

medicaid
and the uninsured

The Current State Fiscal Crisis and its Aftermath

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and the uninsured

The Kaiser Commission on Medicaid and the Uninsured serves as a policy institute and forum for analyzing health care coverage and access for the low-income population and assessing options for reform. The Commission, begun in 1991, strives to bring increased public awareness and expanded analytic effort to the policy debate over health coverage and access, with a special focus on Medicaid and the uninsured. The Commission is a major initiative of The Henry J. Kaiser Family Foundation and is based at the Foundation's Washington, D.C. office.

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Executive Summary

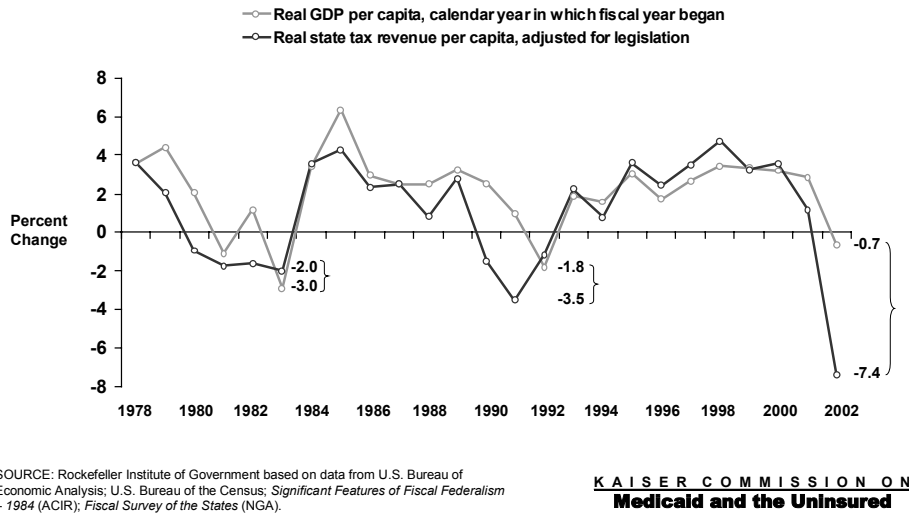
The states are in the middle of a severe budget crisis. Facing aggregate budget shortfalls of over \$70 billion this fiscal year, states have drawn down reserve funds, cut spending, and, in some cases, increased taxes as well. But just a few years ago, states faced extraordinarily strong fiscal conditions. The strong economy, experiencing the longest expansion in U.S. history, and exuberant stock markets helped states cut taxes, increase spending, and shore up reserve funds. Suddenly, as the national economy weakened in 2000 and entered a recession in 2001, the stock markets fell dramatically, tax revenue plummeted, and spending pressures increased. How did states arrive at this point, and what are the prospects for state finances over the next several years?

This paper describes the root causes of the state fiscal crisis, examines trends in state revenues and spending, and offers a prognosis that states are likely to face continued fiscal stress for the next several years. This analysis finds:

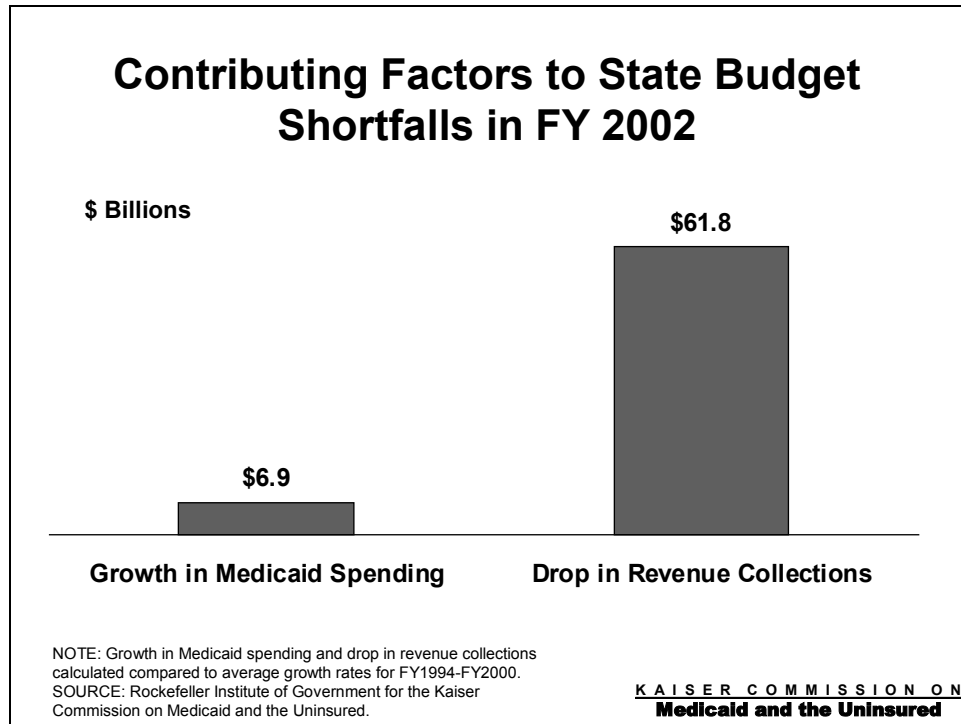
The fiscal crisis facing states is far worse than the condition of the nation's economy.

The national recession was relatively mild, but state tax revenue has been hit hard. Even by the standard of the two previous recessions, in the early 1990s and 1980s, state revenues have declined dramatically. Fiscal year 2002's astonishing 7.4 percent decline in real per-capita tax revenue was more than twice as steep as state tax revenue declines that accompanied the 1990–91 and 1980–82 recessions. The main reason tax revenue fell so sharply relative to the economy is that revenue had been propped up in the late 1990s by unsustainable forces, especially the run-up in the stock market, which have unraveled rapidly in recent years. The result has been that nearly every state faced budget gaps beginning in fiscal year 2002, and these gaps grew in fiscal years 2003 and 2004.

State Tax Revenue Has Fallen Far More Sharply Relative to the Economy than in Previous Recessions (1980-82 and 1990-91)



The primary cause of the state fiscal crisis has been the sudden falloff in state tax revenues. Starting in 2002, state tax revenue collections fell further and faster than anyone predicted. This paper estimates that the falloff in state tax revenues contributed far more to this crisis than the acceleration in Medicaid spending. Tax revenue in 2002 fell short of prior trends by about \$62 billion. Growing Medicaid spending has contributed to state fiscal stress, but plays a far smaller role: growth in Medicaid costs in 2002 raised state spending by about \$7 billion relative to prior trends. In other words, the decline in tax revenue contributed almost nine times as much to state budget gaps in 2002 as did faster-growing Medicaid spending. Other categories of spending have not played a major role in state budget shortfalls, either. This crisis was caused primarily by a sudden and sharp decline in tax revenue.



In the 1990s, state revenues and spending grew significantly, and states also cut taxes substantially. Between 1990 and 2000, revenue states raise on their own increased 81 percent in nominal terms and 26 percent in real per-capita terms. Despite relatively large tax cuts in the second half of the 1990s, states saw a large increase in tax receipts. For example, the income tax as a share of personal income rose by 17 percent between 1995 and 2000 even though states in aggregate were cutting the tax each year. Much of this growth can be traced to the many different ways in which the stock market surge affected state tax revenue. In addition, states benefited from strong personal consumption and from the tobacco settlement. The increase in state revenue in the 1990s relative to the economy was larger than it had been in the 1980s, but smaller than in each of the three preceding decades.

State spending from state funds increased by 26 percent between 1990 and 2000, after adjusting for inflation and population growth. This was slower than the growth of the 1960s and 1980s, but exceeded that of the 1950s and 1970s. These increases continued a longer-term trend of increasing reliance on state and local governments, which have played an increasingly important role in financing and delivering services in the United States for more than 50 years. Much of the growth has been financed by a growing economy, but state and local government also has been increasing relative to the economy. Virtually all areas of state spending increased substantially in the 1990s, with Medicaid dominating state spending growth in the first half of the 1990s, and elementary and secondary education playing a much greater role in the second half.

The state fiscal picture changed dramatically, beginning in 2001. Tax revenue growth slowed in fiscal year 2001 and then plummeted in 2002, reflecting the weakened economy and a 50 percent drop in capital gains. States cut spending growth in fiscal year

2002 and drew down reserves dramatically. In fiscal years 2003 and 2004, with fewer reserves to draw on and little appetite for tax increases other than on cigarettes, most states cut spending growth even further. When comprehensive data are available, total spending from own funds in both years is likely to have been flat, and to have declined modestly in real per-capita terms. Fiscal year 2003, which just ended, showed no bounce-back from the 2002 trough. Preliminary data show that fiscal year 2003 tax revenue, after adjusting for inflation and legislated changes, was down 0.2 percent from the already-low 2002 level.

States are likely to face continued fiscal difficulties for at least the next several years. Although national economic conditions seem to be stabilizing, it is unlikely that any recent improvement in the economy will close states' budget holes for quite some time. There are, broadly, three reasons for this dismal outlook:

- *The prognosis for state revenue growth is dim.* Although the recession is over, employment remains very weak. These conditions are unlikely to bring about a significant change in the state revenue picture. Income tax revenue is likely to begin to grow again, but this growth will be from a far smaller base than before. But capital gains income would have to more than double to return to levels of just two years ago. Since stock markets are lower than they were when many people purchased stocks, capital gain-related tax revenues are unlikely to return to those levels for many years. Revenue from state sales taxes will face erosion due to continuing shifts in consumption from taxed goods to untaxed services and to difficulties collecting taxes on the growing activity conducted via the Internet.
- *At the same time, states face substantial spending pressures.* Many states have adopted elementary and secondary education policies such as high-stakes testing and higher graduation standards that will increase costs by requiring more teachers, more highly paid teachers, or more time in school. Meanwhile, Medicaid spending has been growing rapidly, largely as a result of higher health care costs and increased enrollment fueled largely by the weak economy.
- *States will face additional fiscal stress as a result one-time budget balancing measures.* Many states will face additional pressure because the manner in which they have closed budget gaps for fiscal years 2003 and 2004 has pushed part of the problem into 2005 and beyond. This may be a perfectly rational response given the system in which elected officials operate, but it does exacerbate future problems. And although states received a welcome boost this year from the federal government in the form of temporary fiscal relief, the prospects for sustained fiscal assistance from the federal government are dim, in part because the federal government faces fiscal problems of its own.

The result of these forces and decisions is that state revenue has fallen away from spending, and the falloff, while it may not be permanent, seems likely to persist for years. States will need to make difficult decisions to bring spending and revenue into closer alignment, either by reducing spending or raising revenue. They have begun to do this in their fiscal year 2003 and 2004 budgets. Barring a miraculous return to the fiscal

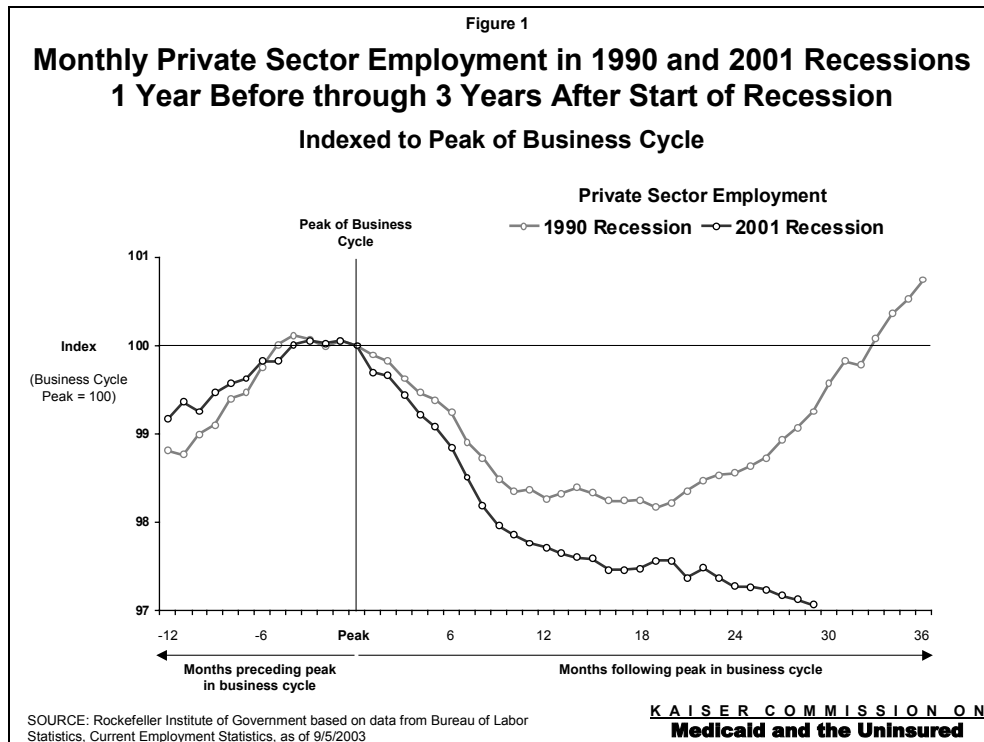
environment of the late 1990s, it will take at least a few more years of difficult spending and revenue decisions before states see their budget problems easing.

Introduction

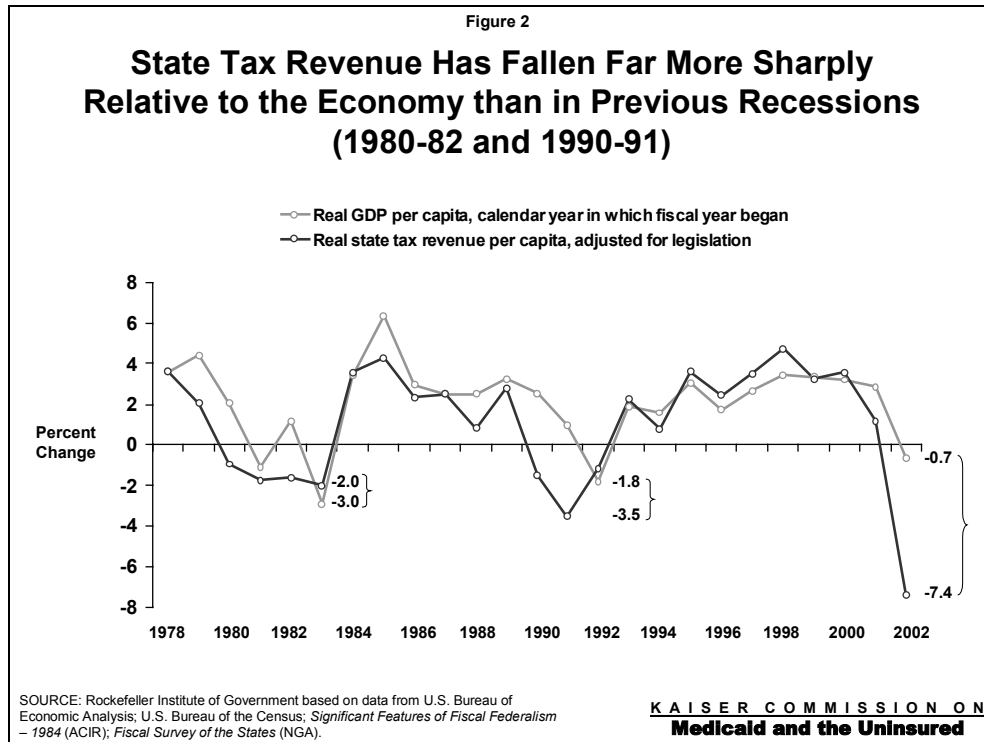
State government tax revenue boomed in the 1990s due to a strong economy and exuberant stock markets, allowing states to increase spending, cut taxes, and boost reserve funds. The national economy weakened in 2000 and entered a recession in 2001, stock markets fell dramatically, tax revenue plummeted, and spending pressures increased. Uncertainties related to the war in Iraq and subsequent rebuilding made the economic environment worse. Almost every state has faced severe budget gaps, has drawn down reserves, and has enacted or is contemplating spending cuts *and*, in many cases, tax increases of some sort. How did states arrive at this point, and what will happen to state finances in the aftermath of the current fiscal crisis?

This fiscal crisis is far worse than the economy would suggest

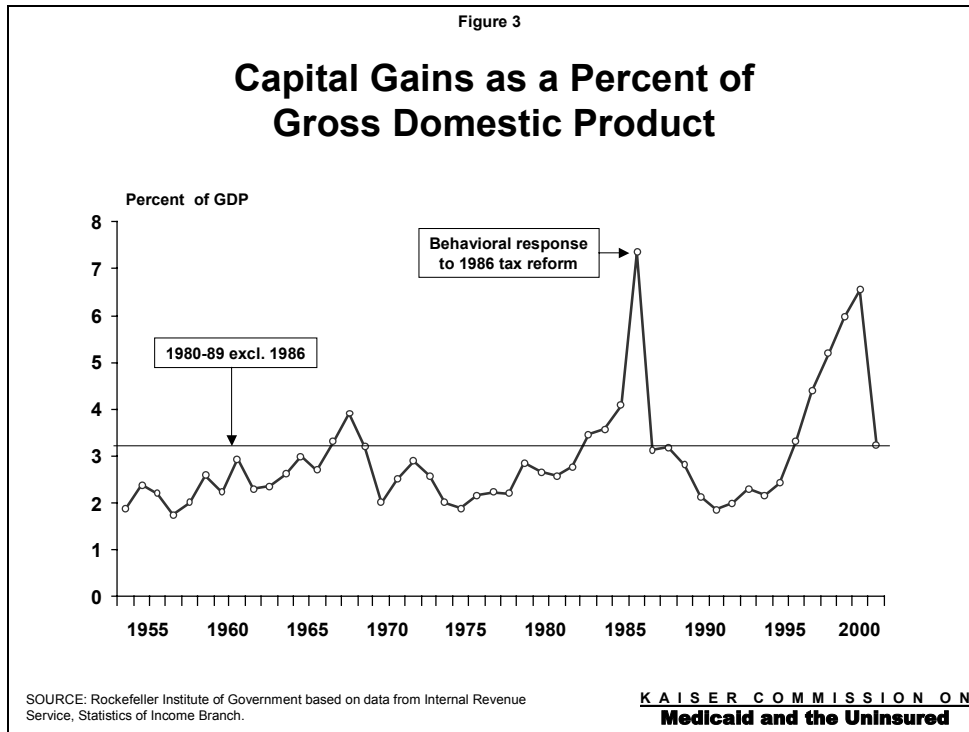
The United States economy entered its tenth postwar recession after March 2001, and growth resumed after November 2001. The recession was brief and mild by historical standards, using the traditional measure of gross domestic product. Although gross domestic product has resumed growing, private sector employment, which is an important factor affecting state tax revenue, has been far weaker in this cycle than in the last one and has continued to decline substantially even after the recession's end, with no slackening yet. Figure 1, which shows monthly private sector employment for the prior recession and recovery, as well as the current one (through August 2003), demonstrates that employment is much weaker this time around and shows no signs of recovery yet.



Despite the mild economic downturn as measured by gross domestic product, state tax revenue has been hit far harder than in the “double-dip” recessions of 1980–82 or the 1990–91 recession. Figure 2, which compares the growth in state tax revenue to growth in the economy, clearly shows this decline. Fiscal year 2002’s astonishing 7.4 percent decline in real per-capita tax revenue (the solid line) was more than twice as steep as declines in the fiscal crises that accompanied the 1990–91 and 1980–82 recessions, even though real per-capita gross domestic product (the dashed line) fell far less this time than in either of the last two crises.



The main reason tax revenue fell so sharply relative to the economy is that revenue had been propped up in the late 1990s by unsustainable forces, particularly forces related to the run-up in the stock market, which more than tripled between the end of 1994 and its March 2000 peak. The strong stock market led to a surge in capital gains, which are included in most states’ income taxes. The market also boosted wages of executives and others who exercised “nonqualified” stock options (the gain from which is taxed as compensation), and benefited state finances in other, difficult-to-measure ways.



These forces unraveled rapidly. Figure 3 shows the extraordinary rise in capital gains in the late 1990s in the context of nearly 50 years of history. After stock markets fell for two consecutive years, this surge was followed by a sharp drop of approximately 50 percent in 2001.² The late 1990s' increase was unlike any other sustained increase in the prior 50 years (the one-year spike in 1986 was atypical, reflecting taxpayer response to President Reagan's tax reform act). The huge drop in 2001 contributed to massive tax revenue shortfalls in the states, which were especially pronounced when 2001 tax returns were filed in April of 2002 – the final quarter of the fiscal year for most states.

Capital gains realizations are not included in traditional measures of the economy, helping to explain why the falloff in revenue was sharper than economic data might suggest.

Even as tax collections began to fall sharply, the cost of Medicaid – the second-largest area of state spending – accelerated rapidly. After increasing by only 5 percent in fiscal year 2000, growth in Medicaid spending from state funds accelerated to 10 percent in fiscal year 2001 and to 13 percent in fiscal year 2002.

The net result of these two major shifts in state finances was widespread and deep budget problems. In fiscal year 2002, 43 states reported budget gaps that opened up after budgets were enacted, and 12 reported problems exceeding 10 percent of their general fund budgets.³ Virtually every state faced a projected budget gap at the start of fiscal year 2003; states attempted to close these gaps through a combination of policies including spending increases, use of reserve funds, and tax increases. Despite efforts to enact balanced 2003 budgets, at least 36 states reported that budget gaps reopened as the year progressed, due to revenue shortfalls and spending overruns. Nearly every state again

faced a large budget gap for fiscal year 2004, and according to the National Conference of State Legislatures, at least 33 states faced gaps exceeding 5 percent of the state budget, and at least 18 faced gaps exceeding 10 percent.⁴

Sudden tax revenue declines have played a much bigger role in the crisis than accelerating spending

What caused the fiscal crisis, sudden tax revenue declines or accelerating spending, especially for Medicaid? We begin to examine this question by comparing two “gaps”:

- The gap between actual fiscal year 2002 tax revenue and what might have been collected at a previously “normal” revenue growth rate.

and

- The gap between actual Medicaid spending in 2002 and what might have been spent at a previously “normal” Medicaid growth rate.

If the revenue gap is larger than the Medicaid gap, then revenue played a bigger role in causing the crisis, and vice versa.

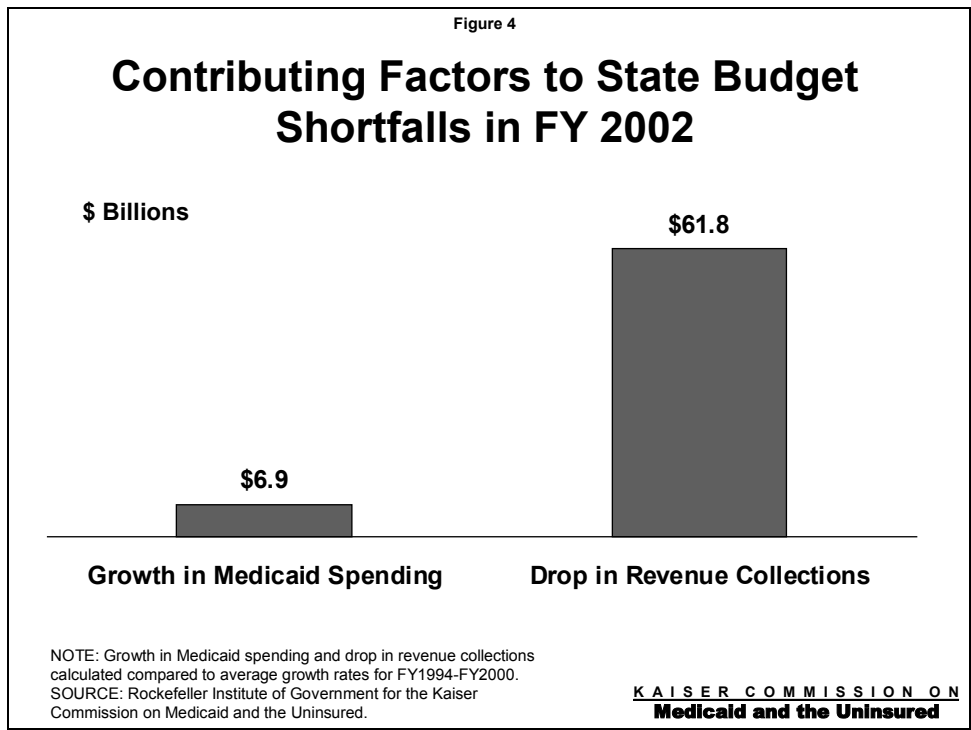


Table 1 and figure 4 illustrate this. The first column begins with actual Medicaid spending from state funds in fiscal year 2001. The next two rows in the column show (1) the actual 2002 growth rate, and (2) an estimate of the previously “normal” growth rate, pegged at 5 percent, which was the median Medicaid spending growth rate during the fiscal boom from fiscal year 1994 through 2000.

The remaining rows show actual Medicaid spending in 2002, estimated “normal” spending, and the gap between the two – Medicaid’s contribution to the fiscal gap under these assumptions.

The next column shows similar information for state tax collections. The 6% “normal” growth rate for taxes reflects actual experience from 1994 through 2000, adjusted for the impact of legislation.

Under these admittedly simple assumptions, the Medicaid acceleration raised state costs in fiscal year 2002 by about \$7 billion relative to prior trends, while the tax revenue falloff reduced tax revenue by about \$62 billion relative to earlier trends – 9 times as much. Plausible alternative estimates of “normal” Medicaid and tax revenue growth all would yield the same fundamental conclusion – the tax revenue decline played a far bigger role in the sudden fiscal problems states faced in 2002 than did Medicaid cost acceleration.

Table 1

What Caused State Fiscal Problems - - Tax Revenue Declines or Medicaid Spending Increases?		
	State Spending From Own Sources on Medicaid	State Tax Revenue
Fiscal year 2001 actual (millions of dollars)	\$ 85,141	\$ 528,169
Actual growth rate	13.2%	(5.7%)
"Normal" growth rate (illustrative)	5.0%	6.0%
Actual fiscal year 2002 amount (estimated - millions of dollars)	\$ 96,380	\$ 498,064
Potential fiscal year 2002 amount at "normal" growth rate (millions of dollars)	<u>89,398</u>	<u>559,860</u>
Estimated contribution to state budget gaps (millions of dollars)	\$ 6,982	\$ 61,796
Ratio of tax gap to Medicaid gap		9 : 1
Sources:		
Medicaid expenditures: State Expenditure Report, National Association of State Budget Officers, Summer 2002 Fiscal Survey of the States, November 2002		
Tax revenue, U.S. Bureau of the Census, adjusted by Rockefeller Institute of Government to remove impact of tax legislation		

Another way of looking at the same issue is to compare actual tax revenue and Medicaid spending to projections used at the time budgets were adopted rather than to “normal” growth. While there are no readily available data on state Medicaid forecasts and forecasting errors, this is relatively easy to do with tax revenue forecasts, as Table 2 shows.

Table 2

Tax Revenue Shortfalls in Fiscal Year 2002		
(Amounts in \$ millions)		
	Shortfall	% Shortfall
Personal income tax	\$ 27,508	12.8%
Sales tax	4,810	3.2%
Corporate income tax	<u>5,921</u>	<u>21.5%</u>
Sum of 3 main taxes	\$ 38,239	9.7%

Source:
National Association of State Budget Officers, Fiscal Survey of the States
November 2002, Table A-9

In fiscal year 2002, collections of major state government taxes fell short of original projections by an astounding \$38 billion, or 9.7 percent.⁵ The income tax accounted for \$27.5 billion, or more than 70 percent, of the shortfall in these taxes. While comparable numbers are not available for Medicaid, it is clear that the tax revenue shortfall must have dwarfed the Medicaid “overage” – looking back to the previous table, even if Medicaid had grown as much as 20% faster than states expected, the additional spending would have been only about \$17 billion, which is less than half of the \$38 billion tax shortfall.

Some analysts have argued that the current fiscal crisis results from rapid growth in state spending during the 1990s. In a technical sense, this argument certainly is not correct. That is, the sudden appearance of large state budget gaps did not result from a sudden increase in spending – as the analysis above makes clear, the gaps result primarily from a sharp falloff in state tax revenue that is far worse than declines in either of the last two recessions. While accelerating Medicaid spending has exacerbated the crisis, non-Medicaid spending has grown more slowly and has been more stable. In fact, state-financed non-Medicaid spending increased by less than 2.3 percent in fiscal year 2002, down substantially from the 7.7 percent increase in 2001.⁶ Thus, non-Medicaid spending plays a smaller role than Medicaid – or no role at all - in the sudden change in state finances.

In a broader sense, however, the argument that the crisis resulted from state spending increases has no simple answer. As will be discussed in the next section, states *did* increase spending substantially in the 1990s. If real per capita spending from state funds had grown at only the rate of population and inflation during the 1990s, current spending would be more than \$120 billion less now than it is – more than the entire budget gap states face. If spending had grown at only the same rate as personal income, current spending would be more than \$40 billion lower than it is now – still enough to avert a sizable portion of the gap.⁷ This is the real point of those who argue state spending is the

problem: “To avoid budget crunches during slowdowns, states should limit spending growth during booms, sort of like setting a lower highway speed limit.”⁸

But is it realistic to say if states had not spent so much, they would not have budget gaps now? No – states generally operate under balanced budget requirements, and if their spending had been lower, then presumably they would have cut taxes to avoid accumulating huge surpluses. Then, when tax revenue fell in fiscal year 2002, states still would have had significant budget gaps. Those who argue that spending is the problem may not really be arguing that spending increases caused state budget gaps – they didn’t – instead, they may be arguing that states have spent more than enough, they should have limited spending increases, and they should now close budget gaps by cutting spending, rolling it back to earlier levels.

The 1990s in the longer-term context

1. State revenue

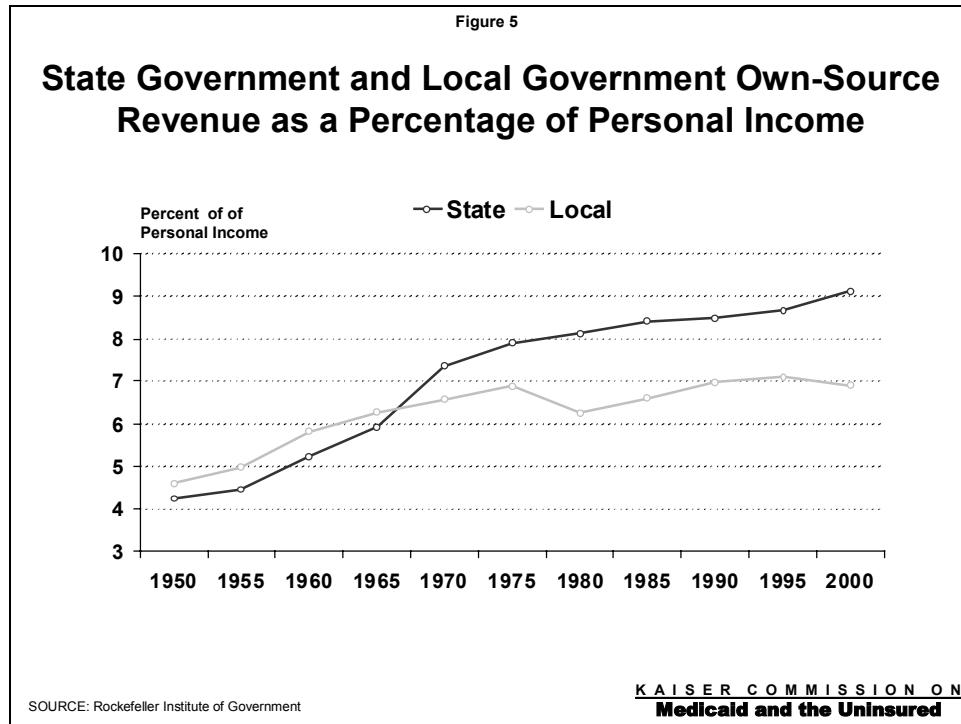
This section examines revenue trends in three phases: longer-term trends, more-detailed analysis of trends from 1990 through 2000, and recent trends. I focus primarily on revenue as a percentage of personal income - a rough measure of the level of revenue relative to the economy and ability to pay.

State and local government revenues have been rising for 50 years

State and local governments financed the increase in spending of the last 50 years in part through economic growth and in part through increases in revenue relative to the size of the economy.

Real per-capita income – one indicator of states’ capacity to raise revenue – increased substantially in each decade, with increases ranging from 12.5 percent in the 1970s to 33 percent in the 1960s. Overall real per-capita income increased by about 13 percent in the 1990s.

Not only did economic growth increase states’ capacity to raise revenue, but as Figure 6 shows, state own-source revenue has risen throughout the last five decades. In 1950 state own-source revenue was 4.2 percent of personal income (a broad measure of the economy), and it increased in each decade, reaching 9.1 percent in 2000. State revenue increased especially sharply between 1955 and 1970, and rose more moderately in other periods. Local own-source revenue rose less sharply and was about the same share of personal income in 2000 as it was in 1970.



State revenue growth in the 1990s

Between 1990 and 2000, nominal state revenue grew 90 percent. This reflected 81 percent growth in “own source” revenue (driven primarily by taxes) and 119 percent growth (more than doubling) in revenue from the federal government.

Much of this revenue growth was related to inflation and growth in the overall size of the economy. In real per-capita terms – one measure of the ability of revenue to finance services – general revenue grew by 32 percent. Real per-capita intergovernmental revenue grew 51 percent and own-source revenue grew 26 percent. Although the revenue available to finance spending grew considerably, the increase relative to the size of states’ economies was much smaller: own-source revenue increased only by 7 percent per \$100 of personal income.⁹

The sources of revenue growth varied significantly within the decade. Table 3 shows major categories of state government revenue in 1990, 1995, and 2000. The first set of columns shows revenue per \$100 of personal income, and the second set of columns shows the percentage change in revenue per \$100 of personal income for different parts of the decade.

Table 3

State government revenue per \$100 personal income, 1990, 1995, and 2000						
	Per \$100 of Personal Income			Percentage Change		
	1990	1995	2000	1990 to 1995	1995 to 2000	1990 to 2000
General Revenue	11.29	12.57	12.66	11.3%	0.7%	12.1%
Intergovernmental revenue	2.76	3.67	3.53	33.0%	-3.7%	28.1%
Own-source revenue	8.53	8.90	9.13	4.3%	2.5%	7.0%
Taxes	6.56	6.79	6.94	3.5%	2.2%	5.8%
Individual income tax	2.10	2.14	2.50	1.9%	16.9%	19.1%
General sales tax	2.18	2.25	2.25	3.4%	-0.2%	3.2%
Excises and selective sales taxes	1.03	1.10	1.00	6.3%	-9.0%	-3.3%
Corporate income tax	0.47	0.49	0.42	4.2%	-15.4%	-11.8%
Other taxes	0.78	0.81	0.78	4.3%	-4.0%	0.1%
Non-tax own-source revenue	1.98	2.11	2.19	7.0%	3.6%	10.9%

SOURCES: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis

In the first half of the decade intergovernmental revenue (essentially, aid from the federal government) per \$100 of personal income increased by 33 percent, while tax revenue – the largest component of own-source revenue – increased by only 3.5 percent. The increase in intergovernmental revenue in this period is really quite significant – in 1990, this revenue was only 24 percent of total state revenue, and yet it grew so rapidly that it accounted for 54 percent of all revenue growth between 1990 and 1995, while taxes, which were 58 percent of revenue, accounted for only one-third of the growth.

This reversed in the second half of the decade – intergovernmental revenue provided only 16 percent of state revenue growth while taxes provided 62 percent of the growth, despite the fact that states were cutting taxes throughout the period.

Perhaps the most surprising number in the table above is the 16.9 percent growth in income taxes per \$100 of personal income between fiscal years 1995 and 2000 – this was much faster than the 1.9 percent increase in the first half of the decade, and occurred despite substantial income tax cuts in every year of the late 1990s, for reasons discussed in the next section. The result was a boom in state tax revenue that allowed states to increase spending even while cutting taxes.

As the table shows, the role of intergovernmental revenue – which is almost exclusively federal aid, and is dominated by Medicaid – varied significantly during the 1990s. States received a substantial boost from the federal government between fiscal years 1990 and 1995, but aid then declined as a share of personal income in the remainder of the decade. Table 4 shows the changing patterns of major categories of federal aid: aid related to public welfare (mostly Medicaid) and for health and hospitals increased dramatically between fiscal years 1990 and 1995, as did aid for education to a lesser extent. By contrast, between 1995 and 2000, relative to personal income, growth in federal aid slowed or turned negative in all major categories.

Table 4

State Revenue From Federal Government						
	Per \$100 of Personal Income			Percent change		
	1990	1995	2000	1990 to 1995	1995 to 2000	1990 to 2000
	Public welfare	1.30	1.96	1.90	50.9%	-3.0%
Education	0.46	0.54	0.54	17.1%	-0.3%	16.8%
Highways	0.30	0.33	0.30	8.7%	-8.9%	-1.0%
Health & hospitals	0.12	0.18	0.18	47.3%	4.1%	53.3%
All other	0.40	0.44	0.41	10.2%	-6.7%	2.7%
Total	2.58	3.44	3.33	33.4%	-3.2%	29.1%

SOURCES: U.S. Bureau of the Census, U.S. Bureau of Economic Analysis
 NOTE: States receive a small amount of intergovernmental revenue from governments other than the federal government, and hence the total here is slightly less than the intergovernmental total presented in Table 3.

What factors drove state revenue increases?

State tax revenue benefited from a confluence of positive trends in the 1990s, several of which were unsustainable.

The national economy consistently grew faster in the 1990s than most economic forecasters expected, in large part because worker productivity, which had grown at an annual average rate of 1.6 percent between 1991 and 1995, accelerated to 2.6 percent between 1995 and 2000.¹⁰

As noted above, the nature of economic growth in the 1990s was especially good for state finances. Taxable income consistently grew faster than broader measures of the economy such as gross domestic product or personal income. That growth resulted in large part from the more-than-quadrupling of realized capital gains between 1994 and 2000.¹¹ This was driven by strong economic growth, rising stock markets, widespread participation in the stock market, and lower tax rates on capital gains. Other income sources also grew faster than the economy, especially taxable retirement income such as distributions from 401(k) plans and IRAs.¹²

State income taxes benefited from the financial market boom in other ways as well. States reported to the Rockefeller Institute of Government in the late 1990s that withholding tax collections were growing far faster than expected because many firms, especially high-tech firms, were compensating high-level employees with nonqualified stock options.¹³

Not only did taxable income grow far more rapidly than the economy, but income growth was disproportionately concentrated among persons in the highest tax brackets. Governments with income taxes, including most states and the federal government, became even more reliant on the income and tax liability of a relatively small percentage of tax filers. Between 1995 and 2000, the number of federal tax returns showing incomes

of \$200,000 or more grew by 117 percent, while the total number of federal tax returns grew by only 10 percent. Taxable income on these high-income returns increased by 161 percent, compared to 60 percent for taxable income on all returns.¹⁴ Because states generally conform to federal income definitions, state income taxes also became far more reliant on a relatively small proportion of taxpayers, thus increasing their volatility.¹⁵

State sales taxes also benefited from a decline in the savings rate – the flip side of which is a rise in consumer spending as a share of income. The savings rate fell from almost 9 percent early in the decade to a record low of 1 percent in 2000. The drop in the savings rate was enough to boost consumption by the end of the decade to a level 8 percent higher than it otherwise would have been, and this benefited state sales taxes.

Should states have known that the extraordinary rates of revenue growth in the late 1990s were unsustainable? Probably – and in fact, many did know this. Several states remarked on this risk in their budget documents, and noted that tax revenue could decline very sharply particularly if the stock market declined. Unfortunately, it was not possible to predict when the decline would come, nor was it easy to predict how sharp it would be – and state budget and political processes do not reward the prudence that would have been needed to prepare for the decline.

How did tax changes in the 1990s affect state revenue?

Between 1990 and 1995, when states were responding to the weakened economy and the 1990-91 recession, they increased taxes substantially. Adding together increases enacted for each year of this period, states increased taxes by more than \$33 billion, with most of the increases taking initial effect in the 1991 and 1992 fiscal years.¹⁶ This understates the total increase significantly because most tax increases were recurring. Some of the increases would become larger in subsequent years and some would become smaller.¹⁷ Assuming all tax increases were recurring and that their initial amounts were reasonable estimates of their recurring value, this would have amounted to about an 11–12 percent increase in taxes, and contributed considerably to revenue growth in the first half of the 1990s.¹⁸

These increases are particularly apparent in excise taxes and sales taxes. As Table 3 above showed, between fiscal years 1990 and 1995, selective sales and excise taxes per \$100 of personal income increased by 6.3 percent, even though these taxes normally decline as a share of personal income if their rates are constant.¹⁹ Similarly, the large boost in general sales taxes as a percentage of personal income is partly an artifact of the higher rates states adopted in the early 1990s, although some of the increase also reflects the consumer spending rebound as the economy recovered from recession.

Beginning with legislative actions for the 1996 fiscal year, states cut taxes annually for each fiscal year through 2002, for an aggregate reduction of somewhat more than \$33 billion in aggregate. This is roughly the same in nominal terms as the increases in the first half of the decade, but not as a percentage of revenue since revenue rose during the period. Using the same method for accumulating tax reductions as was used for tax increases above, this amounts to an aggregate reduction of about 7 percent in taxes.²⁰

Thus, the net result over the course of the two periods appears to have been a small net tax increase.

The tax changes also may have caused a significant shift in the distribution of taxes, although that is difficult to analyze without sophisticated tools. The increases in sales and excise taxes in the early 1990s were similar in size to the increases in income taxes. The tax reductions of the late 1990s, however, were far more skewed toward income taxes. Because lower income people tend to consume a larger share of their income than upper income people, sales and excise taxes tend to constitute a larger share of income for low-income people; by contrast, income taxes usually rise as income rises, and tend to constitute a larger share of income for upper-income people than lower income people.

As a result, considered in isolation, policy shifts in the last decade may have led to lower-income people paying a greater share of state taxes now than in 1990.²¹ Potentially offsetting this, however, is the fact that taxable income of upper-income individuals rose sharply in the late 1990s for reasons discussed earlier, and the net effect of the two changes is not possible to determine without sophisticated empirical methods.²²

Even though state policy actions favored income tax reductions, through most of the 1990s, these actions did not make states less reliant on the income tax – in fact, the extraordinary growth of the income tax, discussed above, means states actually became more reliant on the income tax despite cutting it. The relatively large reliance on the income tax means greater volatility in state revenue structures.

Most of the tax increases enacted so far in the current fiscal crisis have been excise tax increases. If this pattern continues, states may become more reliant on relatively regressive excise taxes. However, it is too early to tell whether that will be the final result – as discussed below, states still face large fiscal problems. If they want tax increases to play a significant role in closing budget gaps, they will need to consider more income tax increases than they have so far.

State revenue has declined dramatically recently

Growth in state tax collections dropped sharply from 6 percent in state fiscal year 2000 to less than 3 percent in 2001, after adjusting for inflation and legislated changes.²³ Income tax growth was fairly strong, but the sales tax slowed and corporate tax collections declined. States that relied heavily on manufacturing industries were hardest hit, particularly the Great Lakes, southern, and Plains states, reflecting declines in manufacturing that began even before the national recession started.

Tax collections worsened significantly in fiscal year 2002, declining each quarter as the year progressed. In the October-December quarter, income tax payments related to capital gains and other nonwage income fell by 27 percent, withholding and sales tax growth was near zero, and corporate tax payments declined by 32 percent.²⁴ The situation deteriorated markedly in the remainder of the fiscal year: the income tax declined by double-digit percentages in the January-March and April-June quarters, the corporate

income tax fell for its sixth and seventh consecutive quarters, and sales tax growth hovered on either side of zero.

Tax collection data suggest that capital gains and similar income declined far more in 2001 than state revenue forecasters expected. Many states budgeted on the assumption that capital gains would decline by 10 to 15 percent, but the decline clearly was much worse. Unfortunately, data from the U.S. Treasury now show that capital gains declined by approximately 50 percent in 2001.

Deterioration continued in fiscal year 2003: adjusted for inflation and legislated changes, tax revenue declined by 0.9 percent in the first quarter of the fiscal year, and by 1.9 percent in the second quarter. Each of these declines is in addition to a decline in the year-earlier quarter, so that real adjusted tax collections in the first two quarters of fiscal year 2003 were below their levels of *two* years ago, while spending pressures are higher than they were two years ago. Payments of estimated income taxes for the 2002 tax year to date were down by 11.8 percent in the median state, suggesting that collections related to 2002 income tax returns filed in April 2003 would be weak, adding to an already difficult fiscal year for states.²⁵ Preliminary figures for fiscal year 2003 as a whole show that tax revenue adjusted for inflation and legislated changes was down by approximately 0.2 percent.²⁶

2. State spending

This section examines trends in state spending in three phases, first setting the scene by describing longer-term trends, then examining in detail trends from 1990 through 2000 using the latest comprehensive and comparable data from the Census Bureau available when this paper was being prepared, and finally discussing what we know about spending trends since 2000 from available but somewhat less comparable data sources.

The previous section focused on revenue as a percentage of personal income, a rough proxy for the level of taxes relative to the size of the economy. In most of this section we examine spending per person, adjusted for inflation.²⁷ This is one of two commonly used approaches for examining spending across states and time – the other common method compares spending to a measure of the economy, such as personal income or gross state product.²⁸ Per-capita spending can be thought of as a rough measure of the level of services provided, while spending as a percentage of personal income can be thought of as a rough indicator of spending relative to ability to pay.

State and local government spending have been rising for 50+ years

State and local governments have increased spending substantially for more than 50 years. Between 1950 and 2000, state spending from own funds (excluding revenue from the federal government) nearly quadrupled, after adjusting for inflation and population growth, and local spending nearly tripled. Figure 6 shows real per-capita spending by state governments and local governments from own funds, at 5-year intervals for the last 50 years.

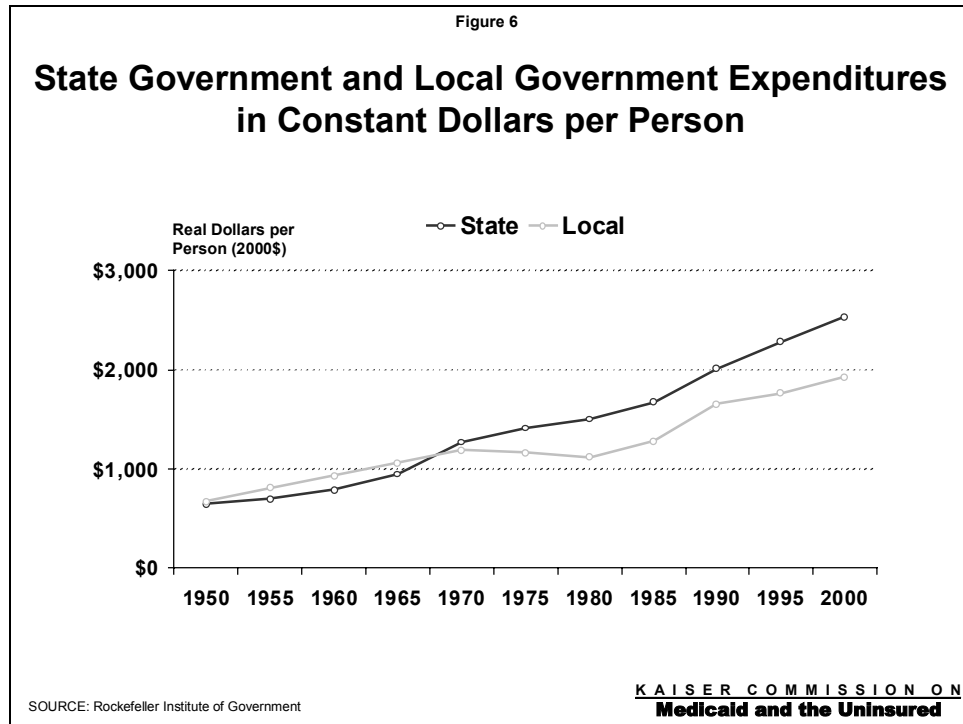


Table 5 shows the percentage change in real per-capita spending from own-source funds by decade and level of government. State governments and local governments both increased spending substantially in most decades, with minor exceptions. The main forces affecting state and local government spending have varied over time, but include:

- “Catch-up” spending after the subdued years of World War II and the Korean War;
- Large increases at the state and local level between the early 1950s and mid-1970s to educate the large cohort of baby boomers, and even larger state increases to shift a greater share of education spending to states from local governments;
- State government spending surged to finance rapid growth of Medicaid shortly after 1965, also in the early 1990s, and in certain other periods. As discussed later, the driving factors for this have varied over time, but have included program expansions, growth in eligible populations, rapid health-care inflation, and efforts by states to maximize Medicaid revenue from the federal government;
- The property tax revolt era, which played a role in local government spending declines of the 1970s; and
- State and local spending increases in the 1990s to finance education for the “baby boom echo” (children of baby boomers).²⁹

Table 5

Percentage change in expenditures from own funds, by decade In real per-capita terms			
	State and Local Government Combined	State Government	Local Government
1950's	30.0	22.5	37.6
1960's	40.8	61.8	28.2
1970's	7.8	17.9	(5.7)
1980's	40.0	33.7	47.3
1990's	21.2	25.9	16.2

NOTES:

- 1950's defined as period from 1950 to 1960, and so on.
- Expenditures adjusted for inflation using the state and local government chain weighted price index

Sources:

- Fiscal data collected by Bureau of the Census, obtained from Significant Features of Fiscal Federalism 1994 Vol. 2, www.census.gov, and Census Bureau staff
- Price index from Bureau of Economic Analysis
- Population data from the Census Bureau

The next table focuses on *state* government spending, showing growth in total spending financed by (1) federal and state sources combined, (2) the federal government, and (3) states' own funds (which corresponds with own-source spending in the earlier table). The table also shows average annual growth of spending from own funds. Among other things, the table shows that growth in revenue from the federal government accelerated sharply in the 1990s, helping total spending to grow more rapidly than in the 1980s.

Table 6

Percentage change in state government expenditures, by decade In real per-capita terms				
	State Government Spending From All Funds	State Government Revenue From Other Governments	State Government Spending From Own Funds	
			Total	Annual Average
1950's	30.6	63.6	22.5	4.1
1960's	64.6	73.3	61.8	10.1
1970's	21.3	31.1	17.9	3.3
1980's	27.8	12.7	33.7	6.0
1990's	32.2	51.3	25.9	4.7

NOTES:

- 1950's defined as period from 1950 to 1960, and so on.
- Expenditures adjusted for inflation using the state and local government chain weighted price index

Sources:

- Fiscal data collected by Bureau of the Census, obtained from Significant Features of Fiscal Federalism 1994 Vol. 2, www.census.gov, and Census Bureau staff
- Price index from Bureau of Economic Analysis
- Population data from the Census Bureau

While state government spending increases of the 1990s were substantial, and it is fair to ask whether they could be supported by the longer run tax revenue outlook, viewed in the context of the last five decades they do not look unusual. We now turn to a more detailed look at the 1990s.

States significantly increased spending in the 1990s

Between 1990 and 2000, state government spending from own sources increased 81 percent in nominal terms, from \$382 billion in 1990 to \$690 billion in 2000. Total state government spending from all sources (including revenue from the federal government) grew by 90 percent, from \$508 billion in fiscal year 1990 to \$965 billion in 2000.³⁰ (Recently released data from the Census Bureau show that total state spending has since passed the trillion-dollar mark.³¹)

Much of the nominal spending increase reflected higher prices and a larger population to serve: prices of the goods and services governments purchase increased 30 percent and the population increased 11 percent.³² After adjusting for inflation and population growth, state governments increased real per-capita spending from own funds by 26 percent in the 1990s, and increased spending from all sources by 32 percent. These spending increases were part of a much longer trend of substantial growth in state and

local government in the United States. As noted above, the own-funds increase was slower than the growth in the 1980s, while the increase in spending from all funds was slightly faster, reflecting an acceleration in aid from the federal government (mostly related to Medicaid).

Table 7 provides a crosswalk between the growth in nominal spending from own funds and growth in spending after adjusting for population growth and inflation.

Table 7

Growth in State Government Spending From Own Funds, Two Decades		
	Percentage Change	
	1980 to 1990	1990 to 2000
General expenditures from own funds, nominal % growth	133.0	80.7
Factors used to compute real per-capita spending growth:		
Population growth	9.9	10.5
Inflation (state & local governments)	58.6	30.0
General expenditures from own funds, real per-capita % growth	33.7	25.9

Sources: Rockefeller Institute analysis of data from U.S. Census Bureau and U.S. Bureau of Economic Analysis

Spending increases were widespread: every state but Alaska increased real per-capita own-source spending in the 1990s, and 38 states increased real per-capita own-source spending by 20 percent or more. (Alaska is an outlier because of its highly unusual tax structure: it is one of only two states that have no broad-based income or sales tax - New Hampshire is the other. In addition, Alaska relies very heavily on oil-related revenue, which dropped by one-half in the last decade while most other states enjoyed a fiscal boom.)³³ The states that spent the least in 1990 tended to increase spending the fastest, as shown in Table 8.

Table 8

States Ranked By Spending Increases in 1990s		
	Real Per-Capita State Government General Expenditures From Own Funds In FY 1990	Percent change from FY 1990 to FY 2000
Mississippi	1,467	64.9
Arkansas	1,546	58.7
New Hampshire	1,535	56.7
Pennsylvania	1,751	49.7
Utah	1,911	49.4
Vermont	2,502	47.5
Texas	1,327	42.5
Minnesota	2,440	42.4
Oregon	1,831	40.5
Michigan	2,163	39.8
Wisconsin	2,180	38.2
South Carolina	1,900	37.3
Nebraska	1,763	36.0
Idaho	1,751	35.5
Montana	1,796	34.9
Colorado	1,695	33.9
Indiana	1,823	32.9
Kentucky	1,878	32.8
Missouri	1,507	29.1
Virginia	2,072	28.4
Illinois	1,776	28.3
Alabama	1,728	27.9
North Carolina	1,964	27.7
Kansas	1,774	27.7
South Dakota	1,551	27.2
Florida	1,705	26.4
Iowa	2,182	26.0
United States	2,056	25.9
California	2,412	25.8
New Mexico	2,693	24.9
Delaware	3,337	24.3
Tennessee	1,448	24.1
Georgia	1,729	23.9
Connecticut	2,825	23.7
Ohio	1,890	23.7
Louisiana	1,874	22.7
West Virginia	1,865	22.4
Maine	2,189	20.4
Maryland	2,131	20.3
Hawaii	3,491	17.2
Washington	2,507	16.8
Massachusetts	2,971	16.6
Rhode Island	2,589	12.9
New York	2,663	12.3
North Dakota	2,303	9.3
Wyoming	2,784	5.6
Nevada	2,288	5.6
Oklahoma	1,763	4.5
Arizona	2,243	4.4
New Jersey	2,492	2.7
Alaska	8,711	(11.5)

Sources: U.S. Bureau of the Census, U.S Bureau of Economic Analysis
of Economic Analysis

Spending increases by functional area

The two largest spending areas in the typical state budget are elementary and secondary education and Medicaid, with most of the former usually paid as aid to local school districts, and most of the latter paid to private medical vendors such as doctors, hospitals, and nursing homes, and to managed care organizations. In state fiscal year 2000, elementary and secondary education accounted for 23 percent of total state spending from all funding sources and Medicaid accounted for 20 percent. Higher education was a distant third, accounting for 11 percent, followed by transportation (9 percent) and corrections (4 percent).³⁴ Cash assistance, while a significant element in state public policy debates, accounted for only two percent of state government spending in 2000.

Medicaid and K-12 education took turns dominating state spending growth in the 1990s, with Medicaid growing extremely rapidly in the first half of the decade, then subsiding and elementary and secondary education growing more rapidly in the second half. Corrections spending also grew rapidly in the first half of the 1990s, but its relatively smaller size means it did not have as large an impact on state budgets or on budget debates.

When we examine individual functional areas, Census Bureau data do not allow us to distinguish state spending state spending financed by federal funds from state spending financed from states' own funds. As a result, Table 9 below shows growth in real per-capita spending from all funds, in each half of the 1990s and for the decade as a whole. (These data do not isolate spending on Medicaid – but the Census Bureau concept of “Medical Vendor Payments” is a fairly good proxy for Medicaid.)

Table 9

Growth in State Government Spending in the 1990s - Includes State Spending From Own-Source and Federal Funds - (% Change in Real Per Capita Expenditures)						
	Total Percentage Change			Average Annual Percentage Change		
	1990 to 1995	1995 to 2000	1990 to 2000	1990 to 1995	1995 to 2000	1990 to 2000
Total General Expenditure	20.5	9.6	32.2	3.8	1.8	2.8
Elementary & Secondary Education	13.2	18.5	34.2	2.5	3.5	3.0
Medical Vendor Payments	77.6	5.9	88.1	12.2	1.2	6.5
Higher Education	11.0	10.8	22.9	2.1	2.1	2.1
Transportation	9.6	9.3	19.8	1.8	1.8	1.8
Corrections	26.1	12.3	41.7	4.8	2.3	3.5
Cash Assistance	9.3	(39.8)	(34.2)	1.8	(9.7)	(4.1)
All Other	14.2	8.8	24.3	2.7	1.7	2.2

Source: Rockefeller Institute analysis of data from U.S. Census Bureau and U.S. Bureau of Economic Analysis

Other information sources suggest that state spending of their own funds was largely consistent with the total spending show in Table 9, at least for the larger functional areas. For example, (1) Data from the National Center on Education Statistics show that state financing of elementary and secondary education grew less rapidly than federal financing during the 1990s, but that even so, the federal share remained relatively small at the end of the decade – still only 7.3 percent of total education spending, up from 6.1 percent in 1990³⁵; and (2) Data from the National Association of State Budget Officers show that reported state spending from own funds on Medicaid grew at rates virtually identical to growth rates for federal spending in both periods above.³⁶ The most significant exception appears to be transportation, where NASBO data show that state spending from federal funds grew slightly faster than spending from state funds during the first half of the 1990s, but in the second half of the 1990s, transportation spending from states’ own funds grew at about twice the rate of spending from federal funds.

What factors drove state spending increases?

Elementary and secondary education

K-12 education spending was driven primarily by increased spending per pupil rather than by increases in numbers of students. Higher spending per pupil partly reflected more staff per student, rising non-staff costs, and other factors. A substantial share of the increase may have been related to the costs of special education, although these costs are difficult to measure comparably across states and time.³⁷ Average teacher salaries did not increase in real terms in the typical state, although a few states did increase teacher salaries considerably.³⁸ Table 10 decomposes changes in real per-capita changes into changes in the numbers of pupils and changes in spending per pupil.

Table 10

Factors Related to Spending on Elementary and Secondary Education 1990 to 2000			
	Real spending per capita (2000 \$)	Pupils per 100 population	Real spending per pupil (2000 \$)
Level in 1990	554.6	16.4	3,376
Percent change:			
1990 to 1995	13.2%	3.2%	9.8%
1995 to 2000	<u>18.5%</u>	<u>1.4%</u>	<u>16.9%</u>
1990 to 2000	34.2%	4.6%	28.3%
Level in 2000	744.3	17.2	4,332

Source: Rockefeller Institute analysis of data from U.S. Census Bureau, U.S. Bureau of Economic Analysis, and National Center on Education Statistics

Medicaid

Between 1990 and 1995, real per capita medical vendor payments grew by 78 percent – an average annual rate of 12.2 percent – and consumed 42 percent of state real per-capita spending growth, despite accounting for only 11 percent of 1990 spending.

Some of this growth is attributable to disproportionate share hospital (DSH) payments, which are included in medical vendor payments in the Census Bureau’s definitions. DSH payments are payments states make to hospitals that serve a disproportionate share of poor patients. They are important because states often were able to recover most or all of these payments in the form of taxes or other required payments from the hospitals, at the same time they used their payments to the hospitals as matching expenditures under the Medicaid program, allowing them to draw down additional federal aid. Many observers considered the use of DSH in this manner a gimmick intended solely to drive up federal aid to the states. Information from the Centers for Medicare and Medicaid Services indicates that nominal DSH payments increased more than tenfold between federal fiscal year (FFY) 1990 and 1995.¹

Even if we remove the impact of DSH payments, however, real per capita spending on Medicaid benefits increased by about 60 percent.³⁹ According to Bruen and Holahan (1999), major factors behind this growth were:

- Medicaid enrollment grew from 28.9 million to 41.7 million reflecting expanded eligibility, the recession of 1990-1991, and other factors. This was a 44 percent increase during a period that saw only 6 percent growth in the overall population. Enrollment of blind and disabled persons, who are far more expensive to care for than other Medicaid recipients, increased by 58 percent. This was a major factor in spending increases.⁴⁰
- Medical care price inflation was 37 percent over the five-year period, compared with 13 percent general inflation for state and local governments.⁴¹ Thus, economywide increases in health care costs were a major factor behind increasing Medicaid costs.
- States became increasingly adept at shifting services from other programs into Medicaid.

As a result of the above factors, nominal spending on Medicaid benefits more than doubled between FFY 1990 and 1995.⁴²

Real per capita spending on medical vendor payments slowed dramatically in the second half of the 1990s, growing by only 6 percent between SFY 1995 and 2000. Essentially all of that growth occurred in SFY 2000, with less than 1 percent growth between SFY 1995 and 1999.

¹ Under federal law, Medicaid DSH payments were capped in the early 1990s, and have been declining in recent years.

Analyses of federal data on Medicaid spending yield insights into the slowdown. Average annual growth in Medicaid expenditures between federal fiscal years 1995 and 1997 was the slowest in the history of the program, according to the Kaiser Commission on Medicaid and the Uninsured, using data from the Centers for Medicare and Medicaid Services. The slowdown continued in FFY 1998. Medicaid enrollment declined during this time, primarily because the improving economy and federal and state welfare reform caused the number of enrolled children and parents to drop, and total Medicaid enrollment fell for the first time in the program's history. Overall Medicaid expenditures grew at an average annual rate of almost 4 percent between FFY 1995 and 1998, reflecting annual average growth in medical services of 5 percent and declines in DSH payments of 8 percent. Spending for managed care, home care, and prescription drugs grew at double-digit rates, while most other spending categories grew at rates of 5 percent or less.

Medicaid spending began to accelerate after FFY 1998, growing by 7 percent in FFY 1999 and almost 9 percent in FFY 2000. The increase reflected a rebound in enrollment, especially for children and families, a surge in expenditures on prescription drugs, and accelerated spending on long-term care, driven by continued double-digit growth in home care expenditures. At the same time, utilization of services increased, especially by the elderly and disabled.

DSH payments declined by just over 1 percent annually from FFY 1998 to 2000. In this period, and perhaps earlier, states began to rely more heavily on "Upper Payment Limit" arrangements to maximize federal reimbursement. (Under these arrangements, states make inflated payments, often to county-owned hospitals or nursing homes, that drive up federal matching payments. The states then recover these payments from the hospitals and nursing homes through intergovernmental transfers from these entities to the state.) However, because UPL payments tend to be included in hospital and nursing home spending and are not separately identifiable, as DSH payments are, it is not easy to be precise about the magnitude or timing of the growing use of UPL arrangements, although the Congressional Budget Office recently estimated that UPL-related payments cost the federal government \$7.4 billion in fiscal year 2002.²

Higher education

As with K-12 education, higher education enrollment did not grow as quickly in the 1990s as the overall population, but state spending per student (including spending from tuition funds) increased very substantially. Table 11 shows trends in major factors affecting higher education spending.

² Congressional Budget Office, Fact Sheet for CBO's March 2003 Baseline, www.cbo.gov.

Table 11

Factors Related to Spending on Higher Education 1990 to 2000			
	Real state government spending per capita (2000 \$)	Enrolled higher education students per 100 population	Real state government spending per student (2000 \$)
Level in 1990	383.4	4.3	8,947
Percent change:			
1990 to 1995	11.0%	-0.2%	11.2%
1995 to 2000	10.8%	-3.5%	14.7%
1990 to 2000	22.9%	-3.7%	27.6%
Level in 2000	471.4	4.1	11,416

Source: Rockefeller Institute analysis of data from U.S. Census Bureau, U.S. Bureau of Economic Analysis, and National Center on Education Statistics

Transportation

Real per-capita spending increased 20 percent. This was driven by a 65 percent increase in real per-capita spending from state bond funds and a 23 percent increase in other state funds (financed largely by motor fuel taxes and other dedicated sources). The federal contribution increased modestly – 10 percent in real per-capita terms.

Corrections

Between 1990 and 2000, real per-capita spending on corrections increased by 42 percent. This increase resulted not from increases in spending per prisoner – in fact, spending per prisoner declined by 18 percent during this period. Instead, spending increased as a result of dramatic increases in incarceration rates. On December 31, 1989, 276 people were incarcerated per 100,000 population, but by December 31, 1999, that had increased to 478 prisoners per 100,000 population – a 73 percent increase in the incarceration rate in 10 years.⁴³ Much of the increase in incarceration rates appears related to new determinate sentencing policies and to drug-related arrests. This led to a prison-building boom in the late 1980s and early 1990s.

Table 12 below shows trends in corrections spending and incarceration rates:

Table 12

Growth in State Corrections Spending, 1990 to 2000			
	Real corrections spending per capita (2000 \$)	Incarceration rate (prisoners per 100k population)	Real corrections spending per prisoner (2000 \$)
Level in 1990	\$91.0	275.9	\$33,004
Percent change:			
1990 to 1995	26.1%	41.6%	-10.9%
1995 to 2000	12.3%	22.5%	-8.3%
1990 to 2000	41.7%	73.3%	-18.3%
Level in 2000	\$129.0	478.2	\$26,969

Sources: Rockefeller Institute analysis of data from U.S. Census Bureau, U.S. Bureau of Economic Analysis, and U.S. Bureau of Justice Statistics

States have begun to curtail spending

Fiscal year 2000 is the latest year for which comprehensive and comparable expenditures data were available from the U.S. Bureau of the Census. However other information sources show that states began to curtail spending growth sharply after 2001, and are now beginning to cut spending in response to the severe fiscal crisis.

Table 13 shows spending growth rates by major function and funding source for fiscal year 2001, and for fiscal year 2002 as estimated in early 2002. While Medicaid spending was expected to grow at about the same rate in 2002 as it did in 2001, states cut sharply their planned spending growth in elementary and secondary education and higher education. In 2002 many states also began implementing measures to control spending growth in their Medicaid programs, and states' efforts at Medicaid cost containment have grown significantly over time.³

³ Vern Smith, Kathy Gifford, Eileen Ellis, and Victoria Wachino, States Respond to Fiscal Pressure: State Medicaid Spending Growth and Cost Containment, Kaiser Commission on Medicaid and the Uninsured, September 2002, www.kff.org

Table 13

Percentage Change in State Government Spending By Function and Funding Source Fiscal Year 2000 to Fiscal Year 2002						
	FY 2000 to FY 2001 Actual Growth			FY 2001 to FY 2002 Estimated as of early 2002		
	State Funds	Federal Funds	Total	State Funds	Federal Funds	Total
Elementary and secondary education	8.0	7.0	7.9	3.3	4.4	3.4
Medicaid	9.8	11.7	10.9	11.0	10.0	10.4
Higher education	7.6	11.5	8.1	4.3	3.1	4.2
All other	7.5	7.4	7.5	1.2	14.2	4.2
Total	7.9	9.4	8.3	3.3	10.8	5.2

Source: State Expenditure Report 2001, National Association of State Budget Officers, Summer 2002
 Note: States cut FY 2002 spending after the date of estimates presented here, but details by function are not available.

Although details are not yet available, actual spending growth in categories other than Medicaid is likely to have been much lower in fiscal year 2002 than shown here. According to the National Governors Association and National Association of State Budget Officers, 37 states cut their budgets in fiscal year 2002, and total general fund spending (roughly analogous to the “state funds” spending shown above) was only 1.3 percent – meaning that spending declined after adjusting for inflation and population growth.⁴⁴ Furthermore, Medicaid spending growth was revised upward to 13.2 percent from the figures shown here, reflecting increases in health care costs and enrollment due to the weak economy.⁴⁵ The state share of Medicaid spending appears to have slowed in fiscal year 2003 to about 8 percent and the federal share of Medicaid spending appears to have slowed to about 9.8 percent.⁴⁶

Before fiscal year 2003 was completed, NGA and NASBO estimated that state general fund spending growth would be approximately 1.3 percent again, with 17 states projecting outright declines in nominal spending. States subsequently cut budgets further for 2003.

Although states expect tax revenue to improve somewhat for fiscal year 2004, spending is likely to be restrained, with states planning to increase general fund spending by about 1 percent above 2003.⁴⁷

3. Reserve funds: States boosted reserve funds but these funds are now nearly depleted

States built their fund balances up moderately in the late 1980s, to a cyclical peak of \$12.5 billion at the end of fiscal year 1989, or 4.8 percent of expenditures. Economic weakness and recession then hit, and states drew down balances by 75 percent in two years, to \$3.1 billion or 1.1 percent of expenditures at the end of fiscal year 1991.

The economy then began to recover, tax increases kicked in, the fiscal boom of the late 1990s began, and by the end of fiscal year 2000, states built their balances up to a 20-year

high of \$48.8 billion, or 10.4 percent of expenditures.⁴⁸ This made them much better prepared for the 2001 recession, in terms of balances, than they were for the 1991 recessions.

The fund-balance cycle has since begun to repeat – states used their balances before adopting significant spending cuts or tax increases, and by the end of fiscal year 2002 had drawn these balances down by 66 percent, to \$14.8 billion or 3.1 percent of expenditures. They drew balances down further by the end of fiscal year 2003, to an estimated 1.3 percent of expenditures.⁴⁹

The outlook for state spending and revenue

1. Forces that will affect state revenue

Personal income tax

Personal income taxes are likely to grow far more slowly than in the late 1990s, when income tax revenue grew faster than the economy despite tax cuts. Nonetheless, over the longer term the income tax will resume its role in most states as the fastest growing major state tax. The reason for this is that income taxes generally are progressive, with higher effective tax rates for higher incomes. As incomes rise due to inflation and productivity growth, the effective tax rate rises, so that tax revenue generally grows faster than income.

Many of the states that benefited most from the financial market run-up of the late 1990s will face the most difficulty now. It is hard to overstate the role that financial markets played in driving up state income tax revenue in many states. States that relied heavily on revenue related to the stock markets now are suffering withdrawal and are likely to take some time to adjust to the new, lowered, revenue environment. While it is difficult to measure precisely which states rely most heavily on this revenue, in part it depends on how much each state's income tax depends on income from capital gains, and how much the state relies on the income tax as a source of revenue. Table 14 ranks states according to an index that takes both factors into account. While there are important factors not reflected in this measure, nonetheless it gives a rough idea of which states are facing and will face difficulty as a result of declines in financial markets.⁵⁰

Table 14

States Ranked By Importance of Capital Gains in 2000			
<i>State indexed to the nation (US=100)</i>			
	Capital Gains as % of Adjusted Gross Income	Income Tax as % of State General Revenue	Combined Effect
California	148	138	205
Colorado	143	121	173
Connecticut	126	132	167
Massachusetts	167	97	163
New York	139	116	160
Oregon	145	99	144
Idaho	116	101	117
Virginia	144	80	115
Maryland	130	86	112
Minnesota	134	84	112
Georgia	138	80	111
New Jersey	113	94	107
Maine	104	103	106
Illinois	100	103	103
Nebraska	105	97	102
Rhode Island	104	98	101
United States	100	100	100
North Carolina	132	70	92
Utah	109	79	86
Vermont	74	108	81
Missouri	109	73	80
Kansas	111	67	75
Montana	75	100	75
Hawaii	94	78	73
Arizona	79	91	72
Ohio	116	61	70
Pennsylvania	82	82	67
Delaware	86	76	65
Oklahoma	100	61	61
Michigan	92	65	60
Iowa	97	62	60
Kentucky	93	61	57
Indiana	101	56	56
Wisconsin	142	37	53
Alabama	74	62	46
South Carolina	94	42	39
Louisiana	55	62	34
West Virginia	70	45	31
New Mexico	57	50	28
Mississippi	53	54	28
North Dakota	36	66	24
Arkansas	82	19	15
New Hampshire	9	128	11
Tennessee	6	72	4
Alaska	-	61	-
Florida	-	132	-
Nevada	-	147	-
South Dakota	-	95	-
Texas	-	91	-
Washington	-	116	-
Wyoming	-	190	-

Sources:
 Income tax as percent of general revenue obtained from U.S. Bureau of the Census
 Capital gains as percent of adjusted gross income obtained from Internal Revenue Service, Statistics of Income branch
Note: Combined effect is first column multiplied by second column, divided by 100

Sales taxes

States are likely to find their sales taxes depressed for three reasons in the coming decade. First, as noted above, consumption had been rising faster than income throughout the 1990s (savings rate was falling), giving a boost to sales taxes. If this simply stops, as has occurred at least temporarily and as many economists expect to continue, the boost to sales tax revenue will be no more. *Consumption may no longer grow faster than income, and may even grow more slowly.*

Second, consumers will continue to shift their spending from goods to services. Most states currently do not tax many services, and services often are difficult to tax for administrative, legal, and political reasons. *Taxable consumption will not grow as quickly as total consumption.*

Finally, not all taxable consumption is taxed. The advent of Internet commerce makes it easier for people to purchase goods without paying tax owed, due to difficulties of collecting taxes on goods sold over Internet or via mail order. Absent concerted state effort, or federal action, sales taxes will continue to erode for this reason. *Taxed consumption will not grow as quickly as taxable consumption.*

Bruce and Fox (2001) project sales tax bases will erode by three percent of total state and local tax revenue between 2001 and 2006, with the continuing shift to services consumption accounting for one percentage point and Internet sales accounting for two percentage points. The five states with the greatest revenue loss as a percentage of total tax revenue are Nevada, Texas, Florida, Tennessee, and South Dakota – non-income-tax states that rely heavily on the sales tax. Each faces erosion in its total tax base of 5 percentage points or more in a five year period – enough to place substantial strain on state and local budgets.⁵¹

Simulations by the Rockefeller Institute of Government that use an economic forecast from Economy.com and take the Bruce and Fox projections into account suggest that in an economic environment in which personal income grows by 5.1% annually the sales tax might only grow by 3.7 percent annually, on average.

Excise taxes

Selective sales and excise taxes will continue to be a weak third leg of state revenue structures. States are likely to raise rates in the current fiscal crisis – in fact, they have already done so – approximately 20 states raised cigarette taxes in the 2002 legislative session – but after this short-term boost, these taxes probably will continue their long-term decline because they generally are imposed on bases that do not keep up with economic growth.

Federal grants

Current projections by the Congressional Budget Office assume that non-entitlement federal grants and other discretionary spending will grow at a 2.4 percent annual rate through 2013.⁵² As required under the federal Deficit Control Act, this allows federal spending to keep pace with the overall rate of inflation, but is a decline in real per-capita

terms since population will be growing. This is considerably slower than the 5 to 7 percent annual growth states experienced in the 1990s for most non-health and non-Medicaid grants.

Medicaid-related revenue is likely to grow at approximately the same rate as Medicaid spending, absent major federal policy changes, or about 8 to 9 percent annually – far faster than the 2.4 percent assumed for other federal grants.

Longer term issues in state tax systems

States face two very significant revenue issues over the longer term, both of which affect sales taxes: the difficulty in collecting taxes from residents who buy goods and services via the Internet or mail order, known as “remote sales,” as discussed above in the section on sales taxes, and the longer-term shift in the economy from consumption of goods, which states generally include in their sales taxes, toward consumption of services, which states tax relatively lightly. Neither issue has easy solutions.

In the case of remote sales, the fundamental problem is that under current law states cannot require out-of-state sellers that do not have a physical presence in their states to collect sales and use taxes on sales to in-state residents, even though a “use tax” on these transactions typically is due. This gives out-of-state sellers an advantage over in-state sellers, who are required to collect the tax. Although Congress has the authority to require out of state sellers to collect these taxes, it has not been willing to do so, on the grounds that under the current patchwork of varying state and local sales tax laws, this would be extraordinarily complex and would put too much burden on remote sellers.

Many states hope to reduce this burden by passing conforming laws under the Streamlined Sales Tax Project (SSTP). Many large, multi-state businesses also support the SSTP because it could reduce their costs of complying with state sales taxes and could also level the playing field with businesses not currently collecting sales taxes on transactions conducted via the Internet or mail order.

States participating in this project hope that if they demonstrate widespread acceptance and use of the streamlined sales tax, Congress will require remote sellers to collect sales and use taxes.

The second major sales tax issue is that many kinds of services are difficult to include in sales tax bases, administratively, legally, and politically. It is relatively easy to decide how and where services to people and property should be taxed: If a barber cuts a person’s hair in the barber’s shop in New York, then New York can tax the service. If a gardener tends property in New Jersey, then New Jersey can collect tax on the landscaping service. It is much more difficult to determine where and how business services might be taxed. For example, should the sale of advertising be taxed in the state in which the business purchasing the advertising is located? In the state in which the advertising agency is located? In the state in which the advertising market is located? Or on some other basis? Similar issues arise in taxing the services of lawyers and many other professionals who operate in a multistate environment.

Revenue risks states face

States face many risks to the revenue side of their budgets in the near term and over the longer term. Most states face two very large risks in the near term. The first is the possibility that economic growth this year and next will be lower than expected. States tend to be relatively conservative forecasters and most base their budgets on economic forecasts that are at or below the consensus of mainstream economic forecasters.

However, that consensus has moved downward significantly since most states prepared their current forecasts, in December or January. The economic outlook has worsened in large part due to uncertainty over the war in Iraq, which led businesses and consumers to put many spending plans on hold, weakening the economy. Nationally, employment declined by approximately 1 million jobs, heightening concerns that the labor market remains extremely weak and that the economy could even endure a double-dip recession.⁵³ Employment declines clearly have been worse than most private and government forecasters expected, and could foreshadow a new round of revenue shortfalls for states.

Another major near-term risk states face is related to the stock market. Even at the new lower levels of the stock markets and capital gains, financial markets can have large and uncertain effects on state budgets. As a result of the large decline in the stock market, many taxpayers have large capital losses that they can use to offset future capital gains, and this could drive state tax revenue down further in the near term, and keep it depressed for years to come. It is very difficult to forecast the size of this effect, and forecasters have widely varying forecasts of capital gains in coming years.

The Congressional Budget Office predicts that after falling by 50 percent in 2001, capital gains fell an additional 17 percent in 2002, and that this decline will be followed by growth of 10 percent in each of the next two years. New York's budget office forecasts that capital gains fell by 37 percent in 2002 and projects that they will decline by an additional 13 percent in 2003. By contrast, Arizona, California, and Colorado all think the 2002 decline will be 10-15 percent and, similar to CBO, they think that gains will increase slightly in 2003. Clearly these estimates are highly uncertain, and have the potential to wreak havoc yet again on state budgets. Preliminary results for the April-June quarter of 2003, which includes the April 15 filing date for 2002 tax returns, suggest that tax returns were weak, but generally not weaker than states had expected.

In addition to these two very specific risks, state revenue forecasts are subject to a host of risks related to the general economic outlook, all of which have the potential to make their actual results significantly different from their projections, in one direction or the other.

2. Forces that will affect state spending

The "Big 3" areas of state government spending are elementary and secondary education, Medicaid, and higher education. Each will face its own set of pressures in coming years.

Elementary and secondary education

Enrollment pressures affecting elementary and secondary education will ease over the next decade. According to the "middle" projections of the National Center for Education Statistics, *national* K-12 public school enrollment will not grow in the 10 years from 2002 to 2012. This is welcome relief from the 11.2 percent growth in the previous 10 years, when the "baby boom echo" – the large cohort of children of baby boomers – was working its way through high school.

Although enrollment pressures may diminish, states will face many other pressures to finance education. The federal government and many states have adopted policies that appear likely to raise the costs of elementary and secondary education substantially. These policies include high-stakes testing, higher graduation standards, prohibitions against “social promotion,” smaller class sizes, expanded student support services, enhanced professional development for teachers, and other activities intended to help students and teachers achieve these goals.⁵⁴ Many of these policies will increase costs by requiring more teachers, or more-skilled and more highly paid teachers, or more time in school for students (and teachers), or more extensive curricula material, or additional building space. While no estimates of the costs of these policies are available, it appears very likely that state-financed costs of K12 education will continue to rise substantially in coming years, as they have for every decade for at least the past 50 years, as the table below shows:

Table 15

School Year	Total Expenditure Per Enrolled Pupil In 2000-01 \$		State Government Share of Total School District Revenue
	Amount	Average Annual % Change	
	1949–50	\$ 1,708	
1959–60	2,622	4.4%	39.1%
1969–70	4,075	4.5%	39.9%
1979–80	5,164	2.4%	46.8%
1989–90	7,135	3.3%	47.1%
1998–99	8,016	1.3%	48.7%

Source: *Digest of Education Statistics 2001*,
National Center on Education Statistics, February 2002,
Tables 36, 65, and 167

Medicaid

The Congressional Budget Office projects that national Medicaid spending will grow about 8.5 percent annually for the remainder of this decade. CBO projects that this rate of growth, which is lower than that the program experienced in fiscal year 2002 and 2003, will be driven by higher prices, increased use of services, and somewhat lower enrollment.⁵⁵ States generally will be affected by the same trends. The projected 8.5 percent growth is considerably higher than growth in the mid-1990's and faster than tax revenue in the typical state is likely to grow.

Table 16 shows state-financed Medicaid expenditures as a share of total state spending in each state. In states where Medicaid is a large share of the budget, rapidly growing Medicaid expenditures may cause significant fiscal stress.⁴

⁴ These figures may reflect states' use of financing strategies, such as upper payment limit strategies, that draw down additional federal funds.

Table 16

State-Financed Medicaid as Share of All State-Financed Spending			
Fiscal Year 2002			
Connecticut	20.5%	Massachusetts	9.8%
Ohio	19.5%	Virginia	9.7%
Pennsylvania	19.3%	Nebraska	9.6%
Washington	19.1%	California	9.6%
New Hampshire	18.3%	South Dakota	9.4%
Tennessee	17.6%	South Carolina	9.4%
Rhode Island	16.8%	Oregon	9.0%
Missouri	15.7%	Arizona	8.8%
New Jersey	14.8%	North Dakota	8.8%
Illinois	14.0%	Idaho	8.3%
Georgia	13.5%	Kansas	8.0%
Florida	12.8%	Kentucky	7.6%
Texas	12.7%	Wisconsin	7.6%
Vermont	12.6%	Oklahoma	7.4%
New York	12.6%	West Virginia	7.3%
Michigan	12.0%	Alabama	7.3%
United States	12.0%	Wyoming	7.0%
		Mississippi	6.9%
		Montana	6.8%
Indiana	11.8%	Iowa	6.7%
North Carolina	11.7%	Arkansas	6.7%
Louisiana	11.6%	Delaware	6.3%
Minnesota	11.5%	New Mexico	5.8%
Maine	11.5%	Hawaii	5.0%
Colorado	10.6%	Utah	4.9%
Maryland	10.3%	Alaska	4.4%
Nevada	10.1%		

Source: 2001 State Expenditure Report, National Association of State Budget Officers, Summer 2001
 Note: Alaska data not available in 2001 State Expenditure Report, and instead are from 2000 State Expenditure Report, for FY 2001

Over the longer term, a major looming risk to Medicaid is that the cost of long term care, hospital care, prescription drugs and other expenditures that are particularly important for the elderly will rise as the population ages. Medicaid expenditures per elderly beneficiary are more than three times as large as expenditures for the non-elderly, and as a result even though the elderly account for only about 11 percent of Medicaid beneficiaries, they account for approximately 31 percent of Medicaid spending.⁵⁶ This will become even more significant in years ahead: about three-quarters of projected growth in Medicaid expenditures is attributable to rising costs of care for the aged and disabled.⁵⁷

While the aging of the population will not be a major issue in the near term for most states, it will hit some sooner than others, particularly a number of southern and western states. According to Economy.com, the nine states shown below are likely to have growth of more than 33 percent between 2002 and 2012 in their population aged 65-and-older:

Table 17

States Where Age 65+ Population Is Projected To Grow By More Than One-Third Between 2002 and 2012	
	<u>Projected Growth</u>
Nevada	63%
Arizona	50%
Colorado	44%
Utah	44%
Oregon	41%
Idaho	39%
Georgia	38%
Alaska	37%
Washington	36%

Source: Rockefeller Institute analysis of June 2002 forecast provided by Economy.com

Higher Education

After coming to a virtual standstill in the late 1990s due to changing demographics, higher education enrollment is likely to grow considerably in the coming 5–10 years for two reasons. First, the leading edge of the large cohort of children of baby boomers (the “baby boom echo”) is exiting high school and entering college. Second, labor market demands are increasing pressures for high school graduates to attend college. According to the U.S. Department of Labor, 43 percent of net new jobs in the 10-year period ending in 2008 will be in occupations that commonly require at least some higher education, even though these jobs constituted only 29 percent of the existing employment base.⁵⁸ According to the “middle” projections of the National Center for Education Statistics, *national* higher education full-time-equivalent enrollment is expected to grow by about 1.3 percent annually in the 10 years from 2002 to 2012, somewhat faster than the overall population growth rate.

In addition, higher education, like other service industries, often do not share in productivity gains and their prices tend to increase faster than overall inflation.

Uncertainties and risks

All budget projections contain uncertainty, although projections of expenditures tend to be somewhat less uncertain than revenue projections. Expenditure uncertainties that states face include:

- Medicaid expenditures are large and difficult to control, and the underlying forces driving growth in Medicaid, and health care expenditures more generally, have been difficult to predict. If health care price inflation accelerates again, it could have a large negative impact on state budgets.

- Implementing higher standards for elementary and secondary education, as all states are doing, could be very expensive. Similarly, hiring and training teachers to teach to the standards could be very expensive. In addition, some states face the risk that they will have to increase education expenditures significantly, depending on the outcome of pending state-specific litigation.
- State and local governments bear much of the responsibility for homeland security, and these costs could be affected by the outcome of the war in Iraq and its aftermath.

Conclusion: States will face budget difficulties for years

At this point, even if budget gaps for fiscal year 2004 remain closed, the outlook for state budgets in fiscal year 2005 is bad, for several reasons. First, the near term economic outlook has deteriorated from what private and government forecasters expected at the time they prepared their forecasts for fiscal year 2004, and employment has continued to decline despite the end of the recession.

Even if the economic outlook had not worsened, states had been predisposed to look for “easy” solutions to 2003 budget gaps – states tend to take the easiest actions first when closing budget gaps, and many of these actions tend to push fiscal problems off to future years. This tendency was exacerbated by the extraordinarily sharp dive in state revenue in the final quarter of fiscal year 2002, as states were debating their 2003 budgets, which overtaxed the political process in many states – policymakers found it extraordinarily difficult to come to grips with the full size of the problems they faced for fiscal year 2003. The result was that most states closed fiscal 2003 budget gaps incompletely, and with solutions that tended to exacerbate problems for fiscal year 2004 and beyond.⁵⁹

Many states appear to have used solutions for fiscal year 2004 budget gaps that follow the same philosophy, pushing problems out to fiscal year 2005 and beyond. Several states, including California, Illinois, Massachusetts, New York, Wisconsin, and others used bonding, tobacco revenue, and other large nonrecurring resources to help close fiscal year 2004 gaps. With reserve funds nearly depleted and large amounts of nonrecurring revenue, many states are almost certain to face large budget gaps again in fiscal year 2005.

After much debate, and to the surprise of many observers, the federal government did enact a package of \$20 billion in temporary fiscal relief for the states, spread across two fiscal years. The package includes \$10 billion in flexible assistance, and another \$10 billion in increased aid for Medicaid available to states that do not change Medicaid eligibility.⁶⁰ While the relief is welcome, it is temporary and relatively small, amounting to about one percent of state own-funds spending.

Over the longer term, the prospects for substantial and sustained increases in federal aid to states appear dim. The federal budget benefited from many of the same forces as state budgets, and it is being buffeted now by the recession and continued economic weakness, the decline in financial markets, accelerating health care spending, tax cuts, anti-terrorism spending, and the military and reconstruction costs of the war in Iraq. In projections released in August 2003 that reflect only some of these factors, the Congressional Budget

Office forecast deficits amounting to \$1.4 trillion in total for the period from 2004 through 2008. Furthermore, these projections likely understate the severity of federal fiscal problems.⁶¹ Thus, a sustained increase in federal aid to the states seems unlikely.

Over the longer term, beyond fiscal year 2005, states are likely to face continued budget difficulties. As discussed above, the income tax is likely to grow more slowly than in late 1990s, depressed in part by the impact of carryover capital losses. The sales tax is likely to grow slowly for the three reasons given earlier: the difficulty of taxing remote sales, the continued shift by consumers toward purchases of relatively hard-to-tax services, and the absence of the boost to consumption seen in the 1990s, when the savings rate plummeted.

Finally, while states face some spending pressures, particularly in Medicaid, which is large, , an entitlement program, and likely to grow by 8 to 9 percent annually – faster than the typical state tax structure is likely to grow.

What would change this dour outlook? Although it is always possible for the economy and stock markets to provide forecasters with positive surprises, in the short term the best that most states probably can hope for is an improvement that will reduce the size of their problems – not make them go away. The decline in revenue and use of nonrecurring resources simply have been too large for state fiscal problems to go away quickly.

Over the longer term – say four or more years - it certainly is possible for states to experience unanticipated good news large enough to lead, yet again, to surpluses. That is what happened in the 1990s. But for the moment, it is hard to see where this good news would come from.

Notes

¹ I acknowledge gratefully the help of Celia Ferradino, graduate assistant at the Rockefeller Institute of Government, in gathering some of the data and studies analyzed in this article.

² Computed from data in the file “01in01si.xls,” dated May 2003, downloaded from the Internal Revenue Service Statistics of Income website (www.irs.gov/taxstats) on August 7, 2003.

³ See “State Budget and Tax Actions 2002”, *NCSL News*, National Conference of State Legislatures, August 28, 2002.

⁴ *State Budget Update: February 2003*, National Conference of State Legislatures, Washington, DC: February, 2003.

⁵ The actual revenue shortfall of \$38 billion is much less than the \$68 billion falloff from “normal” growth estimated above because states were well aware that tax revenue in 2002 would grow much slower than 6 percent – but actual collections still were far less than their dampened expectations.

⁶ Author’s analysis of data in *State Expenditure Report 2001*, National Association of State Budget Officers, Summer 2002.

⁷ Author’s analysis of data from the Bureau of the Census and the Bureau of Economic Analysis.

⁸ See Chris Edwards, “New Data Show State/Local Spending Rose Almost 5 Percent in 2002,” www.cato.org, March 13, 2003.

⁹ NOTE: revenue per \$100 of personal income is shown in the accompanying table. Real per-capita revenue is not shown in the table.

¹⁰ Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2003-2012*, January 2002, Chapter Two.

¹¹ Based on data in “capgain1-2001.pdf” and “in00cm54.xls,” both of which are available on the Statistics of Income area of the Internal Revenue Service website.

¹² Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2003-2012*, January 2002, pp. 50-51.

¹³ State revenue analysts in several states, including California, New York, and Ohio, reported this to Rockefeller Institute of Government staff in periodic informal telephone interviews conducted by Institute staff in the course of preparing the Institute’s quarterly *State Revenue Report*. These interviews were conducted by Elizabeth I. Davis, Nicholas W. Jenny, and Donald J. Boyd.

¹⁴ See Balkovic, Brian, “High Income Tax Returns for 1999,” *Statistics of Income Bulletin*, Spring 2002, for the latest in a series of annual articles on this topic by the Internal Revenue Service. The data in this paragraph were obtained from spreadsheets entitled 95IN01AR.xls, 95IN02AR.xls, and 00in54cm.xls, provided by the Internal Revenue Service’s Statistics of Income branch.

¹⁵ No comprehensive data are available on *state* income taxes paid by these high-income taxpayers, but those taxes would be very substantial.

¹⁶ Two organizations track state tax changes - the National Conference of State Legislatures and the National Association of State Budget Officers – and their methods and numbers differ slightly. The sum of tax increases reported by NCSL for 1990 through 1995 fiscal years appears to be \$33.4 billion, and the total reported by NASBO for 1990 through 1994 is \$36.2 billion (NASBO shows a tax reduction in 1995).

¹⁷ A tax increase could become larger in subsequent years if it was in effect for only part of its initial year, as is often the case. A tax increase might become smaller in subsequent years if the tax base is declining, as is the case with cigarette taxes, or if it was enacted in a fashion that “doubles up” in the initial year, as can occur with an income tax increase that is imposed for the entire tax year in which a state fiscal year begins, and for the portion of the tax year in which a state fiscal year ends. In addition, tax increases that are enacted with phase-out provisions also would decline in value in subsequent years.

¹⁸ In other words, this assumes that the fiscal year 1990 increase recurred in 1991, 1992, 1993, and 1994 at its 1990 value; the fiscal year 1991 increase recurred in 1992, 1993, and 1994 at its 1991 value; and so on. This obviously is a very crude approach to estimating the recurring value of tax increases, and my over or understate their recurring value, but data that would allow a more sophisticated analysis would be extremely difficult to assemble. The 10-12 percent range accounts for the differences between NCSL and NASBO estimates of tax increases.

¹⁹ Many of these taxes, such as cigarette, alcohol, and motor fuels taxes, are imposed on the quantity of goods sold, and these quantities generally either decline (in the case of cigarettes) or may not keep pace with growth in nominal incomes (as is often true with motor fuels).

²⁰ Analysis of NCSL and NASBO tax-cut estimates yields approximately equivalent results.

²¹ Nicholas Johnson and Daniel Tenny of the Center on Budget and Policy Priorities argue this point in *The Rising Regressivity of State Taxes* (Jan. 15, 2002).

²² In a recent study using a microsimulation model, the Institute on Taxation and Economic Policy concluded that the share of all state and local taxes paid by lower income people increased between 1989 and 2002, mainly as a result of higher sales, excise, and (largely local) property taxes. Taxes paid by upper-income individual families also rose, largely due to higher income taxes (perhaps due to rising capital gains, although it is possible to discern this from the methodological description provided by ITEP), but the increases for lower-income families were estimated to be larger than those for upper-income families. (NOTE: I have excluded ITEP's "Federal Offset" for purposes of this discussion.) See *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, Institute on Taxation and Economic Policy, January 2003.

²³ Jenny, Nicholas W., Fiscal 2001 Tax Revenue Growth: Weakness Appears, *State Fiscal Brief* No. 64, Rockefeller Institute of Government, April 2002.

²⁴ Jenny, Nicholas W., *State Revenue Report* No. 47, Rockefeller Institute of Government, March 2002, and Donald J. Boyd and Nicholas W. Jenny, "States Will Raise Their Economic Forecasts But May Lower Their Revenue Forecasts," *State Fiscal News* Vol. 2, No. 3, Rockefeller Institute of Government.

²⁵ See Nicholas W. Jenny, "Sluggish State Revenue Continues", *State Revenue Report* No. 51, Rockefeller Institute of Government, April 2003.

²⁶ See Jenny, Nicholas, W., "Underlying State Revenue Picture Remains Bleak," *The Rockefeller Institute State Fiscal News* Volume 3 Number 6, August 2003.

²⁷ We measure inflation using the state and local government chain-weighted price index, which attempts to measure the prices of goods and services produced by state and local governments. As with all inflation measures, this measure has its flaws, but unless noted otherwise in the text, other measures such as the consumer price index yield conclusions similar to those in this paper.

²⁸ There also are a variety of more-sophisticated approaches to comparing spending levels and policies across states and times, but these go well beyond the purposes and needs of this paper.

²⁹ See Rudolph Penner, *A Brief History of State and Local Fiscal Policy*, Urban Institute, December 1998, Publication A-27, for a good discussion of these trends.

³⁰ Based on data from U.S. Bureau of the Census on state government "general expenditures."

³¹ See state general expenditures for 2001, at www.census.gov/govs/state/01st00us.html.

³² Inflation is based on the state and local government chain weighted price index from the U.S. Bureau of Economic Analysis. Population is based on data from the U.S. Bureau of the Census. By convention, price index data are for the calendar year in which a state fiscal year ends, and population data are for the calendar year in which a state fiscal year begins. Alternative conventions would have no material impact on 10-year growth rates.

³³ See Goldsmith, Scott, Linda Leask, and Mary Killorin, "Alaska's Budget: Where the Money Came From and Went, 1990-2002," *Fiscal Policy Papers* Number 13, Institute of Social and Economic Research, University of Alaska Anchorage, May 2003.

³⁴ These figures are based on data from the National Association of State Budget Officers, *State Expenditure Report 2000*. I use these here, rather than Census data, because NASBO identifies Medicaid as a separate category.

³⁵ *Digest of Education Statistics 2002*, National Center on Education Statistics, Table 156, June 2003.

³⁶ Nonetheless, states were aggressive in maximizing federal Medicaid revenue in this period; some spending counted as "state" spending had the effect of driving up the federal matching rate for Medicaid, even though this is not apparent from financial reports. For a discussion of these methods see Coughlin, Theresa A., and Stephen Zuckerman, "States' Strategies for Tapping Federal Revenues Implications and Consequences of Medicaid Maximization," in Holahan, John, Alan Weil, and Joshua Weiner (Eds.), *Federalism & Health Policy*, Urban Institute Press, 2003.

³⁷ For an analysis of spending changes in New York, see Don Boyd, Hamp Lankford, and Jim Wyckoff, *School District Expenditures and Fiscal Stress*, Condition Report Prepared for the New York State Education Finance Research Consortium, July 2002, <http://www.albany.edu/edfin>.

³⁸ See Digest of Education Statistics 2001, National Center on Education Statistics, Table 78.

³⁹ Based on data from Health Care Financing Administration Form 64. These data show that real per capita “total computable” spending on medical assistance payments (including DSH) increased by 80 percent between federal fiscal years 1990 and 1995, which is remarkably consistent with the 78 percent increase in real per capita medical vendor payments (which also include DSH) between state fiscal years 1990 and 1995. As with the Census data on medical vendor payments, the analysis of HCFA data is based on combined federal-state spending, with adjustments for DSH.

⁴⁰ Computed from Table 2 in Brian Bruen and John Holahan, *Slow Growth in Medicaid Spending Continues in 1997*, November 1999, The Kaiser Commission on Medicaid and the Uninsured, and from population data from the U.S. Bureau of the Census.

⁴¹ Computed from annual average medical inflation rates given in the text of Bruen and Holahan (1999) and from data on the state and local government chain-weighted price index from the U.S. Bureau of Economic Analysis.

⁴² Computed from Table 1 in and Holahan (1999).

⁴³ Based on data from the Criminal Justice Sourcebook, Table 6.27 as of 11/4/2002. These data are for prisoners under federal and state custody combined, but the vast majority of prisoners, by far, are under state custody.

⁴⁴ The Cato Institute has noted that state and local expenditures, as reported by the Bureau of Economic Analysis, grew by 4.9 percent in calendar year 2002. (See Chris Edwards, “New Data Show State/Local Spending Rose Almost 5 Percent in 2002,” www.cato.org, March 13, 2003.) This growth rate appears to be consistent with the NASBO numbers reported here, which anticipate general fund spending in fiscal year 2002 of 1.3 percent, and total spending that presumably is somewhat less than the 5.2 percent shown in the table. The BEA data include spending from all sources and are more closely analogous to the NASBO total spending concept than general fund spending. If “transfers” – which include Medicaid spending – are excluded from the BEA numbers, then state-local spending on items other than transfers was up 3.3 percent in calendar year 2002.

⁴⁵ Fiscal Survey of the States, November 2002, Table 9.

⁴⁶ The 8 percent state-share spending increase is from *Fiscal Survey of the States*, June 2003, p.4. Note that this is the state share. The Congressional Budget Office estimates that the federal share of Medicaid spending rose by about 9.8 percent in federal fiscal year 2003 (*The Budget and Economic Outlook: An Update*, August 2003, p.5). The National Conference of State Legislatures recently reported that states project that the state share of Medicaid will grow by approximately 4 percent in state fiscal year 2004 (*State Budget and Tax Actions 2003: Preliminary Report*, July 23, 2003, p.6), but this was for a sample of only 38 states and was based on projections prepared at the start of the fiscal year. States’ early estimates have proven unreliable in the past and may not be a good indicator of Medicaid spending for 2004.

⁴⁷ *State Budget & Tax Actions 2003 Preliminary Report*, National Conference of State Legislatures, July 23, 2003.

⁴⁸ Fiscal Survey of the States, November 2002, Table 8.

⁴⁹ *Fiscal Survey of the States*, National Governors Association and National Association of State Budget Officers, June 2003, Table 9.

⁵⁰ Important factors not reflected in this index include: (1) the progressivity of a state’s income tax, since the vast preponderance of capital gains are realized by top-bracket taxpayers, (2) the importance of stock options, and (3) the direct impact of the financial services industry on a state’s economy.

⁵¹ Bruce, Donald and William F. Fox, *State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates*, Center for Business and Economic Research, University of Tennessee, September 2001.

⁵² *The Budget and Economic Outlook: Fiscal Years 2004-2013*, Congressional Budget Office, January 2003, p. 80.

⁵³ *THE EMPLOYMENT SITUATION: MARCH 2003*, U.S. Bureau of Labor Statistics, April 4, 2003, <http://www.bls.gov/news.release/empsit.nr0.htm>.

⁵⁴ See Education Commission of the States, 2000-01 Selected State Policies, March 2002, for a listing of state policies that received serious consideration or were adopted in 2000 or 2001.

⁵⁵ See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004-2013*, January 2003, pp. 80-83 for discussion of the CBO Medicaid forecast.

⁵⁶ Based on data in *A Profile of Medicaid: Chartbook 2000*, Health Care Financing Agency, U.S. Department of Health and Human Services, September 2000, p.62.

⁵⁷ See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2004-2013*, January 2003 p.83, and Leighton Ku, *Shift In Costs From Medicare To Medicaid Is A Principal Reason For Rising State Medicaid Expenditures*, Center on Budget and Policy Priorities, March 3, 2003.

⁵⁸ Braddock, Douglas, "Occupational employment projections to 2008, *Monthly Labor Review*, November 1999.

⁵⁹ See Kenneth Finegold, Stephanie Schardin, and Rebecca Steinbach, *How Are States Responding to Fiscal Stress?*, The Urban Institute, No. A-58, March 2003, for examples of these sorts of actions.

⁶⁰ *Jobs and Growth Tax Relief Reconciliation Act of 2003 (Public Law 108-27): Summary of State Fiscal Assistance Provisions*, National Conference of State Legislatures, June 10, 2003, <http://www.ncsl.org/standcomm/scbudg/stateassistancesummary.htm>.

⁶¹ CBO projections make some unrealistic assumptions, among them that discretionary spending will grow more slowly than the economy and more slowly than recent experience, that tax cuts scheduled to expire will not be extended, that Congress will allow unintended increases in the Alternative Minimum Tax to go forward, and that Congress will not enact a prescription drug benefit for Medicare. Furthermore, these projections do not reflect most costs of the war in Iraq and its aftermath. For a discussion of these issues see Kogan, Richard and Robert Greenstein, *The New Congressional Budget Office Forecast and the Remarkable Deterioration of the Surplus*, Center on Budget and Policy Priorities, September 3, 2003.

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