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Tight budgets, rising costs squeeze states
By Pamela M. Prah, Stateline.org Staff Writer

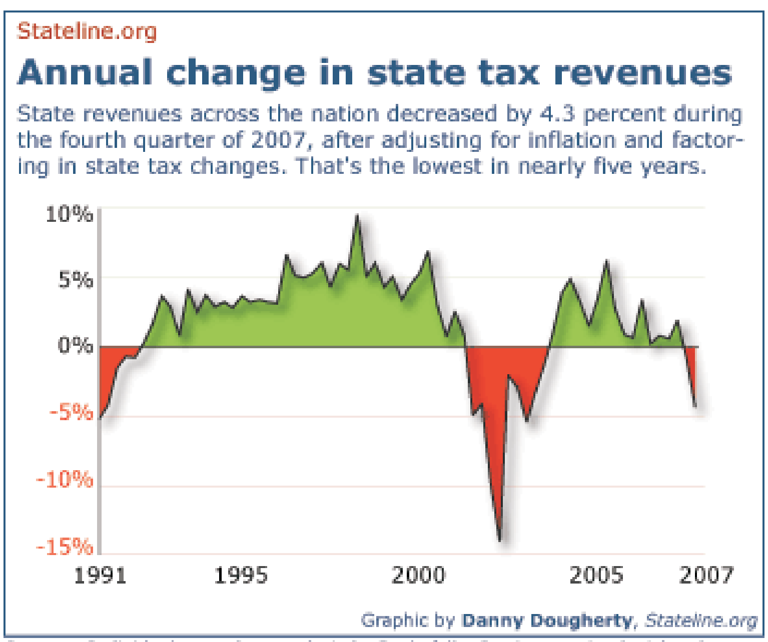
Like an American tourist in Europe, states are seeing their dollars just don't go as far as they used to.

Not only was the amount of tax revenue states collected during the fourth quarter of 2007 the weakest in almost five years, but for the first time since the 1990s, inflation for state and local governments grew substantially faster than for the economy as a whole, according to new data released Monday (March 31) from the Nelson Rockefeller Institute of Government, the public policy research arm of the State University of New York.

"States are experiencing a classic nutcracker effect," Robert B. Ward, the institute's deputy director, said. "Costs are rising sharply just as revenues falter," he said. "The result may be a squeeze on states' ability to fund services," he said.

The battered housing market, record oil prices and creeping unemployment rates have blown billion-dollar holes in state budgets from California to Florida. Consumers and businesses are spending less, so state tax revenues are dipping. And a new bond-market crisis could make it more expensive for states to borrow.

Ward said he was most struck by the rising cost pressures on states and localities. Over the past three years, the institute has noticed an uptick of inflation for all government expenditures, but costs rose faster for states and localities. The latest report shows inflation for states and localities was 3.6 percentage points higher than similar measures for the national economy.



Sources: Individual state data analysis by Rockefeller Institute, using legislated tax changes from National Confernce of State Legislatures and inflation adjustments from the U.S. Bureau of Economic Analysis.

Ward said that rising fuel and employee compensation costs, particularly for health care and pensions for current and retired employees, are partly to blame for states' and localities' decline in purchasing power, but that more research is needed. "It's a very harmful trend," Ward said. "A state's dollar just won't go as far."

The latest Rockefeller numbers also show that the amount of tax revenue states collected at the end of 2007 dropped 4.3 percent overall compared to a year ago, after adjusting for inflation and factoring in new state tax changes.

Without taking the effects of inflation and enacted tax changes, state tax revenues in the fourth quarter grew a meager 2.3 percent, compared to the same period in 2006, the lowest level since the first quarter of 2003.

Both personal income-tax and sales-tax revenue continued to lag, with the slowest growth rates since the second quarter of 2003, the report said. Meanwhile, states' corporate income taxes showed their weakest performance since the first quarter of 2002.

Tax revenue growth was strongest in the Rocky Mountain regions, with an 8.4 percent growth, while the southeast states saw the weakest with 5.7 percent.

Among individual states, Rockefeller said revenues dropped significantly in Arizona, Florida and Nevada — states that enjoyed red-hot housing markets and are suffering now, in large part, because of the housing bubble collapse that led to increased unemployment in sectors such as construction and less spending by consumers. Oregon's revenue dropped partly because the state enacted a large tax rebate that took effect in late 2007.

While the official numbers aren't in yet indicating which states may already be in a recession, the report highlights which states have the highest unemployment, a good indicator, Ward said. Florida, Michigan, Ohio, Rhode Island, Vermont and West Virginia all lost jobs in the last quarter.

Some budget experts see parallels between today's bleak economy and the 2001 national recession. Then, states had to close $264 billion in budget gaps over five years, forcing them to dip into their rainy-day funds, cash out their tobacco settlement money and cut back programs such as dental care for poor people and road construction projects.

Today, 22 states have a collective budget shortfall of at least $37 billion, which is about the same size deficit they had at the start of the 2001 recession, according to the Center on Budget and Policy Priorities, a Washington, D.C., think tank that studies policies affecting the poor. If the current downturn follows the path of previous recessions, 35 to 40 states could face budget cuts in 2009, the National Governors Association recently estimated.

Deficits are a far greater problem for states, because, unlike the federal government, states must make cuts or even raise taxes to balance their budgets.

For its analysis, Rockefeller used information from the National Conference of State Legislatures for legislated tax changes and inflation measurements from the U.S. Bureau of Economic Analysis.