It is a great honor to be here this morning and I thank the Federal Reserve Bank of Kansas City for extending this invitation to me and to The Council of State Governments. Established in 1933, The Council works primarily with state legislatures in tracking trends, carrying out research and analysis and promoting state interests. While I work for The Council's Southern Office, the Southern Legislative Conference (SLC) in Atlanta, The Council is headquartered in Lexington, Kentucky and also has regional offices in New York, California, Illinois and Washington, DC. The Southern Office covers 16 states including two states under the KC Fed's purview (Missouri and Oklahoma).

My remarks this morning deal with the bleak fiscal circumstances affecting almost every state in the country. In particular, it will concentrate on the fiscal situations in some of the SLC states and some of the states belonging to the KC Fed. Broadly, my presentation will consist of five interconnected parts. Part I focuses on our current predicament, both at the federal and state levels. Part II presents two fundamental reasons for the fiscal crisis while Part III delves into some of the specifics of the tightening fiscal conditions in state finances. Part IV presents some of the measures adopted by states in recent times to help alleviate their financial dilemmas and finally, Part V, alludes to near-term prospects at the state level.

Part 1

After a decade of sustained growth, unsurpassed in the economic history of the country, March 1991 to March 2001, the U.S. economy continues to recover from the negative effects of the 2001 recession. While technically the economy has emerged from the recession, a number of disconcerting factors such as the very soft labor market, the steady rise in health care and energy costs, the spate of corporate scandals, the uncertainty over conflict with Iraq, the potential for additional terrorist attacks and the bludgeoning of the stock market continue to stymie the economy's recovery. Consumer confidence continues to plummet too, and the sharp 15 point drop in February 2003 was the lowest the index has been since October 1993. Furthermore, practically every level of government–federal, state and local–find themselves awash in red ink as they continue to grapple with the lingering effects of the 2001 recession and a raft of geopolitical, economic and legislative uncertainties.

At the federal level, after reaching a high of $290 billion in FY 92, the highest level in 40 years, the federal budget deficit began declining steadily thereafter and ran budget surpluses for four consecutive years (FY 98 through 01). Then in FY 02, the federal government officially returned to the red with a $159 billion deficit. For the current FY, FY 03, the White House forecasts a staggering

$304 billion deficit and these numbers do not include the costs of a potential war with Iraq. The president's recently released $2.23 trillion FY 04 budget anticipates a deficit of $307 billion this year and cumulative deficits totaling almost $1.1 trillion over the next four years.

At the state level, the scenario is even more dire with states facing a rising tide of red ink as far as the eye can see. At least 46 states struggled to close a cumulative budget gap of $37 billion in FY 02, their most recently concluded fiscal year. States then grappled with budget gaps totaling $50 billion while enacting their FY 03 budgets; an additional $26 billion in deficits have opened up between November 2002 and January 2003. For the upcoming fiscal year, FY 04, the estimates are even more staggering with states expected to face deficits in the range of $60 billion to $85 billion, representing between 13 and 18 percent of all state expenditures. According to a February 2003 survey, 36 states expect a shortfall in FY 04 and half of them indicated that it would equal at least 10 percent of their budgets. Undoubtedly, this is the worst fiscal crisis states have faced in the post World War II era.

California faces a shortfall of monumental proportions, almost $35 billion in the next 15 months; the City of New York faces a deficit of $1.1 billion this fiscal year and a possible $3.9 billion in FY 04. Unlike the federal government, most states are constitutionally required to balance their books at the end of their one- or two-year budget cycles, so they have been forced to slash spending, raise taxes and deplete reserve funds.

A few examples from around the region help reinforce the dismal choices confronting states. Virginia faces a budget shortfall of up to $2 billion in its current fiscal year and the next and the governor has already made substantial program and personnel cuts. In Texas, the state's budget shortfall for the current fiscal year is almost $1.8 billion and will probably reach a staggering $10 billion in its upcoming fiscal biennium. When Colorado's legislature convened this year, the state faced a shortfall of $850 million for its current fiscal year. In Oklahoma, for the current fiscal year, the state has to deal with a gap of $514 million and the state has already shaved-off hundreds of millions from its FY 04 budget. Maryland faces a combined budget shortfall close to $1.9 billion for the current fiscal year and the next. Alabama is looking at a shortfall of at least $500 million in the new fiscal year. Georgia faces a $620 million deficit in FY 03 while Missouri's shortfall is expected to top $425 million this fiscal year with a $1 billion deficit expected next year. In FY 03, Kansas has to deal with a $312 million deficit while a $750 million shortfall is projected in FY 04. Nebraska faces a shortfall of about $175 million in the current fiscal year while the deficit estimates for the upcoming biennial budget hover close to $675 million.

Part II

The bleak fiscal position states currently find themselves in maybe explained by two fundamental trends. The first trend involves the tremendous negative pressures created by the downturn in the economy, reflected specifically in such trends as dwindling revenue flows, rising unemployment numbers and exploding Medicaid costs. Each of these negative trends pummels state finances in a vicious, self-perpetuating cycle. For instance, while the steep drop in tax revenues, due to severely reduced individual and corporate income taxes–given the high unemployment rate, almost nonexistent capital gains revenue and lower corporate profits–affects the revenue side of the balance sheet, more and more Americans seek assistance from their state governments, whether in the form of unemployment insurance or Medicaid health coverage, pressuring the expenditure side of the balance sheet.

The second fundamental trend involves several structural problems inherent in state tax systems. One of these structural problems pivots around the fact that state tax systems were created half a century ago when the manufacturing and retail economies loomed large. Currently, state economies are driven by service-oriented, international and technology-led activities. The disturbing scenario here is that even when the economy overcomes its current malaise and recovers sufficiently to generate jobs, the structural basis of state revenue systems would not have changed, a development that will continue to seriously hobble state government finances. Specifically, state sales taxes, which average about a third of total state revenues, generally tax transactions involving the sale of goods and not services. With the economy rapidly moving toward more service-oriented transactions, reputedly accounting for 60 percent of personal consumption expenditures in the U.S., this revenue base continues to evaporate. For instance, in 1960, 41 percent of U.S. consumption dollars were spent on services provided by attorneys, accountants, landscapers, exterminators and the like. In 2000, this number had risen to 58 percent. Yet, only three states, Hawaii, New Mexico and South Dakota, obtain a significant portion of their revenue from services.

The other structural issue concerning the eroding state revenue base involves the growing component of sales occurring over the Internet. Currently, there is a federal moratorium on taxing Internet purchases, which expires on October 30, 2003. An overwhelmingly large proportion of the estimated $73 billion in online sales that went through in 2002 occurred free of any sales taxes. It is estimated that revenue losses from Internet and remote sales now amount to about $14 billion and that these losses could approach $45 billion by 2006.

Finally, another structural trend involves the fact that corporate tax revenues have plunged from about 8 percent of total state tax revenues in the early 1990s to less than 4 percent more recently. This drop in revenues is traceable to the exemptions, incentives and tax breaks granted to corporations as well as corporations becoming more astute in minimizing their tax burdens, with a surge in passthrough entities (partnerships, limited liability companies etc.) as opposed to the traditional "C" corporations. Consequently, a number of states, such as Kentucky, Maryland, Arkansas, Missouri, all weighted down by an enormous amount of red ink, are pondering legislation to curtail some of these exemptions and boost their corporate revenue intake.

Part III

As noted earlier, the dismal economic conditions buffeting states are reflected in three major areas: plunging revenue flows, surging unemployment numbers and skyrocketing Medicaid costs.

Anemic state revenue inflows remain one of the most persistent problems of the current economic downturn. A February 2003 survey indicates that in the current fiscal year, FY 03, general fund collections in at least 30 states were below estimates with 12 reporting that collections are even failing to meet revised levels. In addition, for the rest of FY 03, 31 states are concerned about meeting their revenue estimate targets while seven are pessimistic. In FY 02, the 16 SLC states, including MO and OK, were–on average–almost 4.5 percent under their revenue estimates.

Hundreds of thousands of Americans currently find themselves unemployed and it is estimated that the economy has fallen into its worst hiring slump in almost 20 years. In February 2003, the national unemployment rate rose to 5.8 percent (from 5.7 percent in January 2003) and the number of unemployed persons stood at 8.5 million.

With some states experiencing three consecutive years of budget shortfalls, state Medicaid budgets have come under increasing pressure. Responsible for compounding this dire situation are the significant increases in caseload and steep increases in prescription drug prices. These twin forces have acted as pincers to squeeze state Medicaid budgets, a trend that eventually affects overall budgets.

While there has been a steady increase in the average annual growth rate of Medicaid spending since the mid-1990s, in FY 02, the 13 percent increase was the highest in a decade and the second year of double-digit increases. States expect Medicaid spending to increase by 9 percent in FY 03, a number higher than the 4.8 percent average growth rate calculated by state legislatures in establishing their FY 03 Medicaid budgets. Forty states already report shortfalls in their FY 03 budgets and since the beginning of the fiscal year, 49 states have either made or intend to reduce their Medicaid spending. Early estimates indicate that due to major reductions in Medicaid programs, up to two million low-income individuals could lose health insurance coverage this year. Nebraska is one such state and there are plans to drop 16,000 children from the state's Medicaid rolls; Texas proposes to halt enrollment in its Children's Health Insurance Program and end coverage for some of the half a million children now enrolled; Tennessee's Medicaid program faces a $369 million shortfall this fiscal year with a $700 million shortfall forecasted for FY 04; Georgia's proposed cuts to medical providers in its Medicaid program will affect more than 1.2 million people and total more than $330 million and finally, Kentucky's $450 million Medicaid shortfall in the current fiscal year has resulted in program cuts totaling $250 million. States are cutting back on Medicaid by ramping down their already low payments to hospitals, nursing homes and pharmacies, freezing reimbursement rates to doctors and lopping off people or benefits they added in better times.

Part IV

States have adopted a number of actions to deal with their ongoing fiscal dilemmas and they include the following:

- Slashing Spending

In February 2003, 37 states reported that spending was exceeding budgeted levels for the current fiscal year. From the $6 billion trimmed from the Virginia budget in the last two years to the nearly $1.1 billion pared by Missouri Governor Holden two years into his term, states face the unenviable choice of slashing essential programs on account of serious shortfalls. Given the budget shortfall in Texas, close to $10 billion for the biennium, Governor Perry proposes to reduce current state agency spending by an average of 9 percent. Virginia's serious budget shortfall resulted in Governor Warner enacting $858 million in emergency spending cuts last fall including laying-off almost 1,900 state workers. In January 2003, he proposed an additional $400 million in cuts. Due to serious revenue shortfalls in its current fiscal year, Oklahoma's State Office of Finance announced across-the-board budget cuts totaling 9 percent and has proposed cuts totaling $677 million, 12 percent, from its FY 04 budget. In Georgia, former Governor Barnes ordered state agencies to cut spending by 5 percent last fall. Governor Riley in Alabama announced that balancing the budget in FY 04 would require cutting education by 6 percent and other agencies by 20 percent. Missouri laid-off almost 900 state workers and is looking at further layoffs in the areas of foster care and law enforcement alongside freezing aid to public schools. Colorado is enacting across-the-board reductions totaling 10 percent with targeted reductions in K-12 and higher education, Medicaid, welfare assistance, corrections and local revenue sharing. In Maryland, legislative analysts laid out a grim set of options for how the state might deal with its almost $2 billion budget shortfall, including cutting all employee pay by 1 percent, withholding aid to local governments, scaling back scholarships, raising income taxes on the wealthy and hiking the state's sales tax and property tax rates. In an effort to deal with its $511 million projected shortfall for the current fiscal year, Tennessee Governor Bredesden has asked all agency heads to cut almost 8 percent from their budgets. In this vein, a recent report from the College Board announced that battered by government budget cuts, public colleges and universities across the country raised tuition by almost 10 percent in 2002 while tuition at private institutions rose by about 6 percent. On the flip side, state spending at public colleges and universities dropped sharply in 2002 and increased by only 1.2 percent, the smallest increase in a decade. In fact, appropriations dropped in 14 states and the predictions are that 2003 will be even worse.

■ <u>Tapping Rainy Day Funds</u>

In FY 02, 19 states around the country tapped into their rainy day funds to close out their budget gaps and in FY 03, 10 states have already resorted to this strategy. In FY 02, Oklahoma utilized $278 million from its rainy day fund to bridge its shortfall; in the past five years, Oklahoma has used $571 million from its rainy day fund. Last month, Oklahoma's Governor Henry declared a fiscal emergency and tapped into the state's rainy day fund again leaving it with only $74 million. North Carolina used its rainy day fund in the past several years to address budget gaps and the state's rainy day fund has declined from $522 million in FY 99 to $125 million in FY 02. In Louisiana, Governor Foster raided the state's rainy day fund for the first time taking $86 million of the $263 million in the fund. Late last year, Maryland's governor took nearly $190 million from its rainy day fund to partially fix the state's current budget deficit. In Tennessee, Governor Bredesden announced that the $178 million in the state's rainy day fund will disappear by June 2003 as the state closes its shortfall.

- <u>Deploying Tobacco Settlement Monies</u>

A number of states used the proceeds of securitizing their tobacco settlement monies to address mounting budget gaps. While in FY 02, 12 states deployed this strategy, it is estimated that seven states would do so in FY 03. The rating agencies have frowned upon this practice of states using cash infusions from tobacco securitizations to pay for day-to-day operations. Missouri tapped $139 million of its funds to offset its past budget shortfall and is working on a $400 million bond issue to bridge shortfalls in FY 03 and 04. Alabama secured $30 million from its funds for Medicaid. To close the shortfall for FY 02 and clinch its FY 03 budget, Tennessee used the $368 million received to date under the agreement. In addition, Tennessee will count the $160 million to be received every year under the agreement for the next 20 years as "recurring revenue" in its budget deliberations, thereby eliminating tobacco settlement monies for any health or agriculture projects. Similarly, North Carolina proposes taking $60 million of the state's $160 million annual allotment to meet revenue needs.

- Raising Taxes

In FY 02, in a striking difference from the prior seven years, a number of states raised taxes to meet their budgetary obligations. FY 02 was the first year since FY 94 that there was a net state tax increase across states. Yet, demonstrating how difficult it is to raise taxes even in these dire fiscal times, states only raised taxes by 1.2 percent last year whereas in 1991, the last time states were in recession, they raised taxes by 5.4 percent. Oklahoma's Personal Income Taxes went up in FY 02 because of an automatic trigger adopted as part of a tax reduction act in 1998. To balance Oklahoma's FY 04 budget, Governor Henry has proposed 10 different fee increases to bring in about $154 million. Alabama increased business taxes by $58 million by taxing interstate telephone calls. In terms of

Sales and Use Taxes, Tennessee, after a rancourous debate on introducing a personal income tax, raised almost $1 billion in new taxes to balance its books for FY 03. The state portion of the sales tax in Tennessee went up and the 9.75 percent sales tax rate in a number of Tennessee counties makes it the highest in the country. In North Carolina, in an effort to shore up its budget, local governments were allowed to increase their portion of the sales tax by a half cent to 2.5 percent (bringing the total to 7 percent) while there were increases in the upper-end of the state's income tax rates, liquor and motor fuels taxes along with a levy on HMOs. In Louisiana, after a constitutional amendment reinstating a sales tax exemption on food and residential utilities, personal income tax brackets were restructured to move more taxpayers into the top bracket and to disallow some existing deductions. Soon after he was reelected last year, Arkansas Governor Huckabee shocked legislators with his proposal to raise the state's sales tax. Also, in Arkansas, the Senate is now considering a list of 33 tax increases across a number of categories. On another front, there is an increasing trend in states to eliminate certain corporate tax exemptions. Governor Holden in Missouri is calling for eliminating corporate loopholes, a move that could bring in $217 million while Maryland is looking at saving $200 million in lost corporate tax revenue from companies creating out-of-state holding companies. In Kentucky, Governor Patton wants to raise $340 million in new revenue largely by raising the corporate license tax and extending it to limited liability companies and partnerships.

- <u>Hiking Cigarette Taxes</u>

While 21 states implemented or passed higher cigarette taxes in 2002, 26 states have not increased their cigarette taxes for at least five years. Some of the states that increased their cigarette taxes in 2002 were Arkansas (34 cents), Kansas (79 cents), Louisiana (36 cents), Maryland (1 dollar), Nebraska (64 cents) and Tennessee (20 cents). In addition, states are collecting more in tobacco-generated revenue than ever before; in FY 03, states will collect $12 billion in tobacco taxes and $9 billion in tobacco settlement payments. Governor Wise's proposal in West Virginia to increase his state's cigarette tax to 55 cents per pack and use the revenue to bail out the state's Medicaid program has just passed the legislature. Texas is considering raising its cigarette tax to $1 per pack, a move that could generate $1 billion in new revenue. Similarly, South Carolina is considering an increase in its cigarette tax and generating $150 million while Governor Perdue in Georgia has proposed raising the state tax on cigarettes and alcohol to bring in $490 million.

- <u>Cutting Funds to Local Governments</u>

In an effort to balance budgets, states are beginning to slash back on monies forwarded to local governments, a move that counties and cities contend would only force property tax increases and result in statewide budget cuts. In FY 04, Tennessee proposes to retain about $100 million in funds the state used to share with local entities to balance its budget. Texas proposes cutting back on fully paying for a number of local services to generate $600 million in savings to the state. In North Carolina, Gov. Easley proposes taking away $140 million from local governments in school and healthcare expenditures. Maryland's two biggest counties are bracing for cuts in state funds under the Governor's FY 04 budget. In FY 03 and 04, Kansas intends to withhold $134 million previously forwarded to cities and counties.

- <u>Racking Up Debt</u>

According to early reports, state and local governments borrowed $127 billion more than they received in 2002, almost three and a half times the level of 1999. Using borrowed money to balance the shortfalls in their budgets equaled 9.7 percent of state and local revenues in 2002, the highest it has been since the 1950s. The trend in state houses has been to rely more on borrowing to finance their budget gaps–as opposed to raising taxes–with states taking advantage of historically low interest rates. Yet, the heavy borrowing has resulted in the credit ratings of states being negatively affected with Standard & Poor's lowering the ratings of such states as California, Colorado, Kentucky, New Jersey, Tennessee and Wisconsin in the last two years.

- <u>Generating Funds Via Gaming</u>

In another growing trend in these fiscally challenging times, a number of states are focusing on gaming to generate new revenue. When Tennessee voters approved an amendment to the state constitution last year, it cleared the way for the General Assembly to create a lottery that would be constitutionally required to pay for education. When this happens, Utah and Hawaii will be the only two states without any form of legalized gaming. Florida is mulling over installing new video lottery terminals at parimutuel facilities across the state to generate between $500 million and $1 billion annually. The current governor of Maryland campaigned on slots at the racetracks and has proposed 13,500 slot machines to bring in a potential $600 million two years from now. Kentucky's General Assembly is reviewing a proposal from the racing industry guaranteeing the state $400 million up front if slot machines opened at the tracks followed by at least $200 million in each of the next four years. Governor Henry in Oklahoma is strongly advocating a lottery that could generate at least $300 million annually to help fund education. In North Carolina, Governor Easley announced that he would attempt, yet again, to convince the General Assembly to support his efforts for a lottery to finance education. With Arkansas facing a Supreme Court mandate to overhaul schools, there is renewed interest in the legislature on a constitutional amendment to create a state lottery for education. In Nebraska, there are proposals in the state Senate supporting a constitutional amendment to permit casinos in the state.

Part V

Policymakers in almost every state grapple with a dramatic deterioration in their fiscal positions. Rapidly diminishing revenue flows have resulted in reductions in public services and there is no respite in the short term. The exceptions here are New Mexico and Wyoming, states whose economies are dominated by the oil and natural gas industries. While New Mexico just enacted a $360 million tax reduction package, Wyoming has $1.8 billion in its rainy day fund and recently made another $100 million deposit to this fund. The federal government faces its own string of fiscal problems compounded by a range of national security concerns. Yet, the sense of gloom that permeates the financial and economic climate has to be tempered with the following items of positive news: the economy is still expanding with GDP growing by 2.4 percent in 2002; inflation remains quite subdued; record low interest rates with the lowest mortgage rates in four decades propelling consumers to purchase homes and refinance their mortgages; and finally, the efficiency and productivity gains of the late 1990s remain intact and the economy can build on those pillars to reach higher productivity levels and higher incomes in the future. In fact, American productivity has continued to post impressive gains with the 4.7 percent growth in productivity in 2002 being the best since 1950.

Even though the grim fiscal environment confronting states has extinguished most state-led economic development initiatives, there are a few that have to be mentioned. In Texas, state officials were ecstatic in February 2003 when Toyota, the world's third largest automaker, announced the establishment of an $800 million plant to manufacture pickup trucks in San Antonio. In addition to the 2,000 new jobs, the plant is expected to eventually have an economic ripple effect of about $1.4 billion. State and local entities had to come up with a $133 million incentive package for the plant. Governor Johanns in Nebraska has proposed a clusters approach to targeting industries (such as agribusiness, financial services, biotech and software development) to promote economic development in the state. Nebraska is also considering modifying its tax incentive program by lowering the threshold for qualifying for tax incentives and encouraging job creation in rural and low-income urban areas. In Missouri, Governor Holden has proposed cutting the corporate tax rate from 6.25 percent to 5.25 percent. In North Carolina, Governor Easley has proposed a $700 million bond issue for spending on highway maintenance, road and bridge and rail projects. Colorado's Governor Owens signed legislation last month authorizing a $10 million tourism stimulus package to expand the state's tourism industry, which generates $550 million in state and local taxes annually and employs more than 200,000 Coloradans. In Arkansas, the governor recently signed legislation that offers new breaks for R & D efforts and income tax breaks for new businesses in such fields as biotechnology while providing incentives for counties to work regionally to attract new industry.

In closing, while the current fiscal dilemmas confronting states remain the worst in decades, the healthy fiscal situations states found themselves in the 1990s did prepare them for the onset of these grim fiscal times. Most states built up healthy rainy day funds even though they have been forced to draw down these balances in the last few years. Yet, the uncertainty over the situation in the Middle East coupled with the surge in energy costs–impacting everyone from commuters to airlines to factories–has complicated the fiscal scenario at the state level just as it has made the national outlook murkier. Hence, the state fiscal picture will continue to remain cloudy until some of these issues become clearer.