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ISSUE BRIEF

NATIONAL HEALTH POLICY FORUM

The Disappearing State Surpluses: How Come, How Long, and How Will They Affect Social Service Programs?

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A discussion featuring

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With commentary from two state-based fiscal experts

The George Washington University
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State Budget Shortfalls

Overview–*This issue brief focuses on the impact of recent budget shortfalls that many states are experiencing after several years of strong revenue growth. It describes the structure and sources of state revenues and spending and the causes of the recent shortfall. It also summarizes the fiscal trends and federal policies that could result in significant budget shortfalls in the future. Speakers at the Forum session will expand on these topics, give examples of state approaches in addressing the current shortfall, and provide projections on how states will fare in their next budget cycle. The meeting will also provide an opportunity for speakers and participants to explore the ramifications of the budget shortfalls for health and social service programs and policies.*

With the devolution of many health, welfare, and social service programs to state government, the always important issue of state resources becomes critical. Beginning in 1994, states benefitted greatly from a strong economy and robust stock market. Most were able to sustain a pattern equivalent to having their cake and eating it too: cutting taxes, increasing spending, and putting money aside as reserves.[1] The sustained great news was so unexpected that states often underestimated their revenue projections, resulting in annual budget surpluses.

Suddenly, in late 2000, most state budgets began to experience a significant slowdown in their revenue growth to levels not seen in seven years.[2] By the summer of 2001, the revenue decline forced several states to draw upon previous surpluses and on budget reserves to balance their new fiscal year (FY) 2002 budgets.[3] Most were able to cobble together a budget that did little harm to spending programs, but a few were unable to avoid some major spending cuts.[4]

States' budgetary problems have just begun. In the short run, revenue growth continues to decline due to a worsening economy and a much weaker stock market.[5] And the economic aftershocks from the terrorist attacks of September 11 are causing further havoc in already troubled state budgets.[6]

In the long run, the combination of eroding state tax structures and mounting pressures for increased spending may well create a contentious climate for future budget debates.[7] Very difficult decisions will have to be made on tax increases and program spending cuts in order to balance the state budget. This Forum session will examine the forces behind the immediate and long-term budgetary woes of the states and the possible impact of these forces on social spending programs.

CURRENT STRUCTURE OF STATE REVENUE AND SPENDING

To understand the fiscal crisis facing states, it is necessary to examine the two key components of their budgets: revenue (that is, monies raised by the states or received from the federal government) and spending (also referred to as expenditures or outlays). According to U.S. Bureau of Census data, approximately 72 percent of states' revenue is from taxes, fees, and tuition, with the remaining 28 percent coming from intergovernmental transfers from the federal government for such purposes as Medicaid, Temporary Aid to Needy Families (TANF), education and highways (Figure 1, page 3).[8]

Other than intergovernmental revenue, the two most significant sources of state revenues are sales and income taxes. Although each of these sources comprises approximately 18 percent of state revenues overall, states vary considerably in their composition of revenue. Some states (for example, Florida, Texas, and Washington) impose little or no income tax, while others (for example, Delaware, Montana, and Oregon) do not impose a sales tax. Two states, Alaska and New Hampshire, have neither an income nor a sales tax.

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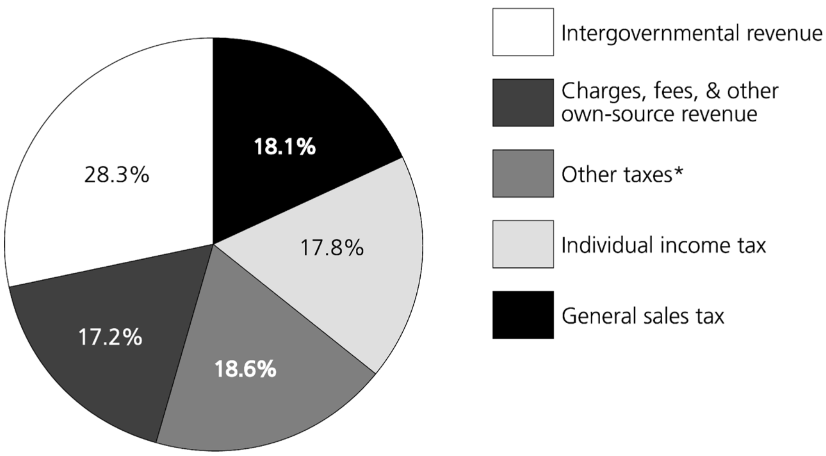
Figure 1
Composition of State Revenue, 1997



Source: U.S. Bureau of the Census
**Includes selective sales taxes, such as cigarette taxes, corporate income tax, and other taxes.*

On the spending side, the largest component, at 20 percent of state revenue, is elementary and secondary education.[9] The next largest, at 16 percent, is medical payments for public welfare (mainly Medicaid).[10] (See Table 1, page 4.) Rounding out the top three categories for state spending, at 11.5 percent, is higher education. The rest of the spending categories are much smaller (for example, cash assistance payments under welfare are below 3 percent). Similar to the revenue side, the composition of state spending varies considerably. For example, Medicaid spending ranges from New York's 24 percent to Alaska's 7 percent.[11]

GROWING SHORTFALLS

In contrast to the federal government, 49 states have a constitutional or statutory provision requiring their budgets to be balanced.[12] When spending increases are significantly greater than projections, or revenues are significantly less, states are forced to make immediate adjustments. The signs of growing shortfalls are ominous. Sixteen states had to cut their FY2001 budgets ; the previous year, only 1 state was compelled to do so.[13] Seven states made across-the-board cuts and the others used budget control methods such as hiring freezes and targeted reductions.

The FY 2002 state budget picture is even bleaker. During the second quarter of 2001, state income tax growth was at the second worst level since 1995, and the state sales tax growth was the slowest since 1991.[14] On the spending side, a survey conducted in early summer of 2001 found that two-thirds of the states estimated their 2002 Medicaid spending will exceed the budgeted amounts.[15]

If the economic downturn is temporary, states can draw upon their projected reserves and rainy day funds to minimize program cutbacks and tax increases. However, if the anticipated recession is deeper and longer than expected, the reserves will not be sufficient to cover the budget shortfall.[16] Projected FY 2002 year-end reserves, based on governors' recommended budgets, represent the smallest percentage since 1994.[17] And the analyses in all of the aforementioned reports do not take into consideration the acceleration in the economy's downturn due to the September 11 attacks.[18]

LONG-TERM STRUCTURAL PROBLEMS

While the short-term challenges are substantial, concerns are being raised over longer-term fiscal problems caused by a built-in structural imbalance between future spending and revenues. On the spending side, there are pressures from the two largest categories, education and Medicaid. Governors have embarked on an ambitious and sustained effort to improve kindergarten through 12th grade (K-12) school standards and student performance. Also, litigation to make state school financing more equitable across school districts and pressure to cut local property taxes may result in more state spending for K-12 education. Medicaid is seeing a resurgence in its growth rate, especially for pharmaceuticals. While the rate of payment growth is not expected to be in the double digits experienced in the late 1980s and early 1990s, it will certainly exceed the average growth rate in state revenue.[19]

On the revenue side, there are concerns over the future growth in the two primary taxes that states rely upon: income and sales. In recent years, the state income tax was often a primary source of the unexpected state surpluses as many people in the higher income brackets experienced extensive increases in income due to capital gains (particularly from the stock market). In turn, states received large, unexpected

Table 1
Composition of State Expenditures in 1997

	Amount ($ billions)	Share
General expenditure	**$788.2**	**100.0%**
Elementary and secondary education	160.3	20.3
Public welfare: medical payments*	127.9	16.2
Higher education	90.5	11.5
Highways	60.2	7.6
Cash assistance and nonmedical welfare assistance	47.9	6.1
Health†	33.9	4.3
Hospitals‡	29.3	3.7
Corrections	29.0	3.7
All other	209.1	26.5

Source: U.S. Bureau of the Census
**Consists primarily of Medicaid payments, but also includes medical payments for other recipients such as those on general relief.*
†Includes expenditures for public health, vital statistics, immunization, maternal and child health, and alcohol and substance abuse, environmental health, and many other programs usually administered by the state health department.
‡Includes financial support of hospitals other than payments such as Medicaid.

increases in income tax collections, resulting in pleasantly surprising surpluses.

States have grown to depend much more on the income tax than they did in the past. An unfortunate hallmark of the state income tax, however, is that the year-to-year receipts can be highly volatile. An economic downturn can quickly devastate a state's budget. For example, California has found that, in the past, state income derived from capital gains fell by as much as 50 percent in one year.[20] Such a swing today would translate into a 10 percent reduction in the state's personal income tax collections and a 5 percent decline in total revenues. Thus, in the coming year, states with income taxes could see the dark side of volatility, major drops in income tax revenue.

Of greater concern in the long run is the erosion of the sales tax base (that is, the types of sales to which the tax is applied). One cause of erosion is a trend toward consumers shifting a greater percentage of purchases to services (such as medical, legal, child care, and financial management services) that are often not taxed like retail consumer goods. Revenue has also suffered from an increase in the number of sales tax exemptions (food and clothing are frequent exemptions) and mail order sales, for which collecting sales tax is nearly impossible. Looming on the horizon is an anticipated surge in e-commerce, which could greatly accelerate erosion in state sales tax collections.[21]

It is important to note that the art of long-term revenue and spending projection is fraught with peril. In the 1990s, some analysts projected states would experience significant shortfalls in their budgets, yet there were annual surpluses.[22] Two critical factors that were not anticipated were the sustained bull stock market and major gains in worker productivity that led to significant growth in real incomes and tax revenue. These trends could continue, or other unanticipated trends may negate the predicted imbalance.

There is, however, another reason to worry about states' future ability to raise sufficient revenue. The recent reduction of the federal estate tax enacted in May of 2001 will result in a substantial decrease in state estate and inheritance tax collections. Since states have tied their own tax to the federal tax, states will lose from $50 billion to $100 billion in revenue over the next 10 years unless they choose the politically difficult path of enacting new state taxes on estates and inheritances.[23] The average state loss of the estate tax will be about 1.5 percent of total state revenue, but some states will be hit harder: New York stands to lose around 2.8 percent; South Dakota, 3 percent; Pennsylvania, 3.5 percent; and New Hampshire, 4.5 percent.[24]

All of this adds up to significant state budgetary concerns, both current and future. Thanks to previous surpluses, spending reserves, and rainy day funds, many states were able to rectify last year's shortfalls without incurring significant pain. That will not be true in the future. If the economy goes into a recession (which appears increasingly certain in the wake of the September 11 attack) or if the predicted long-term structural budget imbalances occur, states will be forced to make very difficult decisions regarding the level of tax increases and spending cuts.

THE FORUM SESSION

Key Questions

The session will provide participants an opportunity to ask speakers such questions as the following:

- Which states are most likely to be affected in the short term and in the long term? What characteristics do they possess that make them vulnerable?
- Which states are least likely to be affected by budget woes, and why?
- Are there budget techniques or new resources that states can employ in addressing the shortfalls?
- To what extent will tobacco settlement monies be used to cover immediate and future state shortfalls?
- In an era of recession, how can states sustain current funding for Medicaid, State Children›s Health Insurance Program, pharmaceutical programs for the elderly, TANF, and other social welfare programs?
- How will states be able to find the resources to address such new issues as building a public health infrastructure that can respond to terrorism and to address such persistent issues as the uninsured, long-term care, and people in poverty?

Speakers

Donald J. Boyd will begin the meeting with an overview of state revenue and spending structures. He will also describe recent state budgetary trends and note the future fiscal challenges of states. Boyd is deputy director of the Nelson A. Rockefeller Institute of Government. He is also director of the institute's Fiscal Studies Program, which, since 1990, has conducted research and analyses on trends in state and local programs and finances.

Raymond C. Scheppach, who has been executive director of the National Governors Association (NGA) for nearly two decades, will provide additional perspective on the impact of economic trends and federal policies on state budgets. Under his direction, the NGA collaborates with the National Association of State Budget Officers in publishing the biannual "Fiscal Survey of States." Two state fiscal experts will be at the meeting to describe how they addressed their recent budgetary shortfalls and what fiscal challenges they face next year.

ENDNOTES

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6. David S. Broder, "Aftershock in State Coffers," *Washington Post*, September 26, 2001, A25; Sue Ann Pressley and Pamela Ferdinand, "Layoffs, Dwindling Tourism a Blow to Struggling States," *Washington Post*, September 27, 2001, A13.
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9. Boyd, *State Fiscal Issues,* 2.

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13. National Governors Association and National Association of State Budget Officers, *Fiscal Survey of States* (Washington, D.C.: National Governors Association and the National Association of State Budget Officers, June 2001), vii.

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18. Pam Belluck, “Attacks Strike Hard at States’ Economies,” *New York Times*, September 20, 2001; accessed September 26, 2001, at http://www.nytimes.com. See also endnote 6.

19. National Governors Association, “States Tightening Budgets, New Report Says,” press release, National Governors Association, Washington, D.C., June 20, 2001; accessed October 3, 2001, at http://www.nga.org/nga/newsRoom/1,1169,C_PRESS_RELEASE^D_2203,00.html.

20. Boyd, *State Fiscal Issues,* 10.

21. California Legislative Analyst's Office, *California Tax Policy and the Internet* (Sacramento, Calif.: California State Legislature, January 31, 2000).

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23. Kevin Sack, “States Expecting to Lose Billions from Repeal of U.S. Estate Tax,” *New York Times*, June 21, 2001, A1, A19.

24. Sack, “States Expecting to Lose Billions.”