CENTER ON BUDGET AND POLICY PRIORITIES

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STATES FACE CONTINUING FISCAL PROBLEMS — EVIDENCE FROM RECENT REPORTS

By Elizabeth McNichol

State government fiscal conditions remain weak, despite recent improvement, according to three of the leading bipartisan or academic organizations that track state taxes and budgets.[1] As states write their budgets for the 2005 fiscal year which begins in most states on July 1, 2004, their revenues are still well below pre-recession levels. States that borrowed money, used reserves, or shifted funds to balance their budgets in prior years have a budget "hole" from which to dig out. And the spending cuts and reduced balances of the last several years have given states little cushion with which to work in enacting balanced budgets.

Spending

- Spending growth is very slow by historical standards. State spending grew 2.8 percent in fiscal year 2004 budgets and is projected to grow another 2.8 percent in fiscal year 2005 according to the NASBO survey.
- Fiscal year 2004 and fiscal year 2005 spending growth is modestly higher than in fiscal years 2002 and 2003 when spending increased only 1.3 percent and 0.6 percent, respectively. However, the fiscal year 2004 and fiscal year 2005 spending growth is less than the increases in population and inflation in those years and well below the 26 year average growth of 6.2 percent.
- An average 2.8 percent rate of spending growth is not sufficient to fund the ongoing level of state services, and in many states will require additional budget cuts.
- As a result of several years of depressed spending growth, state spending as a share of the economy — as measured by Gross Domestic Product — is now at its lowest level in almost 15 years.

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[1] This brief is based on the National Association of State Budget Officer's semi-annual fiscal Survey of the States, the National Conference of State Legislatures' April 2004 State Budget Outlook and the most recent quarterly report on state revenue collections prepared by the Nelson E. Rockefeller Institute of Government.

Selections from the Reports

"While state tax revenue growth is healthy again, real state revenue levels still have a way to go before they have fully recovered from the recession, even though it ended over two years ago. While the curve is now clearly headed upward, it may still be years before the states have as much real revenue as they had before the recession. This drop in state revenues has been reflected in the fiscal outlook of many states, as the budget debate still features spending reductions and tax increases." Nelson E. Rockefeller Institute of Government, State Fiscal News, May, 2004

"Despite some improvements in the states' fiscal situations, the picture is far from rosy. If the states were patients, you could say they are out of intensive care, but they're not out of the hospital yet." Scott Pattison, Executive Director, National Association of State Budget Officers, May 9, 2004

"Although the magnitude of fiscal problems has eased, policymakers remain wary about the future. Most have implemented multiple rounds of budget cuts and have depleted reserves. At this point in the fiscal crisis, there are fewer options to address budget problems. Simultaneously, state officials face pent-up spending needs, especially for those programs that have been cut, and growing health care costs." National Conference of State Legislatures, State Budget Update: April 2004

Revenues

- Revenue collections for the current year, fiscal year 2004, are on target or somewhat above projections. This reduces the need for mid-year budget corrections — an improvement over the situation last year — and is welcome news. However, 2004 estimates were conservative and represented growth from a very low base. The fact that states are meeting or exceeding those low estimates certainly does not imply robust revenue growth.

- Revenue growth is recovering slowly. According to the most recent data collected by the Rockefeller Institute, state tax revenue grew by 5.5 percent in the January to March quarter compared to a year ago, after adjusting for inflation and tax law changes. This *rate* of growth is comparable to pre-recession levels, but it is growth from a low point in state tax collections during the same quarter last year.

- Despite this sign of renewed revenue growth, state revenues have a long way to go before reaching pre-recession levels. The January to March quarter is the third quarter of the current fiscal year. Real tax revenue growth rates for the first two quarters of fiscal year 2004 were well below normal, 0.4 percent and 1.8 percent — less than half the level of the mid 1990s. The Rockefeller Institute report also shows that per-capita state tax revenue adjusted for legislation and inflation remains well below the level of 2000 and has just reached 1997 levels.

- Not all states are experiencing revenue growth. According to the Rockefeller Institute, revenues declined in the last quarter of 2003 in 14 states and grew by less than one percent in seven others after adjusting for inflation and tax law changes. The NCSL report includes a survey of revenue projections for the full fiscal year and finds that eleven states reported revenues below targeted amounts for fiscal year 2004.

Deficits, Surpluses and Rainy Day Funds

- The size of gaps that developed after budgets were enacted this year — a total of $5.3 billion — is much smaller than the budget gaps that developed during the course of fiscal years 2002 and 2003. While smaller, these mid-year gaps are an indication of continued fiscal weakness in a number of states.

- All states used some one-time measures to balance their budgets over the last few years; a number of states relied very heavily on these types of measures. As a result, states will need not just average but higher than average revenue growth in order to sustain average expenditure growth. These one-time revenues will have to be replaced with on-going revenues in future budgets.

- The combination of continued low revenue growth and the need to dig out of a budget hole means that states will face additional deficits in fiscal year 2005. NCSL, NASBO and the Center's own surveys all find that state budgets are not in good shape for the upcoming year — fiscal year 2005. States are taking actions and debating ways to close deficits that equal $36 billion to $40 billion.

- States have exhausted many of the short-term measures they can use to balance their budgets. Federal fiscal aid expires at the end of fiscal year 2004. State reserves have been depleted. According to the NASBO survey, state general fund ending balances and rainy days funds are projected to total 3.1 percent in fiscal year 2005. This is well below the 10.4 percent that states had on hand in fiscal 2000 before the start of the fiscal crisis, and much of the remaining reserves are unavailable because of the design of some state rainy day funds.

Conclusion

In summary, these reports show that while the worst appears to be over for state budgets, the recovery in revenues and spending is very slow. State budgets remain depressed as a result of the poor performance of revenues over the last three years. They have yet to see the kind of recovery that will allow them to get back to normal and restore some of the cuts of the past three years.