State Budgets: Swimming Away From A Sea of Red Ink

Sujit M. CanagaRetna
The Council of State Governments
Southern Legislative Conference

Presentation Before the Association of Capitol Reporters and Editors (ACRE)

Columbia, South Carolina
November 13, 2004
Four Main Parts

I. Where states were

II. National economic trends and their impact on states

III. Structural shifts occurring in state finances

IV. Key issues confronting states in 2005
I. Where States Were: Budget Shortfalls, FY 2002-05

- In the last four fiscal years, state budget shortfalls cumulatively approached a staggering $236 billion.
- By early 2003, California faced a shortfall of $35 billion over the next 18 months.
- Similarly, Texas faced a $10 billion shortfall in its biennial budget.
I. Where States Were: Immediate Effects

Crushing Negative Pressures Generated on State Finances by Downturn in the Economy

(a) Dwindling Revenue Flows
(b) Rising Unemployment Numbers
(c) Exploding Medicaid Costs
I. Where States Were: Strategies Adopted by States to Bridge Budget Shortfalls

- Slashed Spending
- Tapped Rainy Day Funds
- Deployed Tobacco Settlement Monies
- Raised Taxes
- Hiked Cigarette Taxes
- Cut Funds to Local Governments
- Racked-up Debt
- Generated Funds via Gaming
I. Where States Were: Year-Over-Year Quarterly Change in Total State Tax Collections, 1991-2004

II. Where States Are Now

- States had to close budget gaps of about $36 while reaching agreement on their FY 2005 budgets earlier on this year.
- This is a vast improvement from the prior few years when the substantially larger budget gaps required much harsher remedies.
- Among the measures taken this year were slashing spending, raising taxes and fees, tapping various funds, laying off workers and deploying tobacco settlement funds.
II. Where States Are Now

- State revenue picture has improved
- 8.4% growth in revenues in July-Sept. 2004, compared to prior year (4.5% growth adjusted for inflation)
- For Q1 FY 2005, examples of improvements include:
  - AR = $160 million surplus expected for FY 2005
  - NC = 2% more in FY 2005 Q1 than forecasted
  - SC = $350 million more expected next year; revenue expected to grow by 3%
  - VA = $900+ million surplus estimated in FY 2005
  - GA = 14% more in FY 2005 Q1 than forecasted
  - MD = Expected $1 billion budget gap for FY 2005 shrank to $311 million in mid-Nov. 2004
  - MT = $278 million surplus when 2005 session begins
  - VT = 4% more in October 2004 than forecasted
  - MN = For Q1 FY 2005, 2% ahead of forecast
II. Where States Are Now: National Economic Trends

- **GDP**
  - 2001 = 0.8%  
  - 2002 = 1.9%  
  - 2003 = 3.0%  
  - 2004 Quarter 1 = 4.5%  
  - 2004 Quarter 2 = 3.3%  
  - 2004 Quarter 3 = 3.7%

- **Productivity** (Percent Change from Prior Quarter)
  - 2002 = 4.4%  
  - 2003 = 4.4%  
  - 2004 Quarter 1 = 3.7%  
  - 2004 Quarter 2 = 3.9%  
  - 2004 Quarter 3 = 1.9% (smallest increase since 2002)
II. Where States Are Now: National Economic Trends

- **Interest Rates**
  - Interest and Mortgage Rates at historic lows, spurring a tremendous degree of consumer consumption and first-time home buyers and re-financings
  - Fed Funds rate at 1%, a 46-year low, until the Fed raised rates in June 2004, first time in four years
- **Inflation**
  - Inflation, as reflected in the CPI has not exceeded 3% the past seven years, except in 2000. It is expected to be about 3.5% this year, given the steep rise in energy prices
II. Where States Are Now: National Economic Trends

Trends Causing Concern:

- Sluggish Job Growth – After creating 22 million jobs in the 1990s, the current level is well below the 150,000 jobs needed per month to keep pace with the labor market’s growth. As of October 2004, 1.7 million jobs added to the economy in the past year.

- Disturbingly, the labor force participation rate has also declined, i.e., workers who have given up finding a job and left the workforce.
II. Where States Are Now: National Economic Trends

- Rising energy costs, with the rise in oil prices from $30 a barrel a year ago to above $55 barrel a few weeks ago, could further crimp the economic recovery.

- Twin deficits – federal budget and current account – also pose structural concerns regarding the economy.

- Record deficit in the country’s trade and services account, the current account, could drag down the value of the US dollar.

- Dollar’s decline pinches retailers though beneficial to US exporters; $ edged to an all-time low against Euro this week (US$ 1.30 = 1 Euro).
II. Where States Are Now: National Economic Trends

- After budget surpluses between FY 1998 and FY 2001, red ink returned to the federal budget in FY 2002. For the just concluded FY 2004, the deficit was -$413 billion.

- Congressional Budget Office forecasts a deficit of -$2.3 trillion between FY 2005 and 2014.
Structural Shifts Occurring in State Tax Systems

a. State economies now service driven, whereas when tax systems were created, state economies revolved around the retail and manufacturing sectors

b. Steady increase in sales tax-free Internet and Catalog purchases

c. Decline in corporate tax revenues
III. Structural Shifts Occurring in State Finances: Service-Based Economy

- According to a Federation of Tax Administrators study, there are 164 different services taxed across the country.
- 45 states employ a retail sales and use tax.
- Three States (HI, NM and SD) tax more than 140 of these services.
- 13 States (including AR, FL, KS, MS, NY, TN, TX) tax more than 60 of these services.
- The remaining 29 states tax fewer than 60 services, with over half of these states taxing fewer than 30 services.
## III. Structural Shifts Occurring in State Finances: Revenue Losses in Selected States ($ Millions) Due to Internet & Catalog Sales

<table>
<thead>
<tr>
<th>State</th>
<th>2003</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>$2,218.9</td>
<td>$4,620.4</td>
</tr>
<tr>
<td>New York</td>
<td>$1,144.5</td>
<td>$2,427.7</td>
</tr>
<tr>
<td>Texas</td>
<td>$1,479.1</td>
<td>$3,079.9</td>
</tr>
<tr>
<td>Florida</td>
<td>$1,117.8</td>
<td>$2,352.1</td>
</tr>
<tr>
<td>Georgia</td>
<td>$532.9</td>
<td>$1,130.5</td>
</tr>
<tr>
<td>North Carolina</td>
<td>$356.2</td>
<td>$764.9</td>
</tr>
<tr>
<td>Ohio</td>
<td>$547.8</td>
<td>$1,146.8</td>
</tr>
<tr>
<td>Vermont</td>
<td>$26.4</td>
<td>$54.8</td>
</tr>
<tr>
<td>North Dakota</td>
<td>$33.2</td>
<td>$64.6</td>
</tr>
<tr>
<td>Maine</td>
<td>$61.4</td>
<td>$126.6</td>
</tr>
</tbody>
</table>

Source: Bruce & Fox, University of Tennessee, July 2004
According to Federation of Tax Administrators, corporate tax revenues as a percent of total revenues declined by 30 to 40 percent in last 15 years.

According to 2004 SLC report, it was under 5 percent in 2003

Primary reasons include increasing use of pass-through entities; expanded use of tax planning techniques to shelter income from state and federal taxes; and a proliferation of state tax exemptions designed to promote economic growth
IV. Key Issues in 2005: Healthcare

- Major costs drivers: rising enrollment levels; growing prescription drug costs; increasing medical services costs.
- A number of states dealing with the explosion in Medicaid costs even before their 2005 sessions.
IV. Key Issues in 2005: **Unfunded Liabilities**

- State retirement systems need shoring up
  - States issuing debt to secure additional funds (IL, WI, KS, CA)
  - Other elements of the nation’s retirement system face severe fiscal difficulties too

- Workers’ compensation funds in trouble in a number of states
  - Number of states (OK, CA, TN, TX, OR, WV, IO) continue to seek reforms
IV. Key Issues in 2005: Education

- Education, both K-12 and higher education, face severe financial pressures
- Number of states forced to initiate school finance reforms, often on account of court orders
- State budget crises have forced cutbacks in higher education funding. In 2004, tuition at the nation’s public universities rose by an average of 10.5 percent
IV. Key Issues in 2005: Other

- Transportation – Several transportation funding-related ballot initiatives ($28 billion in new revenue) approved at the polls in 2004
- Economic Development - NC, CA, NJ, MI, MS, GA
- Medical Malpractice Reform - MD, MS
Thank You

State Budgets: Swimming Away From A Sea of Red Ink

For more information, please contact
Sujit M. CanagaRetna
404/633-1866
or
scanagaretna@csg.org
www.slcatlanta.org