The Bursting State Fiscal Bubble And State Medicaid Budgets

Many state actions to close budget gaps in FY 2003 may make matters worse in later years.

by Donald J. Boyd

ABSTRACT: States make policy choices about Medicaid eligibility, benefits, and reimbursement rates in the context of the larger state fiscal environment. This paper reviews the factors that made this environment so favorable in the 1990s and examines the state budget outlook. State tax revenue is likely to grow more slowly in this decade than in the last, states will face continued substantial pressures to finance K–12 and higher education, and Medicaid spending has accelerated. States will have to curtail the growth of Medicaid, raise revenue, or constrain growth in education spending to maintain balanced budgets.

MEDICAID IS SECOND IN SIZE only to elementary and secondary (K–12) education in the typical state budget, totaling approximately $221 billion of spending in fiscal year 2002 when all funding sources (federal plus state) are considered, and accounting for 21 percent of the "all funds" state budget.[1] The federal government finances roughly 57 percent of Medicaid, compared with only 19 percent of other state spending, on average, and so Medicaid is a smaller but still sizable 12 percent of spending financed from states' own revenue.[2] Medicaid's budgetary role varies widely across states, reflecting differences in need, fiscal capacity, political ideology, prices, and states' choices about eligibility, benefits, and reimbursement rates.

Because Medicaid is so large and is an entitlement program, it plays a large role in states' fiscal problems and in their potential solutions. When Medicaid is growing rapidly, it places pressure on the rest of the state budget, and when state budgets are in crisis, states may consider cuts in Medicaid eligibility, benefits, and reimbursement rates as ways to achieve savings.

After reaping extraordinary fiscal windfalls during the 1990s, states now are in fiscal crisis. The fiscal boom of the late 1990s turned into the current bust when manufacturing declined, stock markets fell, and the economy slipped into a recession worsened by the attacks of September 11. At this writing, the recession has

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been relatively shallow, but its impact on state finances has been severe. Although there had been some early signs that the economy was emerging tepidly from recession, many analysts now fear that the economy will slide backward again.

After the recession, will state finances boom again? How hard will it be for states to finance Medicaid and other health care programs? I believe that it will be much harder than it was in the 1990s. State finances in the late 1990s were propped up by atypical forces that now are disappearing or reversing. This bursting fiscal bubble spells hard times for most states in the current fiscal year and in the 2004 state fiscal year that begins in July 2003. It also spells additional difficulties for several years to come.

The State Fiscal Boom Of The 1990s

The 1990s opened with a recession that was mild for the nation as a whole but quite severe in some parts of the country, particularly the Northeast and California. States raised taxes by $36 billion in FY 1990–1994, they cut spending greatly, and they drew down fund balances from 4.8 percent of expenditures in 1989 to 1.1 percent in 1991.[3] ("Fund balances" includes reserves set aside explicitly for the purpose of cushioning the impact of a downturn, plus other money on hand that may be used for that purpose even if not designated as a reserve.)

This period of crisis was followed by an extraordinary boom in state finances. State tax revenue repeatedly came in well above projections, and elected officials were in a position that looks especially enviable now. States adopted policies that on their face seem impossible to achieve in combination: cutting taxes year after year, increasing fund balances to a nearly twenty-year high, and increasing spending significantly—all while keeping budgets balanced or in surplus.

■ **State government spending increases.** State government spending increases were substantial and widespread in the 1990s.[4] States as a whole increased spending by 32 percent—a sizable amount—after adjusting for inflation and population growth. Put differently, state government spending per person increased by nearly a third.[5] Every state except Alaska chose to increase spending, usually by a substantial amount—thirty-eight states increased spending by 25 percent or more.[6] Most low-spending states increased spending far more rapidly than high-spending states did. By contrast, states that began the decade with high spending generally increased spending less rapidly than the U.S. average.

Although the pace of state government growth in the 1990s was rapid, that growth was part of a much longer trend of rising state and local government influence in the federal-state-local fiscal system. State governments (and also local governments) have increased spending, even after inflation and population growth are adjusted for, substantially and almost continuously throughout the post–World War II period.[7] State governments increased real per capita spending by 28 percent between 1980 and 1990, by 14 percent in the 1970s, and by 35–40 percent each in the 1960s and 1950s.[8]

Medicaid and K–12 education took turns dominating state finances in the 1990s. In the early years states were hit with the double whammy of responding to the recession and to rapidly escalating Medicaid costs (driven upward in part by the recession).[9] In the latter part of the decade Medicaid growth slowed dramatically, and K–12 education spending was the dominant element.

Spending on "medical vendor payments" (a Census Bureau measure that is close in concept to Medicaid) and on K–12 education together accounted for 32 percent of state government spending in 1990 and for an even larger share of real per capita growth—53 percent between 1990 and 2000 (computed from data underlying Exhibit 1).[10]

These data do not distinguish between spending financed by states' own-source revenue and spending financed by federal grants. This distinction is potentially important, given the large federal role in financing Medicaid. Data from the National Association of State Budget Officers (NASBO), while not as comprehensive or comparable as the census data used here, suggest that federally and state-financed Medicaid spending grew at approximately the same rates in the 1990s, and the federal share of Medicaid remained 57 percent throughout the decade.[11] (Although the reported federal share of Medicaid spending was approximately constant over the decade, hidden behind these numbers is the impact of techniques that states used to drive up the effective federal share of spending, as discussed below.) By contrast, federal support for non-Medicaid spending increased more rapidly than did state support for non-Medicaid spending.

■ **Medicaid spending growth: 1990–1995.** 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 states' real per capita spending growth, despite accounting for only 11 percent of 1990 spending. Almost all of this growth occurred in 1991 and 1992, after which these payments slowed and then flattened out (Exhibit 2).

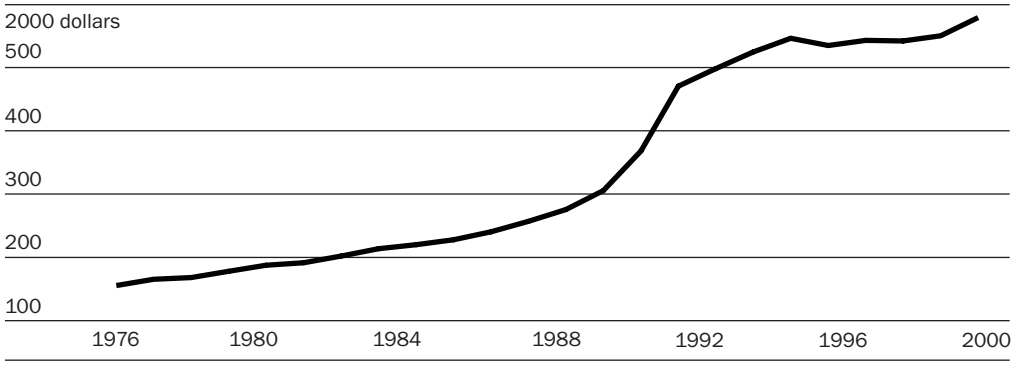
Some of this growth was illusory. Although disproportionate-share hospital (DSH) payments drove up reported state expenditures (they are included in the

EXHIBIT 1
Growth In State Government Spending In The 1990s, Including State Spending From Own-Source And Federal Funds, As Percentage Change In Real Per Capita Spending

	1990–1995	1995–2000	1990–2000
Total general spending	20.5%	9.6%	32.1%
Elementary and secondary education	13.2	18.5%	34.2
Medical vendor payments	77.6	5.9	88.1
Higher education	11.0	10.8	22.9
All other	14.0	7.0	22.0

SOURCE: Rockefeller Institute of Government analysis of data from U.S. Bureau of the Census and U.S. Bureau of Economic Analysis.

EXHIBIT 2
Medical Vendor Payments By State Governments, Including Disproportionate-Share Hospital (DSH) Payments, 1976–2000



SOURCES: U.S. Bureau of the Census; and U.S. Bureau of Economic Analysis.

Census Bureau's "medical vendor payments"), states generally recouped most of the payments through taxes or "donations" from medical providers, thereby increasing state revenue. States also were able to claim a federal match for the payments. The net result was that DSH payments allowed states to finance higher spending on Medicaid services with little true cost to state government, and they also provided general budget relief.

Data from the Centers for Medicare and Medicaid Services (CMS) indicate that nominal DSH payments rose more than tenfold between federal FY 1990 and FY 1995. But even if we remove DSH payments, growth in real per capita spending on Medicaid benefits was substantial, increasing by 60 percent and yielding annual average growth of 9.8 percent.[12]

Other major factors causing this sharp increase included the following. (1) Medicaid enrollment grew from 28.9 million in 1990 to 41.7 million in 1995, a 44 percent increase in a period when the overall population grew by only 5.5 percent. The enrollment increase reflected eligibility expansions, the recession of 1990–91, and other factors. Enrollment of the high-cost blind and disabled populations grew by 58 percent.[13] (2) Reflecting trends in the broader economy, medical care inflation was 37 percent over the five-year period, compared with general price inflation of 13 percent for state and local governments.[14] (3) States became increasingly adept at shifting services from other programs into Medicaid.[15] As a result, total nominal spending on benefits more than doubled between federal FY 1990 and FY 1995.[16]

■ **Medicaid spending growth: 1995–2000.** Real per capita spending on medical vendor payments slowed dramatically in the second half of the 1990s, growing by only 5.9 percent in total between state FY 1995 and FY 2000 (Exhibit 1). Essentially all of that growth occurred in the final year, 2000, with only 0.7 percent growth between 1995 and 1999.

According to analysis of CMS data by the Kaiser Commission on Medicaid and

the Uninsured, average annual growth in nominal Medicaid expenditures between federal fiscal years 1995 and 1997 was the slowest in the program's history.[17] The slowdown continued in 1998. Medicaid enrollment declined in all three federal fiscal years 1995–1998, primarily because of declines in the number of enrolled children and parents as a result of an improving economy and response to federal and state welfare reform, offset slightly by increases in the number of aged, blind, and disabled enrollees.

Despite enrollment declines, spending on medical services still grew at a 5.2 percent rate between 1995 and 1998 because benefits per enrollee increased 6.4 percent annually (far faster than the 2.2 percent general price inflation faced by state and local governments).[18] 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.[19] Total Medicaid spending, which includes payments for benefits plus DSH spending, grew at a 3.6 percent rate, reflecting 7.8 percent average annual declines in DSH payments.

Medicaid spending began to accelerate after 1998, growing by 7.1 percent in federal fiscal year 1999 and 8.6 percent in 2000. The increase reflected a rebound in enrollment of children and families, a surge in spending on prescription drugs, and accelerated spending on long-term care, driven by continued double-digit growth in home care spending.[20] According to Urban Institute researchers, the increase in enrollment of children and families appears to have been primarily among children rather than among nonelderly, nondisabled adults. This probably reflects higher priority given to expanding enrollment of children and their parents, reflected in policies such as increased outreach to Medicaid beneficiaries who remained eligible even if cash assistance was terminated, and state eligibility expansions.[21] In addition, although most states implemented the State Children's Health Insurance Program (SCHIP) as a separate state program rather than as an expansion of Medicaid, it may have had a case-finding effect for Medicaid.[22]

DSH payments declined at a 1.1 percent annual rate from 1998 to 2000. In this period, states began to rely more heavily on upper payment limit (UPL) arrangements to maximize federal reimbursement, but these payments tend to be included in hospital spending and unlike DSH are not separately identifiable.[23]

Growth In Non-Medicaid Expenditures

■ **K–12 education.** The large increase in state government spending on elementary and secondary education reflected enrollment growth, increases in overall spending per pupil, and state policies to finance a larger share of education. Enrollment grew 1.5–2 percent annually in the early years of the decade before easing in the last few years, as the children of baby boomers began to graduate from high school and moved into the workforce or higher education. Even while enrollment was rising, states managed to increase total state-local real spending per pupil by 14 percent in the 1990s, with almost all of that growth in the last five years of the de-

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cade.[24] In addition, many states picked up a larger share of K–12 education costs.

■ **Higher education.** Higher education spending grew 23 percent in real per capita terms—nearly a one-quarter increase at a time when full-time-equivalent enrollment was growing slightly more slowly than the overall population.[25] Still, the increase was mild relative to other spending categories.

■ **Other spending categories.** In aggregate, all other spending grew by 22 percent in real per capita terms. This category was quite diverse: Judicial, general public health (mostly non-Medicaid), and corrections spending grew rapidly—54 percent, 46 percent, and 42 percent, respectively. General interest expense declined concomitant with the fall in interest rates. Cash-assistance spending—small from a budgetary perspective but of great policy interest—fell a dramatic 32 percent in real per capita terms because of widespread and steep caseload declines and benefits that did not keep pace with inflation. Aside from these latter two categories, all major areas of state spending activity grew in real per capita terms.

A Fiscal Wonder Of The 1990s

The substantial spending increases of the 1990s would be remarkable by themselves, but that is not all states did. They also enacted sizable tax and revenue cuts for every state fiscal year from 1995 through 2001 (seven straight years), in aggregate reducing annual state revenue by more than $30 billion from what otherwise would have been collected.[26]

One of the fiscal wonders of the 1990s was that despite continued tax cutting, state tax revenue rose as a share of personal income throughout almost the entire period. I analyze below how each of the three largest tax categories as a percentage of personal income—income taxes, sales taxes, and excise taxes—contributed to the rise in state tax revenue.

■ **State income taxes.** State income taxes generally are progressive, claiming a larger share of income as income rises. Over time they tend to increase as a percentage of income because of economic and inflationary growth, unless states cut them. It is not surprising, therefore, that state income taxes were rising as a share of income during the early 1990s as states raised taxes at the end of the recession. What is surprising, though, is the extremely sharp rise in income taxes as a share of income in the late 1990s—at exactly the time that states were cutting income taxes. Why this happened is a subject of the next section, but it was a major factor behind the fiscal boom of the late 1990s.

■ **State sales taxes.** The sales tax also performed well in the 1990s, rising sharply early in the decade as states raised sales taxes and as consumer spending rebounded after the recession. The sales tax held its own in the latter half of the de-

cade, remaining relatively constant as a share of income. This is a little surprising, because the longer-term outlook for the sales tax is not good: People have been shifting increasing shares of consumption to services from goods, a trend that many economists expect to continue. Many kinds of services are especially difficult to include in sales tax bases administratively, legally, and politically. In addition, unless the question of how to collect taxes on sales conducted via the Internet or mail order is resolved in a fiscally benign manner, states will find it increasingly difficult to collect taxes that are part of the tax base.

■ **State excise taxes.** Excise and selective sales taxes, often based on the quantity sold of a good such as motor fuel or cigarettes, tend not to keep up with income growth and thus fall as a percentage of income except when states raise rates. These taxes continued their long-term decline in the 1990s, save for an increase early in the decade when states were raising taxes in response to the recession.[27]

■ **Net impact.** The net impact of these trends was that total state taxes as a percentage of personal income increased throughout the decade. Taxes had dropped sharply between 1989 and 1991 as a result of the recession, falling from 6.68 percent of personal income to 6.36 percent. As the economy recovered and states increased taxes, taxes rebounded, quickly returning to their prerecession levels by 1994. Taxes continued to rise in most subsequent years, reaching 6.94 percent of personal income by FY 2000.

What Caused The Boom In State Finances?

The latter half of the 1990s was a favorable period for state budgets in almost every way imaginable. I describe the main factors below.

■ **Economy and stock markets.** The national economy consistently grew faster than most economic forecasters expected, in large part because worker productivity grew rapidly. Having grown at an annual average rate of 1.6 percent between 1991 and 1995, it accelerated to an annual rate of 2.6 percent between 1995 and 2000.[28]

Not only was economic growth stronger than expected, but the nature of that growth was especially good for state finances. State income taxes benefited in many ways. Taxable income consistently grew faster than broader measures of the economy did, such as gross domestic product or personal income. This was in large part the result of very rapid growth in capital gains, driven by strong economic growth, rising stock markets, widespread participation in the stock market, growing use of stock options as a means of compensating workers, 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 individual retirement accounts (IRAs).[29]

Not only did taxable income grow faster than personal income, but income growth was concentrated among people with the highest incomes, and it pushed people into higher tax brackets. The number of tax returns with income above $200,000 grew 15–20 percent annually in the late 1990s, while the total number of

tax returns was growing only about 1 percent per year. As a result, much of the income growth was taxed at the highest state income tax rates, driving the "elasticity" of state income taxes up well above what forecasters expected in more normal times. The income tax benefited from the financial market boom in other ways as well. In particular, states reported to the Rockefeller Institute of Government in the late 1990s that withholding tax collections were growing far faster than they had expected because many firms, especially high-tech firms, were compensating high-level employees with stock options. Those options, when exercised, generated taxable wages for the employees and tax revenue for states.

State sales taxes also benefited. Despite several longer-term trends that are negative for sales tax revenue, positive trends in the 1990s masked this weakness. From 1950 through 1993 the savings rate averaged 8.7 percent, never rising above 10.9 percent (in 1982) and never falling below 6.9 percent (in 1955). But immediately after 1992 the savings rate plummeted to levels outside the experience of the previous forty-three years, falling steadily and rapidly to a low of 1.0 percent in 2000 before rising slightly to 1.6 percent in 2001. When the savings rate falls, spending as a percentage of income rises, and this is good for state sales taxes. The fall in the savings rate was enough to boost consumption by 8 percent by the end of the decade, compared with what spending would have been if the savings rates of the 1980s had prevailed. Partly as a result, consumption included in a "typical" sales tax base grew faster than personal income in six of the eight years from 1993 through 2000.[30]

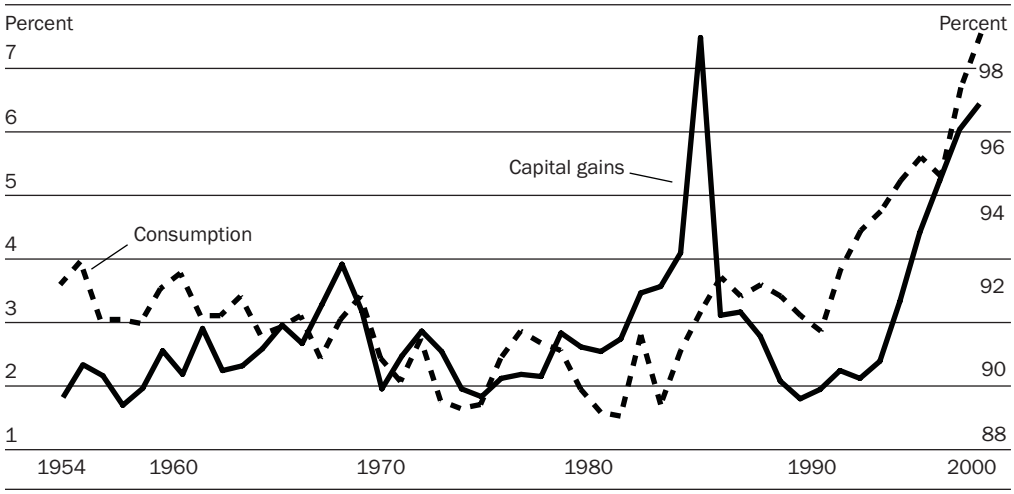
Exhibit 3 highlights just how atypical the late 1990s were.[31] Except for the anomalous capital gains spike in 1986 related to tax reform, no period in the past forty-five years is similar to the extraordinary growth in gains that states saw in the late 1990s. Similarly, the rapid consumption-rate increase, to successive new highs, has no parallel in the previous forty-five years.[32]

■ **Benign spending pressures and a tobacco settlement.** It was not just state tax revenue that benefited from the roaring 1990s. As noted, Medicaid, the second-largest state spending program, came to a standstill in mid-decade after growing dramatically at the start. The slowdown provided a major fiscal benefit to states, making it easier to finance rapid growth in education spending late in the decade.

States received a welfare windfall when the federal government converted welfare funding from an entitlement to a block grant. Caseloads plummeted because of the strong economy and state policy changes, but state revenue from the federal government, which would have fallen with caseloads under the prior Aid to Families with Dependent Children (AFDC) program, remained relatively fixed.

To top it off, states began receiving funds under settlements reached with the five major tobacco companies, allowing states to recoup medical costs of treating tobacco-related illnesses, a large share of which states paid for under Medicaid. The agreements will result in payments to states, over time, of nearly $300 billion.

EXHIBIT 3
Increase In Capital Gains As Percentage Of Gross Domestic Product (GDP) And Consumption As Percentage Of Disposable Income, 1954–2000



SOURCES: U.S. Bureau of Economic Analysis; and Statistics of Income Branch, Internal Revenue Service.
NOTES: The left vertical axis represents capital gains as a percentage of GDP; the right vertical axis, consumption as a percentage of disposable income. The high point in capital gains represents a behavioral response to 1986 tax reform. Consumption for 2001 (not shown) was 98.4 percent of disposable income.

The initial annual payments averaged about 1–2 percent of tax revenue for states as a whole—a considerable source of new money.

These forces taken together meant that the typical state ran unanticipated surpluses in the late 1990s and had the wherewithal to cut taxes, raise spending, and increase reserve funds.

The State Fiscal Bubble Has Burst

As the 1990s came to a close, many of the extraordinary factors that caused the fiscal boom ended or began to reverse. The manufacturing sector endured a "stealth recession" in 2000, with manufacturing jobs declining. This was followed by the national recession that began in 2001. In addition, the Standard and Poor's 500 Index fell 10 percent between December 1999 and December 2000, fell another 13 percent in 2001, and appears headed for a third double-digit decline in 2002.

■ **State tax revenue has fallen dramatically.** State tax collections slowed in FY 2001 to 2.5 percent, after adjusting for inflation and legislated changes, down sharply from 6.3 percent in 2000.[33] Tax collections worsened in FY 2002, declining in nominal terms in each quarter and deteriorating as the year progressed. State tax collections declined by 10 percent in the April–June 2002 quarter, driven by a 26 percent year-over-year decline in income tax payments related to capital gains and other nonwage income, exacerbated by near-zero withholding and sales tax growth and a 12 percent decline in corporate taxes.[34]

Tax collection data suggest that capital gains and similar income declined far

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more in 2001 than state revenue forecasters expected. Many states budgeted on the assumption that capital gains would decline by 10–15 percent. The California Legislative Analyst's Office (LAO) estimates that capital gains and nonqualified stock-option income of Californians declined by an astounding 62 percent, falling from $200 billion in 2000 to $77 billion in 2001.[35] The Congressional Budget Office (CBO) notes, "Some early evidence suggests that options income may have fallen by 50 percent in calendar year 2001."[36]

■ **Medicaid spending has accelerated.** Medicaid growth accelerated in 1999 and 2000, and the pace quickened after that. States reported that for state FY 2001 Medicaid spending grew 10.9 percent and exceeded budgeted amounts in thirty-one states, requiring supplemental funding. States estimate that Medicaid spending grew 13 percent in FY 2002 and that thirty-six states will spend more than originally budgeted.[37] According to a survey of state Medicaid officials, the recent growth surge has been driven by increases in the cost of prescription drugs (now approximating 20 percent annually), enrollment increases, increasing costs of long-term care, and provider payment increases.[38]

■ **States report budget gaps and actions to close them.** Declining revenue and increased Medicaid spending opened FY 2002 budget gaps in forty-three states totaling at least $36 billion. Twelve states reported gaps exceeding 10 percent of their general fund budgets. Most states faced gaps for FY 2003 as well.[39]

Although some states took extremely difficult gap-closing actions, many relied heavily on fund balances, tobacco settlement funds, gimmicks, and taxes on out-of-favor activities such as smoking. Key actions include the following. (1) Forty-two states drew down fund balances from $32 billion to $18 billion between FY 2001 and 2002, a decline of 42 percent. Fund balances will decline further in 2003. (2) At least twenty-three states tapped capital funds, highway funds, and other special funds. (3) At least sixteen states used tobacco settlement money. (4) At least twenty-six states cut spending plans for 2003, especially in higher education, corrections, and even Medicaid. (5) Forty-five states implemented Medicaid cost containment measures in FY 2002; forty-one states planned further cost containment actions in 2003. (6) At least sixteen states raised taxes by 1 percent or more of tax revenue, for a total increase of $6.7 billion, or 1.2 percent of the budget. Cigarette taxes were most popular in frequency and magnitude, accounting for slightly more than 40 percent of the tax increases. In addition, a handful of states (Kansas, Indiana, New Jersey, and Tennessee) enacted large broad-based tax increases, but these were the exceptions rather than the rule.[40] Detailed examination of selected budgets adopted for FY 2003 suggests that many states closed budget gaps primarily with one-time actions, spending deferrals, revenue acceler-

ations, and cigarette taxes and that actions designed to bring revenue and spending into recurring balance were extremely rare.

After The Crisis, Will The Boom Resume?

Even after the recession ends, the next half-decade looks much more difficult than the last: Revenue growth will be slower, spending pressures have picked up, and many actions states have taken to close budget gaps in FY 2003 have pushed part of the current fiscal problem into FY 2004 and beyond.

■ **Revenue growth will be slower than before.** Even after recovery takes full hold, the current downturn will have fiscal effects that could linger for years. As the economic recovery progresses, stock market–related income could grow rapidly from newly depressed lows, but it is important to keep this rapid growth in perspective: Rapid growth from a now-lowered base still may leave revenue below the level of recurring revenue. For example, California's LAO projects that stock market–related income will grow 18 percent in each of the next two years. It would take an additional four years of growth at 20 percent annually—well over twice the growth in the broader economy—before capital gains and stock option income would exceed the 2000 peak.[41] Under these seemingly cheery assumptions, this element of California's revenue structure would reattain its 2000 level in 2007. Fortunately for other states, the California situation is worse than average: California's tax structure relies more on this type of income than other states do, and its high-tech economy benefited more from growth in this income than other states did. But the same issues will arise elsewhere to a lesser degree.

The LAO assumption of rapid growth is not the only possible assumption. Capital gains could retrench further, returning to longer-run relationships between gains and the economy; in fact, that is the working assumption of the CBO's long-run projections. Under this scenario, capital gains and similar income might experience a spurt of growth after the recession ends, followed by sluggish growth for several years.

Outlook for income taxes. All is not gloom in income taxes. Eventually they will benefit from a burst in growth from the now-lower base when the economy recovers; over the longer term, taxable retirement income will continue to grow more rapidly than the economy as a whole; and progressive income tax structures mean that income tax elasticity generally will exceed 1. Income tax revenue will grow faster than the economy but probably much slower than in the late 1990s.

Outlook for sales taxes. The sales tax held up quite nicely during the 1990s, and, unlike in the last recession, it has performed better than the income tax in the current recession. But the longer-term outlook for the sales tax remains unattractive for three reasons. First, it is hard to imagine that people will consume an ever-rising share of their income. If the savings rate simply stops falling and consumption stays at its current high level relative to income, states will lose the annual boost to consumption growth they benefited from throughout the 1990s. Second,

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people have been shifting consumption from heavily taxed goods to lightly taxed services, and this shift is likely to continue. Finally, under current laws it is difficult for states to collect taxes legally owed on Internet-related transactions. Donald Bruce and William Fox estimate that state and local governments lost approximately $7 billion of tax revenue in 2001 because of their inability to collect taxes on taxable Internet transactions. They expect this loss to grow to $24 billion by 2006, amounting to an incremental loss of about 3 percent of total state tax revenue in five short years.[42] All three issues suggest that the sales tax will be under considerable pressure for years to come.

Prognosis for excise taxes. Selective sales and excise taxes will continue to be a weak third leg of state revenue structures. States will raise rates in the current fiscal crisis, but after this short-term boost in tax revenue, they will continue their long-term decline because they generally are imposed on bases that do not keep up with economic growth.

Likelihood of federal windfalls. Finally, states will find no easy assistance elsewhere. The federal budget benefited from many of the same forces as state budgets, and it is being buffeted now by the recession-induced undoing of those trends. Additional windfalls from the federal government seem unlikely. In August 2002 the CBO lowered its previously lowered ten-year forecast even further, reducing revenue projections by $678 billion and increasing spending projections by $688 billion (largely related to terrorism-response legislation), for a worsening of the ten-year outlook by $1.4 trillion—and these projections incorporate the assumptions that discretionary spending will grow more slowly than the economy and more slowly than recent experience and that tax cuts scheduled to expire will not be extended.[43]

■ **Spending pressures have picked up.** As noted earlier, states spent much of the good news of the 1990s on recurring programs, increasing the real per capita size of state government by about one-third. This increased spending was supported by revenue that may have appeared permanent at the time, but the sharp drop-off in revenue recently—particularly the drop related to financial markets—suggests that states' spending is now sharply out of line with states' revenue structures. Furthermore, there are some trouble signs ahead for spending.

The three largest spending areas in the typical state budget are Medicaid, K–12 education, and higher education. Each of these areas will present states with special challenges in the coming half-decade.

Medicaid. Medicaid was tamed only temporarily. For the past three years it has resumed growing rapidly, and at faster rates than states anticipated. States appear to be budgeting too optimistically for FY 2003, which began 1 July 2002 in most

states: Appropriations from state funds assume growth in Medicaid of only 3.7 percent, despite the fact that Medicaid grew by approximately 10 percent annually in the two prior years and that states project enrollment growth of 6.2 percent for the fiscal year (in other words, states implicitly are assuming that spending per beneficiary will decline, despite recent experience to the contrary). The Kaiser Commission on Medicaid and the Uninsured considers substantial additional Medicaid budget shortfalls likely in state FY 2003.[44]

The CBO projects that national Medicaid spending will grow about 9 percent annually for the remainder of this decade, driven by health technology improvements, demographic changes, and a general absence of incentives to hold down health care costs. This is sharply higher than growth in the mid-1990s and much faster than the typical state revenue structure is likely to grow in an environment in which personal income is likely to grow by about 5 percent annually.[45]

Education. On the education front, growth in K–12 enrollment has slackened in many states. However, states face other pressures in elementary and secondary education, as well. Policies to reduce class sizes, support higher graduation standards, and accommodate higher standards for teachers all could be expensive. In addition, if states wish to continue the long-term trend toward greater state and less local financing of education, they will have to find additional funds.

In higher education, the baby-boom echo is exiting high school, and college enrollment rates of high school graduates are rising. According to the U.S. Department of Labor, 43 percent of net new jobs in the ten-year period ending in 2008 will be in occupations that commonly require at least some higher education, even though these jobs constitute only 29 percent of the existing employment base.[45] This suggests continuing upward pressure on college enrollments and state financing of higher education.

■ **State solutions will push part of the problem off to future years.** When states close budget gaps, they often follow relatively predictable patterns. They appear to choose solutions, at least initially, that are not politically controversial. Some of the easiest actions states can take, which they often take early in a crisis, are drawing down reserve funds, accelerating revenue, delaying spending, and implementing various financial transactions and gimmicks such as securitizing tobacco settlement revenue (selling bonds secured by tobacco settlement funds and using the proceeds for operating purposes). They tend to hold off on large spending cuts and large tax increases until after they have had several years of fiscal difficulty and have exhausted less painful options.

The early actions to deplete reserves, accelerate revenue, delay spending, and refinance debt often have the effect of pushing part of a fiscal problem into later years. Drawing from reserve funds or accelerating revenue essentially creates "one-shot" revenue that supports recurring spending, postponing but not avoiding difficult decisions about how much spending states can support on an ongoing basis.

Often, as these bills come due, and as the fiscal crisis lengthens and deepens, states will take more severe actions, either raising taxes or cutting spending, often late enough in the cycle that the economy is then recovering. In the two most recent fiscal crises, the recessions of 1980–82 and 1990–91, states drew down reserves in the earliest years of crisis and finally raised taxes later in the crisis. State budgets adopted for FY 2003 suggest that this is happening again. States relied very heavily on reserve funds, gimmicks, and cigarette taxes to close their latest budget gaps. In most states these actions will make matters worse in later years.

Difficult Choices Ahead

The net result of slowing revenue growth, increasing spending pressures, and state solutions that worsen the near- and middle-term outlook is that states face a major challenge in financing Medicaid spending, while still facing cost pressures in the two other largest spending areas, K–12 and higher education.

While this is not a scenario for doom and gloom, it does suggest that state finances will be constrained tightly over the next several years even if the economy recovers well from the recession. States already have begun to look for budget savings by altering Medicaid eligibility, benefits, and reimbursement rates. That search is likely to intensify in the budget debates for FY 2004, which will take place in most states between January and June of 2003, and it is likely to continue for the foreseeable future.

Any opinions expressed in this paper do not necessarily reflect the views of the Nelson A. Rockefeller Institute of Government.

NOTES

1. National Association of State Budget Officers, *State Expenditure Report 2001* (Washington: NASBO, Summer 2002).
2. Ibid.
3. National Governors' Association and National Association of State Budget Officers, *The Fiscal Survey of States: May 2002* (Washington: NGA/NASBO, Summer 2002).
4. Most of the analysis in this section is based on detailed government finance data obtained from the U.S. Bureau of the Census for the year 2000. In calculating real expenditures per capita I use the state and local government chain-weighted price index prepared by the U.S. Bureau of Economic Analysis.
5. State government spending also increased rapidly as a percentage of personal income, from 11.09 percent in 1990 to 12.42 percent in 2000, an increase of 12 percent.
6. Alaska's 1990 real per capita spending, at $10,191, was more than twice that of Hawaii, the second-highest state. Alaska's spending declined 5.4 percent from 1990 to 2000.
7. See R. Penner, *A Brief History of State and Local Fiscal Policy,* Pub. no. A-27 (Washington: Urban Institute, December 1998).
8 Rockefeller Institute of Government analysis of data from Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism 1994,* vol. 2 (Washington: ACIR, 1995), Tables 1 and 41; databases on state and local government spending developed by the Rockefeller Institute from data obtained in a variety of electronic formats from the U.S. Bureau of the Census, under special requests; annual population data obtained from U.S. Bureau of the Census, "Population Estimates," 29 April 2002, eire.census.gov/popest/estimates.php (15 August 2002); and state and local government chain-weighted price index data obtained from Bureau of Economic Analysis, "National Income and Products Account Tables," Table 7.11, 27 September 2002, www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N (5 October

2002).

9. Medicaid has countercyclical elements—in recessions, when state revenue falls, Medicaid spending pressures grow. John Holahan and Bowen Garrett estimated that an increase in the unemployment rate from 4.5 percent to 5.5 percent would cause the number of Medicaid beneficiaries to increase by 1.5 million or 3.6 percent, causing Medicaid expenditures nationally to rise by approximately $2.7 billion or 1.3 percent. See J. Holahan and B. Garrett, "Rising Unemployment and Medicaid," *Health Policy Online,* No. 1 (Washington: Urban Institute, 16 October 2001), www.urban.org/UploadedPDF/410306_HPOnline_1.pdf (9 November 2002).
10. "Medical vendor payments" include payments to hospitals, doctors, and other private medical vendors but not payments by state governments to local government entities such as local hospitals. Thus, medical vendor payments largely include DSH payments (as they are made mostly to nongovernmental providers) and largely exclude UPL-related payments (made mostly to local government providers).
11. In real per capita terms, federally financed Medicaid grew 89 percent between 1990 and 1995, and state-financed spending grew by 92 percent. Similarly, between 1995 and 2000 federally financed real per capita Medicaid spending grew by 7.4 percent, while state-financed spending grew 7.8 percent. NASBO, *State Expenditure Reports* (1992, 1997, and 2000).
12. Based on data from the former HCFA Form 64, now CMS Form 64. These data show that real per capita "total computable" spending on medical assistance payments (including DSH) increased by 80 percent between FY 1990 and FY 1995, which is remarkably consistent with the 78 percent increase in real per capita medical vendor payments (which also include DSH) between state FY 1990 and FY 1995.
13. Computed from B. Bruen and J. Holahan, "Slow Growth in Medicaid Spending Continues in 1997" (Washington: Kaiser Commission on Medicaid and the Uninsured, November 1999), Table 2; and from population data from Census Bureau, "Population Estimates."
14. Computed from annual average medical inflation rates in Bruen and Holahan, "Slow Growth in Medicaid Spending"; and data from the BEA's state and local government chain-weighted price index.
15. Bruen and Holahan, "Slow Growth in Medicaid Spending."
16. Ibid., Table 1.
17. V. Smith et al., *Medicaid Spending Growth: Results from a 2002 Survey* (Washington: Kaiser Commission, September 2002).
18. Computed from B. Bruen and J. Holahan, "Acceleration of Medicaid Spending Reflects Mounting Pressures" (Washington: Kaiser Commission, May 2002), Figures 1 and 5; and data from the BEA's state and local government chain-weighted price index.
19. Bruen and Holahan, "Acceleration of Medicaid Spending."
20. Ibid.
21. Ibid.
22. Implementation of SCHIP is reported in the SCHIP eligibility section of the data file "kffdata0c4.tab," from Kaiser Family Foundation, "State Health Facts Online," June 2002, www.statehealthfacts.kff.org/cgi-bin/healthfacts.cgi?action=rawdata (25 September 2002), data attributed to the Center on Budget and Policy Priorities. Although enrollment data include enrollment associated with SCHIP Medicaid expansions, because of the way that the CMS reports data, expenditure data do not include Medicaid SCHIP expenditures. Even if they did, however, the impact would not be significant: Total SCHIP expenditures of states that implemented SCHIP as a Medicaid expansion were only $242 million in state FY 2002. By contrast, the total increase in Medicaid spending between FY 1998 and 2000 was $27.8 billion.
23. Bruen and Holahan, "Acceleration of Medicaid Spending."
24. See D.J. Boyd, "Long Rise in Education Spending Slows as Economy Weakens," *State Fiscal News* 2, no. 2 (Albany, N.Y.: Rockefeller Institute of Government, 2002); and U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics, 2001,* NCES 2002-130 (Washington: NCES, 2002).
25. NCES, *Digest of Education Statistics, 2001,* Table 201.
26. Computed by summing the annual revenue reductions reported in NGA/NASBO, *The Fiscal Survey of States: May 2002* (Washington: NGA/NASBO, Summer 2002), Table 7.
27. Nicholas Johnson and Daniel Tenny have pointed out that states' policy changes have tended to make state taxes more regressive, in part because states have been relatively unafraid to raise excise tax rates and because they have focused their tax cutting on the income tax. Despite these policies, the net result of the strong economic forces at work may have been a more progressive state tax system, as states have become increasingly reliant on the income tax. See N. Johnson and D. Tenny, *The Rising Regressivity of State Taxes*

(Washington: Center on Budget and Policy Priorities, 15 January 2002).

28. See Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2003–2012* (Washington: CBO January 2002), chap. 2.
29. Ibid., 50–51.
30. A "typical" sales tax base treats as nontaxable food purchased for off-premises consumption, housing consumption, medical care, personal business services, education and research, religious and welfare services, certain purchased transportation, and selected other items.
31. Exhibit 3 is based on capital gains data in the document "capgain1-2001.pdf," from the Statistics of Income page of the U.S. Treasury Department's Web site, www.irs.gov/taxstats (June 2002), and from savings-rate data obtained from BEA, "National Income and Product Accounts," Table 2.1. I plot both data series on the same graph not to posit a relationship between capital gains and the consumption rate, but simply to show that states fortuitously benefited from two major trends outside the bounds of postwar historical experience, occurring at the same time. There could well be a relationship between capital gains and the consumption rate, such as a "wealth effect" leading people to spend more when asset values and capital gains are high. But it would take more than simple graphical analysis to uncover such an effect.
32. There are some plausible reasons for why capital gains rose and the savings rate fell in the 1990s. Obviously the stock market contributed to capital gains, but so did lower tax rates on gains—a benefit that will endure even if old market levels will not. Similarly, the lower savings rate could have reflected greater long-run confidence in the economy, more stability in earnings, higher asset values, and other factors that might lead people to save less for an uncertain future—and some of these factors also could endure.
33. N.W. Jenny, *Fiscal 2001 Tax Revenue Growth: Weakness Appears,* State Fiscal Brief no. 64 (Albany, N.Y.: Rockefeller Institute of Government, April 2002).
34. See N.W. Jenny, *State Revenue Report,* no. 49 (Albany, N.Y.: Rockefeller Institute of Government, September 2002); and D.J. Boyd and N.W. Jenny, "States Will Raise Their Economic Forecasts but May Lower Their Revenue Forecasts," *State Fiscal News* 2, no. 3 (Albany, N.Y.: Rockefeller Institute of Government, 2002).
35. California Legislative Analyst's Office, *2002–03 Budget Bill: Perspectives and Issues* (Sacramento: LAO, February 2002).
36. CBO, *Where Did the Revenues Go?* Revenue and Tax Policy Brief (Washington: CBO, 13 August 2002), 4.
37. See NASBO, *State Expenditure Report 2001* (Washington: NASBO, Summer 2002) for reported Medicaid spending. For budget shortfalls, see Smith et al., *Medicaid Spending Growth.*
38. V. Smith and E. Ellis, *Medicaid Budgets under Stress: Survey Findings for State Fiscal Year 2000, 2001, and 2002* (Washington: Kaiser Commission, October 2001). See also K. Levit et al., "Inflation Spurs Health Spending in 2000," *Health Affairs* (Jan/Feb 2002): 172–181.
39. See National Conference of State Legislatures, "State Budget and Tax Actions 2002," *NCSL News* (Denver: NCSL, 28 August 2002).
40. Ibid., 1, 6–10.
41. $77 billion plus two years of growth at 18 percent and four more years of 20 percent growth yields $222 billion, after compounding.
42. See D. Bruce and W.F. Fox, *State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates* (Knoxville: University of Tennessee, Center for Business and Economic Research, September 2001).
43. CBO, *The Budget and Economic Outlook: An Update* (Washington: CBO, August 2002).
44. Smith et al., *Medicaid Spending Growth.*
45. Based on long-term economic forecast provided in Economy.com, *Precis, U.S. Macro* 7, no. 3 (West Chester, Pa.: Economy.com, June 2002).
46. D. Braddock, "Occupational Employment Projections to 2008," *Monthly Labor Review* (November 1999): 51–77.