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Understanding State Budget Troubles

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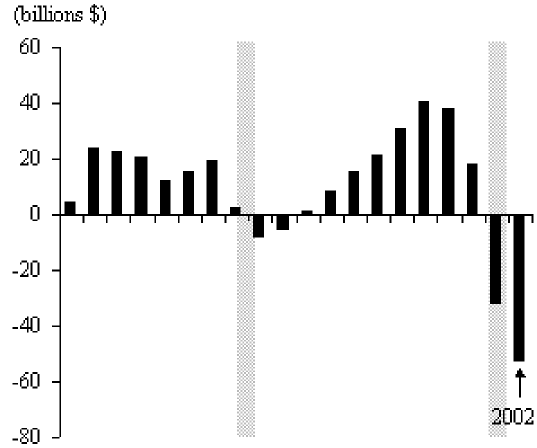
Fiscal 2004 started on July 1 this year, and it brought little solace to many lawmakers struggling to bring state and local spending back in line with revenues. On the heels of a difficult fiscal 2002 and a worse fiscal 2003, state budget leaders were forced to augment programs of temporary fixes—including deferrals, fund shifts, tapping reserves, and borrowing—with more permanent adjustments, such as slower spending growth and increased taxes and fees. That being said, most states maintained or increased nominal spending levels in fiscal 2004. The current outcome is not unusual. State and local government spending generally flattens out during economic downturns but rarely declines, as budgetmakers spread the pain of difficult adjustments over several years. The gradual process of working through budget problems typically restrains state and local governments well after the national economy recovers. This *Economic Letter* reviews the magnitude and genesis of states' current fiscal problems, examines the adjustments states made in fiscal 2004, and discusses the likely impact of state budgets on the national and regional economies.

Revenues, spending, and fiscal health

Throughout much of the 1990s state and local revenue growth outpaced expectations, allowing governments to expand spending, provide tax relief to citizens, and accumulate sizeable reserves. According to the National Conference of State Legislatures (NCSL 2003), even with rapid spending growth—46% between 1993 and 2000—and sizeable tax cuts—$35 billion between 1995 and 2000—state and local governments ran yearly surpluses for much of the 1990s expansion. States used these surpluses to build reserve funds (year-end balances plus rainy day funds) close to 11% of general fund spending.

In late 2000 the picture began to change, with many states facing spending commitments in excess of revenue flows. In 2001, state and local governments ran a deficit of more than $30 billion. State and local finances deteriorated further in 2002 and the first half of 2003. The inability to fund budgeted spending through yearly revenue flows forced states to dip into reserves, which began to decline rapidly in 2001. NCSL data show state reserves amounting to only 3.1% of general fund spending at the close of fiscal 2003.

Figure 1. State and local government current account balance



Source: NIPA.

Figure 1 illustrates these developments and provides some historical context by displaying the calendar year differences in actual state and local revenues and expenditures, typically referred to as current surpluses (positive values) or deficits (negative values) over the last 20 years; the data are from the Bureau of Economic Analysis, National Income and Product Accounts (NIPA). Measuring the relative size of state and local fiscal problems by the size of the annual NIPA deficits relative to the size of total spending, the present state and local fiscal problem is far more severe now than in the early 1990s recession. For example, during the early 1990s recession, states faced an average annual deficit of about $6.3 billion (average of 1991 and 1992), amounting to about 0.8% of 1992 state and local expenditures. This time around, state and local governments so far have recorded an average current deficit of $41.6 billion, representing about 3.1% of 2002 expenditures. NIPA data for the first half of 2003 point to little improvement, suggesting that both the magnitude and the duration of states' present fiscal difficulties will be greater than in the early 1990s.

Looking at state reserves data from the NCSL indicates a much larger swing in the size of the state cushions this time than during the previous recession in the early 1990s. During the 1990s recession, state reserve funds fell from about 5% of general fund spending to about 1% of general fund spending, a 4 percentage point decline. As indicated earlier, in the recent downturn, state reserve funds fell from a peak of nearly 11% of general fund spending to about 3.1%, a 7.9 percentage point drop. Recent data from the NCSL show that, through the first half of 2003, about 40 states had reserves less than 5% of general fund spending.

Roots of the problem

Reasons cited for states' most recent fiscal difficulties include deep dives in revenues, cost overruns on federally mandated programs, and rapid spending growth more generally. In terms of revenues, the collapse of the stock market and the generally slow economy have kept tax receipts well below expectations in most states. The largest errors in forecasts have been for corporate and personal income taxes, which account for a little over half of all state tax revenue. Sales tax revenues have performed much better, coming in at or only slightly below expectations. On average, total state tax collections have run about 10% below forecast over the past three years, with nearly every state experiencing some shortfall.

Although state forecasts for revenues proved too optimistic, they were not out of line with experiences in past economic downturns. Consistent with the revenue growth pattern during the early 1990s recession, most states planned for revenue growth to slow modestly for a short period as the economy weakened and then to pick up as the economy recovered (Figure 2; note that the subsequent decelerations in revenue growth from 1992

Figure 2. State and local revenue (year-over-year percent change)

Source: NIPA.

through 1996 were associated with ongoing economic weakness in California and with state and local tax relief outside of California).

At the same time states were "over-forecasting" revenues, they also were underestimating the costs of several programs under federal and state mandates. Nearly every state with a reported budget shortfall noted cost overruns on some budgeted item. Overruns were largest and most common in the Medicaid program, where provider fees and prescription drug costs rose much more rapidly than states had predicted. Several states also struggled with unbudgeted costs in welfare programs and corrections. Higher than expected welfare expenditures largely were driven by caseload increases associated with the weakening economy. Spending on corrections rose for a variety of reasons, including higher salary costs associated with competition for security personnel after September 11.

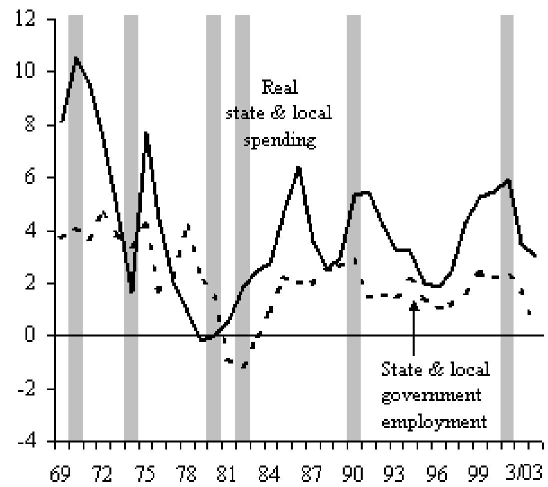
While overly optimistic revenue forecasts and unexpected increases in costs contributed to state budget problems, longer-term and more fundamental spending decisions states made during the expansion also helped set the stage for a budget crisis. During the good times of a booming economy and surging tax revenues, states increased spending rapidly, funding expansions in a wide range of programs including education, Medicaid, welfare, and corrections. In so doing, states departed sharply from standard spending rules that hold either real per capita state spending or state spending relative to personal income constant. For example, among all states, real per capita state and local spending increased 36% between 1989 and 2000. State and local spending as a share of personal income rose from 13.1% in 1989 to 14.2% in 2000. When the economy and state revenues began to falter, these increases proved difficult to roll back. As a result, state spending continued to rise in 2001 and 2002, pushing both real per capita spending and spending as a share of personal income to historic highs.

State budgets and economic activity

While budget gaps have garnered considerable attention and clearly pose significant challenges for state and local lawmakers now and into the future, the magnitude of their impact on the national and regional economies is less clear. One reason involves the measurement of widely cited budget shortfalls and the budget "cuts" required to resolve them. Estimated budget shortfalls usually refer to the difference in desired spending and projected revenue flows; thus they frequently overstate the adjustments required to keep state and local spending at existing levels. California's budget numbers provide a good example. California's governor estimates the state's budget shortfall to be $38 billion, which represents the difference between current revenue expectations and what spending might have been if the economy had not weakened. This desired spending figure includes a significant increase in spending relative to existing levels. Thus, the state can substantially reduce the $38 billion shortfall without reducing nominal spending in the state. While such adjustments to expectations can be painful, they arguably have a less negative impact on current rates of economic growth than do cuts to actual spending levels.

These measurement differences can be seen in the outcomes of the fiscal 2004 state budget processes. Reports from state legislatures indicated that fiscal 2004 state budgets were balanced with significant cuts in planned spending (including deferrals), modest use of nonrecurring revenues and rainy day funds, and some tax and fee increases. Looking carefully at those states reporting significant "budget cuts," one finds that most maintained or slightly increased nominal spending in 2004. For example, in Minnesota, which reported 15% cuts in spending across most state agencies, nominal spending is budgeted to increase 5.8% from fiscal 2003 to fiscal 2004. States unable to come up with the funds to support increases kept nominal spending constant; California and New York relied heavily on deferrals and nonrecurring revenues to support fiscal 2004 spending and will enter fiscal 2005 with structural shortfalls.

Figure 3. Slow to fall, slow to rise (year-over-year percent change)



Source: BLS, NIPA.

This pattern of maintaining nominal spending during down times is not unusual. In fact, state and local governments generally try to prevent declines in real spending levels as well as in state and local employment, choosing instead to spread the pain of difficult adjustments over several years. This is illustrated in Figure 3, which shows real state and local spending growth and state and local employment growth from 1969 through early 2003. Real state and local spending and employment rarely fall; the exception is the early 1980s. Typically, state and local spending and employment growth hold up during recessions, come down sharply in subsequent years, and recover more slowly than the rest of the economy, as states work through any shortfalls accumulated during the downturn. This pattern reflects several constraints on state budgets, including the slow pace of political dealings and the unpopularity of sharp cuts in spending or large increases in taxes. Overall, this slow-to-fall and slow-to-rise pattern in state and local government spending and taxing spreads the economic impact of state budget squeezes over several years, making it less of a factor in any particular period.

The key point about state budgets and the economy is that the health of the economy determines the health of states' budgets. Ongoing economic weakness limits states' abilities to grow their way out of current problems, making legislative discipline even more important. Sustained improvement in the national and regional economies will be critical to improvement in state fiscal conditions.

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