SPECIAL ISSUE

THE FEDERAL RESERVE BANK OF CHICAGO

MARCH 2004
NUMBER 200b

Chicago Fed Letter

State budgets and the economy

by Richard Mattoon, senior economist

On November 12, 2003, over 70 policymakers, fiscal analysts, and academics gathered at the Federal Reserve Bank of Chicago to examine the fiscal condition of the state government sector. The conference was cosponsored by the Federal Reserve Bank of Chicago and the National Tax Association.

In opening remarks, William Testa, vice president and director of regional programs at the Chicago Fed, noted that despite a shallow national recession that ended in November 2001, state budgets have suffered through three years of fiscal stress and conditions do not appear to be improving. A key question is whether the relationship of state budgets to the economy has changed over the most recent economic cycle. Fred Giertz from the University of Illinois at Urbana–Champaign and executive director of the National Tax Association responded that the recent performance of state budgets (and revenues) suggests a structural change in state fiscal systems.

The first panel featured the state budget directors of Michigan, Indiana, Illinois, Iowa, and Wisconsin. Moderator Therese McGuire from Northwestern University noted that researchers at a conference[1] held in spring 2003 emphasized the sharp revenue decline and the political reluctance to raise major tax bases in the recent recession. She suggested that the narrowing and erosion of many tax bases may have exacerbated the recession's impact on state revenues.

1. General and K–12 expenditures

	Total general expenditure	K–12 expenditure
	(annualized percent change in real per capita expenditures)	
Illinois	2.75	4.22
Indiana	3.30	3.45
Iowa	3.22	3.37
Michigan	4.68	11.55
Wisconsin	3.53	6.49
U.S.	2.39	3.23

NOTE: Time period is FY1992 to FY2000.
SOURCE: Dye and Merriman (2003).

Michigan

Mary Lannoye noted that a new Democratic governor was elected in Michigan last year—the first in 12 years. However, Republicans control both chambers of the state house, requiring bipartisan support for the budget. Michigan's fiscal year runs from October to September and its budget is principally comprised of two major funds—a general operating fund and a school aid fund—each with a different revenue structure. Revenue declines have been more concentrated in the general fund, which relies on the personal income tax and the state's single business tax. General fund revenues fell in FY2001 and FY2002 and are forecasted to decline in FY2003 and FY2004. General fund revenues of $7.78 billion in FY2004 will be lower than those the state received in FY1993. In contrast, the school aid fund relies on a more stable mix of property and sales taxes and gaming income and has continued slow revenue growth.

Lannoye noted that Michigan's general fund budget has been structurally out of balance[2] from FY2001 through FY2004. The general fund spending gap reached $944 million in FY2003 and is estimated at nearly $1.6 billion in FY2004. To close the FY2004 budget, the state made over $1 billion in spending reductions, including 10% cuts to higher education and 9% cuts to local government. Other actions included $240 million in revenue enhancements, nearly $200 million from a revenue sharing accounting adjustment, and $122 million from a change in corrections

policy. The state also received $305 million in aid from the federal government as part of this year's special state aid program. As in many states, one of the biggest budget pressures in Michigan is Medicaid. The state's caseload has risen by 232,000 since 2000 and the percentage of the general fund spent on Medicaid has grown from 19% to 25%. It may reach 29% by FY2005. The state's economy continues to be sluggish with quarterly employment growth forecasted as being quite low. Further, given the high level of motor vehicle sales in recent years, auto-dependent Michigan is not expecting the surge in auto demand that it has seen after past recessions. Finally, several of the state's tax bases are being challenged as previously legislated tax cuts are implemented, along with federal changes to the estate tax.

Indiana

Marilyn Schultz described Indiana's budget situation as resulting from a "perfect storm." A court mandate forced the state to replace the property tax assessment system. This resulted in a sweeping state tax restructuring in 2002 that shifted spending responsibilities from the local to the state government. The tax reform streamlined the state's corporate tax structure, increased state responsibility for K–12 school operating budgets to 85%, and increased the homestead credit to 20%. While state revenues grew only 1.3% in FY2003, local property tax growth for calendar year 2003 was 13.4%. Schultz reported that the state ran a $766 million operating deficit (7.7% of base operating revenue) and estimates deficits of $822 million and $653 million in FY2004 and FY2005, respectively. She characterized the deficit as structural, in part reflecting the shift to state funding of K–12 education and state-provided property tax relief.

In FY2002–03, the state managed to balance its budget through cuts in higher education and funding of state agencies, adjustments to Medicaid forecasts, corrections reductions, and limited K–12 reductions. In all, this reduced spending by $993.8 million. However, further adjustments were needed in the FY2003 budget because the state had underestimated the amount needed for property tax relief credits. This resulted in a 5% cut in state agency budgets. The FY2004–05 budget makes provisions for another $258 million in reductions, mostly by reducing the K–12 ADA (Americans with Disabilities Act) flat grant and eliminating state support for K–12 transportation.

Schultz noted that hard choices still lie ahead. The state will need to examine how changes in state and local tax bases will affect the fiscal climate and pay attention to how federal tax law changes and technology changes (such as increased Internet sales) will come into play. Schultz noted that the state would have been in significantly worse shape had it not been for an exceptionally high budget reserve (20% of expenditures in 1998) and $206 million in recent federal aid.

Illinois

John Filan began by reviewing the FY2003 budget actions. When the new governor came into office in 2003, the state faced an estimated $5 billion budget deficit (out of a general fund budget of $23 billion) with three-fifths owing to structural factors. Filan attributed the deficit to three factors—a slow economy; structural budget problems, including Medicaid cost increases and underfunded state pensions; and managerial problems that made it difficult to rapidly adjust spending to reflect declining revenues. Complicating matters was what Filan termed "the hidden deficit" of delayed payment of income tax refunds and underfunding of both Medicaid and the state pension system. The state pension system had an estimated unfunded liability of $35 billion in 2002, the worst among all states. To help close the gap, Illinois issued $10 billion in pension bonds and, despite this action, the state still ranks last in the nation in terms of unfunded liability. To clear overdue bills, the state undertook short-term borrowing of $1.2 billion, taking advantage of low interest rates. Finally, the state has had to bear the cost of a very aggressive capital construction program started under the previous administration.

Illinois has imposed a hiring freeze and reduced its personnel to 63,000 (through early retirements), the lowest since 1983. Many state agencies were required to make 15% cuts in their budgets and to put the money aside in reserve funds. Many tax credits for corporations have been eliminated and consumer fees increased. Filan noted that since Illinois is a low income tax state, it must increase consumer fees to balance income tax performance. In addition, the state started charging the nearly 600 different governmental funds of the state of Illinois an administrative fee to cover overhead. This yields $400 million annually. Finally, the state has produced savings by issuing variable rate debt.

Still, Filan said that FY2004, with an estimated deficit of $1.5 billion to $2 billion, would be as difficult as FY2003. While sales taxes have shown limited improvement, income tax and gaming revenues have been either flat or slightly down. The bright spots in the revenue picture have been produced through a tax amnesty and increased fee collections.

Filan noted that the governor has clear funding priorities. At the top of the list are K–12 education and health care for the indigent. Funding for agency requests will stay under pressure. State tax credits will receive scrutiny. Filan estimates these cost the state $4 billion in revenues annually.

Iowa

Randy Bauer noted that in the current budget cycle, revenues fell faster and deeper than in previous cycles. Iowa experienced declines in revenues in both FY2002 and FY2003, representing the first outright decline in revenue since the early 1980s. The state has tried to meet this challenge by reducing expenditures. By FY2003, state taxes as a percent of income stood at 6.1%, the lowest level in 33 years. The state has not tried to raise taxes and in fact continues to enact tax cuts that were legislated before the state faced this fiscal downturn.

Bauer argued that the magnitude of state deficits, with most states facing

gaps of 10% or more, suggests a structural issue, given that the recession ended in 2001. Further, structural changes to tax laws appear to have narrowed tax bases and reduced the usual bounce back in revenues from the recovery. Finally, demographics, particularly an aging population, is driving health care expenditures. Bauer also said that Midwest states have been particularly hurt because of their economic reliance on manufacturing.

Looking ahead, Bauer said states need to devise tax structures with more reliability, predictability, and sufficiency. This could include broadening the sales tax base to capture the e-commerce and service economy. Reforms to corporate income taxes might also be necessary. Countercyclical taxes are also showing erosion. Both inheritance and cigarette tax revenues have declined significantly in the last decade. Finally, states need to build larger reserves.

States can still issue debt and take advantage of low interest rates, although state credit ratings have been declining. Debt accounted for 9.7% of state and local revenue in 2002, 3.5 times the level of 1999. However, many states have limited their options by enacting tax and expenditure limits. Finally, Bauer suggested that politics rather than finance has a great deal to do with how states are responding. Many governors ran on pledges of no new taxes and are unwilling to abandon these pledges.

Wisconsin

David Riemer (who resigned as state budget director in late October) noted that the new Democratic governor entered office with the state facing an estimated deficit of $3.2 billion. Riemer said that a primary goal in Wisconsin was to protect education and health care programs and to close the deficit without tax increases. To accomplish this, the state made base cuts in agency budgets totaling $500 million, along with a $250 million cut in the budget for the University of Wisconsin system. The state transferred funds from the transportation budget and used nontax revenues such as federal aid and tribal gaming revenues to help fund the budget. In addition, the state sold pension bonds.

Riemer noted several risks to the current budget. First, preliminary tax collections have yet to indicate a significant gain in revenues. Second, Medicaid enrollments may exceed projections. However, Riemer noted that the state's structural budget problem goes beyond tax issues. Several long-term trends will continue to pressure Wisconsin and other states. The first is changing demographics—the aging of the population, the decline in the share of workers, and an increase in school age children. Second, Riemer suggested that productivity gains in the government sector will be harder to come by. While better management and more efficient administration might slow or level expenditure growth in health care and education, reducing costs will be difficult.

Finally, Riemer noted that although cities are the wealth-producing engines of the economy, state programs often do not help cities to be successful. For example, Wisconsin's widely praised welfare to work program (W-2) has failed to establish policies to connect city workers to the labor market. Similarly, transportation and land use policies have not been designed to improve urban productivity and enhance economic growth.

Understanding state budgets

Richard Dye (Lake Forest College) and David Merriman (Loyola University Chicago) presented joint work examining both the fiscal and political dynamics affecting budgets in the five states of the Seventh Federal Reserve District (see figure 1, front page). Dye noted that there is significant heterogeneity in the fiscal behavior of the five states. While total tax revenues from FY1992 to FY2000 grew rapidly in Illinois (3.8% annualized change in real per capita revenue), Michigan (6.29%),[3] and Wisconsin (3.79%), growth was more subdued in Indiana (1.73%) and Iowa (2.02%). The U.S. average for this period was 2.83%. Second, Dye noted that elementary and secondary school expenditures grew more rapidly than total expenditures in every state.

Dye next presented data on year-end fund balances. For the nation as a whole, total fund balances (year-end reserves plus budget stabilization funds) peaked in FY2000 at 10% of total expenditures. Indiana, Iowa, and Michigan showed greater willingness to accumulate large balances. Indiana's balance peaked at slightly more than 23% of expenditures in 1999, Iowa's reached 20% in 1998, and Michigan's peaked at 15% in 2000. In contrast, Illinois and Wisconsin had peak balances in 2000 of 6.5% and 7% of expenditures, respectively.

Next, Merriman presented a model where state revenue is assumed to be proportional to economic activity, which in turn is assumed to vary with a regular and predictable business cycle. Using this model, Merriman suggested that a structural balanced budget could be constructed that sets full employment revenues[4] equal to spending. Under such a regime, budget officials would need to hoard surpluses during good times and spend them down during bad times. Merriman suggested that when further complexities are added to this simulation, it becomes more difficult to maintain such a savings program. The first complexity is recognizing that the business cycle has not been symmetric, with expansions lasting almost five

Michael H. Moskow, *President;* Charles L. Evans, *Senior Vice President and Director of Research;* Douglas Evanoff, *Vice President, financial studies;* David Marshall, *Vice President, macroeconomic policy research;* Daniel Sullivan, *Vice President, microeconomic policy research;* William Testa, *Vice President, regional programs and Economics Editor;* Helen O'D. Koshy, *Editor;* Kathryn Moran, *Associate Editor.*

Chicago Fed Letter is published monthly by the Research Department of the Federal Reserve Bank of Chicago. The views expressed are the authors' and are not necessarily those of the Federal Reserve Bank of Chicago or the Federal Reserve System.

© 2004 Federal Reserve Bank of Chicago
Chicago Fed Letter articles may be reproduced in whole or in part, provided the articles are not reproduced or distributed for commercial gain and provided the source is appropriately credited. Prior written permission must be obtained for any other reproduction, distribution, republication, or creation of derivative works of *Chicago Fed Letter* articles. To request permission, please contact Helen Koshy, senior editor, at 312-322-5830 or email Helen.Koshy@chi.frb.org. *Chicago Fed Letter* and other Bank publications are available on the Bank's website at www.chicagofed.org.

ISSN 0895-0164

times longer than downturns. Introducing this complication leads to a very volatile reserve fund. Reserves would need to build to very high levels in short order and be drawn down similarly fast. Merriman noted that it would be extremely difficult, from a political perspective, to maintain such a regime.

Finally, Merriman presented work based on James Poterba's deficit shock methodology to study state response to fiscal surprises. He noted that in the real world, budget analysts are unlikely to know when turning points in the business cycle will occur. This is further complicated by uncertainties in the relationship of revenues and expenditures to economic activity. Poterba introduced a measure of deficit shock[5] to examine how states responded to a downturn. When Dye and Merriman calculated the deficit shocks for the Seventh District states during and soon after the recessions of 1990 and 2001, they found that Iowa and Michigan experienced deficit shocks in FY1990 before the recession. By FY1991, all of the states except Wisconsin had deficit shocks and, in FY1992, all except Michigan had experienced even larger deficit shocks than the previous year, although the national recession had ended. A similar pattern is emerging for 2001. Only Michigan had a significant deficit shock in FY2000, but by 2001 all of the states had mild deficit shocks. By 2002, conditions had worsened significantly. Data for FY2003 are not yet available.

Recent budget cycles

Fred Giertz (University of Illinois) and Seth Giertz (Congressional Budget Office) presented their work comparing state budget responses to economic conditions since the early 1950s. Using revenue data, Fred Giertz showed how real per capita state taxes performed both before and after a recession. In the current business cycle, the per capita tax growth leading up the recession was not unusually strong, but the decline in revenues after the recession has been considerably sharper. Giertz concluded that for 2001–03, the underperformance in tax revenues exceeded reasonable expectations relative to the shallow decline in the economy. Further, much of this underperformance has not been fully explained, and it appears that these problems will continue into FY2004.

Then, Seth Giertz presented a model that describes predicted versus actual revenue performance for each state over the three most recent recessions. Across several measures, 2002 represented the worst revenue performance for a large group of states. However, some states experienced less revenue stress in 2002 than they had in 1980–81.

Fred Giertz then discussed what states might have done to reduce their budget problems. Resisting permanent tax cuts and increasing the size of rainy day funds would have helped, but both face political constraints. Instituting temporary tax cuts would help, but is not seen as very practical. In the long run, only bringing revenues and expenditures into harmony will address the problem.

Conclusion

Conference presenters painted a relatively gloomy picture for state budgets. It appears that states' fiscal problems are being driven by structural conditions that will not be fully resolved by improving economic conditions. Difficult decisions about revisions to state revenue and expenditure systems still lie ahead.

---

[1] State Fiscal Crises: Causes, Consequences, and Solutions, cosponsored by Northwestern University, The Urban Institute, and The Brookings Institution, April 3, 2003, Washington, DC.

[2] She defined "structurally out of balance" as expenditures exceeding ongoing baseline revenues.

[3] Michigan's high rate of change was caused largely by tax policy. The state took over significant funding responsibility for K–12 education and in the process boosted the sales tax rate.

[4] Full employment revenues are the level of revenue a state receives on average over the course of the business cycle.

[5] Deficit shock measures (actual outlay – forecasted outlays) + (forecasted revenues – actual revenues) + (change in tax – change in spending).