviewees speculated that higher federal matching may have had a larger impact in states with more generous rates than California, which currently receives the minimums of 50 percent for Medi-Cal and 65 percent for Healthy Families.

Colorado

Although Colorado has a fairly diverse economy, many of its industries were adversely affected by the recent recession. Colorado's fiscal security relies more heavily than that of any other state on capital gains. Actions taken in Colorado's recent budget shortfall reflect strict limits on state revenue and spending; increasing tax revenue was ruled out because voter approval is required to do so, and the state's 6 percent yearly appropriations growth limit provided a strong incentive for the legislature to preserve the appropriations base.

The Budget Process

Each November the governor submits a budget proposal for the following fiscal year, which runs from July 1 through June 30. The proposal is reviewed by the Joint Budget Committee (JBC), comprising two majority members and one minority member from each chamber of the General Assembly, for a total of six. The JBC is by far the most powerful body in the budgeting process. While it receives the governor's proposed budget, it writes an entirely separate budget, which is turned into legislation, passed by the General Assembly, and given to the governor for line-item vetoes and signing.

The Governor's Office of State Planning and Budgeting (OSPB) and the Legislative Council each produce revenue estimates four times per year: in March, June, September, and December. There is no formal consensus process to reconcile these estimates, but there were only minor differences between the two between FY 2002 and FY 2004. The governor's budget submission is based upon OSPB's September estimate. The JBC adopts a revenue estimate by February 1 with which to begin the budgeting process.

Mid-year budget amendments are made through the so-called "supplemental" process, which takes place while the General Assembly is in session between January and May. As in the full budget process, the governor proposes supplementals, but the JBC drafts the actual legislation that is acted upon by the full General Assembly.

Political and Legal Context

Colorado's economic prosperity over the past decade has been based on telecommunications, high technology industries, and tourism. All three sectors were hit particularly hard in the recent recession. Personal income taxes account for about 60 percent of Colorado's general-fund revenue and are closely tied to stock market performance. The Rockefeller Institute of Government named Colorado the state with the greatest stock market risk to revenues because of its dependence on the income tax, and more specifically on capital gains income taxes (Boyd 2000). Sales taxes provide 32 percent of general-fund revenue, and also fell sharply after the attacks of September 11, 2001 (Colorado Legislative Council 2002b).

After 24 years of Democratic governors (12 years each for Richard Lamm and Roy Romer), Colorado elected Republican Bill Owens in 1998. During those same 24 years, Republicans held the majority in Colorado's House and Senate. Control of the Senate switched to the Democratic Party in 2000 and returned to the Republicans in 2002 (Brown 2000). Colorado's governorship is a relatively weak position, with no authority to introduce legislation—a fact with particularly important implications for the budget. Colorado has eight-year term limits for all legislators and for the governor, which first went into effect in 1998.

Colorado faces several legal constraints that have made its choices in the current fiscal crisis unique among the states we studied. As described in more detail below, the state's fiscal decisions have been constrained by its revenue limit, spending limit, property tax limit, recent tax cuts that cannot be reversed without a popular vote, requirements for K–12 funding growth, and a senior tax rebate program.

Colorado's Taxpayers Bill of Rights (TABOR) constitutional amendment was passed in 1992 and set strict limits on state revenue. Each year, revenue may not exceed the previous year's revenue plus inflation and growth in population. If revenue exceeds that allowed by this formula the surplus must be refunded to taxpayers within one year after the fiscal year in which they are collected. During FY 2002, $927.2 million in surplus FY 2001 revenue was refunded to taxpayers (Colorado Legislative Council 2002a). While TABOR mandates the refund, it is silent as to the mechanism of the refund and the distribution across taxpayers. TABOR requires voter approval of any policy that increases state revenue. TABOR also requires that a 3 percent reserve fund be kept for emergency purposes, such as natural disasters; use of the TABOR reserve for economic downturns is explicitly prohibited (Colorado Fiscal Policy Institute 2002). TABOR's chain growth formula has the effect of ratcheting down the state's revenue base in years of economic downturn, a phenomenon that has occurred in the current recession. Furthermore, because TABOR's limit is based on inflation and population growth, and not personal income growth, it fails to allow recovery of the revenue base after an economic downturn.

In 1999 and 2000, the General Assembly passed two permanent reductions in the income tax rate. It fell from 5 percent to 4.75 percent in 1999, and then to 4.63 percent in 2000. These income tax rate reductions decreased revenue by $361 million in FY 2002 and $385 million in FY 2003. The sales tax rate was also reduced from 3 percent to 2.9 percent by the 2000 legislature. This sales tax reduction decreased FY 2002 and FY 2003 revenues by $74.7 and $79.9 million, respectively (Colorado Office of State Planning and Budgeting 2001). These tax cuts were viewed as a mechanism for bringing revenues more in line with what was permitted under TABOR. It should also be noted that TABOR would require a public vote to reverse these cuts.

In 1977, passage of the Kadlecek amendment statutorily limited Colorado's general-fund spending growth to 7 percent per year and required a reserve equal to 4 percent of appropriations. This spending growth limit was reduced in 1991 with passage of the Arveschoug-Bird amendment, which statutorily limits annual appropriations to 5 percent of Colorado personal income or 6 percent growth over the previous year's appropriations, whichever is smaller (Colorado General Assembly 2000). Since 1991, the 6 percent limit has been the effective constraint. Because the growth limit is calculated on the prior year's appropriations, the General Assembly and governor have strong incentives to appropriate up to the limit to preserve flexibility for the following year.

Colorado has a 4 percent statutory reserve requirement. If those reserves fall below 2 percent, the governor is required to formulate a plan to bring reserves back up to 2 percent, notify the General Assembly of the plan, and implement the plan in a timely manner. The governor is expected to issue executive orders that decrease personnel costs before cutting services. Exceptions to the statutory reserve requirement have been made in FY 1991–93 and FY 2002. During the recession of the early 1990s, the required reserve was lowered from 2 percent to 1 percent. For one year, FY 2002, the statutory reserve was completely eliminated. TABOR makes creating a rainy day fund very difficult, since rainy day appropriations would occur at the expense of already constrained levels of revenue and spending, thus competing directly with governmental operations.

In 1982, voters passed the Gallagher Amendment, which constitutionally mandates commercial property owners to contribute 55 percent of property taxes at a fixed rate of 29 percent of assessed value. Residential property owners contribute the remaining 45 percent of property taxes at a rate that varies to preserve the ratio. Colorado's residential property growth has outpaced commercial growth over the past 20 years, leading to residential property tax rates falling from roughly 21 percent in 1982 to 9 percent today (Coffman 2003a).

With property taxes a major source of K–12 education funding, some argue that declining property taxes under the Gallagher Amendment led voters to pass Amendment 23, which guarantees increased funding for K–12 education, in November 2000. The amendment requires per pupil funding and state funding of programs for students with special needs to increase by 1 percent over the rate of inflation for 10 years and at the rate of inflation thereafter. Amendment 23 also created a State Education Fund, exempt from both TABOR and the Arveschoug-Bird spending limit, into which 7.2 percent of state income tax revenues are deposited each year. Finally, Amendment 23 required K–12 general-fund appropriations to increase by a minimum of 5 percent annually for 10 years. This general-fund maintenance-of-effort requirement, however, does not apply in any fiscal year in which Colorado personal income grows less than 4.5 percent between the two previous calendar years (as was the case in FY 2003).

Finally, in November 2000, voters amended the constitution with Referendum A, or the "Homestead Exemption." The Homestead Exemption reduces by one-half the taxable value of the first $200,000 of a house owned by a senior citizen for over 10 years, regardless of income. The Homestead Exemption requires the state to reimburse local governments for lost property tax revenues (Coffman 2003b). It allows the legislature to temporarily cancel the rebate in years of budgetary stress, an option the legislature used to pass the FY 2004 budget.

Since the passage of Senate Bill 1 in 1997, 10.355 percent of Colorado's sales and use tax revenue has been diverted each year to the Highway Users Tax Fund (HUTF), and transportation projects are no longer given general-fund appropriations. The HUTF transfer is scheduled to continue until FY 2008, but only occurs in years when there is enough revenue to fund a 6 percent increase in general-fund appropriations and to devote 4 percent to the statutory reserve fund (Colorado Joint Budget Committee 2002). HUTF is intended for 28 statewide transportation projects that will improve Colorado's long-term infrastructure (Colorado Department of Transportation 2000). Earmarking transportation and K–12 funding through Senate Bill 1 and Amendment 23 has drastically limited Colorado's discretionary spending. Large discretionary spending remains in higher education and corrections, which accounted for a combined 25 percent of FY 2003 general-fund appropriations. Social services spending in the Department of Human Services and the Department of Health Care Policy and Financing accounted for 28.4 percent of FY 2003 general-fund appropriations.

Fiscal Pressures and Policy Responses

FY 2001

Colorado's total FY 2001 appropriations were $12.1 billion. In March 2000, gross general-fund revenue estimates for FY 2001 were $6.643 billion. Actual FY 2001 general-fund revenues fell 1.6 percent below these estimates, a shortfall of $106.7 million. Colorado's economy had begun to slow in FY 2001, but its reserves were large enough to cover the shortfall, so the state experienced no budget deficit.

FY 2002

Colorado's total enacted FY 2002 appropriations of $12.9 billion allowed for appropriations growth of 12.6 percent in education, 8.6 percent in human services, and 11.3 percent in health care policy and financing (primarily Medicaid) from FY 2001 levels (Colorado Joint Budget Committee 2002).

Legislative Council's March 2001 revenue forecast estimated FY 2002 general-fund revenues of $6.635 billion. By the end of FY 2002, actual general-fund revenues totaled $5.6 billion, a 15.6 percent decline. Between revenue forecasts dated March 2001 and September 2002, income tax revenue to the general fund declined 22.3 percent, or $932.5 million. Two hundred million dollars of the income tax loss is attributable to weakened stock market performance (Colorado Legislative Council 2002b). In the same period FY 2002 sales tax revenues declined by 7.6 percent, or $145.1 million (Colorado Joint Budget Committee 2002).

The FY 2002 revenue shortfall was bridged in three stages as downwardly revised revenue estimates came out in September and December of 2001 and again in March 2002. In the end, FY 2002's budget was balanced with a mix of cuts to capital spending (30.9 percent), one-time transfers and refinancing (33.9 percent), cuts to operating budgets (15.6 percent) and cancellation of the Senate Bill 1 transfer to HUTF (19.6 percent).

In the summer of 2001, there was a general expectation that the revenue forecasts to be released in September 2001 would be revised downward. The September 2001 revenue estimates, released before the terrorist attacks of September 11, showed a revenue decline of $310 million since FY 2002 began in July. During a special session in October 2001, the legislature reduced capital construction funding by $219.3 million and decreased the yearly transfer to HUTF by $173 million. These efforts left an $82.3 million cushion to absorb revenue losses expected as a result of September 11. Governor Owens also ordered 1 percent across-the-board cuts to all state agencies, with the exceptions of K–12 education and Medicaid service premiums, which fund acute and long-term care. Implementation of this cut was at the discretion of department heads, who generally made cuts that did not affect client services.

December 2001 revenue estimates for FY 2002 showed a further decline of $155.1 million. In March 2002, the legislature eliminated transfers of $121.4 million in sales tax revenue to capital construction, HUTF, and Older Coloradoans funds and redirected this revenue to the general fund. This eased the general fund shortfall but also helped to preserve the 6 percent spending growth base. General-fund expenditures were reduced by $120.7 when the legislature enacted the governor's new order of 1.5 percent across-the-board cuts (2.5 percent cumulative) to all agencies except K–12 and public safety. Once again, these cuts were fairly manageable and services were not significantly affected. Next, the legislature reduced the state's K–12 maintenance-of-effort funding level from 5.8 to 5 percent, the minimum allowed by Amendment 23, to cut $15.7 million. The legislature authorized Medicaid refinancing that let public hospitals pay the state $11.2 million to generate additional federal matching funds (Colorado Joint Budget Committee 2002).

Finally, the legislature authorized Governor Owens to transfer $147.3 million from several smaller trust funds to the general fund (Colorado Legislative Council 2002b). Including these cuts, the state transferred $487.2 million from 24 trust funds to the general fund over the course of FY 2002. Repayment of the funds was scheduled, but was not legally binding, leading the state's Deputy Treasurer to remark, "In a technical sense, it's borrowed, but in a practical sense, it's gone" (Martinez and Kreck 2002). Treasurer Mike Coffman, who is responsible for investment of the state's trust funds, has spoken publicly against their use, saying, "These are checking accounts, certificates of deposits and individual retirement accounts belonging to the people of Colorado…It is completely irresponsible for the Joint Budget Committee to put filling the state's coffers above Colorado's working families" (Fletcher 2002).

In late February, Governor Owens ordered a hiring freeze on the entire state government until June 1, 2002, and a temporary spending freeze on all capital construction projects less than 25 percent completed, with the exceptions of public safety and K–12 projects.

In March 2002, revenue estimates fell by an additional $232.1 million. In May, the legislature, still in its regular session, reacted by passing Governor Owens's freeze on capital construction projects and by transferring the $53.6 million saved from the capital construction fund to the general fund. The legislature also authorized expenditure of the entire statutory reserve in FY 2002, and made additional mid-year budget cuts totaling $16.9 million.

Although the bulk of Colorado's FY 2002 shortfall was handled using one-time revenues, some programs serving low-income citizens were affected. The Colorado Child Care Assistance Program (CCCAP), for which state funding changed from a county match rate formula to an inflation-adjusted block grant in 1997, has endured temporarily unfilled vacancies in licensing and administration. Staff positions have also been cut from CCCAP at the state level.

Colorado's county-based system for administering most social services programs makes it difficult to capture the full extent of the consequences of program cuts made to date. Our research did not attempt to gather spending data at the county level. In certain areas, such as TANF, child care, and child welfare, the state provides block grants to counties. While some have commented that these funds are insufficient, the state does not have the information needed to document their adequacy.

FY 2003

Original FY 2003 budget appropriations totaled $13.64 billion and contained growth of 5.6 percent for human services, 8.6 percent for health care policy and financing, and 11.2 percent for education (Colorado Joint Budget Committee 2002). The budget was based on the Legislative Council's March 2002 general revenue estimates of $6.359 billion.

When formulating their FY 2003 budget requests, each department was instructed to carry over the 2.5 percent across-the-board cuts that had been made in FY 2002. On May 31, 2002, Governor Owens angered Democrats by cutting $228 million from the legislature's FY 2003 budget, remarking, "The guiding fact is this: despite revenues being down 13 percent this year [FY 2002], next year's budget increases spending 7.3 percent. This is a 20-percentage-point swing away from fiscal reality." JBC member Penfield Tate (D-Denver), however, argued that the legislature's budget was balanced without cuts, that the cuts would unnecessarily affect vulnerable citizens, and that the legislature would have liked to work with the governor to resolve the issue in another way (Paulson 2002).

The governor's cuts included $46 million in broadly distributed line item vetoes, $140 million from the announcement of a 4 percent across-the-board cut (which left K–12 exempt), and $30 million through a continued freeze on capital construction projects (Colorado Office of the Governor 2002; Paulson 2002). Among the vetoed items were the entire Tony Grampsas Youth Services Program, which was created in 1994 to counteract increasing youth crime and violence; a 7.7 percent increase for Colorado universities; and $5.3 million in state funding for county health departments.

Governor Owens contended that the 4 percent cuts were sufficient to bring reserves back to 2 percent of general-fund appropriations, but OSPB revenue estimates did not support this statement. Lack of transparency in the budget-cutting process was a point of friction between the executive branch and the legislature and advocacy groups. Owens refused legislators' appeals to announce details of the 4 percent cuts until November 15—10 days after his reelection.

The impacts of the 4 percent cuts on Medicaid were announced first when Medicaid suppliers, providers, and clients were notified of changes in June 2002. The program's budget was cut by $38.8 million for a reduction of $64.8 million, including loss of federal matching funds. Aid to the Needy Disabled (AND) benefits were reduced slightly, and the Aid to the Needy Blind program (ANB) enforced time limits for the first time. The Medically Correctable Program, which pays for surgeries that enable disabled individuals to work, was eliminated. Provider reimbursement rates were reduced by 5 percent for emergency transportation, county transportation, lab and x-ray services, home health care, private duty nursing, durable medical equipment, and some psychotherapy claims. Hospital rates in urban and rural areas declined by 7 and 2 percent, respectively. Pharmacy rates declined from the average wholesale price (AWP) minus 12 percent to the AWP minus 14 and 45 percent for brand name and generic drugs, respectively (exceptions were made for pharmacies not located within 25 miles of another pharmacy). Maximum daily reimbursement rates for home care were also reduced (Colorado Department of Health Care Policy and Financing 2002).

Other impacts of the 4 percent cuts were closure of 21 drivers licensee offices, elimination of 729 job vacancies, occasional serving of cold lunches at prisons, elimination of beds in correctional and mental health facilities, and cuts in higher education to be made at the discretion of colleges and universities (Sanko 2002).

By September 2002, FY 2003 general-fund revenue estimates had declined 10.6 percent since March, income tax revenues dropped 13.2 percent, and sales tax revenues fell 7.5 percent (Colorado Joint Budget Committee 2002). At this time the FY 2003 budget fell $388.3 million below balance (Colorado Legislative Council 2002b).

Further FY 2003 spending reductions of 6 percent were released in November 2002, bringing total reductions for that year to 10 percent. Prisons and schools were exempt from these cuts, and Medicaid was instructed to cut only 3 percent, or $26.8 million. Governor Owens proposed delaying state worker paydays from the last to the first day of each month to shift June 30 payments of $91 million to July 1, delaying expenditures from FY 2003 to FY 2004. Finally, he proposed delaying repayments to trust funds swept in FY 2002 and FY 2003 (Owens 2002).

In early March 2003, Governor Owens received bills to reduce the FY 2003 budget by $809 million and signed $750 million of the package. Medicaid services for legal immigrants were eliminated, despite an American Civil Liberties Union (ACLU) class-action suit against the cut. Programs funded by tobacco settlement payments, including visiting nurse and reading programs, were cut. The tobacco settlement program cuts also resulted in the elimination of prenatal care coverage under Colorado's SCHIP program, Child Health Plan Plus (CHP+), and the capping of child enrollment in CHP+. However, the governor, who had fought hard in 2001 to expand CHP+ to pregnant women, announced in early June 2003 that $5.6 million from federal aid to states, part of President Bush's $350 billion tax cut, would restore these CHP+ cuts (Austin 2003; Denver Post 2003). Other March budget-balancing actions included shifting the state payday; changing Medicaid payments from cash to accrual basis to save $67 million; laying off over 200 state employees; canceling the presidential primary; and refinancing license plates with HUTF funds.

Governor Owens initially refrained from signing five bills. The first, to reduce the amount of state tax collections kept by vendors from 3.3 to 2.3 percent, would have raised $4.5 million in additional revenue (J. Martinez 2003a). The second, to raise $3.4 million by increasing docket fees in the Judicial Department by 50 percent, was not signed by Owens, but he later said that he would allow the increase, although he was against it. Owens later signed three bills to provide $16.4 million, less than the $19 million he proposed, in economic stimulus for tourism, agricultural products, and business development. Money for the stimulus plan came from the state's unemployment trust fund (J. Martinez 2003e, f).

Later in March 2003, new revenue estimates indicated that Colorado's FY 2003 shortfall had risen from $809 million to $969 million, due mostly to a sharp decline in personal income tax collections. Despite alarm from members of the legislature, Governor Owens responded, "It's a challenge, not a crisis." The new revenue estimate left the legislature with an additional $159.6 million to cut with only three months remaining in the fiscal year (J. Martinez 2003c).

The remaining FY 2003 budget shortfall was bridged in late March. State employees were each furloughed for three days to save $12.9 million. Another $75 million came from reserves. Finally, $12 million of the economic stimulus package was revoked and $5.6 million more was cut from tobacco settlement–funded programs (J. Martinez 2003g). Legislators left the governor with authority to tap $159 million in emergency reserves to balance the final FY 2003 budget if necessary.

Budget Outlook

Legislators became vocal early about how difficult FY 2004 would be. JBC vice chairman Rep. Brad Young (R-Lamar) commented, "When you see what's coming at the start of next year, you're going to be shocked. We're talking about getting rid of a quarter of state government except K–12" (Associated Press 2003b).

Colorado's March 2003 revenue estimates suggested that FY 2004 revenue would fall $79.5 million short of spending and reserve obligations, assuming almost $1 billion in FY 2003 cuts were continued in FY 2004 and no other changes were made (Colorado Legislative Council 2002c).

Governor Owens's FY 2004 budget proposal included general-fund spending growth of 2.7 percent, with 10 percent across-the-board cuts carried over from FY 2003. Owens proposed notable growth for prisons (7.5 percent) and public health (16 percent). The governor intended to protect the Department of Corrections from the worst cuts after an inmate murdered a prison guard in October 2002. The executive proposal predicted Medicaid caseload growth of 8.2 percent in FY 2004 (Austin 2002). Owens proposed partially restoring funding for the Tony Grampsas Youth Services Program. Owens also recommended offering early retirement incentives to 3,400 of the state's 47,000 full-time workers.

After considering the executive budget proposal, the JBC recommended dozens of measures to cut roughly $969 million from the FY 2004 budget. In the end, the budget was passed with a broad mix of spending cuts and cuts to state workers, fee increases, elimination of the Homestead Exemption for seniors, and creative accounting measures.

FY 2003 cuts to Medicaid coverage for legal immigrants were carried into FY 2004. A plan to limit Medicaid prescriptions to eight at a time was implemented statewide on May 1, 2003.[7] Doctors were to call a state-hired pharmacist for approval of drugs over the limit. However, the plan was temporarily halted in late May in response to irate calls from doctors who reported spending over half an hour on the phone for approvals. The prescription limit will be reinstated after a better system is devised (Auge 2003). Disabled children narrowly avoided cuts: allowable hours of home nurse care, which previously could not exceed 20 per day without special approval, were limited to 16 per day, but new revenue from a bill expanding greyhound racing was applied to the program (Morgan 2003). Other cuts affected student financial aid, state libraries, and the Colorado Council for the Arts.

State workers were dealt a series of setbacks in the budget process. After three furlough days and over 200 layoffs in FY 2003, roughly 600 layoffs were budgeted in FY 2004. Judicial employees, who endured eight furlough days in FY 2003, were furloughed another five days in FY 2004. State salaries were frozen for the year, and 174 court system vacancies were kept unfilled.

Legislators also circumvented TABOR's requirement of voter approval for tax increases by raising several fees, which TABOR does not regulate. Families with children enrolled in Medicaid's Home and Community-Based Care or the Children's Extensive Support programs would be assessed monthly fees of up to $250 for a single child. Another bill allowed a $1 monthly fee to be charged for using the electronic transfer of benefits system in several human services programs, including Colorado Works (TANF), AND, ANB, and Old Age Pension. Fee increases applied to several other areas of society, including licenses for nurses, teachers, and drivers; inspections of restaurants and nursing homes; and fees for courts, dentists, and farmers. Fines for graffiti were increased. A proposal for a $10 fee on gun-buyer background checks was defeated in the legislature (J. Martinez 2003d). Another failed attempt to circumvent TABOR, a bill to allow institutes receiving less than 10 percent state funding to qualify for "enterprise status," was vetoed. The bill would have allowed the University of Colorado, receiving 9.8 percent state funding in FY 2004, to raise tuition without affecting the TABOR revenue limit (Associated Press 2003c).

In a controversial move, Democrats and Republicans compromised on a vote to suspend the Homestead Exemption, which gives property tax rebates to seniors who have owned their houses for over 10 years. The three-year suspension came after just one year of rebates. Initially, Democrats killed the bill, leaving Republicans to feel the wrath of seniors if they passed it. However, Democrats won Republican support for three of their own bills in exchange for their support of the Homestead Exemption suspension. The three bills reduced the fee retained by vendors for collecting sales taxes from 3.33 percent to 2.33 percent for 2 years, transferred $9.5 million from the HUTF, and reduced prison sentences for first-time nonviolent offenders. The bill reducing prison sentences was later vetoed by Governor Owens (Associated Press 2003c; J. Martinez 2003b).

Colorado's legislature left open the option to securitize half of its tobacco settlement payments. Securitization would generate $260 million for the state's emergency reserve, but after a $10.12 billion Illinois decision against Philip Morris, the state questioned the reliability of tobacco payments. A bill allowing the governor to sell and release certain state properties in the event of an FY 2004 shortfall was passed as a backup to securitization. Under the plan, state buildings would be sold and leased back by the state. State ownership would resume at the end of the lease period.

In early June 2003, Governor Owens announced his plan, which won favor from Republicans and Democrats alike, to restore some FY 2004 cuts with Colorado's share of $20 billion federal aid to states. Of the $146.3 million allocated to Colorado, $5.6 million went to restore CHP+ cuts, $4 million to restore grants formerly funded under the Tony Grampsas youth program, $3 million to fund child literacy programs, and $2 million to aid higher education. The remaining $132 million was left in reserves for the future. Revenue estimates released in mid-June 2003 projected FY 2003 and FY 2004 revenues to be $28 million and $138.6 million lower than forecast in March 2003. The estimates indicate that another $206.7 million is needed to balance the FY 2004 budget (Colorado Legislative Council 2003).

Reforming Colorado's Fiscal Limits

Colorado's fiscal crisis has created momentum to reform the state's many fiscal limits, but actually implementing specific reforms may require more momentum than exists. Early in the 2003 session, the JBC announced that it was considering asking voters to reform parts of TABOR, Amendment 23, and the Gallagher Amendment. Later, it was said leaders would meet after the session's close to discuss reforms.

Amendment 23, mandating yearly increases in K–12 spending above the rate of inflation, created the State Education Fund to receive roughly 7.2 percent of state income tax revenues. The nature of the revenue crisis, with income tax revenues declining most sharply, has led to questions about the solvency of the fund. Furthermore, it was assumed that the State Education Fund would indefinitely be funded out of the TABOR surplus, which disappeared and is not expected to return until FY 2005. Required K–12 increases, in the absence of a TABOR surplus, equate to a dollar-for-dollar decrease in the general fund available for other programs. Meanwhile, property taxes, another major source of K–12 funding, have steadily declined since passage of the Gallagher Amendment.

TABOR's revenue limit and requirement that voters approve tax increases has put immense downward pressure on Colorado's tax collections. Sales and income tax cuts in the late 1990s, along with naturally declining residential property tax rates under the Gallagher Amendment, are more difficult to reverse under TABOR.

Additionally, TABOR's "ratcheting down" effect, staved off in FY 2002 by transferring trust funds to the general fund, but effective in years since, means that Colorado will begin economic recovery from a permanently reduced revenue base.

Specific reforms considered have not been publicized, but possibilities are endless. Reforming the Gallagher Amendment to allow higher ratios of residential property tax collections could take pressure off the State Education Fund, and reduce the overall budgetary strain created by Amendment 23. Compromising the strictness of TABOR would go further to allow K–12 spending increases without the current implications for other departments. Finally, use of the TABOR reserve in an economic downturn is explicitly barred. A campaign to create a true rainy day fund exempt from TABOR revenue limits has been spearheaded by Treasurer Mike Coffman.

Conclusions

Colorado's budget difficulties emerged in FY 2001 and were handled with limited consequences for services in FY 2002, when the state relied on short-term revenue transfers, extensive use of reserves, and across-the-board cuts.

The first 2.5 percent across-the-board cuts were managed without much loss of service through cutbacks in administration and personnel, but the later 4 and 6 percent cuts were more visible. Certain budget areas were protected in the first cuts, in many cases as a result of previously enacted measures such as Amendment 23, which mandates yearly K–12 education funding increases. Medicaid was protected, until the 4 percent cuts, to minimize loss of federal matching. Although Governor Owens prioritized protecting transportation funding, an area that receives no general funding, the department was cut with cancellation of the HUTF transfer. Also, despite the governor's efforts to protect corrections funding in FY 2004, the department could not be spared.

Colorado faced substantial challenges in FY 2003 and FY 2004. With no rainy day fund, little room to increase revenue, and most creative accounting techniques already adopted to get through the FY 2002 shortfall, the state's alternatives were limited to tobacco securitization, sizeable budget cuts, selling state buildings, and the unlikely possibility of going to the voters to seek new revenue. Furthermore, economic recovery will never raise the lowered base for the TABOR revenue limit.

The myriad constraints on response to fiscal stress make Colorado's situation extreme. Various cries to reform Colorado's many fiscal restraints have become more common since budget shortfalls began in mid-2002. However, reliance on short-term measures and painful cuts to weather the fiscal storm may allow the state to avoid these changes.

Florida

Because Florida does not have a personal income tax, the stock market decline and the subsequent reduction in income from capital gains during the 2001 recession did not have an important impact on its fiscal condition. Nonetheless, Florida, like many other states, has suffered major fiscal stress since the summer of 2001. The terrorist attacks of September 11, 2001, reduced tourism, a major component of Florida's economy, and diminished state sales tax revenue. Florida's tax revenue has been reduced by several cuts in its intangibles tax since 1999 and by state tax policies that accommodated changes in federal tax policy. Florida's corporate income tax revenue fell because of legislative changes to harmonize with federal "bonus depreciation" provisions. Bonus depreciation allows businesses an additional 30 percent credit on depreciation of property bought between September 11, 2001, and September 10, 2004 (Florida TaxWatch 2002). Florida's estate tax revenue will be phased out in FY 2005 due to changes in the federal estate tax.

Florida's rapidly growing population has created pressure to increase spending. Pressures have been intensified by voter initiatives that mandate new spending in many areas. The lobbying power of Florida's large elderly population also influences expenditures.

Political and Legal Context

In FY 2000, Florida had general own-source revenue of $18.8 billion, federal assistance of $10.1 billion, and other revenue-trust fund and revenue shared with local governments of $12.3 billion, totaling $41.2 billion. Florida's biggest expenditures were for human services and education (Florida Senate 1999). Much of this spending was not easily controlled by the state. Most human services spending went to Medicaid or was passed to local governments. Most education spending went to state aid to local districts for operating expenses.

When Governor Jeb Bush was inaugurated in 1999, Florida had a $3 billion surplus. However, spending initiatives, several recent tax cuts, and the economic downturn made it difficult to balance Florida's budget in FY 2002, FY 2003, and FY 2004, and threaten to create problems for years to come. Between 1999 and October 2002, Florida enacted tax cuts worth an estimated $1.7 billion, cumulatively reducing state revenues by $5–6 billion (Kennedy 2002). Tax reductions included several cuts in the rate and exemption level of the intangibles tax, which imposes levies based on ownership of investments such as stocks, bonds, and mutual funds. In addition, Florida scheduled a phaseout of its estate tax by FY 2005 to complement the phaseout of the federal tax, scheduled for completion in FFY 2010. Finally, the estimated cost of Florida's adoption of a federal corporate income tax cut, referred to as "bonus depreciation," was $262 million in FY 2002 and FY 2003 and $124 million in FY 2004 (Fineout 2002b).

The revenue and economic effects of "bonus depreciation" in Florida have been especially controversial. Supporters hope this provision will stimulate investment, economic activity, and tax revenue. Critics argue that since there is currently little demand, businesses are likely to wait until the end of the three-year period to invest. An analysis by former chief legislative economist and director of the nonpartisan Office of Economic and Demographic Research Ed Montenaro concluded that the cut would have a slightly negative effect on Florida's job market (News-Journal Online 2002).

After the national economic downturn in the spring of 2001 and the terrorist attacks of September 11, Florida finished FY 2001 with general revenue of only $19.2 billion, or about 2 percent greater than the previous fiscal year. After a string of many years in which general revenue had grown at least 5 percent, this fiscal downturn was extraordinary.

New spending pressures intensified Florida's fiscal difficulties. In November 1998, voters approved a revision to the state constitution that mandated state, rather than county, government assume financial responsibility for the court system by FY 2004. This transfer of responsibility is expected to cost the state government $800 million to $1 billion per year. Rather than gradually phasing in state funding, the governor and legislature provided no additional funding until FY 2004, when the court system suddenly placed a major new burden on the state budget.

Florida also struggled with local governments over funding of its SCHIP program, called Healthy Kids. Florida is the only state in which counties are required to match state expenditures on SCHIP. About half of Florida's 67 counties are required to contribute up to 20 percent, while the rest have no matching requirement (Medimetrix Consulting 2000; Oppel 2001). Several Florida counties have failed to match state SCHIP funds in the past. As a result, SCHIP was not offered in these counties, federal funding was lost, and SCHIP participation was reduced (Dubay, Kenney, and Haley 2002). Governor Bush twice vetoed legislation eliminating the county match.

Additional spending pressure originated from a November 2000 voter mandate for construction of a statewide high-speed rail, to begin by November 2003. Construction is expected to cost at least $70 million in FY 2004 when the state will have to issue bonds worth up to $1.5 billion. Total costs of construction could reach $21.9 billion by completion (Kennedy 2002; Pendelton 2002; Rado 2002).

Florida began the 2001 recession with large reserves in its general, lottery, and tobacco funds. General fund surpluses are automatically placed in the state's working capital fund (WCF). At the start of FY 2002, the WCF contained $408 million. Florida also has a budget stabilization fund (BSF), which, by law, must contain a minimum of 5 percent of general revenues. This fund may only be used to pay for deficits and natural disasters and must be repaid within five years. The BSF contained $941 million at the start of FY 2002.

Florida uses a consensus revenue estimating process to predict revenues and assure a balanced budget. Florida's process is one of the most highly structured in the nation. Representatives of four groups, the Governor's Office of Policy and Budget, the Senate Finance and Taxation Committee, the House Fiscal Responsibility Council, and the nonpartisan Legislative Office of Economic and Demographic Research, meet for two revenue estimating conferences each year, although additional conferences can be called by any of the four principals at any time.

Florida's estimated revenues are all classified as recurring or nonrecurring. Although no law requires it, in practice only recurring revenues are used to pay for recurring programs. Thus, the phaseout of the federal estate tax meant that Florida immediately lost access to all estate-tax revenue for recurring programs.

In 1994 Florida adopted a constitutional amendment that limits growth in yearly revenues to the five-year average rate of growth in state personal income. In FY 2002, an amendment to replace this revenue limit with an appropriations limit narrowly passed the House but was killed by the Senate. Designed to further constrain state government growth, the appropriations growth limit would have used a formula based on consumer price index (CPI) growth and population growth. It also would have banned ad valorem taxes on tangible property including real estate and vehicles (J. Thomas 2002).

Florida law provides two adjustment mechanisms that are activated if a general revenue deficit occurs. If the deficit is less than 1.5 percent of general fund appropriations, the governor and the chief justice must submit a plan of action to the legislature. However, if the deficit is larger than 1.5 percent of appropriations, responsibility falls directly to the legislature (Florida TaxWatch 2001c).

Florida's Senate, House, and governorship have been controlled by the Republican Party since the 1998 election. In both the House and the Senate, the Republican majority has been larger than the three-fifths needed to propose constitutional amendments that voters could approve by referendum. The 2002 elections increased this majority by one in the Senate and by three in the House (Royse 2002). Feuds between Republican Party leadership became the center of debates over the intangibles tax and sales tax reform, and later erupted over the FY 2004 budget. Florida's eight-year legislative term limits went into effect for the first time in 2000. Sixty-three of the 160 Florida legislators in office in 2001 were freshmen (Kennedy 2001). Term limits have also shifted experience to Florida's Senate, as most Senate newcomers served previously in the House. In the 2003 session, the longest serving legislator in Florida's Senate first ran in 1980, while the longest-serving representative first ran in 1996 (K. Thomas 2003).

Fiscal Pressures and Policy Responses

FY 2001

Consensus revenue estimates from December 2000 showed FY 2001 revenue at $19.36 billion, but actual FY 2001 revenue totaled only $19.18 billion. However, this decline was smaller than the state's working capital fund, and thus Florida did not have an FY 2001 budget deficit (Florida Office of Economic and Demographic Research 2001).

The governor's FY 2001 budget proposed provision of health insurance for children through Healthy Kids, expansion of services for the developmentally disabled, and services for abused and neglected children and the elderly. While total spending on Medicaid was scheduled to rise, the governor's budget also proposed several actions to cut Medicaid spending and/or services including competitive bidding for pharmaceuticals, which would save almost $300 million. The governor also proposed $313 million in tax and fee cuts, most importantly a cut in the intangibles tax (Florida TaxWatch 2001a). General fund and total spending in FY 2001 were $19.7 billion and $52.5 billion, respectively.

FY 2002

Even before Governor Bush released his FY 2002 budget proposal in January 2001, it was clear that Florida would face a budget squeeze. Revenues were growing less rapidly than they had in the past, a cut in the intangibles tax was scheduled, and Medicaid costs were expected to grow by almost $1 billion in the coming fiscal year (Florida TaxWatch 2000). The governor's budget request of general-revenue spending of $20.1 billion was only 0.10 percent greater than FY 2001. Although the governor proposed increasing trust fund spending by $1.4 billion (5.8 percent) nearly every category of spending was scheduled for a cut with only the Department of Health and Human Services (DHHS) and Governmental Operations and Support getting substantial increases (4.0 and 7.9 percent, respectively).

When the consensus revenue estimating conference met as scheduled in March 2001, it issued revenue estimates of $20.1 billion for FY 2002. Although these estimates were only 1 percent lower than the December 2000 estimates, they threatened to derail the governor's proposal to cut the intangibles tax. While the governor and the House continued to support the tax cut, the Senate was resistant (Florida TaxWatch 2001b).

In June 2001, after the governor's vetoes, the FY 2002 budget included general-fund spending of $20.3 billion with $19.7 billion from recurring revenues and $584 million from nonrecurring revenues (Florida House of Representatives 2001). While the budget included significant overall increases in spending for DHHS in general and Medicaid in particular, it included $531.3 million in cuts for specific aspects of the Medicaid program: a new drug formulary cut $206.3 million, a 6 percent reduction in hospital reimbursements cut $88.1 million, Medicare crossovers were limited to save $59 million, and basing HMO rates on the net cost of drugs saved $32.5 million. It is worth noting that the legislature regularly makes policy changes to slow the increase in Medicaid spending. In almost every year since FY 1993, Medicaid policy changes have reduced spending growth by more than $100 million.

Following the adoption of the FY 2002 budget, Florida's consensus revenue estimating conference was not scheduled to meet again until September 13, 2001. However, even before the terrorist attacks of September 11, it was clear that revenue forecasts would have to be significantly reduced (Florida TaxWatch 2001c). After the attacks it was known that the economic situation was in flux and Florida, because of its dependence on tourism, might be negatively affected. Florida's tourism industry fell into decline after the attacks. People's reluctance to fly resulted in a decline in state sales tax revenue. Unemployment peaked at 5.8 percent in December 2001, with job losses concentrated in low-skill service occupations, such as those in the restaurant and retail industries (A. Martinez 2001).

Officials decided to go ahead with the revenue estimating conference that had been scheduled for September 13 and to present data as if the September 11 terrorist attacks had not happened. A second special revenue estimating conference was held on October 15, 2001. This conference produced estimates that incorporated the effect of the September 11 attacks. The October forecast predicted that general fund revenues for FY 2002 would be about $1.3 billion less than had been thought in March 2001. FY 2002 revenue declines were broad-based, affecting corporate income, sales and use, and estate taxes (Florida Office of Economic and Demographic Research 2001). Slow revenue growth was also forecast for FY 2003.

Florida's fiscal stress was further intensified because the October revenue estimating conference officially incorporated the effects of federal legislative changes that phased out the federal estate tax. This had two important implications for Florida. First, because Florida's estate tax is linked to the federal estate tax, it would also phase out. Second, and more disruptive in the short term, any estate tax revenue Florida received during the phaseout would be treated as nonrecurring revenue, to be spent only on nonrecurring programs. The October 2001 consensus estimating conference meant that Florida's FY 2002 budget had an official shortfall of $1.3 billion.

Bridging the FY 2002 shortfall took two special legislative sessions. In the first, which occurred in October 2001, the House unexpectedly passed the Senate's version of budget cuts without change. Passage was politically unappealing to some members of the Senate who had agreed to an increase in the exemption rate of the intangibles tax as a bargaining chip rather than a genuine policy initiative. The classification of estate tax revenues as nonrecurring revenue caused further friction during the first special session. Some legislators felt that because the estate tax would not be entirely phased out until FY 2005, the revenues should continue to be spent on recurring programs.

Rather than sign or veto the legislation emerging from the first special session, Governor Bush called a meeting of House and Senate leaders. A new, more broadly acceptable budget deal was hammered out and a second special session was called. The legislature agreed to a plan that deferred the intangibles tax cut for two years, preserving $128 million in tax revenue. The legislature also passed cuts in general revenue-operating spending of $1.02 billion. These cuts were partially offset by a $283 million increase in trust fund spending for operating expenses. The net cut in operating expenses was $742 million. Almost 65 percent of the cuts ($481 million) were accomplished through reductions in aid to local governments, with the biggest fraction coming from a $309 million cut in state aid to public schools.

DHHS, which originally had an FY 2002 operating budget of $5.1 billion dollars (roughly 25 percent of the state total), absorbed a net cut of $109.5 million (about 15 percent of the state total) and lost 390 of the 1,814 cuts in state positions (Florida Senate 2001). In deciding which services to cut the legislature debated a wide variety of options (Florida House of Representatives 2001). In the end, the legislature decided *not* to reduce the Medicaid eligibility income threshold for pregnant women from 185 to 150 percent of the federal poverty guidelines, which would have reduced expenditures by $34.4 million. The legislature also rejected a proposal to delay staffing increases for nursing homes that would have reduced expenditures by almost $57 million. The legislature passed a number of moves to enhance efficiency. Medicaid fraud and abuse initiatives, estimated to net the state $21.6 million, were expanded. Also passed were incentives for pharmacies to dispense drugs from the Medicaid preferred-drug-list that yielded the state $7.9 million.

Various cuts were enacted. The single biggest cut in the DHHS budget was $22.5 million in the pharmaceutical expense assistance program. This program, which originally had been projected to have 31,000 participants, had received $30 million in funding for FY 2002. But during the early part of FY 2002, fewer than 7,000 people actually participated. During the special session, the legislature provided funding to the program that would be adequate if the lower level of participation continued for the remainder of the fiscal year. The legislature also reduced spending on home-based services to AIDS patients ($10 million), a tobacco education program ($7.5 million), data center administration ($5 million), and a number of other relatively small (under $5 million) programs.

In addition to these relatively modest budget cuts, the legislature adopted much more severe cuts scheduled to take effect at the start of FY 2003. The largest of these cuts within DHHS was the termination of Florida's Medically Needy program for adults, in which about 27,000 Floridians enroll. Under this optional Medicaid program chronically ill individuals whose incomes would otherwise be too high to qualify for Medicaid become eligible for services if their medical bills would leave them with less than $180 per month for other expenses (Florida Democratic Party 2002). Federal law requires Medically Needy participants to spend down their income to $180 per month, but this requirement was never enforced in Florida, where the state instead paid all bills of Medically Needy individuals. Elimination of this program would have reduced state expenditures by almost $285 million in FY 2003.

The legislature also made it more difficult for elderly and disabled individuals to qualify for Medicaid by lowering the Medicaid for Aged and Disabled (MEDS/AD) income cutoff from 90 to 88 percent of the federal poverty guidelines. This change would reduce FY 2003 state Medicaid expenditures by $64 million. To replace MEDS/AD, the legislature created the Silver Saver program, which covers elderly and disabled individuals over 65 with incomes between 88 and 120 percent of the federal poverty guidelines. Silver Saver covers most who were made ineligible for MEDS/AD, but left those who are disabled and under 65 uninsured.

The FY 2003 Medicaid budget was reduced by an additional $31 million by eliminating adult dental, vision, and hearing services. Recurring funding for Medically Needy, MEDS/AD, and adult dental, vision, and hearing services was eliminated effective January 1, 2002, but the legislature budgeted nonrecurring funds to continue the programs through the remainder of FY 2002.

Criminal justice and corrections programs, which originally had an FY 2002 operating budget of almost $3 billion (roughly 15 percent of the state total), absorbed a net cut of $87 million (about 12 percent of the state total) but lost 1,075 of the 1,814 staff positions (almost 60 percent) cut statewide (Florida Senate 2001). The legislature did not make cuts in its $1.25 billion budget for prison beds, correctional officers, and health services to inmates. Prison sentences were not short-ened and inmates continue to serve at least 85 percent of their sentences behind bars. Cuts to juvenile preventive services were debated, but strong lobbying on the part of child advocacy groups preserved many of these programs. State agency administrative spending was cut by almost $21 million and 347 full-time equivalent administrative positions were eliminated. Almost $27 million was cut from education and substance abuse treatment services for inmates and offenders sentenced to community supervision. Some juvenile services were cut or amended: Juvenile home detention was replaced with electronic monitoring, and the Children in Need of Support/Families in Need of Support program (CINS/FINS), which serves juveniles who are not in foster care or juvenile justice but still require attention, had its budget reduced by $5.6 million (Florida Senate Democratic Office 2002). As with the DHHS budget, some of the biggest cuts were postponed until the start of FY 2003. The Department of Corrections Probation Program budget was cut $19.1 million in FY 2003 with 409 FTE positions scheduled for elimination. It was expected that staff reductions could be handled through employee attrition with no layoffs necessary.

Florida's TANF program, Work and Gain Economic Self-Sufficiency (WAGES), did not experience any major cuts in FY 2002, perhaps because WAGES is funded only slightly above Florida's required maintenance-of-effort level. Although Florida's child care services program did not experience any cuts in FY 2002, House Democrats failed to pass an amendment in the second special session that would have increased funding to eliminate long waiting lists.

The legislature doubled the FY 2002 advertising budget for Florida's tourism industry to about $40 million. With this increase, the state mounted a massive advertising campaign aimed at bringing tourists from driving distances into the state. The campaign is credited with Florida's faster than expected sales tax revenue recovery.

FY 2003

Florida's FY 2003 budget was passed during a special session in May 2002 after the regular session was stalemated over state adoption of a federal corporate income tax cut that allows corporations to take 30 percent "bonus depreciation" on new equipment over three years. Although the tax cut will go into effect in 16 states, Florida was one of only three that passed laws to conform; the other 13 conformed automatically (N. Johnson 2002a). This tax cut resulted in a $186 million revenue loss in FY 2003. The FY 2003 budget did not, however, contain a sales tax holiday that shoppers had enjoyed in the four previous years (Fineout 2002a).

General-fund appropriations for FY 2003 included just over $20 billion in recurring revenues and $638 million in nonrecurring revenues. Total general-fund appropriations of $20.6 billion were 1.7 percent greater than the originally enacted FY 2002 budget and 6.7 percent greater than actual general-fund appropriations in FY 2002 after taking mid-year spending reductions into account (Florida Legislature 2002).

DHHS was to receive $5.5 billion, up from $5.1 billion in the original FY 2002 budget. The Medically Needy program was partially restored until May 1, 2003, when those enrolled would have to meet a $450 per month spend-down requirement, up from the previously unenforced $180 per month requirement. Adult dental, visual, and hearing services were also temporarily restored, although adult dental now covers only emergency procedures. The Healthy Kids SCHIP program, with a federal match of 70 percent, was expanded in the FY 2003 budget to cover 40,000 to 45,000 additional children, while many Medicaid programs, with a federal match rate of only 57 percent, were cut (National Conference of State Legislatures 2000). Less than one hour before Medically Needy cuts were to be implemented on May 1, 2003, the legislature passed a bill to restore the program until the end of FY 2003—a two-month extension (Kennedy 2003).

Budget Outlook

Florida's child population is one of the fastest growing in America. In November 2002, voters approved two education initiatives that will further stress the state's budget. One requires that class sizes be capped at mandated levels by FY 2010 and is projected to cost between $10 and $27 billion over eight years. Starting in FY 2004, the legislature must provide enough funding for each school district to decrease average class size by two students at each grade level (Harrison 2002). The second new initiative guarantees free prekindergarten to all four-year-olds and will cost between $425 and $600 million per year. Prekindergarten must be available to all by the 2005–06 school year. Governor Bush supported the prekindergarten initiative but campaigned against the class-size reduction initiative.[8]

While Florida's FY 2003 budget required neither significant revenue enhancement nor significant cuts in any budget area, the extensive use of nonrecurring revenues in FY 2003 made passing the FY 2004 budget more difficult. In FY 2004, public school enrollment is expected to grow by 65,000 students at a cost of $300 to $400 million (Kennedy 2002). The class size and universal prekindergarten initiatives will also present fiscal difficulties. Governor Bush's FY 2004 budget proposed paying for the class-size initiative with various trust funds, rather than new revenue sources. The executive budget also proposed tuition increases of 7.5 percent at state universities and community colleges to cover part of class-size spending (Twiddy 2002). The Department of Children and Families, which administers WAGES, child care, child welfare, Healthy Kids, and other programs, requested $473.5 million in extra funding to improve services, but the governor proposed only a $138.2 million increase (Florida Department of Children and Families 2002; Marbin Miller 2003). Finally, the requirement that the state fund the court system will go into effect. Senate President Jim King (R-Jacksonville) quipped that the legislature would "probably screw the counties" by rescinding other county aid to cover the court-funding mandate if no new revenue sources are approved (Cotterell 2003d). Construction of the voter-approved bullet train must begin by November 2003, but Governor Bush intends to send the bullet-train initiative back to voters, this time with a price tag attached (Cook Lauer 2003).

Florida's 2003 regular session ended in early May without an FY 2004 budget. The Senate proposed as much as $1.4 billion in new revenue, $950 million in new state revenue and $450 million in new federal match. Raised by increasing turnpike tolls and home sale fees, repealing several sales tax exemptions, increasing tuition, and placing video gambling in jai alai frontons and dog tracks, the Senate's new revenue sources would be used to fund several things not included in the House budget. The Senate proposed additional funding for public schools, state employee raises, and higher education enrollment growth. The House budget, on the other hand, reserved up to $100 million for tax cuts or economic stimulus, and allowed universities and community colleges to raise tuition by 12 and 7.5 percent, respectively (the Senate budget allowed for tuition increases in universities [7.5 percent], community colleges [7 percent], and for out-of-state and graduate students [10 percent]) (Florida TaxWatch 2003).

After meeting privately with King and Byrd, Governor Bush announced that a special session would begin in mid-May. Before the session, King said he would not demand revenue increases in the special session (Cotterell 2003a). In the end, the $53.5 billion FY 2004 budget was balanced with no new taxes, over $150 million in fee increases, and $1.3 billion in nonrecurring revenues, of which $830 million came from trust funds. The state issued $600 million in bonds to fund the class-size initiative and eliminated 1,700 staff positions. In addition, Florida shoppers would have no back-to-school sales tax holiday in August 2003.

Legislators once again found funding to continue the Medically Needy program (Atwater 2003). A scheduled increase in nursing home staffing requirements, however, was delayed. Florida's SCHIP program, Healthy Kids, saw many cuts: Enrollment was capped, child dental benefits were limited to $750 per child per year, monthly premiums rose from $15 to $20, certain copayments were increased, and an outreach program to help parents understand program enrollment was eliminated (Skidmore 2003).

State employees received a 2 percent salary increase, but also a 16 percent increase in health insurance premiums. Funding for the highly successful antismoking program, Florida Tobacco Control, was nearly eliminated in the FY 2004 budget. The Department of Health lost 98 positions, 79 of them in the antitobacco program (Cotterell 2003e).

Florida's Department of Children and Families received a total increase of $91.8 million over FY 2003 levels, but a rise in federal funding was the source of the increase. DCF's general funding actually fell by $64.9 million. The budget fell far short of the $473 million increase requested by the department in November 2002. The DCF budget funded several steps to decrease employee turnover, including pay raises and a car insurance stipend for some employees. The budget also funded 376 new staff members in child services, but eliminated 163 staff positions in the department as a whole. Seventy-eight of these positions were vacant, and the other eliminated workers may be absorbed within DCF (Cotterell 2003e).

The biggest areas of state worker layoffs were in the Departments of Corrections and Juvenile Justice. Corrections lost about 200 positions, some of which were vacant. Juvenile Justice lost 247 positions, of which 54 were vacant (Cotterell 2003e).

K–12 education funding increased by $837 million in FY 2004, but more than half of that went to class-size reduction. Teachers are not likely to receive raises, and some districts are even expecting to run deficits.

Several fees were increased, including those to renew suspended licenses, to keep poisonous reptiles, and for out-of-state hunters. Tuition increases were mandated to account for decreased higher education funding. College and university tuition will rise 8.5 percent, with an option to raise graduate and out-of-state tuitions as much as 15 percent. Community college tuitions would rise 7.5 percent (Royse 2003).

On May 28, 2003, President Bush signed into law a $350 billion tax package that included $20 billion in fiscal relief for states. Florida's share of the aid will be $948 million. Legislators added language to the FY 2004 budget that directs the first payment of federal aid, due in October 2003, into reserves (Cotterell 2003c). Several legislators, both Democratic and Republican, have asked that the money instead be spent to fund current education needs. Democrats suggested that Governor Bush is saving the money for FY 2005, when President Bush is up for reelection (Associated Press 2003a).

In mid-June 2003, Bush signed the FY 2004 budget after vetoing $35.2 million, including $7.2 million appropriated for bullet train construction. Bush indicated that spending cuts will not be restored, even if revenues improve (Cotterell 2003b).

Conclusions

Florida's fiscal crisis differed from that experienced in other states because the state has no income tax, and thus was not directly affected by plummeting capital gains collections. However, tourism, Florida's main industry, was adversely affected by the terrorist attacks of September 11, 2001. This resulted in a sales tax revenue shortfall and unemployment concentrated in unskilled labor. These conditions, combined with several voter-mandated spending increases and permanent tax cuts, put Florida's fiscal health in jeopardy.

Education and human services were Florida's only large general-fund budget areas cut in FY 2002. The $1.3 billion shortfall was bridged using a mix of cuts, trust funds, and an intangibles tax cut deferral. The legislature minimized cuts in FY 2002, FY 2003, and FY 2004 with nonrecurring revenues.

When cutting social programs, Florida's legislature attempted to harm the fewest people and minimize pain. No major cuts were made to programs serving children, although the disabled were less protected. Virtually all of Florida's cuts in social services involved some aspect of health care for low-income individuals. Cuts included both formal strategies such as reforming Medicaid's preferred drug list and reducing the eligibility income for MEDS/AD, and informal strategies such as increasing enforcement of the spend-down requirement for the Medically Needy program.

Although Florida entered the fiscal crisis with over $900 million in its budget stabilization fund, that money has not been touched. The requirement that the fund be repaid to reach 5 percent of general-fund appropriations within five years is the most commonly cited reason that the fund has not been tapped. Despite the BSF's massive size, using it to bridge the fiscal crisis has not entered serious political dialogue. Further, it is likely that Florida's share of the federal aid to states will be added to reserves.

Michigan

In June 2000, the Associated Press reported that Michigan's "strong economy is giving lawmakers more options than ever for covering the state's share of the bill for higher education, health care, prisons and schools," and quoted political consultant Tom Shields as saying "They're tripping over money in the hallways at the Capitol" (Hoffman 2000). By May 2001, less than a year later but well before the tragedy of September 11, Michigan's general-fund revenues were $433 million (almost 5 percent) below expectations. As the year progressed Michigan's budget problem worsened, and it became clear that fiscal difficulties would persist through 2002, into 2003, and probably beyond. Yet the state did not cancel or postpone a previously scheduled cut in personal income taxes, and it increased K–12 spending.

Unlike most states, which have July to June fiscal years, Michigan's fiscal calendar runs from October through the end of September. This significantly enhanced Michigan's ability to handle the fiscal crisis of 2001. Michigan had time to make mid-year adjustments in fiscal 2001 once budget experts realized that revenues were below predictions in the early spring of 2001. After the attacks of September 11 worsened the near-term economic outlook, Michigan had the entire 2002 fiscal year (which would begin on October 1, 2001) to plan and implement budget cuts or revenue enhancements, whereas states with July-June fiscal years had already gone through most of their first quarter. Michigan was further advantaged because the auto industry, an important part of the state economy, responded to the nationwide economic downturn with sales promotions (offering consumers zero percent financing) rather than layoffs. The promotions resulted in increased income tax revenues since autoworkers remained on the job, and significantly enhanced sales tax revenues as new car sales continued unabated.

Michigan also faced some unusual challenges. John Engler, a popular and high-profile governor who had acquired a national reputation as a fiscal conservative, was finishing the second of his two terms and was ineligible to run for re-election due to term limits, as were the other three officials elected statewide and 27 of 38 state senators (Range 2002). Previously scheduled rate cuts in personal and business taxes took effect just as revenues were falling. Legislators who remained generally lacked experience with budget downturns. Cyclical budget pressures have been further intensified by the tightening of federal Medicaid rules that will eventually cost the state hundreds of millions of dollars.

Political and Legal Context

Michigan, long known as the home of the U.S. auto industry, has been disproportionately dependent on the manufacturing sector for jobs and economic health for many years. In recent years state government officials have made a concerted and apparently successful effort to diversify Michigan's economy. Michigan's unemployment rate, long above the national average, dropped below it in the mid- and late 1990s. Among elected officials in Michigan there is near-consensus that economic diversification and economic growth will require a well-funded educational system from kindergarten through college.

Michigan's school finance system was completely overhauled in 1993 and 1994. Local property taxes to support education were reduced by more than two-thirds. Proposal A, approved by 69 percent of the voters in March 1994, provided replacement sources of school funding by increasing the state sales tax from 4 to 6 percent and creating a new state property tax. If Proposal A had not passed, a statutory alternative relying primarily on an increase in the state income tax would have taken effect. Under Proposal A, the share of school spending financed at the state level has increased from about one-third to nearly four-fifths. In most districts, property taxes on homeowners provide none of the funding for school operating costs (Addonizio, Kearney, and Prince 1995; Kearney 1994; Michigan Office of Revenue and Tax Analysis 2002).

Michigan's own-source state revenues are distributed into two major funds: the school aid fund ($12.5 billion) and the general fund ($8.6 billion).[9] Michigan also spends about $3 billion on transportation, which is funded by dedicated road and gas taxes, and about $1.5 billion on revenue sharing with local governments, funded by a portion of the sales tax. Federal funds provide an additional $8.3 billion to the general fund and $1.3 billion to the school aid fund (Michigan House Fiscal Agency 2002). Virtually all of the money in the school aid fund is distributed to local school districts to pay school operating costs. Major federal and general-fund expenditure items include community health, which largely consists of Medicaid ($8.7 billion); the Family Independence Agency (FIA), which largely consists of TANF ($3.8 billion); higher education ($1.9 billion); and corrections ($1.7 billion) (Engler 2002).

The school aid fund receives revenues through designated shares of the state sales, income, and property tax revenues.[10] The most important sources of general fund revenues are the personal income tax ($4 billion), the single-business tax ($1.9 billion), and the sales and use taxes ($1 billion) (Michigan House Fiscal Agency 2002).

Since the school finance reform of 1993–94, Michigan has had bipartisan support for increased state funding of local schools. Many Michigan legislators view education spending as a key pillar of the state's attempt to strengthen and diversify its economic climate. Between 1995 and 2002 the "basic" foundation level of per pupil funding, guaranteed in all school districts, was increased from $5,000 to $6,500. Special education funding and higher education funding have also increased substantially (Engler 2002).

During the 1990s Michigan expanded Medicaid coverage with a 13 percent increase in recipients between 1990 and 2000. Michigan significantly expanded eligibility for health coverage for children (to 200 percent of the federal poverty guidelines) by establishing MIChild (Michigan's SCHIP program) and other programs. At the same time Michigan has deinstitutionalized many of its mental health services. State costs for these services have been controlled by increased use of Medicaid managed care and by establishing special financial partnerships with local government that made it possible to obtain additional federal Medicaid matching funds.

Recent federal rules will constrain Michigan's use of some of these mechanisms and will cost Michigan nearly $600 million per year by 2006 (Reinhart 2002a). To prepare itself for this transition, Michigan established the Medicaid Benefits Trust Fund with Public Act 489 of 2000. PA 489 specifies that the fund consists of "unexpended state restricted revenues and local revenues received . . . as a result of additional Medicaid special financing payments above the level assumed in the appropriations for fiscal year 2000, 2001, and 2002." The fund had a balance of $421 million at the end of FY 2001 (Reinhart 2002b).

At the same time Michigan was able to deposit significant funds in its budget stabilization fund. Michigan made substantial contributions to this fund in each fiscal year from 1993 to 1996 and again made substantial contributions in FY 1999 and FY 2000. By the end of this period the fund was at its highest level ever and had a balance of more than $1.1 billion (Michigan Citizens Research Council 2001).

Despite these major spending initiatives Michigan had been able to enact significant tax rate cuts in the late 1990s. Throughout his term of office Governor Engler had made tax cuts a top priority. Between 1991 and the beginning of 2001 Michigan legislated dozens of tax cuts that reduced revenues by an estimated $20 billion over the period. (Engler 2001). In 1999, when economic activity was vigorous and economic growth strong, Michigan approved a plan to phase in substantial cuts in the single-business tax (SBT) and the personal income tax. The SBT, which was 2.3 percent in 1998, was scheduled for elimination by rate reductions of 0.10 percentage point each year for a period of more than 20 years. The personal income tax rate was to be phased down from 4.4 percent to 3.9 percent over a period of five years.

The revenue estimating process largely depoliticizes technical budget questions. The limits to state spending are determined by a mandatory consensus revenue estimating process that has representatives from the House, Senate, and executive branch (either the state budget director or the state treasurer). These officials participate in a formal revenue estimating process and have regularly scheduled conferences in January and May of each year. The executive branch is required to use the January consensus forecast in its executive budget proposal, generally issued soon after the start of the calendar year. The May revenue forecast dictates available revenue when the legislature considers appropriations bills in June or July. Any of the principals in the revenue estimating group may initiate a special meeting to revise revenue estimates at any time (Ross 2001).

The governor can set budget and fiscal priorities with limited legislative interference. The Republican Party controlled both houses of Michigan's legislature and the executive branch during FY 2001 and FY 2002 budget discussions. Most of the negotiations about the budget shortfalls were conducted behind closed doors among a small group of party leaders.

In November 1992 Michigan voters adopted term limits that restricted the governor, other statewide elected officials, and state senators to a maximum of two terms of four years each. State representatives were allowed three two-year terms.

Term limits have meant relatively large turnover in Michigan's House of Representatives: In 1998, for example, 63 of Michigan's 110 House members could not run for reelection (National Conference of State Legislatures 2002). Since the restrictions did not come into force until January 1993, the November 2002 elections were the first time term limits affected incumbent senators and the governor. Twenty-seven of 38 incumbent state senators and the incumbent governor (Engler) could not run for reelection in 2002. The massive turnover in the state legislature may have affected the policy process. Observers suggested that some lame-duck legislators were unwilling to fully confront the fiscal crisis that emerged as their terms drew to an end in late 2002.

Fiscal Pressures and Policy Responses

FY 2001

Michigan's January 2001 consensus revenue estimating conference predicted general fund/general purpose revenues would be $9.6 billion in FY 2001 and $9.8 billion in FY 2002. As data about actual tax collections came in during February and March it became clear that these estimates were overly optimistic. When the consensus revenue estimating group met again in May 2001 it reduced FY 2001 estimated revenue by $433 million (about 4.5 percent) and FY 2002 estimated revenue by $518 million (about 5.6 percent).

The governor and legislature had little room to maneuver in order to accommodate the new FY 2001 revenue forecast because, by the end of May 2001, only one-third of the fiscal year remained. Given its limited options the leadership closed the FY 2001 budget gap primarily by short-term mechanisms. Two hundred and twelve million dollars that had been left in the "cash balances account" at the end of FY 2000 was used to pay FY 2001 bills, $72 million was withdrawn from the state's budget stabilization fund, and $211 million of bonds were issued to pay for building projects previously planned on a pay-as-you-go basis.

FY 2002

Revenue estimates dropped throughout FY 2002, primarily because income tax revenues went down as income from capital gains fell with stock market declines. The state's fiscal condition would have been much worse but for the post-September 11 decisions of the major auto manufacturers to offer zero percent financing (interest-free loans on new cars). Zero percent financing prevented income tax revenues from falling even further by keeping the auto factories open, albeit without the overtime or new hiring characteristic of more prosperous times, and increased sales tax revenues by stimulating new car sales. Despite the general economic slowdown actual sales tax revenues were close to forecasts. The state's school aid fund met revenue projections because most of its revenues came from sales and property taxes.

In response to the May 2001 consensus forecast that there would be $518 million less revenue in FY 2002 than had been expected in January, Governor Engler trimmed his FY 2002 budget recommendation by $210 million; cuts included cancellation of scheduled construction projects. An additional $155 million from the budget stabilization fund was tapped, and a surplus in the tobacco settlement fund of $75.5 million was used. Local revenue sharing payments were also capped, saving an additional $28 million of state revenue.

Despite the stimulus offered by zero percent financing, analysts in the legislative branch soon became pessimistic that revenues would meet even their reduced targets. Executive branch officials initially were more optimistic. But by the late summer of 2001, pressure was building for a special revenue estimating conference that would almost certainly lower forecasts. After the terrorist attacks of September 11, all debate about the necessity for revised consensus revenue estimates ceased—it was clear that new estimates were essential.

In October 2001 a special consensus revenue estimating conference was called. The conference reduced estimated general-fund revenue for FY 2001 (which had just ended) by $156 million and lowered its estimate for FY 2002 revenues by an additional $462 million beyond the May 2001 reductions.

The reduced FY 2002 consensus revenue estimates issued in October 2001 triggered a legal requirement that the governor take action to bring expenditures in line with revenue. Governor Engler consulted with legislative leaders and issued an executive order in November 2001. Under Michigan law the full legislature did not have to act; only the approval of the two appropriations committees was required to ratify the executive order. Furthermore, the executive order could not be amended—the committees were required to accept or reject the order as submitted. Both committees accepted the executive order.

The governor's executive order generated about $145 million of additional spending capacity by sweeping "lapses" (i.e., surpluses) of various trust funds into the general fund. For example, a lapse of $12.8 million in the comprehensive transportation fund and a lapse of $72.5 million in the merit award (scholarship) trust fund were swept into the general fund. There were also small reductions in capital outlays ($21.8 million) and local revenue sharing ($37.2 million) but the bulk of the cuts was accomplished through a $285 million reduction in general fund spending for departmental budgets.

About 40 percent of the $285 million in departmental cuts came from a $112 million reduction in general-fund expenditures for the Department of Community Health (DCH). However, this did not represent a $112 million cut in DCH services. A movement of funds from the Medicaid benefits trust fund into the general fund accounted for more than half ($60 million) of the $112 million. DCH was also able to obtain $216 million in revenue/transfers from special or restricted funds. Some DCH programs were cut. For example, $9 million in subsidies to graduate medical education were cut and hospital payments were reduced by $13 million due to changes in diagnosis-related groups. However, on net DCH emerged from the November 2001 executive order with about 1 percent more revenue than it had when FY 2002 appropriations were originally approved.

FIA, which administers the state's TANF program, took a total cut of slightly more than $24 million in general-fund revenues but received supplemental general-fund revenues of $20 million designed to support a cash assistance caseload that had increased from 66,762 in November 2000 to 77,470 in March 2002. Child support incentive payments to counties were cut by $2.4 million and $6.1 million of child support incentive payments was redirected into child support enforcement. Since these expenditures met federal matching requirements Michigan could cut its own spending while counties received an increase in incentive payments. FIA also reduced expenditures by $7 million through workforce attrition and scaling back two juvenile justice facilities. There were also smaller cuts in a variety of FIA programs including emergency relief, Community Action Agencies, and juvenile justice.

In addition to specific departments cuts an early retirement program was put in place and state workers were given until May 2002 to choose this option. Eventually the early retirement program resulted in an 8 to 10 percent reduction in force. Across state government, only one out of four workers was to be replaced. However, FY 2003 budget legislation mandated a one-for-one replacement of foster care and protective services workers. Nonetheless, FIA was hit particularly hard by retirements since it had many senior employees.

The fiscal picture continued to deteriorate. When the consensus revenue estimating group met for their regularly scheduled meeting in January 2002, they found that FY 2001 had finished even weaker than they had anticipated in October 2001. Actual FY 2001 general-fund revenues were $43 million below the already pessimistic October 2001 consensus estimates. In January the consensus estimating conference lowered FY 2002 general-fund revenue estimates by $50 million. The prognosis for FY 2003 was also bleak. The committee projected general-fund revenues of $8.7 billion, substantially less than those projected for FY 2002 and about 3 percent less than actual revenues in FY 2001. The governor used these consensus estimates in preparing his FY 2003 executive budget (Engler 2002).

As CY 2002 wore on it became clear that the fiscal situation had worsened still further and substantial changes in the governor's budget would be required. At the regularly scheduled May 2002 revenue estimating conference, estimates of FY 2002 and FY 2003 revenues declined by $350 million and $320 million, respectively. To balance the FY 2002 budget the state drained nearly all remaining money out of the budget stabilization fund, reduced payments to local governments by an additional $26 million, generated $46 million by the sale of state property, and cut expenditures by an additional $68 million.

FY 2003

FY 2002 general-fund appropriations had been $9.3 billion. With only $8.7 billion in projected revenue and about $400 million dollars of "unavoidable" spending increases, the FY 2003 executive budget, released in February 2002, recognized a funding gap of almost $1 billion. The governor proposed a four-pronged strategy for closing the gap. Thirty-three percent of the gap would be closed by expenditure reductions. Twenty-five percent would come from the Medicaid benefits trust fund. The budget stabilization fund and other one-time revenues would cover 30 percent of the deficit and the remaining 12 percent would be paid for by a freeze on state revenue sharing payments to local governments. The executive budget did not propose any significant new revenue sources and did not halt the previously scheduled cuts in the single-business tax and the personal income tax. In keeping with the budget priority that had been accorded to education the executive budget proposed a $450 million dollar (3.8 percent) increase in the school aid fund and unchanged spending for higher education. The Department of Community Health was scheduled for a small (less than 1 percent) cut in general-fund revenue but an overall increase (once federal and other funds were considered) of nearly 5 percent. FIA was to get a 2.8 percent general-fund increase and a 3.3 percent overall increase.

Governor Engler did propose cuts in spending for agriculture (1.3 percent), environmental quality (14 percent), history, arts and libraries (3 percent), and natural resources (12 percent). The Michigan Strategic Fund, used for economic development, was cut 8 percent. The executive budget also indicated $50 million in savings from unallocated agency reductions and $46 million in savings from reduced debt service costs.

While the governor scheduled FIA for a small overall increase, he did suggest some cuts in specific programs. The governor recommended that funding for a children's clothing allowance under the Family Independence Program (Michigan's TANF program), originally a substitute for a cost-of-living increase that went only to nonworking recipients, be cut from $12.9 million to $4.3 million. A small amount of funding for child advocacy centers and child well-being programs was cut, with some money redirected to employment and training services. Michigan's child support enforcement program has consistently failed to meet federal goals and has recently incurred substantial federal fines. Nevertheless, the governor recommended a $2.6 million cut in general-fund revenues ($8 million total cut) in spending for this function.

Since 1991 Michigan had gradually expanded eligibility for health care for children. The governor's FY 2003 budget provided funds so that under the MIChild program all Michigan children living in families with incomes below 200 percent of the federal poverty guidelines would be eligible for health care. The FY 2003 executive budget also included funding to expand MIChild into the MIFamily program by extending coverage to parents of eligible children.

The most contentious items in the governor's FY 2003 budget were the decision not to halt the scheduled personal and business tax cuts and the decision to freeze local revenue sharing. There was strong legislative support for the tax cuts. The original legislation enacting the single-business tax cuts contained a provision that halted the cuts if the state's budget stabilization fund fell below $250 million. As the 2002 calendar year proceeded it became clear that this provision threatened to derail the SBT tax cut scheduled for January 2003.

Both houses of the legislature approved a provision that would have removed this trigger and kept the SBT cut. The generally worsening economic climate along with the SBT cut (which would have lowered revenues by about $87 million) could have left the state with a substantial deficit in FY 2003 even without the passage of expensive constitutional amendments. The governor worked for a legislative compromise. Democrats, whose votes were needed to offset the defections of some Republicans who opposed any tax increase, supported a 50 cent per pack increase in the cigarette tax (to $1.25 per pack), expected to generate $290 million annually (Michigan Department of Treasury 2002), in return for the governor's agreement to retain the trigger delaying the SBT cut. The legislation delaying the SBT cut, however, accelerated the phaseout of the tax, repealing it altogether in 2009 rather than 2022 as previously scheduled. To generate additional revenues, a new Sunday lottery was approved over the objections of Republicans from Western Michigan.

Governor Engler used his line-item veto to remove $845 million in local government revenue sharing from the FY 2003 appropriations bill. Under the Michigan constitution, the governor could approve the entire $845 million or veto the entire amount, but could not reduce it to a lower total. Governor Engler, who had long advocated reductions in revenue sharing, argued that the state needed to reserve this amount in case the voters approved three pending ballot measures. One measure would have mandated that tobacco settlement revenues be used to increase payments to hospitals and nursing homes. This measure would have had an immediate annual cost of $250 million. The second measure would have required binding arbitration for state employees. Although the cost of this provision is difficult to quantify, many observers believed its financial impact would be substantial. The third measure cited by Governor Engler would have changed state drug penalties to emphasize treatment over incarceration.

After a tense political standoff the Speaker of the House, a close political ally of the governor, released his members to vote their conscience on overriding the revenue sharing veto, and Lieutenant Governor Dick Posthumus, the Republican candidate for governor, announced his support for the override. In the vote that followed, a governor's veto was overridden for the first time in 25 years. As it turned out, the drug treatment measure did not receive enough signatures to make it onto the ballot, and the binding arbitration and tobacco settlement measures were rejected at the polls. The funds that Governor Engler had put aside could thus be used to fund local revenue after all.

Michigan's FY 2003 general fund budget was $9.19 billion, nearly the same dollar amount as final FY 2002 spending (also $9.19 billion). The FIA budget of $1.17 billion was increased by about $7 million and the community health budget of $2.49 billion was increased by about $42 million. However, fiscal constraints led the governor and legislature to delay implementation of the new MIFamily SCHIP parental expansion. The only item in the general fund budget that received a substantial percentage change in funding was debt service, which was reduced by $37 million (38 percent).

Within a few months, many analysts saw evidence that the May consensus budget estimates, which had informed FY 2003 budget deliberations, were overly optimistic. In August 2002, the director of the Senate Fiscal Agency, a participant in the consensus revenue estimating process, issued a memorandum concluding that "The impact of the continuing economic downturn is that the…[FY 2003 general fund] budget that was recently approved by the Legislature will likely need to be adjusted in order to ensure a balance between estimated revenues and appropriations" (Olson 2002). Fiscal decisionmaking, however, was put on hold while officials awaited the outcome of the November election, in which a new governor was to be chosen for the first time in 12 years, and more than three-quarters of the seats in the Senate would be filled by newcomers.

Governor Engler's last executive order, prepared after the election, cut $230.6 million from general-fund expenditures and $106.8 million from special purpose appropriations. Executive Order 2002-22 provided for general-fund cuts of 2.5 percent to all departments except for FIA (1.0 percent), corrections (1.0 percent), military and veterans affairs (1.0 percent) and the state police (1.5 percent). The order stated specifically that the cuts to FIA, community health, and education would not reduce the state's TANF maintenance-of-effort requirement. Democratic efforts to postpone the pending income tax reduction instead of making the cuts received support from 3 of the 10 Republican members of the Senate Appropriations Committee for a time, but in the end the House and Senate committees voted along party lines and approved the order (Andrews and Range 2002; Christoff 2002).

The outgoing legislature also passed two tax reduction measures sponsored by Senator Joanne Emerson, one of the many leaving office due to term limits. SB-1422 narrowed the definition of gross receipts used for the SBT (Lane 2002). SB-1446 reduced penalties for not paying income or business taxes, for not remitting withheld employee taxes to the state, and for paying taxes with a bad check (Associated Press 2003d).

Term limits dictated that John Engler, the dominant figure in Michigan politics for over a decade, would leave office after the 2002 election. In that election, Jennifer Granholm, the Democratic attorney general, defeated Republican Lieutenant Governor Dick Posthumus to become Michigan's first woman governor. Republicans, however, kept control of both legislative chambers, losing a seat in the Senate but gaining six in the House.

During her campaign, Granholm promised not to raise taxes and expressed support for the school funding mechanism established by Proposal A in 1994. The January 2003 Consensus Revenue Agreement, indicating that FY 2003 revenues would be $143 million below the November estimate, provided an early test of her priorities. Executive Order 2003-3 included reductions of $125 million in general-fund expenditures and $20 million in special purpose expenditures. Child care cuts made up more than half of the $31 million cut from the FIA budget, which was not specifically protected. The community health budget was cut by nearly $17 million, including $10 million in pharmaceutical services. The state's four-year colleges also absorbed major spending reductions. Governor Granholm's executive order was approved by the House and Senate appropriations committees.

Budget Outlook

While some officials believed a strong recovery leading to adequate revenues was possible, many of the people most knowledgeable about revenue estimation were quite pessimistic. There is a widespread belief that Michigan's recent tax cuts and spending patterns leave it with a significant structural deficit. That is, under any reasonable assumption about revenue growth, current spending patterns are unsustainable without changes in policy to enhance revenue (Citizens Research Council 2002). The pending loss of hundreds of millions of federal dollars in Medicaid matching funds will certainly intensify Michigan's fiscal stress. Although another round of automobile price cuts may provide a temporary boost, the September 2003 unemployment rate of 7.4 percent, the highest level in 10 years, shows that the state economy remains weak.

The consensus revenue estimating conference in May 2003 agreed on an estimate of FY 2003 revenues that was unchanged from the January consensus estimate, suggesting that it may be possible to avoid further budget adjustments in the current fiscal year. The estimate for FY 2004 revenues, however, was $32.9 million lower than the January estimate, making it that much harder for the Democratic governor and Republican legislature to agree on a budget for FY 2004.

Governor Granholm's budget for FY 2004, issued in March 2003, set general-fund spending at $8.6 billion, 2.4 percent below FY 2003 levels. Higher education and local revenue sharing (a frequent target for Governor Engler) were among the biggest sources of savings. The executive budget increased funding for FIA and community health to cover expected caseload increases. The budget also restored Medicaid coverage for 40,000 caretaker relatives of foster care children, whose benefits were eliminated by Governor Engler. Services to mandatory Medicaid recipients, however, would be reduced under a proposed waiver.

The budget did not propose increases in any of the broad-based taxes, but it included some revenue enhancements framed as closing tax loopholes, including reversal of some of the tax changes made in the last two months of the Engler administration. Republican legislators objected to these changes. They also sought to preserve the $2,500 merit award scholarships established with tobacco settlement money in 1999. Governor Granholm proposed reducing the awards to $500 per student and using the savings for Medicaid. Republican legislators also expressed skepticism about the governor's expectations that public employee unions will agree to renegotiate existing contracts, saving the state $250 million, and that two new games will increase lottery revenues by $50 million (Andrews 2003; Gray and Bell 2003).

The governor and the legislative leadership reached agreement on the FY 2004 budget on July 15, 2003. The terms of the agreement made Governor Granholm happier than House Democrats (Bailey 2003b). The $700 million in additional federal aid that the state will receive under the national tax cut legislation facilitated agreement. The budget allocates $200 million of this aid to the budget stabilization fund, the Medicaid trust fund, and a new contingency fund for schools.

The budget agreement provides some new revenues, but does not increase the sales tax, income tax, or single-business tax. The agreement closed some tax loopholes, but fewer than Governor Granholm had targeted (M. Johnson 2003). Tougher efforts to collect unpaid property taxes are expected to raise $35 million (Shine 2003). Two new lottery games were approved to raise $50 million for the School Aid Fund. Penalties on bad drivers were increased, with the added revenues used to maintain Engler's merit scholarships at $2,500.

General-fund spending was set at $8.89 billion, a nominal increase of 1.1 percent above FY 2003 spending (Bailey 2003b). The budget provides money to buy a laptop computer for every sixth-grader in the state, but cuts funding for adult education by two-thirds and reduces job training funding as well. A 2.3 percent cut in higher education funding was expected to translate into tuition increases of 6 to 12.4 percent (Bailey 2003a). Local revenue sharing was reduced by 3 percent. A Medicaid adults benefit waiver, awaiting federal approval as of mid-August, would restore coverage for 40,000 caretaker relatives of foster children, but reduce services for mandatory Medicaid recipients.

The budget agreement assumes $230 million in savings from concessions by state workers, including giving up a previously negotiated 3 percent wage increase. As of mid-August employee unions had not agreed to these concessions. The state plans to offer the unions future leave time to compensate for lost wages if the IRS indicates that the exchange would be permitted under federal tax laws (Lane 2003).

Conclusions

Even if there had been no economic downturn, Michigan would have faced a significant fiscal challenge early in the decade because of previously legislated tax cuts, reduced federal support for Medicaid spending, and a rapidly changing and inexperienced legislature. The sudden economic downturn that occurred beginning in the spring of 2001 may have simply hastened the advent of a problem that was destined to occur.

Michigan first became aware of fiscal stress during the late spring of 2001. Because the state had built up a large surplus in both its budget stabilization fund and its Medicaid benefits trust fund it was able to adjust to revenue shortfalls in FY 2001 and FY 2002 with relatively little change in spending. In FY 2002 previously legislated cuts in the personal income and the single-business tax were allowed to continue. The state maintained its commitment to increase funding for local school districts.

In FY 2003 the state increased cigarette taxes and delayed a previously scheduled cut in the single-business tax. Across-the-board spending reductions played a small role in coping with fiscal distress. Programs aimed at vulnerable populations have generally been protected to date although the state's early retirement program had a particularly severe effect on FIA. Medicaid services have generally not been cut but many Medicaid providers did not receive a scheduled reimbursement increase in the FY 2003 budget. Perhaps more serious in the long term, most of the Medicaid benefits trust fund, which had been intended to ease Michigan's transition as the federal government limited some Michigan matching programs, has been spent to tide Michigan over the current fiscal crisis: by the end of FY 2003, $44 million will remain of the $605 million deposited into the fund since 2000. In the next few years Michigan may have to adapt to significantly reduced federal support for Medicaid.

When Michigan did cut social programs, it generally accomplished this by delaying implementation of new programs (for example, not expanding MIChild to

MIFamily), by forcing social service agencies to absorb staff declines resulting from the state's early retirement program, and by failing to fund increases in provider reimbursements to offset increases in costs. Providers have not received an across-the-board increase since the early 1990s. There is no evidence that the state has used informal strategies, such as reduced outreach, to hold costs down.

Michigan pays close attention to federal matching rates. In response to the fiscal crisis the state legislature gave the FIA director authority to realign sources of financing in order to maximize the state's TANF MOE expenditures. For example, Michigan was able to ease its FY 2002 fiscal stress by moving some funds from child support incentives to child support enforcement, making them eligible for a federal match. Michigan has gone to great efforts to make sure that state funds are used to draw down the maximum amount of federal matching dollars whenever that is consistent with the state's policy objectives. In FY 2003 Michigan increased spending on the federally funded Low-Income Home Energy Assistance Program by almost $19 million.

At the end of FY 2000, Michigan had budget reserves equal to 15.4 percent of annual expenditures, the highest figure among the seven states in our study (NASBO 2001). These reserves helped the state to avoid the most difficult choices among social service programs in FY 2001 and FY 2002. In FY 2003, however, child care funding has been cut and caretaker relatives have at least temporarily lost Medicaid coverage. The Medicaid waiver that would restore coverage for caretaker relatives in FY 2004 would also reduce services for other Medicaid recipients. Legislative resistance to the minor tax changes Governor Granholm has proposed so far suggests that as long as control of state government is divided along current lines, Michigan will rely primarily on expenditure reductions that affect social programs along with spending in other categories to make up any future shortfalls.

Mississippi

Mississippi, like many Southern states, did not experience the economic boom of the late 1990s as fully as states in other parts of the country. Nationally, gross domestic product growth averaged 4.03 percent per year between 1996 and 2000, but Mississippi's gross state product growth averaged only 2.54 percent per year in the same period (Bureau of Economic Analysis 2002). Compared with other states, Mississippi is lacking in computerization and information technologies (IT), which led the growth in the nation's economy throughout the 1990s. In 2001, 6 percent of Mississippi's workers were in the IT sector, compared to the national average of 11 percent (Mississippi Institutions of Higher Learning 2001). The state has the fifth highest concentration of total employment in manufacturing in the nation (Hovey and Hovey 1999), and a labor force of relatively unskilled workers. The absence of a substantial high-tech industry may have impeded growth in the late 1990s but it also may have insulated Mississippi from the consequences of the high-tech collapse in 2001.

Mississippi's emphasis on low-tech manufacturing, however, leaves the state vulnerable to economic downturns, and indeed Mississippi's economy was one of the first to feel the recession. Manufacturing employment in Mississippi began to fall in May 2000. Between January 2000 and June 2001, over 17,000 manufacturing jobs were lost (Mississippi Institutions of Higher Learning 2001). However, in January 2002 manufacturing employment finally stopped declining and began inching upward. The strength of the American auto industry, in the context of the recession, has also helped maintain Mississippi's economy.

Health care costs increased nationwide in recent years, and Mississippi's were no exception. Mississippi's Medicaid prescription drug costs increased by almost 40 percent, or $125.6 million, between FY 2001 and FY 2002 (Mississippi Office of the Governor 2002b). Medicaid nursing home costs increased by 6 percent, or $23.6 million, from FY 2000 to FY 2002. Medicaid enrollment in Mississippi grew 16 percent from FY 2000 to FY 2001 (Sawyer 2002a). As of August 2002, Medicaid covered 709,000 people, about 25 percent of Mississippi's population (Musgrove 2002).

Mississippi recently increased spending in three areas without raising state tax rates. The first fiscal commitment involves teacher pay raises. As of 2001, Mississippi was ranked 49th in average teacher pay. Legislation supported by Governor Musgrove to raise the state to 19th in the nation was passed. Second, Mississippi has increased its spending on economic development. Between FY 1992 and FY 2000 debt service costs in the state's budget associated with economic incentives to businesses have increased almost fivefold. In August 2000, Mississippi launched the Advantage Mississippi Initiative to lure businesses to locate in Mississippi through a variety of tactics including tax incentives and high-speed data access. In June 2002, Nissan built a new plant in an expansion of its Canton area facility. The third area of spending initiatives is health care. In 2000, Mississippi initiated an extensive SCHIP outreach program that expanded SCHIP and Medicaid rolls (Sawyer 2002b).

Meanwhile, federally imposed Medicaid disproportionate share hospital (DSH) and intergovernmental transfer (IGT) caps and cuts have reduced the state's ability to obtain federal funds. Mississippi has not recently raised its cigarette tax, which is among the lowest of non-tobacco producing states (Federation of Tax Administrators 2001). Mississippi has a booming gaming industry, partially owing to its relatively low gaming tax. Gaming taxes in FY 2002 made up 6.2 percent of all tax collections and 5 percent of general-fund revenue (Mississippi Gaming Association 2002). In a recent effort to improve tax collections from out-of-state patrons, the state now automatically collects a 3 percent income tax on casino winnings, rather than relying upon winners to later file a return and pay the taxes owed.

Mississippi had a sizeable rainy day fund when recent fiscal pressures began. State law calls for a working cash stabilization reserve account funded by transfers from the general fund. The balance at the end of the fiscal year can equal up to 7.5 percent of the next year's general-fund appropriations. The state must transfer up to 50 percent of any excess cash balances from the general fund to the reserve account at the end of the fiscal year. Withdrawals from the fund cannot be built into the budget but are available in case of a shortfall, and are limited to $50 million per year if revenue is below estimate.

In 1999, Mississippi was the first state to establish a health care trust fund with money from the state's tobacco settlement. Annual revenues from the settlement are approximately $136 million (Mississippi Treasury Department 1999). For the first few years, state law set a fixed amount to be transferred from the health care trust fund to the health care expenditure fund, which is used to fund current expenses. In subsequent years the amount of the transfer was to be determined based on earnings from the trust fund. As discussed below, actions were taken that modified this when fiscal conditions worsened.

Political and Legal Context

Ronnie Musgrove, a Democrat, was elected governor in November 1999, and his term expires in January 2004. Musgrove is known for promoting teachers' pay raises, children's health, and economic growth. These emphases are directly reflected in the state's major spending initiatives.

The Mississippi legislature holds an abbreviated session (90 days) and has very limited staff. Democrats have an overwhelming majority in both the House and Senate, but partisan differences are small and party affiliation does not play a major role in voting.

Both the governor and legislature prepare budgets based on a revenue estimate provided by the Revenue Estimating Committee. Five entities are represented in the consensus revenue estimate process: the Treasurer, the Tax Commission, the University Research Center, the Joint Legislative Budget Committee, and the State Fiscal Officer (from the Department of Finance and Administration). The governor prepares his budget and submits it to the legislature. The legislature builds its own budget, using the governor's budget only as a guide. By statute, the legislature can only appropriate 98 percent of projected revenue.

During the fiscal year, the governor has discretionary and mandatory authority to manage the budget. If, in any month during the fiscal year from October on, revenues fall more than 2 percent short of projections for the fiscal year through the current month, the governor is required to adjust spending to stay within projected revenue. The governor has the authority to reduce any agency's budget up to 5 percent; however, the governor cannot cut any one agency by more than 5 percent until all agencies are cut by 5 percent.

The legislature routinely pushes for a more optimistic projection of revenue than does the governor. For example, the governor advocated reducing the revenue estimating committee's projection of FY 2002 revenue growth to 1 percent, while the legislature adopted an estimate of 3.7 percent (Ford 2001). Over-projection of revenue provides a time "bridge" for necessary budget cuts. However, in Mississippi the governor is responsible for cutting agencies when revenues fall below projections (Salter 2002). This division of responsibility is a source of great tension between the governor and the legislature. In FY 2002, Governor Musgrove vetoed the budget passed by the legislature, claiming that it was based upon overly optimistic revenue estimates. The legislature overrode his veto.

Fiscal Pressures and Policy Responses

FY 2001

Unlike in most other states, the first evidence of fiscal difficulties in Mississippi came from increased spending, not declining revenues. In July 2000, it became apparent that Medicaid appropriations were not sufficient to cover the rapidly expanding Medicaid rolls. Subsequently, it became clear that revenue growth was slowing as well. Mississippi relied heavily on reserve funds to balance the budget in response to the FY 2001 revenue shortfall. The governor has the authority to transfer $50 million from the working cash stabilization reserve account to the general fund and did so in 2001. The legislature authorized an additional transfer of $35 million. No significant changes were made to raise revenue. With the exception of corporate tax revenue, which fell by $17.4 million, all other major areas of revenue exhibited a year-over-increase. Total state revenues from all governmental sources increased by $471.9 million, or 5.4 percent, between FY 2000 and FY 2001. However, of the total increase, some $436.7 million was attributed to federal, earmarked funds (Mississippi Department of Finance and Administration 2000, 2001). But because state general fund year-over-increases were lower than expected, Mississippi reduced general-fund appropriations by $106.8 million and special funds appropriations by $12.3 million. When revenue fell below 98 percent of projections, it triggered the requirement that the governor make cuts. Governor Musgrove cut 3.8 percent across the board.

FY 2002

Early on, Governor Musgrove attempted to prepare Mississippi for poor FY 2002 revenue performance. On July 26, 2000, in response to falling FY 2001 revenues, the governor issued zero-increase budget instructions to executive agencies as they prepared their budget requests for FY 2002. In November 2001, the revenue estimating committee recommended an FY 2002 revenue growth rate of 3.7 percent. By March, Governor Musgrove was appealing for a more modest growth rate of 1 percent. However, the legislature passed the FY 2002 budget in April based on the 3.7 percent revenue growth rate, publicly acknowledging the possibility that revenue might not reach expectations, and reserving legislative authority to reduce the estimate if revenue did not grow as forecast (Ford 2001). Subsequently, the Joint Legislative Budget Committee adopted two downward revisions to the estimate, totaling $179.6 million for FY 2002.

Before FY 2002 had even begun, Governor Musgrove asked state agencies in May 2001 to allocate only 45 percent of their budget in the first six months of FY 2002, to soften the impact of future budget cuts. As expected, in October 2001 tax collections fell below estimates by $22.1 million, bringing the total FY 2002 shortfall to $66 million, more than the 2 percent threshold. By statute, the governor and state fiscal officer were required to cut agencies' appropriations. The governor reduced all agencies except education by 3.35 percent, saving the state $53.6 million.

January 2002 marked the seventh consecutive month of revenue shortfalls, and the total revenue shortfall rose to $158 million. Consequently, in February the governor reduced agency funding by a further $116.8 million, the fourth budget cut in two fiscal years. This time education received a substantial cut of $61.8 million. Ultimately most education funding was restored—$37.3 million by the legislature in April and $12.9 million by the governor in June.

Other agencies receiving cuts in February included public safety ($1.4 million), student financial aid ($1.3 million), the Supreme Court ($876,725), and the Mississippi Emergency Management Agency ($138,443). Medicaid received a $10.1 million reduction, increasing the FY 2002 Medicaid deficit to $158 million.

Medicaid's FY 2002 deficit was exacerbated by the increase of new Medicaid recipients, whose eligibility was discovered during the effort to increase enrollment to the SCHIP program, which had enrolled 55,002 participants as of February 2003. Total certified eligibles for Medicaid enrollment jumped from 560,000 in FY 2000 to 650,000 in FY 2001 and 709,000 in FY 2003. Medicaid's expenditures consequently increased by 25 percent in FY 2002, and were forecast to increase by over 22 percent in FY 2003. Another contributing factor in the FY 2002 shortfall was a decline in the Medicaid federal match rate, which dropped from 76.82 percent to 76.09 percent, representing a loss of $20 million.

The governor and the legislature debated Medicaid solutions for months, ultimately passing HB 1200, the Medicaid bailout bill, in March. Most of the Medicaid deficit ($108 million) was closed with funds from the tobacco settlement. Medicaid also received $29.5 million from the budget contingency fund (Mississippi House of Representatives 2002). The Medicaid bailout bill increased copayments and limited prescriptions to help control use. On the provider side, the bill cut reimbursements by 5 percent and cut drug prices from wholesale minus 10 percent to wholesale minus 12 percent. Pharmacist dispensing fees were reduced by $1. On the recipient side, the Medicaid bailout bill raised copayments on prescriptions from $1 to $3, reduced the number of prescriptions Medicaid patients are allowed from 10 to 7 (5 without prior approval), and increased the number of years between payments for new eyeglasses from three to five (Mississippi Office of the Governor 2002a).

Many other proposals were considered. The legislature considered imposing a $1 fee on doctors for every patient office visit to generate revenues that could be used to draw down federal Medicaid matching funds. However, after a strong effort from the doctors' lobby, the proposal was withdrawn. The governor and the legislature worked hard to avoid cuts in eligibility and benefits.

Governor Musgrove proposed accelerated business tax payments in FY 2002 to help cover the shortfall in Medicaid. While this proposal was well received, the legislature delayed acceleration of business tax payment to FY 2003 to give businesses time to adjust. The governor's proposal included monthly payments year round but the legislature only approved early tax payments for the month of June, allowing an extra month of revenue to be collected in FY 2003.

The Medicaid bailout bill also allowed Medicaid to pay the Department of Human Services (DHS) $4 million for contracted services. In the FY 2002 budget, general-fund appropriations to DHS were 14 percent lower than in FY 2001, a decrease of $11 million. This cut was made during the normal budget process, leaving DHS with an $8 million deficit. State Fiscal Officer Gary Anderson requested a transfer of $4 million in rainy day funding to the state's general fund to avoid deficit appropriation requests to the legislature for DHS.

There was substantial dispute within the state regarding the size of the DHS deficit. The state must meet federal maintenance-of-effort requirements in order to receive its TANF grant from the federal government. MOE is calculated on a federal fiscal year basis (October 1 through September 30), which does not match the Mississippi fiscal year (July 1 through June 30). When DHS delayed asking for additional funding to meet the federal fiscal year 2002 MOE requirement until the state's fiscal year 2003 (the first three months of which fall in federal fiscal year 2002), some accused the department of downplaying its budget problems.

In general, both the governor and the legislature tried to avoid spending reductions in growth areas such as K–12 education, DHS, Medicaid, and corrections. Mississippi's Department of Corrections has been a fast growing department and requested a deficit appropriation in FY 2002. The high federal match for Medicaid, and MOE requirements for TANF, helped shield those programs from cuts. The governor and legislature were more open to cuts where they could be made up with fees (for example, at state universities).

Ultimately, FY 2002 revenues came in $264.8 million short of projections, or 2.1 percent below those of FY 2001. Mississippi's main tourist attraction, its gaming industry, is less reliant on air transportation than that of other states. Therefore, Mississippi was largely protected against the dramatic tourism decreases experienced elsewhere after the terrorist attacks of September 11. Both sales and gaming tax revenues came in 2 percent over FY 2001 (Mississippi Department of Finance and Administration 2002). However, general-fund revenue came up short because of declining income tax revenue. Expenditure pressures exacerbated budget problems in FY 2002. Mississippi was committed to $72.5 million in additional teacher pay, $26.6 million in state employee salary raises and insurance compensation, and

$10.3 million in pay increases for university and community college faculty and staff (Salter 2002).

Of the total $264.8 million FY 2002 shortfall, $72 million was covered by the 2 percent of funds that was not appropriated. In FY 2002, Mississippi again transferred $50 million from the working cash stabilization fund to the general fund. As mentioned above, Mississippi further transferred $108 million from the tobacco settlement fund. The remainder of the revenue shortfall was balanced by agency reductions.

FY 2003

The FY 2003 budget assumed 3.8 percent revenue growth, down from the original estimate of 4.3 percent. The governor advocated a more modest growth rate of 2.65 percent. No tax increases were enacted for FY 2003. To cover program shortfalls, Mississippi again relied on short-term measures to balance the budget. The legislature enacted House Bill 1379, requiring businesses to submit their tax payments one month early (June 2003 instead of July 2003). To cover Medicaid's rising costs, the legislature appropriated $131.9 million from the health care expendable fund, $104 million of which will be used as matching funds (Mississippi House of Representatives 2002).

On the expenditure side, Mississippi continued to cut agency budgets across the board. In the past, the budget included funding for 50 percent of an agency's vacancies. Now, only 25 percent are funded and any position vacant for more than 60 days is eliminated. Agency directors cut travel, equipment, and contractual services as needed. Layoffs, a large concern of the legislature and the governor with an election approaching in 2003, were avoided.

DHS woes continued in FY 2003 with a 6 percent cut in the normal budget process. As discussed above, DHS requested part of the MOE needed for FFY 2002 in the FY 2003 budget. The legislature believes the state can satisfy the MOE requirements by counting additional types of expenditures, such as educational assistance to TANF recipients. Separate from the need to meet MOE requirements, DHS faces a $19.8 million shortfall to meet its existing financial obligations. Over the past two years, DHS has endured a 21 percent reduction in general-fund appropriations. While TANF, food stamps, and child welfare caseloads rose, agency staffing declined. DHS believes any additional cuts will result in decreased services. Indeed, in February 2003 DHS received $1.1 million to hire more social workers in areas where caseloads are greater than 100 per person (Sawyer 2003b).

The state faced shortfalls in Medicaid again in FY 2003. The legislature appropriated $246.8 million for FY 2003, including $131.9 million from the health are expendable fund. The governor vetoed the Medicaid appropriation bill, protesting that the appropriation was insufficient, but the legislature overrode his veto. As of the end of January the Medicaid deficit was reported to be $53 million, down from the original estimate of $75 million (Goodman 2003b).

Though K–12 education has been able to maintain constant funding and see across-the-board teacher pay raises, higher education has been cut a total of $98 million (16 percent) since FY 2000. Universities have repeatedly raised tuition to keep up with expenses (Kinspel 2002).

There is some sentiment that prisons are taking too much of the state's discretionary money. With an increasing prison population under federal court orders on space and conditions, Mississippi took the initiative to expand state prison facilities. Though the prison population has topped out, Mississippi has already built facilities. Some claim there is pressure to fund "phantom" prisoners for the regional institutions that do not need them but want to keep the jobs, resulting in the state subsidizing local facility operations with state assistance and funds.

In June 2002, Governor Musgrove, as he had done the previous year, issued a 5 percent withhold to alleviate the harshness of a potential 5 percent budget cut. Agencies could spend 45 percent of their annual budget for the first six months. Indeed, FY 2003 saw three major rounds of budget cuts. Despite revenue collections in September 2002 being 2.9 percent higher than estimates, total FY 2003 revenue at the end of October 2002 fell $35.5 million below projections, triggering the governor to make budget reductions. Governor Musgrove cut spending by $11 million across all state agencies except for education. In December the revenue shortfall grew to $57 million, prompting Governor Musgrove to cut another $11 million from all agencies except education (Sawyer 2003e). Through April, revenue lingered $125 million less than projections (Sawyer 2003d). Poor income tax revenue is viewed as the main culprit of the revenue shortfall. In February, Governor Musgrove issued yet another round of budget cuts totaling $33 million, from all agencies except education. Further, the governor transferred $16 million from the working cash stabilization fund to the general fund to help bridge the revenue shortfall. Mississippi is left with a reserve balance of $101 million (Mississippi Office of the Governor 2003a). In March, Mississippi refinanced state bonds for an estimated state savings of $12.3 million in FY 2003 and FY 2004 (Mississippi Office of the Governor 2003b).

Budget Outlook

The Joint Legislative Budget Committee constructed the FY 2004 budget on an estimate of 3 percent revenue growth, bringing the total budget to $3.6 billion. Governor Musgrove's revenue estimate places the growth rate at 2 percent. Because of the poor FY 2003 revenue performance, lawmakers began to seriously consider ways to increase state revenue. The legislature debated a 50 cent per pack cigarette tax increase. The tax increase would raise the price of cigarettes in Mississippi up to the national average, increase revenue by an estimated $73.1 million, and decrease future health care costs by $1.6 million. However, the proposal did not receive the necessary three-fifths support in the legislature or support from the governor.

Mississippi also considered legalizing video poker. The measure would have raised state revenue by an estimated $68 million, with 40 percent of the revenue increase earmarked for Medicaid. The measure eventually died in committee. Ultimately, Mississippi enacted no new tax initiatives in FY 2004 and both Musgrove and his Republican opponent maintain that no tax increases will be necessary in 2005.

Major spending considerations for FY 2004 included teacher salary increases, health insurance premium increases, and debt service. However, the state used a number of nonrecurring revenue sources in FY 2003 that were unavailable in FY 2004. Indeed, during construction of the budget in January, lawmakers found themselves $400 million short. By March, legislators were still in need of $170 million. One of the first bills to pass the 2003 session, at Governor Musgrove's suggestion, added $260 million to K–12, college, and university funding as a priority. The bill covered $92 million for teacher pay raises and restored $18 million to higher education funding. By this act, Mississippi used all discretionary funds to increase education spending from 57.8 percent to 62 percent of the budget.

In the absence of tax increases and nonrecurring FY 2003 revenue sources, Mississippi used most of its remaining reserves, $77 million, to balance the FY 2004 budget. Governor Musgrove vetoed a bill suspending the 98 percent appropriations limit for one year, which would translated into an extra $71 million in FY 2004 revenue that could be appropriated. After the legislature sustained his veto, the governor agreed to a compromise. For FY 2004 only, the state will spend the 2 percent of revenue that is usually set aside. Borrowed funds from other state agency accounts, however, will be used to put $50 million back into the rainy day fund (Goodman 2003a).

The $3.6 billion budget fully funds education, but most other state agencies expect shortfalls. Medicaid's deficit is estimated at $91 million, $13 million higher than the Department of Medicaid anticipated. Because of Mississippi's high federal match rate, in a worst-case scenario Medicaid could be $400 million in deficit. The DHS shortfall is estimated to be between $10 and $20 million. The Department of Corrections commissioner expects the FY 2004 shortfall to be $60 million, which is partially a result of receiving $25 million less than last year (Sawyer 2003a). The budget also takes $50 million from the Department of Transportation that will not be paid back.

The FY 2004 budget leaves many unresolved issues. Currently Medicaid has been instructed to spend at current service levels despite its large deficit. Most other departments, with the notable exception of education, are also in need of more money in FY 2004. The next legislature, elected this year, will be forced to come up with creative solutions to balance the budget (Snowden 2003).

As part of President Bush's tax cut legislation, passed in May, Mississippi will receive $69.8 million this federal fiscal year and $140.9 million next federal fiscal year. The state plans to spend these federal funds on special education and Medicaid (Sawyer 2003c).

Conclusions

FY 2003 marked the third year in a row of not meeting budget expectations in Mississippi. The longevity of the revenue slump has been unexpected. On the expenditure side, all agencies endured cuts of up to 5 percent in FY 2002 and FY 2003. Mississippi's federal Medicaid matching rate, over 76 percent, is the highest in the country. However, not even this could protect all Medicaid services in the face of such prolonged fiscal troubles.

Mississippi has relied heavily on drawing down reserves to avoid budget cuts. To help close budget shortfalls, Governor Musgrove used $50 million from the working cash stabilization fund in FY 2001, another $50 million in FY 2002, and $16 million in FY 2003. The state has also used tobacco settlement money to help fund Medicaid shortfalls. In general, Mississippi has tried to avoid drastically cutting any particular service and has spread budget cuts across the board.

Mississippi's budget has been continuously strained for such a prolonged stretch that it is impossible to shield any program from budget cuts. Within programs, strong lobbies (such as educators, doctors, and prison guards) have managed to avert some cuts. But money is tight everywhere. In fact, among agencies, department heads seem to be asking for less money than needed in order to appear to be good financial managers.

Compared with many states, Mississippi operates at a very low level of service. After three years of budget decreases, agencies have nothing "optional" left to cut. In Medicaid, shortfall closure strategies affected both providers and recipients. So far, DHS cuts have been felt primarily through decreased personnel.

The extremely generous federal match rate does seem to play a role in protecting Medicaid services. Governor Musgrove, the legislature, and Medicaid Director Rica Lewis-Payton have worked hard to minimize health care cuts in both the midyear and the annual budget processes and to maximize the federal dollars Mississippi receives. In TANF, Mississippi sees MOE requirements as the upper limit of welfare spending as well as the lower bound. The DHS is understaffed and underfunded.

The two most important factors in Mississippi's ability to respond to fiscal stress have been the state's substantial buildup of reserves and the 98 percent appropriations limit. In FY 2001, $85 million from the working cash stabilization fund alone was used to compensate for revenue shortfall. In FY 2002, 27 percent of the revenue shortfall was handled without cuts because appropriations were limited to 98 percent of revenues. The working cash stabilization fund covered 19 percent, while the state's tobacco money made up for 41 percent of the FY 2002 revenue shortfall. Likewise, in FY 2003 the appropriations limit saved Mississippi from millions of dollars worth of difficult decisions, and both rainy day and tobacco reserve money ensured that agencies did not receive extreme budget cuts.

Mississippi's FY 2001–03 budget problems have intensified a "political blame game" between the governor and legislature (Salter 2002). The legislature has strong incentives to pass budgets based upon unrealistic revenue estimates, ignoring the governor's pleas and vetoes, knowing that the governor is required by statute to implement cuts that yield a balanced budget in the end. As a result, the publicly adopted budget is not an accurate portrayal of what the state's spending will be for the year. Meanwhile, since the governor has complete discretion in how to make cuts so long as they fall within the statutory formula, the budget cutting process occurs without public oversight and without buy-in from the legislature. The governor publicly complains about the legislature's reluctance to use "real numbers," while the legislature claims that it is avoiding potentially unnecessary budget cuts. This back and forth between the governor and the legislature makes it even harder to address Mississippi's already severe budget problems.

New Jersey

During the national economic boom of the mid- to late nineties, New Jersey was particularly fortunate. It enjoyed strong job and income growth and a low unemployment rate. New Jersey's per capita income was among the highest of any state (Whitman 2000b). New Jersey's tax revenues also exceeded expectations despite 43 tax cuts between 1994 and 2002, including three broad income tax rate cuts in 1994, 1995, and 1996. At the same time taxes were being cut, spending increased rapidly. Because the tax revenue increases were probably unsustainable, some analysts believed that New Jersey's fiscal balance was precarious (Cambria 2001).

Shortly after releasing her proposed FY 2002 budget in January 2001, the state's Republican governor, Christine Todd Whitman, left office to head the Environmental Protection Agency (EPA) in the newly constituted administration of President Bush. Whitman's proposed FY 2002 budget described New Jersey's economic and fiscal conditions as strong, recommended a 6.5 percent increase in spending, and projected the highest state budget surplus in history.

Under the New Jersey constitution, Senate President Donald DiFrancesco (R) became acting governor when Whitman left. DiFrancesco concurrently retained his position as Senate majority leader. In the November 2001 election, the Democratic candidate, James McGreevey, was elected. Governor McGreevey assumed office in January 2002 and released his proposed FY 2003 budget in April 2002.

McGreevey's budget plan was designed to deal with what it described as "the worst fiscal crisis" in New Jersey history—a budget shortfall of $5.3 billion. The proposed budget's suggested remedy for the shortfall included a combination of $2.9 billion in additional revenues and $2.4 billion in spending constraints (McGreevey 2002b).

Political and Legal Context

The governor, New Jersey's only statewide elected official, is constitutionally responsible for certifying revenues, and therefore has primary responsibility for fiscal discipline. The New Jersey legislature is much less powerful than the governor on fiscal issues. Regardless of which party controls the legislature, the governor's budget proposal is usually approved with little change

The Office of Legislative Services (OLS) produces independent revenue estimates for the legislature. However, this office does not have direct access to individual tax returns and must defer to its executive branch counterpart, the Office of Management and Budget (OMB), on some questions. Both agencies tend to be relatively free of partisan influence and their leadership often continues in office even when a new political party takes power. Ultimately the legislative and executive staffs usually concur on revenue forecasts. The OLS advises the legislature during the budget debate but the legislature generally defers to the governor.

New Jersey revenue estimates are officially updated every 6 months. It is difficult to make mid-year corrections in expenditures when revenues fall because most spending is allocated prior to December. Most revenues come in during the second half of the fiscal year. By the time a discrepancy is identified, freezing spending usually will not produce significant savings.

New Jersey has several legal provisions that dedicate revenue to specific purposes. In particular, a constitutional provision requires that all income tax revenues be deposited in the property tax relief fund. These revenues may only be expended for grants-in-aid or state aid. While this can seriously limit state budgetary flexibility, in recent years it has not been a binding constraint because total expenditures for grants-in-aid and state aid exceeded income tax revenue. New Jersey has spent money where it perceived the most need.

New Jersey, the nation's ninth most populous state, had state expenditures of about $34 billion in FY 2002, of which about $8 billion came from federal funds. Approximately 23 percent of the state budget goes for elementary and secondary education, primarily aid to local school districts. Another 22 percent of the budget goes for the state's very generous Medicaid program. No other budget category constitutes more than 8 percent of spending (NASBO 2002c).

New Jersey has a pervasive culture of local "home rule" and provides significant support to local governments with a relatively small share of the state budget directly administered by state employees. Direct state services make up only about 21 percent of state own-source spending while state aid and grants-in-aid to lower-level governments account for 70 percent of state own-source spending (DiFrancesco 2001).

New Jersey has diversified revenue sources with about $7.9 billion in income tax revenues and $5.7 billion in sales tax revenues in FY 2001. The state's biggest business tax, the Corporation Business Tax (CBT), has become a less important source of revenue in recent years but still provided almost $1.4 billion of revenues in FY 2001 (McGreevey 2002b).

Before 2001 the state's most recent period of fiscal stress was the recession of the early 1990s. Then-Governor James Florio (D) responded to this problem by calling for significant increases in the state income and sales taxes (1990). The tax increases were approved by the state's legislature, which was controlled by Democrats. The Democratic party paid a high political price for this solution. The Republicans captured the legislature shortly thereafter, at which point the sales tax increase was quickly reversed, and then Christine Todd Whitman (R) won the governorship in 1993. Unlike her predecessor, Governor Whitman strongly advocated tax cuts. With the aid of a cooperative legislature and a strong economy Whitman oversaw three successive cuts in income tax rates. Cuts in several other taxes were also phased in during the Whitman administration.

During the mid- to late nineties New Jersey benefited from the national economic boom and experienced extraordinary increases in income tax revenues from both wages and capital gains. During this period the state consistently found that April revenues exceeded those certified the previous June (the so-called "April surprise”). Between 1997 and 2001, revenues grew $2.9 billion, an average of $725 million per year (Cambria 2001). State agencies and legislators became accustomed to having extra resources toward year-end and began planning for such eventualities. In this environment it was relatively easy to develop a political consensus for increased spending and tax cuts.

Particularly important recent spending initiatives in New Jersey include increased aid to low-income schools and state-supported health insurance for low-income families. Aid to low-income schools is court-ordered to help equalize resources between “property-rich” areas and areas with fewer resources, commonly referred to as “Abbott” districts. Some post-1996 increases in funding for this program are counted toward the state’s maintenance-of-effort (MOE) for TANF.

New Jersey’s health insurance program for low-income families, FamilyCare, is an extension of the state’s SCHIP program. Originally, program administrators felt that it would take three years to reach 120,000 enrollees because of low take-up rates in the past for insurance programs. But after unprecedented response to the program, enrollment was capped at 185,000 in June 2002.

Several significant tax cuts were also approved. At Governor Whitman’s urging the NJ Saver program was implemented in FY 1999 (to rebate 1998 school property taxes). This very popular form of direct property tax relief was designed to be phased in over a 5-year period. A freeze in property taxes for qualified senior and disabled citizens was also approved in FY 2000 (Whitman 1998). In addition, an increase in the property tax deduction for veterans (from $50 to $250 per household) was phased in over a four-year period beginning in 1999. Finally, New Jersey adopted an earned income tax credit (EITC) modeled on the federal program that is scheduled to phase in between 2001 and 2004.

While these spending increases and tax cuts appeared affordable in the late 1990s, some state officials charged with the responsibility of monitoring revenue were concerned that they were not sustainable in the long term. These analysts noted that households at the top of the income distribution were responsible for much of the increased income tax revenue. By 1997, the 11 percent of taxpayers with incomes over $100,000 paid 70 percent of all state income taxes (New Jersey Office of Legislative Services 2000). Any change in the economic fortunes of this group of households could suddenly and dramatically alter New Jersey’s fiscal condition.

Fiscal Pressures and Policy Responses

Beginning in 1998, OMB estimators warned the governor that New Jersey revenues were very fragile. Because much of the growth in state income tax revenues came from growth in stock options and bonuses and capital gains, any decline in the stock market could have large implications for New Jersey revenues. New Jersey’s revenue estimators predicted that when people believed that the stock market was going to take a downturn, they would exercise stock options, which receive the same tax treatment as wages. This would result in a large one-time increase in income tax revenue. At the same time, it would portend a decline in future revenues. OLS and OMB agreed on this prediction, and warnings were again issued in 1999 to the governor and legislature. These warnings were largely ignored. Warnings became stronger over time, though it was impossible to predict exactly how large a crash would be and when it would occur.

By July 2001, there was some evidence that revenues would fall soon, but significant uncertainty remained. The terrorist attacks of September 11, 2001, extinguished any hope that significant revenue declines could be avoided.

In January 2001, Governor Whitman certified FY 2002 revenues of $22,874 million. By April 2001, OLS was predicting revenues of only $22,038 million, $836 million below the executive estimates (New Jersey Office of Legislative Services 2001a). To take into account the decline in wages and the softening stock market, OMB brought its estimates down somewhat, but, as it would turn out, not nearly enough. Political factors played a role in this technical decision. A sitting governor was leaving office and bound for a nationally prominent post. The evidence for predicting near-term revenues was quite shaky so it was difficult for OMB to present a strong case that a particular estimate was correct. By May 2001, OLS issued revised estimates that were $1.18 billion below the original FY 2002 estimates certified by the governor. At that time, they also warned the legislature that these estimates were optimistic and could go down even further (New Jersey Office of Legislative Services 2001b).

FY 2001

In FY 2001 New Jersey's income tax, sales tax, and CBT accounted for 72.2 percent of receipts, up slightly from FY 2000 when they accounted for 71.2 percent. As shown in table 2, revenues from the income and sales taxes increased from FY 2000 to FY 2001 while corporate business tax revenue declined slightly (Whitman 2001a).

No mid-year corrective measures were taken in FY 2001, because New Jersey did not have a budget deficit at this point. However, by the end of FY 2001, it became apparent that it would be difficult to balance the FY 2002 budget. New Jersey ended FY 2001 with a surplus of $1.3 billion. This surplus included $720 million which constituted the surplus revenue (or rainy day) fund (Whitman 2001a).

FY 2002

When Governor Whitman presented her FY 2002 budget in January, she touted it as a responsible budget that would be beneficial to the long-term fiscal condition of New Jersey:

Table 2. New Jersey Revenue Changes, FY 2000–01

	FY 2000 ($ millions)	FY 2001 ($ millions)	Percent change
Gross income tax	7,205.3	7,989.2	10.9
Sales tax	5,508.1	5,758.7	4.5
Corporation business tax	1,452.1	1,389.5	–4.3
Total (includes other taxes and fees)	**19,897.2**	**20,960.9**	**5.3**

Sources: Whitman (2000a) (FY 2000 data) and DiFrancesco (2001) (FY 2001 data).

> The fiscal 2002 Budget continues on the trend of the last eight years to improve upon the fiscal condition of the State. Over the last seven years, the rate of growth in the State's annual budgets has been held to an average of 5.1 percent. This Budget contains only $33 million in one-time budget solutions, compared to the fiscal 1994 Budget which was balanced with $1.5 billion of one-shot appropriations. The structural deficit has been greatly reduced by restraining budget growth. Overall budget growth over the eight years is the lowest since the first half of the 1950s. Our prudent management of the State's finances has been recognized by objective outside evaluators, such as the major rating agencies: our bond rating has been upgraded four times since 1994. (Whitman 2001b)

Compared with FY 2001, Whitman proposed increases in nearly all parts of the budget. Direct state services (DSS) increased by $126 million, equal to the inflation rate of 2.8 percent.[11] State aid and grants-in-aid enjoyed larger increases of 8 and 9 percent, respectively (Whitman 2001a). While some individual programs saw modest net decreases overall spending was scheduled to increase.

While Whitman's proposed budget was balanced it could not be implemented because revenues were far below predicted levels. In February 2001, it became clear that the FY 2002 revenue projection for income tax was $1 to $2 billion too high and that actual sales tax revenues would also be significantly below predictions. Ultimately official revenue estimates were lowered by about $900 million. In the May 2001 revisions of the budget, the OLS issued a report warning that revenues would be $1.6 billion less than projected in January. Most of this decline was attributed to a projected 25 percent decline in income tax revenue from capital gains. OLS noted that even the revised estimates might be too optimistic (New Jersey Office of Legislative Services 2001b). Final estimates were not released until June 15, 2001, even though the legislature had to finalize the budget by the start of the new fiscal year on July 1, 2001. Ultimately, newly elected Governor McGreevey faced a current-year operating deficit of nearly $3 billion (13 percent of original FY 2002 appropriations) by the time he took office in mid-January 2002 (McGreevey 2002b).

Mid-Year Shortfalls

FY 2002 is the first year in recent history that New Jersey experienced a year-over-year revenue decline, though it is not expected to be the last. In December 2001, shortly after McGreevey was elected, he announced there was a $2 billion shortfall for FY 2002. Even before taking office he requested that all unspent funds be frozen. However, legislators were unwilling to accept this edict. Nonetheless, by the end of February 2002, the budget was brought into balance.

The major factor contributing to the budget shortfall was the decline in income tax revenues. Table 3 shows the three major taxes and the declines in revenue projections from January 2001 to May 2002. In December 2001, $118.2 million was expected to be generated from miscellaneous taxes, fees, and revenues, primarily the transitional energy facilities assessments (McGreevey 2002a).

Table 3. New Jersey Revenue Projections, FY 2002 ($ billions)

	January 2001	June 2001	December 2001	May 2002
Income tax	8.9	8.6	7.3	6.7
Sales tax	6.2	6.2	6.0	5.9
Corporate business tax	1.5	1.7	1.1	0.9

Sources: DiFrancesco (2001) (January 2001 projections); McGreevey (2002b) (June 2001 and December 2001 projections); and New Jersey Office of Legislative Services (2002b) (May 2002 projections).

Expenditure Pressures

New Jersey's expenditure pressure has been exacerbated because many permanent programs have been phased in, or paid for with temporary revenues. Examples include the phase-in of the EITC and the NJ Saver programs discussed above.

New Jersey has been able to control spending growth in most programs. In particular, New Jersey faced less pressure from increasing Medicaid costs than many other states. The state controlled the rising cost of its FamilyCare program by capping enrollment in FY 2002.

Although many New Jersey citizens were directly affected by the terrorist attacks on the World Trade Center, most analysts believe the budgetary impact has thus far been negligible. Social service agencies in New Jersey provided a tremendous response during the initial days after September 11, but the federal government reimbursed New Jersey for much of the cost. The Department of Human Services continues to be concerned about some longer-term impacts including the need for additional mental health services for both individuals and organizations.

Response

To close the FY 2002 shortfall, unspent funds were swept from accounts with balances and shifted to accounts with shortfalls. For the most part, the response was largely short-term and allowed Governor McGreevey to avoid large scale changes. Notably, two longer-term solutions were implemented beginning in FY 2003, an increase in the corporation business tax and an increase in the cigarette tax.

Short-Term Measures

To close its budget deficit, New Jersey relied heavily on drawing down reserves and trust funds (table 4). In FY 2002, the $720 million rainy day fund was completely depleted. In addition, New Jersey's tax amnesty program ultimately brought in $270 million in revenues, almost double what was initially anticipated. In addition to the measures listed in table 4, a $325 million surplus in the payroll tax fund was essentially diverted to a health care fund.

Governor McGreevey froze all unspent funds as soon as he took office. All discretionary funds (equipment, travel, discretionary grants-in-aids) were diverted and a hiring freeze was put in place. In addition, most departments faced a 5 percent across-the-board cut to their administrative functions.

Table 4. New Jersey Supplemental Revenue Used to Close the Budget Shortfall, FY 2002 ($ millions)

Revenue item	Amount
Tax amnesty program	150.0
Extension of transitional energy facility assessment	99.0
New Jersey Redevelopment Authority	18.5
New Jersey Health Care Facilities Financing Authority	16.5
Other resources and fund balances (unspecified sources)	38.0
State disability benefit fund	50.0
University of Medicine and Dentistry of New Jersey Self-Insurance Reserve Fund	25.0
New Jersey Insurance Development Fund	46.0
Tobacco settlement fund, NJ insolvent HMO assistance	8.9
Medical malpractice reinsurance recovery fund	11.1
Total	**$463.0**

Source: New Jersey Office of Legislative Services (2002b).

Spending Changes

Late in calendar year 2001, New Jersey deferred a Medicaid physician fee increase. As is typical in most years, the rollout of some programs was delayed by unforeseen administrative or technical difficulties. In FY 2002 the expenditure reductions resulting from these delayed rollouts reverted to a central budgeting authority and were used to fill gaps elsewhere in the budget. Most programs receive money (and spend it) at the beginning of the fiscal year. Higher education is one of the few state programs that receives its allocation monthly, thus making it available for mid-year budget cuts. As a result, higher education endured a 5 percent mid-year reduction. Medicaid and school aid also spend money monthly, but it is politically unpalatable to cut these programs once funding has been approved. Unlike most states, New Jersey overestimated Medicaid caseloads and rates. Because of this, there was a surplus, which was used to prevent cuts in human services expenditures.

Revenue Changes

New Jersey implemented transit fee increases during FY 2002. Lawmakers also securitized half of New Jersey's tobacco settlement, which accounted for an additional $1.0 billion in revenues. Initially, the tobacco money was to be used in FY 2003, but $700 million in tobacco funds were used to shore up the FY 2002 budget. New Jersey shifted neither expenditures nor revenues across fiscal years.

FY 2003

At the start of FY 2003, Governor McGreevey anticipated the largest budget shortfall in New Jersey history—$5.3 billion, or 22 percent of the total projected FY 2003 budget. The governor's proposal divided the budget closing measures roughly equally between spending reductions ($2.4 billion) and revenue increases ($2.9 billion).

Spending Changes

State spending on education (primary and secondary) was held to FY 2002 levels. The 5 percent across-the-board cuts that were enacted as part of the FY 2002 were maintained in FY 2003. The phase-in of the New Jersey Saver program was delayed for one year for people with incomes below $200,000, and people with incomes over $200,000 no longer received the benefit. New Jersey anticipated decreasing the state workforce somewhat in FY 2003. The most significant cost saving measure was to freeze aid to local schools districts. This probably cannot be sustained in FY 2004 because of the burden it imposes on local school districts, according to our interviews.

Revenue Changes

New Jersey was more proactive than most states in finding new sources of revenue. Beyond the tax amnesty programs for both businesses and individuals, New Jersey postponed the phaseout of the transitional energy facility assessment, a tax imposed on utility companies in anticipation of decreased taxes from deregulation. There was little political opposition to this because the tax is spread across a very large base (all people who pay for energy).

New Jersey's most significant revenue change was the overhaul of the corporate business tax (CBT). Prior to reform the minimum assessment amount was $200. Throughout the 1990s, companies gained expertise in exploiting loopholes in the CBT, leaving many large companies paying the minimum amount, which was less than the tax paid by many low-income households. In reforming the CBT, a new alternative minimum assessment (AMA) was put in place, and many loopholes were closed. The average assessment under the reformed CBT with several loophole closures in place was $2,000. This tax reform was expected to increase CBT revenues from $820 million to $1.85 billion (New Jersey Office of Legislative Services 2002).

While such a significant tax reform would normally be extremely controversial, the McGreevey administration was able to make the change more palatable by reminding legislators and constituents that revenues from the CBT had declined quite dramatically in recent years despite rapid increases in the profits of New Jersey corporations. Perhaps even more compelling was the argument that the tax reform simply closed loopholes in the existing tax, which corporations had become increasingly adept at exploiting. As evidence for this, the McGreevey administration could point to Governor Whitman's predicted FY 2002 CBT revenues of $1.6 billion (Whitman 2001b). Thus, the Democrats could argue that the tax reforms did not impose an unreasonable burden on business, but were simply a more efficient way of collecting revenues that Republicans had already agreed were due. New Jersey was one of only six states to implement a tax increase worth more than 3 percent of total revenues in FY 2002 (N. Johnson 2002b).

Cigarette taxes were increased from $0.80 to $1.50 per pack. Initially, Governor McGreevey proposed increasing the cigarette tax to $1.30 per pack but this amount was later deemed insufficient. The new tax rate matches New York City's. NJ Transit had fee increases, as did several other programs (see table 5). Two proposals were considered but not enacted: imposing a sales and use tax on complimentary rooms and meals and repealing the recently enacted tax reduction for cigars and tobacco products.

Table 5. New Jersey Executive Proposals for New Revenue, FY 2003 ($ millions)

Revenue item	Amount
Business tax changes	1,003.0
Tobacco settlement securitization	1,075.0
Cigarette tax rate increase	200.0
License and registration fees increases (cars, trucks, tractors, boats)	24.3
Eliminating discount purchase of drivers' abstracts (insurance and credit companies)	27.0
Department of Environmental Protection fee increases	18.0
Various other fee increases	5.6
Changes to estate tax to uncouple from federal estate tax credit	72.0
Abrogating reciprocal income tax agreement with Pennsylvania	37.5
Imposing sales and use tax on complimentary rooms and meals	33.0
Repeal of recently enacted tax reduction for cigars and tobacco products	7.0
Total	**$2,502.4**

Source: New Jersey Office of Legislative Services (2002b).

Finally, the state decoupled its estate tax from the federal estate tax so as not to be affected by the Economic Growth and Tax Relief Reconciliation Act of 2001. This avoided a tax revenue decline of $699 million for New Jersey between 2003 and 2007 (New Jersey Policy Perspectives 2003). Despite these changes, nearly $478 million of federal funds continued to be at risk when the FY 2003 budget was passed, because New Jersey's application for a prescription drug waiver had not yet received federal approval.[12]

Recent estimates indicate New Jersey will need to deal with a $1.3 billion budget gap in FY 2003 before balancing the FY 2004 budget. Major actions taken to close the FY 2003 gap include using $413 million in remaining funds from tobacco securitization; delaying payments totaling $361 million for primary, secondary, and higher education; underspending $134 million in several budgeted programs; refinancing debt to save $68 million; and using balances of $137 million from available funds. In addition, $166 million more in revenue was collected in the tax amnesty program than had been anticipated in the initial FY 2003 budget.

Budget Outlook

The revenue situation continues to worsen for New Jersey. OMB anticipates lower year-over-year revenues again in FY 2004. Though the option of further tobacco securitization was foreclosed through the end of June 2003 by commitments the state made in prior years, substantial sales are anticipated in FY 2004.

Predicted receipts for FY 2004 are currently $22 billion (compared with $23.4 billion in FY 2003) (McGreevey 2003). Assuming only maintenance-level spending, New Jersey estimates annual expenses of $27 billion in FY 2004—a

$5 billion budget gap. To close the gap, Governor McGreevey proposed a budget that included both spending cuts and tax increases. In his initial proposal, McGreevey ruled out raising the three major taxes—personal income, sales, and the corporation business tax. Ultimately, these taxes were not increased, though estimates from the corporation business tax increased by $50 million after the initial budget was created (Jackson, Dyer, and Gohlke 2003).

On the spending side, Governor McGreevey proposed to further restrict the NJ Saver program to disallow the rebate for households with income above $100,000. (In FY 2003, the rebate was restricted to households with incomes above $200,000.) The final budget kept the earlier, more generous, restrictions in place—but reduced the average credit from $500 to $250. Higher education faced a cut of $100 million—but eventually lost about half that (Delli Santi 2003). Many state agencies faced cuts in their administrative functions, but no direct cuts were levied. Instead, attrition and increased realization of operating efficiencies allowed the overall size of New Jersey government to shrink.

To increase revenues, Governor McGreevey proposed securitizing an additional $1.3 billion from the tobacco settlement and increasing the per-pack cigarette tax by 40 cents. In addition, hotel tax increases are proposed. All of these measures passed with larger increases than what were initially proposed. New Jersey securitized $1.5 billion from the tobacco settlement, increased the cigarette tax by 55 cents per pack, and increased hotel taxes and other fees.

Conclusions

Prior to FY 2004, New Jersey relied heavily on "fund raids" and other one-time savings and revenue measures, including securitization of one-half of the state's share of the tobacco settlement fund, to close budget gaps. New Jersey has few remaining one-time solutions. New Jersey's one longer-term strategy has been to revamp the corporation business tax, but even this measure is a temporary one that will be revisited in the coming years. New Jersey has not relied on accounting gimmicks and is unlikely to do so because of a strong feeling that the state's present accounting system is well respected by outsiders and enhances its bond ratings.

Thus far, New Jersey's biggest expenditure reductions have been higher education, FamilyCare, and aid to school districts. The cuts to FamilyCare would likely have happened even if the budget were not under such stress because enrollment was much higher than initially budgeted. Higher education became a victim of the budget ax because of the timing of its funding. Aid to school districts is a very large expenditure item that was frozen rather than explicitly cut.

As part of the $20 billion federal bailout, New Jersey expects to receive $561 million. Because many lawmakers expect that New Jersey will receive less federal aid than they budgeted from a prescription drug waiver and Medicaid funds for nursing homes, the new money will likely be held in reserves and used to cover shortfalls in these two programs. New Jersey lawmakers anticipate a downward revision to revenue estimates, supplying one more reason to save the money from the federal bailout (Donohue 2003).

Washington

Washington's state constitution declares that it is the "paramount duty of the state to make ample provision for the education of all children residing within its borders." The state supreme court has ruled that this provision requires the state to fund basic education. Because basic education receives such steadfast protection, other parts of Washington's budget necessarily become vulnerable when budget pressures arise, unless revenues can be increased.

Current pressure on the budget stems from rising health care costs and decreased revenues. Costs are increasing for Medicaid, the state-funded Basic Health Plan (BHP), and state employee health benefits. Decreased revenues are a product of the general economic slowdown, the impact of September 11 on Boeing (a long-time important employer in the state), and the sudden high-tech collapse. The state's response to these pressures has been to draw on reserves, securitize a portion of its tobacco settlement revenue, and make select budget cuts. Washington does not have an income tax; other broad-based taxes have not been increased, though the state will raise some revenue through increased enforcement of current tax laws, new taxes on certain out-of-state purchases, and participation in a multistate lottery.

Political and Legal Context

Washington experienced steady revenue growth throughout the late 1990s as the economy enjoyed a sustained period of expansion (table 6). Because Washington does not have a personal income tax, this revenue growth was relatively tempered. The state did not see the radical revenue influxes from the taxation of higher incomes and capital gains that states with personal income taxes saw. From 1991 to 2001, personal income increased 54 percent, while revenues increased 43 percent.

Policymaking in Washington frequently occurs through direct initiatives by the voters. In 1993, voters responded to tax increases by passing Initiative 601 (I-601), which limits expenditure growth to a level determined by increases in population and cost of living (McIntire 1996). This initiative has been credited with keeping Washington from dramatically expanding spending programs, a fact that may have aided the state in weathering this recession. On the flip side, it leaves Washington in a difficult position if caseloads grow at a rate greater than inflation and population or if program changes result in increased resource needs. Any tax increase that would bring in revenue above the I-601 limit requires approval by two-thirds of the legislature and a majority of the voters.

As a result of I-601, new spending initiatives have been modest. Recent voter initiatives have resulted in further increasing education spending above the constitutional guarantee of funding for basic education. These measures have increased spending and earmarked property tax revenues, 75 percent of excess reserves, and a

Table 6. Washington General Fund–State Collection

Biennium	Current dollars (millions)	Percent change from prior biennium	1996 dollars (millions)	Percent change from prior biennium
1991–93	14,862.2	11.7	16,237.3	4.3
1993–95	16,564.6	11.5	17,296.8	6.5
1995–97	17,637.7	6.5	17,638.8	2.0
1997–99	19,620.1	11.2	19,028.2	7.9
1999–2001	21,262.1	8.4	19,803.6	4.0
2001–03[a]	21,162.0	–0.5	19,035.1	–3.9
2003–05[a]	22,741.0	7.5	19,785.1	3.9

Source: Washington State Office of the Forecast Council (2003), table 3.4.
a. June 2003 forecast.

share of certain lottery revenues for primary and secondary education. This earmarking resulted in the transfer of $452 million from the state general fund to dedicated education accounts during the 2001–03 biennium.

Washington approved a series of tax cuts (and limits to tax increases) between 1994 and 2001. In some cases, the limitations or reductions were adopted by the legislature while in other cases they were enacted by the people via the initiative process. Perhaps most significant is Initiative 695 (I-695), which reduced the motor vehicles excise tax from 2.2 percent of a vehicle's value to a flat $30 fee. Under a prior measure approved by the voters (Referendum 49), the revenue from this source was dedicated to transportation and local governments. Localities experienced decreased revenues from I-695, but the state initially replaced a portion of the local funding with state funding.

Increases in health care costs have put pressure on Washington's budget. To partially relieve these costs and to leverage new funding dedicated to the BHP, 27,000 immigrants (primarily documented adults and undocumented children) were made ineligible for Department of Social and Health Services (DSHS) Medical Assistance, which had provided them with state-funded benefits that mirrored Washington's Medicaid program.

Washington's "budget reserves" are a rainy day type of account (the emergency reserve fund) and an unobligated ending balance. At the conclusion of the 1999–2001 biennium, these reserves totaled almost $1.1 billion. When the FY 2001–03 budget was initially written, there was expected to be $600 million remaining in those funds at the end of the biennium.

At the start of the 2001–03 biennium, Washington Democrats held the governorship (Gary Locke), had a two-member majority in the House (50-48), and a one-vote majority in the Senate (25-24). In November 2002, when the governor was not up for re-election, the Democrats extended their majority in the House (52-46), but Republicans gained a one-vote majority in the Senate.

Washington's budget is developed by the biennium (e.g., 2001–03), though spending limits are annual. The state has no personal or corporate income tax. A 1933 decision by the state supreme court held that both violated the state constitution. Sporadic attempts to reverse this ruling by amending the constitution have been unsuccessful. Most recently, the legislature created the Washington State Tax

Structure Study Committee to report on how well Washington's current tax system works and how it might be changed to better serve the citizens of the state. The committee, known as the Gates Commission after its chair, William Gates, Sr., included professors in public finance, tax economics, accounting, and tax law as well as legislators from both houses and parties. In its report to the state legislature, the Gates Commission concluded, "Washington's current system was fundamentally inequitable to low- and middle-income people, unfair to many businesses, and subject to sharp fluctuations in revenue" (Washington State Tax Structure Study Committee 2002). It recommended two broad measures: Replacing the current business and occupation tax with a value-added tax, and implementing a flat rate personal income tax in order to reduce the state sales tax and eliminate the state property tax. The commission also recommended several incremental measures that Washington could take.

Fiscal Pressures and Policy Responses

The Office of the Forecast Council holds responsibility for forecasting revenues four times each year, though it produces additional estimates as appropriate. The council estimate is the official state estimate used in developing budgets. No alternate estimate exists, though the council produces both pessimistic and optimistic estimates in tandem with the official estimate. The council consists of two members appointed by the governor and four members from the legislature (Washington State Office of the Forecast Council 2002). At least four members must vote to approve the estimates. Because the council contains members from both the executive and legislative branches, Washington officials share the same opinion about when the economic downturn began and the magnitude of the downturn. The first signs of the coming downturn appeared in spring 2001, as detailed below.

FY 2001

Washington revenue estimates changed very little during the second half of the FY 1999–2001 biennium. The September 2000 forecast estimated the FY 1999–2001 total general fund at $21,073 million, compared with a June 2001 estimate of $21,285 million. No steps were needed to balance the budget at the end of FY 1999–2001.

Expenditure Pressures

On November 6, 2000, Washington voters passed Initiative 732, which guaranteed teachers and school administrators inflation-pegged raises beginning in the 2001–02 school year. On the same day, voters approved Initiative 728, which earmarked 75 percent of excess emergency reserve funds, $140 per student (increasing to $450 per student in FY 2005) in property tax revenue, and a share of unobligated lottery revenue, for schools. Schools could spend the funds on reducing class sizes, hiring teachers, or extending the school day. Over a six-year period, I-728 was expected to provide $1.8 billion in funding to Washington's school districts (Washington Research Council 2000).

Washington's Medicaid costs grew during this time period at a rate of 12–15 percent per year, putting increased pressure on the budget. Washington's budget is not affected by change in welfare caseloads, for the most part, because that money is set aside in what is called the "welfare box." Since 1996, the legislature has allowed the governor to decide how TANF and child care funds will be used. While more programs are offered when caseloads are low and fewer programs are offered when caseloads are high, the budget for Washington's TANF program, WorkFirst, is self-contained and tends not to affect other departments.

Revenues

In November 1999, voters approved I-695, replacing the motor vehicle excise tax, then 2.2 percent of a car's value, with a flat $30 fee. When the state Supreme Court declared the measure invalid because it violated a constitutional provision that governs the legislative and initiative processes, the legislature passed a bill that repealed the state portion of the tax. A significant portion of this tax was distributed to localities and the state provided some general-fund revenue to partially offset lost revenues. The voters approved a measure repealing certain locally imposed portions of the tax in 2002. Because the economy was experiencing tremendous growth at this time, increased yields from other taxes—primarily sales taxes—prevented a precipitous drop in overall revenues.

FY 2002

In the 1999–2001 biennium, spending from the general fund was $21.006 billion. For the 2001–03 biennium, Governor Locke recommended a total budget of $22.726 billion—an overall increase of roughly 8 percent. This budget allowed for spending increases in human services ($7.073 vs. $6.350 billion), public education ($10.541 billion vs. $9.444 billion), and higher education ($2.816 billion vs. $2.550 billion).

The Washington economy, and thus revenues, remained strong throughout 2000. The Office of Forecast Council released the first forecast for the FY 2001–03 biennium in February 2000 (see table 7). Slight upward revisions were made in June and September 2000. Revenue projections were revised downward for noneconomic reasons in November 2000, when forecasters adjusted for the impact of Initiatives 722 and 728 by subtracting $482 million.[13] Offsetting increases in anticipated revenues produced a net reduction of $439 million in the November forecast.

The following year was very different. Revenue estimates were revised downward in March, June, September, and November of 2001. Each time, the decrease was primarily owing to economic factors. The March 2001 estimate was revised slightly upward ($12 million) as a result of reevaluating the impact of Initiatives 722 and 728, but that upward change was masked by the $124 million in projected revenue declines. The largest decrease in the estimates occurred in November 2001 when $813 million was removed from the biennial forecast (Washington State Office of the Forecast Council 2001). This was the largest quarterly revision to the forecast since the council was created in 1984. All together, the forecast was revised down-

Table 7. Track Record for the Washington General Fund-State Cash Forecast, 2003–05 Biennium

Date of forecast	Total general fund-state cash basis ($ millions)	Total change change from prior period ($ millions)	Change from noneconomic factors ($ millions)	Change from economic factors ($ millions)	Percent change from prior period	Cumulative change from February 2000 ($ millions)	Cumulative percent change from February 2000
February 2000	$22,534						
June 2000	22,604	71	–3	74	0.31	71	0.31
September 2000	22,766	162	5	157	0.72	233	1.03
November 2000	22,327	–439	–482	43	–1.93	–206	–0.92
March 2001	22,216	–112	12	–124	–0.05	–318	–1.41
June 2001	22,099	–116	–27	–89	–0.05	–434	–1.93
September 2001	22,022	–77	18	–96	–0.03	–511	–2.27
November 2001	21,209	–813	–34	–779	–3.69	–1,324	–5.88
February 2002	20,962	–247	19	–266	–1.16	–1,571	–6.97
June 2002	21,140	178	93	85	0.85	–1,393	–6.18
September 2002	21,106	–34	0	–34	–0.16	–1,427	–6.33
November 2002	21,126	20	0	20	0.09	–1,407	–6.24
March 2003	21,163	36	0	36	0.18	–1,371	–6.08
June 2003	21,162	–1	0	–1	0.00	–1,372	–6.09

Source: Washington State Office of the Forecast Council (2003), table 3.14.
Note: Numbers may not add up to total because of rounding.

ward eight times between its initial release and June 2003, producing a net decline of more than 6 percent from the February 2000 estimate.

The spending increases for education approved by the voters put continued pressure on the Washington budget. In addition, Medicaid costs continued to grow. To make matters worse, Boeing, a major employer in the state, saw decreased demand for airplanes in response to September 11. This decrease led to the layoff of nearly 27,000 workers, mostly in the Puget Sound area, by June 2002 (Garber 2002). Highly skilled workers such as mechanics, engineers, and aerospace workers were particularly hurt. Boeing had also moved its headquarters to Chicago in 2001, though the impact of the move was mostly symbolic.

Washington also felt increased pressure from a lack of federal funds. In its initial budget, lawmakers anticipated receiving $920 million in Pro-Share revenues during the FY 2001–03 biennium. These funds would ultimately be both reduced and delayed. Because Washington's budget is biennial, measures were not taken to close any gap for FY 2002.

FY 2003

Washington's budget deficit for the 2001–03 biennium reached $1.543 billion prior to passing the supplemental budget for 2002. The governor's 2002 supplemental budget attributed $1.156 billion of the shortfall to revenue loss and the remaining $387 million to caseload growth and other spending pressures. Policymakers employed several one-time revenue-increasing measures, coupled with reductions in planned spending, to close this gap.

Like most states, Washington drew down its reserves. When the FY 1999–2001 budget was passed, reserves totaled $1 billion. The initial FY 2001–03 budget used some of that, but still projected that there would be $608 million in reserves at the end of the biennium. By the time the legislature passed its supplemental budget in March 2002, reserve funds held $304.8 million (Washington Office of the Governor 2002).

In addition, Washington securitized one-third of its tobacco settlement ($450 million). This action was very controversial. The attorney general, a Democrat who had fought very hard for the tobacco settlement, opposed securitization, while Republicans opposed what they characterized as a one-time budget gimmick. Democratic legislators saw no alternative to using the money.

Revenue Increases

Washington increased revenues by $90 million in three ways: joining a multistate lottery ("The Big Game"); imposing use taxes on out-of-state shipping, advertising, and repair services to match in-state sales tax rates; and adding auditors at the Department of Revenue to collect taxes owed. Governor Locke proposed tax increases on gambling, but these were not adopted by the legislature.

Washington shifted costs by increasing licensing fees to fund the cost of inspections to some state-licensed facilities. The state also required community mental health programs to spend down their reserves. These reserves accumulated when the state paid more money to support these programs than was spent by these programs.

Spending Cuts

Spending cuts in the 2002 Supplemental Budget hit state employees particularly hard. Four hundred and nineteen state employees were laid off at the end of FY 2002 (Condon 2002). The state cancelled one of the biennium's two scheduled COLAs for all employees except public school and community college teachers. K–12 teachers lost a planning day. State employees also paid more for their health insurance, saving the state $47 million. Reduction of the state's contribution to the pensions of state employees and teachers saved an additional $63 million.

Higher education was also cut. The state removed $54 million from higher education budgets while allowing tuition increases of 16 percent for research universities, 14 percent for four-year colleges, and 12 percent for two-year colleges. Governor Locke vetoed funds for faculty recruitment and retention.

Human services experienced significant cuts, mainly in its health programs. Reduced pharmacy payments caused several pharmacies to declare they would no longer provide services for Medicaid patients. The state started a mail order prescription service to deliver medication to enrollees who live far from any participating pharmacy.

Prior to the cuts, 27,000 immigrants, primarily documented adults and undocumented children, received the equivalent of Medicaid coverage through state-funded benefits under the DSHS Medical Assistance Program. Eligibility for DSHS Medical Assistance was terminated for these children, who were made eligible for—but not automatically enrolled in—Washington's Basic Health Plan (BHP). The BHP provides fewer services than Medicaid and requires copayments and premiums, although plan members can be sponsored by an organization that pays a share of the premium. The cost of the BHP and the requirement of a new application mean that many of the children will end up uninsured. When Medicaid coverage of these children ended on October 1, 2002, 39 percent were enrolled in the BHP and 16 percent were in the process of applying (Foster 2002). Because the BHP does not include dental care, the state provided funding to clinics, particularly in eastern Washington, to provide uncompensated care.

No cuts were made in Washington's SCHIP program. This program remains small because the state has been unable to get federal approval to use SCHIP funds for the children to whom coverage had been extended before SCHIP was created in 1997.

Approximately 100,000 people were affected when Washington eliminated its state Supplemental Security Income (SSI) payments. This money was used to finance the services for the developmentally disabled required under the terms of a proposed lawsuit settlement. The state is using its spending on the developmentally disabled to meet its SSI maintenance-of-effort requirement.

The upper income limit of eligibility for the Working Connections child care program was changed from 225 percent to 200 percent of the federal poverty guidelines. Copayments were also increased. Because child care is within the "welfare box" controlled by the governor, these changes did not require legislation, but could be made through revisions to administrative regulations. No waiting lists were reported for those who remained eligible for child care subsidies.

Additional cuts to human services came on the administrative side. Between 60 and 70 full-time equivalent staff were laid off, while others were organized out of jobs. These cuts, coupled with cuts across DSHS two years earlier, eliminated 600 of the department's 18,000 full-time-equivalent staff. In total, DSHS saw a 10 percent cut to its central administration budget in FY 2003. There have been increases in departments where the number of people needed to do jobs is sensitive to caseload changes (such as child protective services and developmentally disabled services). DSHS has increased the use of technology in an effort to maintain the same quality of service while streamlining and consolidating physical presence in its offices.

Significantly, Washington reduced state funding provided to localities by $59 million by ending the practice of backfilling revenues lost from I-695. A much smaller assistance program for certain cities and counties was implemented and support for public health districts was retained. In addition, the state closed a juvenile rehabilitation facility and shifted some costs ($17 million) that would otherwise have been funded in the operating budget to the capital budget. Washington issued bonds to cover the latter.

Budget Outlook

Assuming a maintenance-level budget, Washington officials anticipated a shortfall of as much as $2.6 billion over the 2003–05 biennium (R. Thomas 2003b). The education initiatives discussed earlier and continued increases in health care costs account for much of the budget pressure. In order to deal with this shortfall, Governor Locke developed a "priorities of government model" that requires the state to develop goals, analyze the best way for the state to meet these goals, and develop a way to measure progress towards the goals. The state will no longer rely on incremental increases in program budgets consistent with inflation and caseload changes, but rather on developing priorities and funding them consistent with the budget. The hope is that this will allow the state to limit the need for spending decreases and revenue increases (Evergreen Freedom Foundation 2003).

In accord with the new model, Governor Locke's biennial budget for FY 2004 and 2005 identified 10 priorities. The first priority was increasing student achievement in elementary, middle, and high schools, with reduced achievement gaps between ethnic and income groups, improved test scores, and increased high school graduation rate as indicators of success. While Governor Locke proposed increased funding for the programs he thought would most clearly address these goals, he recommended suspending increased funding for further K–12 class size reductions.

During the November 2002 elections, Democrats increased their majority in the house by two seats, giving them a 52 to 46 majority. Control of the Senate was reversed when Republicans gained a seat. They now hold a 25 to 24 majority. Democratic Governor Gary Locke is continuing his term. At the ballot box, Washington voters approved Initiative 776, which limits local government's ability to impose taxes or fees on motor vehicles for transportation purposes. Voters defeated Referendum 51, which would have increased funding for transportation projects through increased taxes and fees, and Referendum 53, which would have restructured unemployment contributions for typically seasonal employers.

Governor Locke's proposed budget for the 2003–05 biennium did not include a general tax increase, but instead focused on balancing the budget with spending cuts. Significantly, Governor Locke proposed to suspend increased spending for further reductions in elementary school class size, reduce the size of government by another 2,500 full-time employees, and reduce spending in the health services account. The Senate approved a budget that did not include general tax increases. The Senate did, however, vote for a gas tax increase that would help fund transportation (Ammons 2003). The House initially favored a budget with $650 million in tax increases, including a two-tenths of a cent increase in the sales tax (Galloway 2003). The budget it approved had $320 million in tax increases, including a 50 cent per pack increase in the cigarette tax and an extension of the sales tax to candy and gum, but not including the proposed change in the sales tax rate (Thomas and Postman 2003).

The two chambers could not reach agreement on a budget during the regular legislative session. In a special session, the legislature approved a budget that relied primarily on spending reductions to close the gap between revenues and expenditures.[14] The new budget eliminated 1,156 state positions, some through layoffs. State employees were denied a cost-of-living increase and made responsible for more of their health care costs. Home health care workers received only 75 cents of the $2 per hour raise they had negotiated with the state. Revisions to the class-size initiative, I-728, postponed the date spending per student would reach $450 from FY 2005 to FY 2007. The initiative to increase teacher salaries (I-732) was also scaled back.

State Medicaid spending for the biennium was set at $300 million below maintenance level. The sources for these savings included premiums for families with incomes above 100 percent of the federal poverty guidelines, reduced adult dental care, and replacement of the open-ended program that provided aid to hospitals serving the medically indigent by two smaller, capped grants. Outside Medicaid, current BHP participants received continued coverage, but more restrictive eligibility criteria were applied to new applicants.

The 2003–05 budget did not contain any increases in the state's broad-based taxes, but it did provide for $208.9 million in revenue enhancements. The legislature, for example, moved up the due dates for retailers' monthly sales tax payments by five days and increased penalties for underpayment of excise taxes. Once again, the legislature funded additional slots for auditors and other revenue enforcement officials. The changes to I-728 reallocated an additional $237 million from the dedicated Student Achievement Account to the General Fund (Washington State Office of the Forecast Council 2003).

As the Washington legislature met in special session to consider the 2003–05 budget, the U.S. Congress approved $20 billion in state aid as part of its tax cut legislation. Washington stands to receive about $400 million. The budget used most of this aid to restore state reserves, but many legislators expect continued pressures to use the money now (R. Thomas 2003a). The June 2003 revenue forecast, issued after the legislature approved the new budget, suggests that revenues will be stagnant or decline slightly (Washington State Office of the Forecast Council 2003).

Conclusions

Washington has employed a diverse strategy to deal with budget shortfalls, including spending reductions, tobacco securitization, use of reserves, and, to a lesser extent, revenue increases. Budget reductions have included reductions to localities, which placed local governments in the position of either reducing spending (and services) or identifying additional revenue sources. In FY 2002 and 2003, four-year colleges and universities experienced operating cost budget cuts of approximately 5 percent and community colleges experienced a 3 percent reduction; institutions were permitted to offset a portion of the reduction with increased tuition revenue. Nearly all state employees saw increases in their out of pocket costs for health care and elimination of an expected COLA. Some state employees were laid off.

Because nearly half of the Washington state budget is for constitutionally protected basic K–12 education and debt service on already issued bonds, any reductions made typically fall on the remaining portion of the budget. This made non-entitlement programs, including discretionary human services programs, discretionary K–12 education programs, higher education, and general government particularly vulnerable, and they all were reduced to varying degrees. Further cuts could be quite devastating to health programs. TANF funds were also excluded from cuts. In Washington, the governor allocates TANF funds and because Washington has not experienced an increased caseload, services have been maintained at levels similar to those in pre-shortfall budgets. Administrative cuts in DSHS caused layoffs and reorganizations.

Both providers and recipients shared in the cuts to health programs. Providers saw lower reimbursement rates for prescription drugs, which put pressure on the delivery of prescription drugs to Medicaid users in Washington. Immigrants ineligible for federal benefits were shifted from state-funded, Medicaid-like coverage to the narrower coverage and higher out-of-pocket costs of the state-funded Basic Health Plan.

Washington had already expanded Medicaid coverage to children up to 200 percent of the federal poverty guidelines prior to the enactment of the SCHIP program. While the state did expand coverage to 250 percent of the federal poverty guidelines, it has been unable to use its full federal SCHIP allocation. Officials do attempt to maximize other federal Medicaid money.

Most of the money for work supports in Washington comes from TANF funds, and because caseloads did not increase for a sustained period, Washington has been able to maintain services. Officials reported no waiting list for child care, but income eligibility standards were changed from 225 percent to 200 percent of the federal poverty guidelines.

Notes

1. Other Urban Institute researchers focused on the effects of fiscal stress on health policies in a companion project focusing on the same seven states. Their findings are presented in Holahan et al. (2003a and 2003b).
2. The fiscal year begins on October 1 in Michigan and on July 1 in the other six states. States name fiscal periods differently: New Jersey's FY 2002 budget would be called 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 October 1.
3. Figure 3 does not show this shift because the revenues go into the School Aid Fund, not the general fund.
4. Our calculation of Colorado spending data differs from NASBO's method: we subtract the TABOR refund from Colorado's expenditures. Calculating the refund, which was over $900 million in FY 2001 and FY 2002 but did not occur in FY 2003, as an expenditure causes NASBO to report a large spending cut that does not appear here.
5. All percentages of total state expenditures are from NASBO (2002c).
6. Governor Davis repeated his proposal to eliminate Stage 3 in his 2002–03 mid-year spending reduction, only to have the legislature reject it again. Elimination of Stage 3 then became part of Governor Davis's FY 2004 budget. The May 2003 revision expressed continued concern about Stage 3 but postponed action until later in the legislative session. See Davis (2003).
7. Exceptions from the eight drug limit included anti-psychotics, contraceptives, chemotherapy, and drugs for diabetes, perinatal nutrition, and HIV/AIDS.
8. Class size caps will be 18 students for kindergarten through third grade, 22 students for grades four through eight, and 25 students in high school classes. See Bridges (2002).
9. Expenditure data in this paragraph are for FY 2002.
10. Revenue data in this paragraph are for FY 2002.
11. This direct state service budget excludes Medicaid—a very significant expenditure item.
12. As of October 2003, a decision had still not been made regarding this waiver.
13. Initiative 722 nullified fee increases adopted without voter approval between July 2, 1999 and December 31, 1999. Vehicles would be exempted from property taxes and the limit on property taxes would be 2 percent per year, starting with the 1999 valuation.
14. Our discussion of the 2003–05 biennial budget is based on Washington Office of the Governor (2003); Washington State Senate Ways and Means Committee (2003); and Le (2003).

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