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STATE BUDGETS NOT YET OUT OF THE WOODS

Sustained Revenue Growth Needed to Restore Pre-Recession Levels of Services

Despite the recent growth in state revenues, states still are not able to provide the level of programs and services they did five years ago, before the fiscal crisis hit. A new Center report, *Framing the Choices,* urges state policymakers to be cautious about enacting new tax cuts or implementing previously enacted tax cuts at a time when revenues and services have not yet recovered from the economic downturn and the federal government is poised to reduce funding for state programs.

"States have gone through an unusually difficult recession, stated Robert Zahradnik, the report's lead author. "While states are now starting to enjoy solid revenue growth, it's way too soon to break out the champagne."

Between 2000 and 2004, state revenues fell $184 billion below the level needed to maintain services at their 2000 level. To return to 2000 service levels by 2007, state revenues would need to grow by nearly 10 percent per year, faster than the 7.8 percent growth they recorded in the final quarter of 2004.

Enacted and Proposed Tax Cuts Threaten Restoration of Services

By the end of fiscal year 2004, state revenues had grown faster than inflation for seven straight quarters, following eight straight quarters of growth at or below inflation. However, the state fiscal situation remains tenuous.

A number of states have enacted "backloaded" tax cuts in recent years that have not fully taken effect but will cost them roughly $4.4 billion a year as they phase in. When fully implemented, for example, **Michigan's** business tax cuts will cost an estimated $2.2 billion annually, **Pennsylvania's** business tax cuts will cost an estimated $1.5 billion annually, and **New Mexico's** personal income tax cuts will cost an estimated $277 million annually.

In addition, several states are considering new tax cuts that would cost states roughly $2.2 billion a year if enacted in their original form.

For example, **Ohio** governor Bob Taft has proposed a tax plan that would cost at least $400 million when fully implemented in 2010 and would weaken long-term revenue growth by making the state more dependent on cigarette and alcohol taxes. The state House has endorsed most of the governor's plan and has added a business tax cut that would cost $450 million a year when fully implemented.

States also face structural budget problems caused by outdated tax systems that do not keep up with changes in the economy. (In coming weeks the Center will issue a major report providing state-by-state information on these structural problems.) For these and other reasons, states should be extremely cautious about taking steps that would weaken revenues.

Meanwhile, **Washington** recently approved a measure to *strengthen* revenues, while **Connecticut** and **North Carolina** are considering such a step. (**Indiana** governor Mitch Daniels proposed a temporary tax surcharge, but the legislature rejected it.)

States Relied on Service Cuts to Balance Budgets During Downturn

One reason for the emergence of such a large ($184 billion) revenue gap during the downturn is that the downturn was both longer and deeper than the previous downturn, in the early 1990s. The current fiscal crisis has lasted five years in most states, compared to three years for the fiscal crisis of the early 1990s.

Another reason is that states did much less to bolster their revenue systems during the recent downturn than during the earlier one. State tax increases in the recent downturn were less than half as large as in the 1990s downturn.

Instead, states relied heavily on service cuts to close budget gaps. In fact, they were three times more likely to close deficits through spending cuts than through revenue increases. (In the early 1990s, in contrast, states closed deficits using roughly equal shares of revenue increases, spending cuts, and one-time measures such as spending reserve funds.) Partly as a result of this reliance on spending cuts, state spending in fiscal year 2004 fell to its lowest level as a share of the economy since the mid-1980s.

The spending decline weakened a broad array of government services. For example, more than a million people nationwide lost public health coverage during the downturn as a result of funding cuts in Medicaid and the State Children's Health Insurance Program. In 35 states, per-pupil spending on K-12 education fell between 2002 and 2004 after adjusting for inflation. Tuition and fees for state higher education have jumped by 35 percent in the past four years after adjusting for inflation.

"States' top priority should be to repair the damage that has been done to core services like education and health care," said Zahradnik.

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The Center on Budget and Policy Priorities is a nonprofit, nonpartisan research organization and policy institute that conducts research and analysis on a range of government policies and programs. It is supported primarily by foundation grants.