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Welfare Reform & Beyond

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Another State Fiscal Crisis: Is There a Better Way?

Executive Summary

The weak economy has precipitated another state budget crisis. State tax revenues have dropped sharply, while their costs continue to rise. To maintain budget balance, states are cutting employment and services while raising fees and taxes. These actions delay economic recovery and offset the economic stimulus coming from monetary policy and the federal budget. Since state budget reductions fall heavily on programs that serve the low-income population, state budget crises tend to hit the most vulnerable when they are already feeling the impact of a weak economy. In an effort to keep up with the rising cost of state services, states have increasingly relied on income taxes. Income tax revenues grow faster than relatively sluggish sales tax revenues, but the more rapid growth comes at the price of greater volatility over the business cycle.

This brief describes the state fiscal problem and suggests some solutions. The federal government could provide immediate fiscal relief to the states, and adopt a longer run program to mitigate cyclical swings in the state revenues. States could build more adequate reserves in good times. They could work together to modernize and harmonize their tax systems and share some jointly collected revenues.

The Severity of the Current State Fiscal Crisis

State revenues grew strongly in the second half of the 1990s, despite tax reductions in many states. With the economy booming and the stock market soaring, most states found that actual revenues persistently exceeded budget estimates. States with personal income taxes experienced a positive "April surprise" for several years running. Between 1994, when the effects of the last recession ended, and 2000, most states were able to increase spending, reduce tax rates, and build up their reserves at the same time. But an economic slowdown at the end of 2000 was followed by recession in 2001, the shock of September 11, and a slow, tentative economic recovery that has yet to show any momentum.

State revenue collections plummeted in the second half of 2001 and kept falling. A negative “April surprise” came in 2002. State personal income tax collections in the April-June quarter were 22 percent below the prior year. Sales tax revenues held up better, as consumers continued to spend. Nevertheless, overall state tax revenues for that quarter were down 13 percent from the year before after adjusting for legislated tax changes and inflation.

Most states had to struggle to balance their budgets in fiscal year 2002. They cut planned spending, delayed scheduled tax cuts, and dipped into their reserves. Achieving balance for fiscal year 2003 proved even more daunting. Revenue shortfalls were even larger,

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reserves were lower, spending pressures on low-income programs were increasing, and medical price inflation was pushing Medicaid costs up fast. States instituted hiring freezes, cut spending for corrections, elementary, secondary and higher education, Medicaid, childcare, and general support for local governments. They tapped special funds, raised fees, and turned to new sources, such as gambling. But revenues are continuing to drop, and budgets that appeared to be balanced when they were enacted are likely to require additional spending cuts or revenue increases to keep them balanced. Looming decisions for fiscal 2004 appear to be even more difficult.

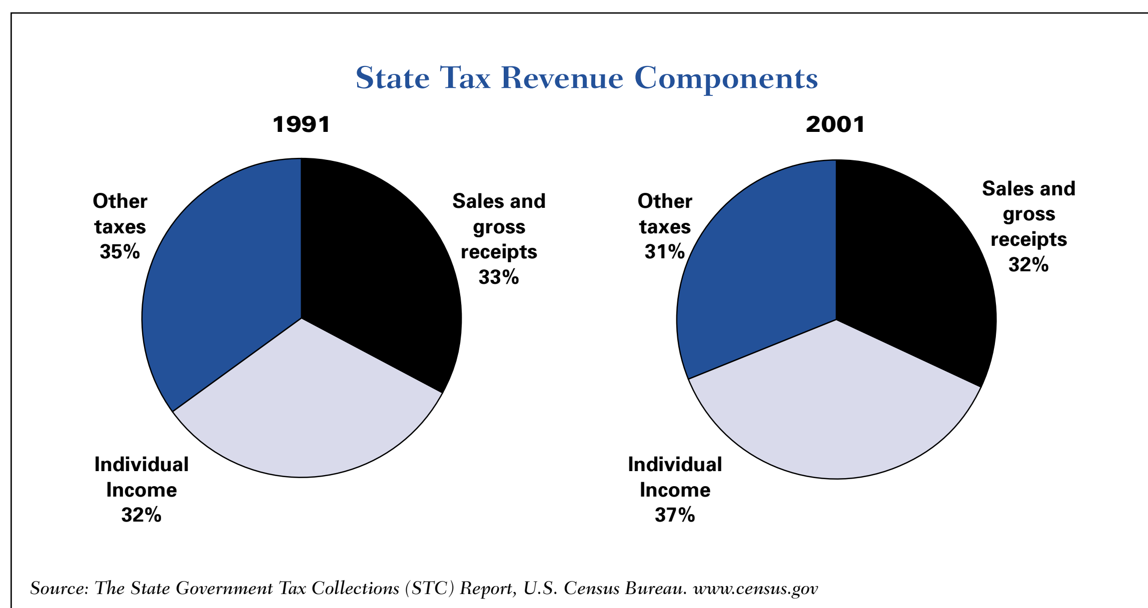
Why are the States Hurting So Much?

At first glance, the current crisis in state budgets is more severe than one would expect, given that the economy is recovering from a mild recession and unemployment is below six percent. Much of the severity relates to the nature of the prior boom and its impact on the income tax. Profitable corporations rewarded employees with big salary increases, bonuses, and stock options. The high-flying stock market generated large realized capital gains. States with significant reliance on income taxes found that their tax revenues escalated fast, then fell off a cliff when markets and corporate earnings dropped and brought down high-end compensation.

Income tax revenues have not begun to recover and may be slow to do so, even if the recovery picks up speed. Equity markets may not rise if investors remain cautious in the face of recent experience and corporate scandals. Even if stock prices rise, state revenue growth will be delayed as taxpayers off-set new capital gains against old losses.

Moreover, the revenue drop coincided with upward pressure on the spending side. States are coming to grips with the costs of greater security in the face of terrorist threats. States are trying to improve school performance and deal with new federal requirements for testing and raising educational standards. The rapidly rising cost of Medicaid creates even greater pressures on state budgets.

The state budget crunch also threatens progress on welfare reform. In the late 1990s states shifted resources from cash assistance to services for the working poor. They expanded training, day care, and other services in an effort to help low-income people find and retain jobs. With low unemployment rates, welfare recipients moved into jobs, cash assistance rolls dropped, and states were able to pay for new services within the federal Temporary Assistance for Needy Families (TANF) block



Source: The State Government Tax Collections (STC) Report, U.S. Census Bureau. www.census.gov

grant. Indeed, caseloads dropped so rapidly that many states had unspent TANF funds. In 2001, states spent about $2 billion more than their TANF grants, using carry-over funds from prior years. When the economy weakened, however, caseloads stopped falling in many states and in some cases have begun to rise. The carry-over funds are no longer available, and TANF block grants are not indexed for inflation. Without additional federal money, services such as training and day care for working families are being cut back.

The nineties boom left states in a better position to deal with budget adversity than they were during the 1990-91 recession. The revenue increases of the late nineties enabled most states to increase spending, cut tax rates, and build up reserves. By the end of fiscal 2000, states had reserves equal to more than ten percent of their expenditures, compared with less than five percent at the end of 1989. Unfortunately, states did not save enough and reserves are fast disappearing. In a report by the Center for Budget and Policy Priorities, Iris Lav and Alan Berube calculate that states on average would need reserves of more than 18 percent of expenditures to get through a replay of 1990-91 without raising taxes or cutting expenditures.

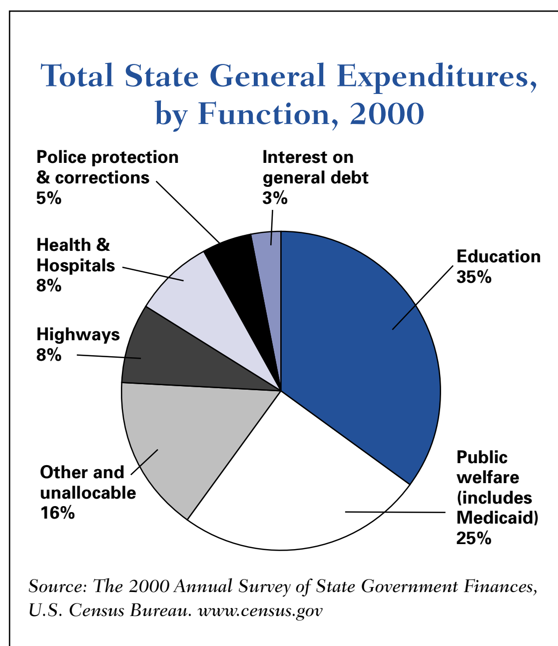
Although the initial revenue drop was steep, it is too soon to tell whether the aftermath of the 2001 recession will end up being worse for state governments than 1990-91. The earlier recession was also a relatively mild one, but the effect on state governments was severe and lasted at least three years. If the current weak recovery turned into a double dip recession or a prolonged period of slow growth, the outlook for state budgets would be increasingly grim.

Throughout much of the 1990s, Congress kept a tight rein on grants to states as it tried to balance the federal budget, but loosened the reins somewhat after it achieved that goal in 1997. With the budget in deficit again, policymakers are under pressure to meet increasing federal spending needs, including defense, homeland security, and the looming costs of Medicare and social security as the "baby boomers" retire. Ultimately, a squeeze on total budgetary spending would limit grants to states and localities.

The Impact on Low-Income People

When faced with an unexpected budget gap, state budget-makers look for the easiest ways to eliminate it. They try to avoid cutting services. Instead, they tap reserves, find uncommitted funds, finance a higher share of capital projects with bonds instead of operating revenue, freeze hiring and travel, and postpone building maintenance and other projects that are not urgent. Recently some states have securitized their tobacco settlements in hopes of obtaining the promised money sooner. But these one-time options are limited. If the budget gap persists, programs will have to be cut or taxes raised. Program cuts tend to fall heavily on services to low-income people which, for both political and technical reasons, are often easier to cut than other state spending commitments. Spending for debt service, pensions, long-term contracts, and formula grants to localities must be paid first, and the proceeds from dedicated taxes cannot be moved easily to pay other

Total State General Expenditures, by Function, 2000



Source: The 2000 Annual Survey of State Government Finances, U.S. Census Bureau. www.census.gov

expenses. Hence, low-income programs get hit hard when a weak economy reduces revenue. If the weakness persists, the cuts get larger just when the low-income population needs help the most.

In their efforts to close budget gaps in fiscal years 2002 and 2003, states have cut Medicaid, child care, after-school programs, job training, housing subsidies, and other services for low-income people. They are likely to cut more as they move into 2004.

Medicaid has been a target because it is growing so rapidly. The re-escalation of medical price inflation, especially prescription drug prices, and growing caseloads partly attributable to the weak economy, generated aggregate state Medicaid spending increases of about 12 percent in both 2001 and 2002, with more of the same expected in 2003. The Kaiser Commission on Medicaid and the Uninsured has documented the scope of state actions to cut Medicaid spending. These have included reducing covered services, cutting eligibility, instituting or increasing co-pays, and reducing provider reimbursement.

Similar reductions in child care and early childhood education programs have been documented by the Children's Defense Fund. States have been reducing eligibility for child care and preschool programs, reducing provider payments (which tends to reduce quality of care), and increasing parent fees. Waiting lists for child care are growing in many states.

Responsibilities Outrunning Resources

It seems outrageous for the world's wealthiest country to rely on a system of state finance that exacerbates cyclical swings in the economy and cuts services for low-income families when their need is greatest. Moreover, even with healthy economic growth, state revenue systems may prove increasingly unable to meet the demands placed on them. The political forces arrayed against tax increases are at least as strong in state capitals as they are in Washington, and states use low tax rates to compete with each other for residents and businesses in an increasingly mobile economy. Politics, plus pressure to hold down tax rates for fear of losing jobs and affluent people, may result in under-funding services that most citizens favor and that would help the economy grow.

Many observers of state finance believe that states face a long-run "structural" problem, in the sense that the cost of state services rises faster than their tax base. State services tend to be labor intensive. Unless productivity can be improved—and there is little scope for such improvements in education, medical care and social services—the cost of delivering the same services rises with real wages and faster than Gross Domestic Product (GDP). The cost of Medicaid adds to the problem when medical prices rise more rapidly than general inflation.

While costs of state services tend to grow faster than GDP, the sales tax—a major source of state revenue—tends to grow slower. The sales tax was the largest revenue source for states in the aggregate until surpassed by the personal income tax in the 1990s. Over the years, the state sales tax base has been eroded by exemptions often designed to mitigate the regressive nature of the tax. Moreover, sales of goods are easier to tax than sales of services, but the growth of goods purchases has lagged way behind services. Electronic and mail order catalogue sales—which are small compared to in-store sales, but growing rapidly—are mostly not taxed.

States are working to reduce the variation and complexity in their sales tax systems that provide the justification for not taxing remote sellers. Since 2000, the Streamlined Sales Tax Project has worked to simplify and modernize sales and use tax collection and administration across state lines. Thirty-nine states and the District of Columbia are now involved in the project. Federal support for the Streamlined Sales Tax Project would help the states solve part of the problem.

Concern about the slow growth of state sales tax revenues was reduced by the rapid growth of consumption in the 1990s and the failure of electronic sales to live up to the exaggerated predictions of early enthusiasts. State income tax revenues took off in the 1990s and surpassed sales taxes in aggregate state revenues. While less progressive than the federal income tax, state income taxes tend to grow faster than GDP or personal income. The fact that states collectively have become more dependent on income taxation reduces the fear that their revenues will grow more slowly than GDP over the long run. The price is the greater volatility of revenues over the business cycle illustrated by the current crisis.

States face tough choices in designing revenue systems. If their revenue bases are to grow fast enough to cover the rising cost of state services, states must continue to shift their reliance toward income taxes and away from sales taxes. Such a shift would make state tax systems more progressive, but exacerbate their instability. Moreover, states are reluctant to raise income taxes for fear that if their rates get too high they will discourage individuals and businesses from locating in the state.

The fundamental question is: what do Americans want their state governments to do and are their revenue systems equal to the task? The devolution of responsibilities to the states was an explicit objective of the Reagan administration in the 1980s, which raised the pressure for expansion of state services. The trend continued in the 1990s, more as a by-product of federal fiscal stringency than as a policy. The federal success in turning the huge deficits into surpluses was partly attributable to caps on discretionary spending, including grants to state and local governments. As the federal government restrained grants to states in order to balance its own budget, states picked up more responsibilities. Between 1990 and 2000, state spending rose twice as fast as federal domestic spending. But now state revenues are dropping and seem unlikely to recover quickly, while the demands on states are still growing. It is time to reexamine whether the states have the resources to deliver what is expected of them.

Mitigating Cyclical Instability and Interstate Tax Competition

The first priority should be finding ways of mitigating cyclical swings in state revenues. Some ups and downs in state revenues are undoubtedly beneficial. Moderate reductions in revenues force states to tighten up program management, increase efficiency, and eliminate outdated or low-priority activities. Moderate increases in revenue during a strong growth period afford states the opportunity to chose whether to expand and improve services or pass the benefits of economic growth back to taxpayers by reducing taxes. On the other hand, large swings in state revenues, especially sharp drops in a weak economy, lead to short-sighted cuts in spending that are especially hard on low-income groups at exactly the wrong time and tend to increase the amplitude of cyclical swings in the economy as a whole.

Local revenues are less cyclically sensitive than state revenues, since localities depend heavily on less volatile property taxes. But localities also rely on state grants for education and other purposes. It is hard for states to cut such grants quickly, but a protracted shortfall at the state level seriously affects towns, cities, and counties. Big cities, which have broadened their tax bases in recent years to include sales, income, and business taxes, are experiencing sharp revenue drops at present, both in the their own sources and in state aid. Hence, mitigating cyclical swings in states would help localities as well.

The second priority is to find ways of modernizing and harmonizing state tax systems to make them more capable of financing the responsibilities that citizens want them to take on. Interstate variation in taxing and spending gives citizens of each state the opportunity to choose the services they want

most and decide how to pay for them. But paying taxes in multiple jurisdictions is costly both to the collectors and payers. Competition among states for citizens and businesses in an increasingly mobile economy can also lead to a race to the bottom and lower levels of services than citizens collectively are willing to pay for. Mitigating tax competition and reducing evasion of state taxation would strengthen state revenue systems.

First approach to reform: reduce the cyclical instability in state revenues

- **What the federal government can do**

  Immediate action: Congress could appropriate funds in fiscal 2003 to provide significant temporary relief to state governments with a pass-through to troubled localities. Substantial immediate federal relief could avoid deep cuts in state services and tax increases, which would weaken the economy further and injure vulnerable citizens. Congress could act to increase the federal share of Medicaid on a temporary basis to avoid further cuts in the program and take some pressure off the states. Lawmakers have already introduced bipartisan bills raising the Federal Medical Assistance Percentage (FMAP).

  Long term: Congress could enact a permanent program of counter-cyclical revenue sharing, which would trigger automatic federal grants in a recession based on national or state economic indicators or a combination of both. Such a program would help to avoid state actions that would exacerbate the next recession.

- **What states can do**

  Accumulate more reserves. States could adopt stricter rules to force themselves to save more in their rainy day funds as the economy recovers. The new rules should be adopted now when the need for them is obvious. By the time the economy is growing strongly again, stricter reserve rules will be resisted, because politicians will be under pressure to use the revenues for spending increases and tax cuts.

  Keep less volatile taxes in the mix. States should continue to rely on income taxes and make them as progressive as politics allow, but sales taxes should not be allowed to wither away. They should be modernized to cover services as well as goods.

Second approach: harmonize state tax systems and reduce cross-border competition

- **Mega-version:** With the cooperation of the federal government, states could adopt one or more common state taxes and share the revenues on a formula basis.

  A common tax on corporations operating across state lines, for example, would reduce collection costs and mitigate the loss of revenue that arises from multi-state corporations gaming the complex variations in current corporate taxation at the state level. A common shared sales tax would reduce competition for cross border sales in multi-state metropolitan areas and make it possible to tax catalogue and electronic sales as effectively as sales by brick and mortar stores.

- **Mini-version:** Complete the Streamlined Sales Tax Project and, with support of Congress, convince the courts that simplification and advances in technology have made it feasible for remote sellers to collect state sales taxes. If this fails, enact a federal tax (or a common state tax under an interstate compact) on electronic, catalogue, and other long-distance cross border sales, and share the proceeds among the states on a formula basis.

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