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STATES CUT SPENDING IN FY 2002 AND FY 2003 ADDITIONAL CUTS LIKELY UNLESS NEW REVENUES ARE RAISED

By Kevin Carey

Summary

There has been a dramatic deterioration of state fiscal conditions over the last year. Rapidly declining tax revenues have led state policymakers to implement significant reductions in public services. It often is difficult, however, to determine the amount by which state spending has been reduced, since budgeting conventions differ greatly among states. One way to consider the magnitude of the budget cuts is to compare current growth in state spending with the growth of spending in normal times; the growth in normal times can be taken as an approximation of the amount of spending growth necessary to maintain programs and services. Using this type of comparison, it is clear that state spending for fiscal years 2002 and 2003 is well below the level necessary to maintain services.

Preliminary data from a survey of 43 states suggest that overall state spending grew by only 1.3 percent in state fiscal year 2002; some 14 states spent less money in FY 2002 than in FY 2001. Spending for FY 2003 is slated to grow by only 1.4 percent.

These amounts are far below the long-term trend in state expenditures to support government programs and services. From 1989 to 2000, state spending grew at an annual rate of 5.3 percent. If spending in FY 2002 had grown at the long-term trend rate rather than at 1.3 percent, an additional $20 billion would have been expended in that fiscal year. An additional approximately $20 billion is missing for FY 2003.

In order to reduce spending by this “missing” $40 billion, states implemented a variety of budget reduction strategies. Some states have cut services for those most in need of assistance during an economic downturn. Eligibility has been restricted for health insurance, child care, and income support services that benefit low-income families. Medicaid benefits have been reduced, job training programs for people trying to move from welfare to work have been cut, and the cost of child care for low- and moderate-income families has been significantly increased.

Other state budget cuts in various programs and services have been made. Cuts in funding for public universities have resulted in higher college tuition, shifting the cost of balancing state budgets to students and their parents. Reductions in state aid for public schools and local governments have resulted in school program cutbacks and have to some degree shifted a greater share of the burden of funding schools to local property tax payers. Other reductions in funding have been implemented for state parks, museums, libraries, public health, and public safety.

These and other state budgets cuts have been implemented to close state budget deficits that totaled approximately $40 billion for FY 2002 and $50 billion for FY 2003. Those deficits are primarily the result of weakening state revenues; state revenues overall have declined in four consecutive quarters. Revenues dropped by 10.4 percent in the last quarter of FY 2002 compared to the same quarter in the previous year (the largest decline since at least the 1980s) and the decline appears to be continuing in many states. The short-term outlook for state fiscal conditions is bleak, as a number of states have recently increased their estimates of budget deficits in FY 2003, and some states have begun to forecast significant shortfalls in FY 2004.

States have managed to maintain a small amount of spending growth in FY 2002 and FY 2003 by relying heavily on one-time budget-balancing measures such as spending down rainy day funds or delaying payments to local schools until future years. Many states have all but exhausted such measures, leaving them to close future budget shortfalls through some combination of revenue enhancements or further spending cuts that are likely to be harmful to low-income populations and individuals and families suffering from the weak economy. Those states that choose to increase their revenues have a number of viable options available, including maintaining state estate taxes that otherwise would be phasing out as a result of federal law, closing corporate tax loopholes, raising income taxes for upper-income taxpayers, and expanding the sales tax to include some services. These options can help stabilize flagging revenue streams and prevent further cuts to needed public services.

State Expenditure Growth Slowed Significantly in FY 2002 and Will Continue to Be Slow in FY 2003

Preliminary estimates from 43 states indicate that state general fund expenditures increased by only 1.3 percent in state fiscal year 2002 (See Table 1). Fourteen states spent *less* money in FY 2002 than in FY 2001. The increase in state expenditures in FY 2002 was well below long-term trends. State general fund expenditures grew by an average of 5.3 percent from FY 1989 to FY 2000, a time period encompassing a full economic cycle, including both the recession of the early 1990s and the subsequent recovery and expansion.[1] Had states been able to sustain that trend in FY 2002 by increasing expenditures 5.3 percent over the FY 2001 amount of $488.6 billion, total expenditures for FY 2002 would have been approximately $514.5 billion.[2] If the preliminary findings of a 1.3 percent spending increase found in our survey of 43

[1] National Association of State Budget Officers, *Fiscal Survey of the States*¸ various years. For a more detailed discussion of recent state spending trends, see Liz McNichol, *Did States "Overspend" During the 1990s?*, Center on Budget and Policy Priorities, 2002.

[2] Because Table 1 does not contain information for every state, the results are extrapolated for the purposes of this comparison. The $488.6 million amount represents total FY 2001 state general fund expenditures, as reported in NASBO, *2001 State Expenditure Report*. The *State Expenditure Report* survey indicates a slightly higher increase in FY 2002 expenditures than found in this report, showing growth of 2.5 percent from FY 2001. It should be noted, however, that many of the states responding the NASBO survey submitted their estimates of FY 2002 expenditures in January – March 2002, prior to the drastic decline in revenues experienced by many state during the April – June 2002 period. As a result, it is likely that some states implemented further spending reductions that are not reflected in the NASBO report, but are captured in our survey, which was conducted after the fiscal year closed.

Table 1
State Expenditures and Appropriations 2001 - 2003

State	Total General Fund Expenditures FY 2001 ($ millions)	Total General Fund Expenditures FY 2002 ($ millions)	Pct. Change 01 - 02	Total General Fund Appropriations FY 2003 ($ millions)	Pct. Change 02 - 03
Alabama	$5,213.0	N/A	-	N/A	-
Alaska	$2,284.8	$2,503.9	9.6%	$2,398.0	-4.2%
Arizona	$6,384.2	$6,341.2	-0.7%	$6,168.8	-2.7%
Arkansas	$3,258.9	$3,182.4	-2.3%	$3,317.0	4.2%
California	$78,053.0	$76,863.0	-1.5%	$76,722.0	-0.2%
Colorado	$5,341.8	$5,653.0	5.8%	$5,798.5	2.6%
Connecticut	$11,864.5	$11,964.0	0.8%	$12,343.7	3.2%
Delaware	$2,429.0	$2,467.6	1.6%	$2,450.0	-0.7%
Florida*	$20,065.4	$19,207.0	-4.3%	$20,645.4	7.5%
Georgia	$15,600.8	N/A	-	$16,106.0	-
Hawaii	$3,264.3	$3,656.1	12.0%	$3,546.5	-3.0%
Idaho	$1,828.6	$1,979.4	8.2%	$1,967.9	-0.6%
Illinois	$22,371.6	$23,409.0	4.6%	$22,298.0	-4.7%
Indiana*	$10,084.7	$9,790.1	-2.9%	$10,447.1	6.7%
Iowa	$4,887.3	$4,610.2	-5.7%	$4,878.5	5.8%
Kansas	$4,429.6	$4,368.8	-1.4%	$4,444.5	1.7%
Kentucky	$7,040.5	$7,081.6	0.6%	N/A	-
Louisiana	$6,537.6	$6,279.8	-3.9%	$6,636.0	5.7%
Maine	$2,571.4	$2,583.7	0.5%	$2,709.6	4.9%
Maryland	$10,238.0	$10,561.0	3.2%	$10,585.2	0.2%
Massachusetts	$20,367.9	$20,958.1	2.9%	$21,004.1	0.2%
Michigan	$9,606.0	N/A	-	$9,087.0	-
Minnesota*	$12,702.7	$13,058.7	2.8%	$13,858.4	6.1%
Mississippi	$3,630.6	$3,552.0	-2.2%	$3,514.2	-1.1%
Missouri	$7,729.0	$7,606.0	-1.6%	$7,797.0	2.5%
Montana	$1,273.9	$1,355.0	6.4%	$1,271.0	-6.2%
Nebraska	$2,477.9	$2,598.7	4.9%	$2,621.2	0.9%
Nevada	$1,776.7	$1,768.5	-0.5%	$1,902.0	7.5%
New Hampshire	$1,153.6	$1,192.8	3.4%	$1,247.4	4.6%
New Jersey	$21,279.4	$22,431.4	5.4%	$23,401.7	4.3%
New Mexico	$3,827.6	$4,049.2	5.8%	$3,877.6	-4.2%
New York	$39,702.0	$41,222.0	3.8%	$39,747.0	-3.6%
North Carolina	$13,400.0	$13,800.0	-	N/A	-
North Dakota	$830.9	$861.0	3.6%	$884.0	2.7%
Ohio	$21,144.2	$21,627.4	2.3%	$23,039.4	6.5%
Oklahoma	$5,330.8	$5,399.3	1.3%	$5,600.0	3.7%
Oregon	N/A	N/A	-	N/A	-
Pennsylvania	$19,861.7	$20,429.4	2.9%	$20,695.8	1.3%
Rhode Island	$2,482.7	$2,660.4	7.2%	$2,664.5	0.2%
South Carolina	$5,422.9	$5,178.8	-4.5%	$5,437.4	5.0%
South Dakota	$793.2	$848.0	6.9%	$875.0	3.2%
Tennessee*	$7,015.1	$7,500.0	6.9%	$7,937.0	5.8%
Texas	N/A	N/A	-	N/A	-
Utah	$3,711.0	$3,731.0	0.5%	$3,568.6	-4.4%
Vermont	$881.2	$872.1	-1.0%	$898.2	3.0%
Virginia	$12,283.6	$12,013.8	-2.2%	$12,207.7	1.6%
Washington	$10,826.9	$11,217.4	3.6%	$11,565.8	3.1%
West Virginia	$2,706.8	$2,816.8	4.1%	$2,930.0	4.0%
Wisconsin	$11,077.7	N/A	-	$11,080.0	-
Wyoming	$1,026.5	N/A	-	$1,474.7	-

Source: Survey of state budget offices conducted in August and September 2002

Notes to Table 1

Florida – Many spending cuts implemented during a 2001 special session were subsequently restored in 2002.

Indiana – The FY 2003 spending increase is attributable to recent legislation that reduced local property taxes, funded by an increase in state sales taxes, resulting in increased disbursement of property tax replacement credits to local units of government, which are reflected as new state expenditures.

Minnesota – The majority of FY 2003 state spending growth is attributable to a recent change in education funding in which $800 million in local property tax revenues were replaced by equivalent transfer payments from the state.

Tennessee – Tennessee was able to maintain spending growth by raising over $800 million in new tax revenues for FY 2003, including an increase in the sales tax, cigarette tax, and various business taxes.

states is assumed to be characteristic of total state spending growth, FY 2002 expenditures will have been $495 billion. The difference, $19.5 billion, represents the approximate amount that states were forced to cut expenditures below normal levels. This is a conservative estimate of the amount by which budgets were cut, since the growth in health care cost in the past two years has increased the cost of maintaining public services, so current expenditure needs may be above the long-term average. Medicaid costs grew by 11 percent in 2002.

The impact of weak revenues on state spending is also reflected in state expenditure plans for FY 2003. State general fund appropriations for FY 2003 are estimated to be 1.4 percent higher than FY 2002 expenditures. Actual FY 2003 expenditures may be lower than appropriations. Many state budgets for FY 2003 are based on economic forecasts that assume some renewed growth in state revenues during the fiscal year. If state revenue growth continues to stagnate or decline, many states may be forced to implement mid-year cuts to already-reduced FY 2003 appropriation levels.

A Wide Range of Public Services Have Been Cut

The budget reductions implemented for FY 2002 and FY 2003 have been wide-ranging. Many governors have implemented what might be termed “first round” administrative reductions in state spending, including restrictions on out-of-state travel and moratoriums on equipment purchases. Beyond that, personnel expenses in state agencies have been cut through a variety of measures, including hiring freezes, involuntary unpaid furloughs, early retirement programs, and state employee layoffs. These personnel measures can leave agencies understaffed and can impair the ability of residents to access government services and benefits. In addition, across-the-board percentage reductions in state agency budgets have been implemented in many states, either through executive action or as part of legislative budget-balancing plans. In some cases these cuts trim administrative costs, but in other places they result in reductions in services to low-income families.

Across-the-board cuts and administrative reductions were among the first spending cut measures implemented in many states. They often proved insufficient to fully close state budget gaps. This is because the large majority of all state expenditures are for non-administrative expenses such as funding for K-12 education, support for public universities, child care services, support for low- and moderate-income families, health care for low-income and elderly persons, and aid for local units of government. Once state fiscal problems become severe, specific cuts to these essential public services can be difficult to avoid unless new revenues are raised. Examples of specific reductions in state support for public services can be found below.

Medicaid

States are having particular difficulty in maintaining funding for their Medicaid programs. A recent report by the Kaiser Commission on Medicaid and the Uninsured noted that state Medicaid costs grew by 11 percent in fiscal year 2002 — consistent with the 12.7 percent growth in private health insurance costs — and are expected to continue to grow at double digit rates in 2003.[3] Yet declining revenues and budget constraints led states to appropriate only a 4.8 percent increase in Medicaid spending for fiscal year 2003. To bridge this gap, many states have already cut their Medicaid programs; others are likely to do so later this year if they cannot find a way to increase the funds available for the program. The Kaiser survey found that 45 states took action to reduce Medicaid in FY 2002, and 41 states have plans to do so in FY 2003.

- Benefits were reduced in 22 states in FY 2002 and/or FY 2003. Eight states cut or reduced dental benefits for adults. States also implemented restrictions on home health, podiatry, chiropractic services, eyeglasses, psychological counseling, and translator services.

- Eligibility for medical services was restricted in 25 states in FY 2002 and/or FY 2003. In **Missouri**, 32,600 people are losing their Medicaid health insurance. **Nebraska** cut 25,000 people, and **Massachusetts** cut 50,000 people.

- Copayments for health care services other than prescription drugs were instituted or increased in 16 states in FY 2002 and/or FY 2003. Copayments were implemented for services including transportation, doctor visits, and non-emergency visits to emergency rooms. **Rhode Island** began charging a five percent additional premium for households with income above 150 percent of the poverty line. Research has shown that copayments are a significant deterrent to the use of essential medical care and prescription drugs among low-income populations, and that there are adverse health consequences when such treatment is foregone or delayed.

The Kaiser survey was taken in May and June of 2002. Since then, additional reductions in Medicaid for fiscal year 2003 have been announced. For example, in mid-September **Oklahoma** announced sharp reductions in eligibility for children and seniors, and a complete elimination of its medically needy program. These changes together will result in approximately 20,000 people in **Oklahoma** losing health care coverage.[4]

Although **Tennessee** has not cut services or eligibility for residents qualified for Medicaid, it has made deep cuts in its TennCare program, which serves individuals and families with incomes above the Medicaid eligibility limits. Many adults with incomes above the poverty level and children whose family income is more than twice the poverty level will lose benefits. It is estimated that 160,000 enrollees will lose health insurance through being removed from TennCare.

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[3] Kaiser Commission on Medicaid and the Uninsured, *Medicaid Spending Growth: Results from a 2002 Survey,* September 2002.

[4] Oklahoma is considering postponing the implementation date of these cuts from November 1, 2002 to March 1, 2003.

Child Care

A recent report by the Children's Defense Fund found that budget shortfalls have forced a number of states to reduce funding for child care, despite the fact that the number of low-income families needing child care services has grown significantly in recent years.[5] The impact of funding cuts has been felt in a number of ways.

- Waiting lists for child care programs are growing larger. **Florida** added more than 12,000 children to its waiting list, while **Indiana** added more than 11,000 children. **Texas** added more than 5,000 children to its waiting list. Other states that increased the size of waiting lists include **Tennessee** and **Minnesota**, while the total number of states with waiting lists increased from 17 to 19.

- Eligibility for services has been restricted. **Nebraska** reduced the eligibility level for child care assistance from 185 percent of the federal poverty line to 120 percent for some families, while **New Mexico** reduced eligibility from 200 percent of the poverty line to 100 percent. Eligibility was also restricted in **Indiana, New York**, and **West Virginia**.

- Parent fees have increased. Indiana plans to increase parent fees for all families above 100 percent of the poverty line, while co-payments were increased in **West Virginia** and **North Carolina**.

- Supports have been reduced for parents not on welfare who are pursuing education and training. **Illinois** cut such funding by $7.5 million, a program was eliminated in **Colorado** that provided child care subsidies to parents in school, and **Alabama** postponed plans to extend child care assistance to families in college.

TANF

As a result of the weak economy and increasing unemployment rates, some states have projected increases in TANF cash assistance caseloads that would require additional spending on cash benefits. A number of states are having difficulty maintaining TANF programs because reserves of federal TANF funds are dwindling. Some states have already made cuts to TANF-funded programs.

- **Indiana** plans to reduce TANF spending by $54 million by, among other steps, cutting TANF funding for child care programs by nearly $10 million and reducing spending on a range of social service programs by nearly $7 million.

- **Massachusetts'** FY 2003 budget reduces funding for several critical safety net and work support programs supported with federal TANF or state maintenance-of-effort funds: funding for employment services for cash assistance recipients was reduced by 20 percent; an eviction prevention program that helped about

[5] *Low-Income Families Bear the Burden of State Child Care Cutbacks,* Children's Defense Fund, September 2002.

8,000 families last year was terminated; and assistance for thousands of legal immigrant families was eliminated.

- **Tennessee's** current budget reduces TANF spending by $20 million, affecting transportation assistance, job skills training, and substance abuse services.

- In February 2002 the state of **Washington** implemented $54 million in cuts to welfare programs, which affected many programs including job skills training and job retention initiatives.

TANF cuts of some kind of have been implemented in a number of other states, including **Arizona, Arkansas, California, Connecticut, the District of Columbia, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, North Carolina, Ohio, West Virginia,** and **Utah.**

Higher Education

State support of public universities has been significantly affected by state budget deficits. Many state institutions of higher education have acted to make up for lost revenues by sharply increasing tuition, effectively shifting some of the burden of balancing state budgets to students and their parents. Tuition increases also reduce access to higher education for low- and moderate-income families. The College Board recently reported that tuition at four-year public colleges and universities increased by an average of 9.6 percent nationwide. Significant tuition increases include:

- Tuition and fees at the University of Kansas will be more than 20 percent higher in 2002.

- Trustees at Penn State University increased tuition by 13.5 percent, the first double-digit increase since 1984.

- Freshmen at Texas A&M University will pay at least 26 percent more in tuition and fees in 2002 than in 2001.

Tuition increases of greater than eight percent were implemented at public universities in many other states, including **Alabama, Alaska, Idaho, Illinois, Indiana, Iowa, Kentucky, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, South Carolina, Virginia, Washington, West Virginia,** and **Wisconsin.**

K-12 Education

Many state policymakers have worked to minimize the impact of state budget deficits on local schools, given the public popularity of education spending. But the fact that K-12 education costs represent the single largest expense in state budgets has made such reductions unavoidable in some states.[6] Cuts in local school aid may result in increased local property taxes, as schools seek to replace lost state aid with increased local revenues. Budget cuts can also result in scaled back programs, larger class sizes, and reductions in teacher compensation.

- Budget cuts in **Idaho** trimmed $23.3 million from 2002 state funding for local schools.

- State distributions for K-12 education in **Illinois** were $176 million less in 2003 than in 2002.

- State support for local school operating costs was reduced by $115 million in **Indiana**, causing schools to fill the shortfall by internally reallocating local funds that had been previously designated for construction and maintenance costs.

- K-12 education funding in **Massachusetts** for FY 2003 was cut $75 million below FY 2002 levels. Funding for after-school programs was eliminated, and early childhood education funding was reduced significantly.

- The governor of **Kansas** announced $17.5 million in cuts to local school budgets in August 2002.

- Budget-balancing legislation passed in **Washington** included $92 million in reductions for K-12 education.

Aid to Local Governments

A number of states provide aid to local units of government such as counties, cities, and towns. Some state policymakers have sought to shift some of the impact of state budget deficits to local governments by reducing the state aid those local units receive.

- State distributions to local governments in **North Carolina** were cut by $209 million in FY 2002 and $333 million in FY 2003, forcing some cities and towns to consider raising local property taxes to make up the difference. Localities will have the option to raise local sales taxes to fill the shortfall in state aid, a solution that would fall heavily on low-income residents because sales taxes are regressive.

- Local revenue sharing in **Michigan** for FY 2003 was frozen at the FY 2002 level, saving the state $120.6 million.

[6] A recent report from the U.S. Senate Committee on Health, Education, Labor, and Pensions and the House Education and Workforce Committee estimated that total projected state expenditures on K-12 education for 2003 are $6.7 billion below the amount necessary to accommodate normal increases in student population and per-student expenditures.

- **Illinois** redirected $25 million in local taxes from local units of government to the state general fund.

- **Iowa** cut $5.5 million in reimbursements to counties for the cost of various property tax reductions, causing many counties to raise property taxes to make up for the lost revenue.

Many cities, counties, and towns operate programs that benefit low-income families. State budget cuts that reduce local revenue can jeopardize the ability of municipalities to provide those services.

Unspecified Cuts

The ultimate impact of budget cuts for FY 2002 and FY 2003 cannot yet be determined fully in some states, because some legislatures declined to make specific reductions. Instead, policymakers set overall target levels for spending cuts and invested their governor with broad discretion as to which programs and services should be reduced or eliminated.

- **California's** recently-enacted budget-balancing plan for FY 2003 authorized the Governor to reduce funding for state operations by up to $750 million.

- **North Carolina's** budget for FY 2003 required the governor to make $41 million in unspecified cuts to government expenditures.

Other Reductions in Public Services

Other state budget cuts have run the gamut of public services, from public safety to environmental protection to transportation. Examples include:

- $7.5 million was cut from programs aimed at preventing youth violence in **Colorado**.

- Jury trials in **Alabama** were temporarily suspended in FY 2002 due to budget problems, and may be suspended again in FY 2003.

- A $2 million reduction in funding for flu vaccine in **Massachusetts** resulted in a 19 percent reduction in vaccine purchases by the state Department of Health.

- Payments to over 2,000 foster parents in **South Carolina** were reduced by $20 per month due to cuts in the Department of Social Services budget.

- Access to state parks has been reduced in states including **Massachusetts, Indiana,** and **Alaska,** while other states have raised fees for visitors.[7]

[7] *USA Today,* July 24, 2002.

- Budget cuts forced the closure of the only state-run drug and alcohol rehabilitation center in **Iowa**.

The Decline in State Revenues is Accelerating While a Number of States are Increasing Estimates of Future Budget Deficits

The decline in state spending growth in FY 2002 and FY 2003 is primarily a result of a dramatic weakening of state revenues collections. While economists estimate that the overall economy began to recover from the recent recession late in calendar year 2001, state revenues continued to decline throughout FY 2002. The Rockefeller Institute of Government recently reported that in the period of April – June 2002, the final quarter of FY 2002 for most states, state revenues declined 10.4 percent from the same quarter in 2001.[8] This was the fourth consecutive quarter of revenue decline, and the steepest percentage decline in at least 12 years. The second-largest drop during that time was in the previous quarter, the January – March 2002 period, in which revenues declined by 7.8 percent.

The revenue drop came despite the fact that some states are beginning to realize revenues from recent tax increases. Without those increases, revenue would have declined by 11.9 percent. The continued decline in state revenues after the beginning of economic recovery is consistent with the experiences of previous recessions, in which state revenue growth has lagged recovery by 12 to 18 months.[9]

Declining revenues have created significant gaps between ongoing revenues and needed expenditures in the states. Data from the National Conference of State Legislatures and other sources indicate that the states had budget deficits of approximately $38 billion in FY 2002. States faced larger deficits between revenues and needed expenditures in formulating budgets for FY 2003, with estimated deficits of $50 billion, larger as a percent of revenues than in 1992, the worst year for state budgets in the recession of the early 1990s.[10] Actual FY 2003 state budget deficits are likely to be higher than that amount, as a number of states have recently increased their projections of budget shortfalls for the current fiscal year. Those states include **Arizona, Colorado, Connecticut, Delaware, Kentucky, Maryland, New Mexico, Nevada, North Dakota, Oklahoma, Oregon, South Carolina, and Vermont**. Some states, including **California, Delaware, Maryland, Maine, Michigan, Minnesota, Montana, Texas,** and **West Virginia** have also predicted budget shortfalls in FY 2004 and beyond. State fiscal problems are unlikely to abate in the near future.

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[8] Nicholas W. Jenny, *State Tax Revenue Decline Accelerates*, Rockefeller Institute of Government, September 2002.

[9] It is unclear, however, whether the clock has begun to run on that time lag, since capital gains realizations – the decline of which has been a major contributor to the revenue shortfall – have not yet begun to increase.

[10] State budget deficit data from NCSL, *State Budget and Tax Actions 2002: Preliminary Report* and various state sources.

Revenue Solutions Are Needed for State Revenue Shortfalls

The current outlook for state fiscal conditions is not good. Barring an immediate, dramatic, and unexpected turnaround in state revenues, state fiscal conditions in the near future will likely continue to be as bad or worse than those experienced during the last 12 months. In addition to facing the prospect of continuing weak or negative revenue growth, many states will have to balance additional deficits that develop for FY 2003 and FY 2004 budgets without the availability of drawing on "rainy day funds" and other financial reserves to plug revenue holes. Many states used both reserve funds and other one-time budget-balancing measures in FY 2002 and in enacting FY 2003 budgets, including temporarily delaying payments to local schools and selling off the rights to future revenues from the national tobacco settlement. State that relied heavily on drawing down reserve funds in FY 2002 may face similar mid-year budget problems in FY 2003 and FY 2004 with little or no reserves remaining.

With many one-time measures now unavailable, states that continue to experience ongoing budget deficits will likely be forced to choose between raising new revenues and reducing the quality of education, health care, public safety, and other vital public services. Fifteen states raised taxes in 2002, raising new revenues of $8.3 billion. Those that choose to raise revenues to ameliorate ongoing fiscal problems have a range of viable policy options available. They include:

Temporarily or permanently raising income taxes for upper-income taxpayers – During the last recession, states including **California, Maryland, Nebraska, Rhode Island,** and **Vermont** raised income tax rates for upper-income taxpayers to help close budget deficits, a strategy that was also used in 2001 in **North Carolina**.

Personal income taxpayers enjoyed the lion's share of state tax cuts during the boom years of the 1990s. Of the $35 billion in state tax cuts passed from 1994 to 2001, the majority – $19 billion – came in the form of personal income tax cuts.[11] States believed these tax cuts to be affordable in part because personal income tax revenues at that time were growing impressively. A significant portion of the high growth of personal income tax revenues was likely the result of income taxes on capital gains realized in the stock market. As the stock market bubble has since deflated and capital gains income has plummeted, personal income revenues have dropped. Few expect capital gains realizations to return to their overheated level of the late 1990s.[12] The rate cuts that once seemed affordable during a time of bubble-driven income tax revenues are now dragging down state tax collections and worsening state budget deficits. States can fix this problem by reversing income tax cuts implemented during the expansion.

Closing corporate tax loopholes – State corporate income tax revenues have dropped precipitously during the current fiscal crisis, showing a year-over-decline in seven consecutive quarters through the end of FY 2002.[13] The long-term trend for state corporate income tax

[11] Nicholas Johnson, *The Rising Regressivity of State Taxes*, Center on Budget and Policy Priorities, 2002.
[12] Capital gains realizations reached more than six percent of GDP in the late 1990s. Once the economy fully recovers, most analysts expect capital gains realizations to stabilize at their long-term trend of approximately three percent of GDP.
[13] Jenny, 2002.

revenues is also negative, as those revenues have declined steadily as a percentage of all state revenues over the years. State corporate tax revenues also have declined as a share of profits, and many corporations are able to completely escape taxation on profits. By closing the loopholes that make tax avoidance possible, states can raise new revenues without making fundamental changes to their corporate tax structure.[14] States that have recently employed this strategy include **New Jersey**, which closed part of its budget deficit by increasing corporate income tax collections by between $600 million and $800 million (excluding some temporary measures).

Preventing the loss of estate tax revenues – Federal legislation was passed in 2001 that has the effect of phasing out state estate taxes over four years. States can act to prevent this revenue loss by enacting legislation to "decouple" from the federal law and maintain their current estate tax. Sixteen states are currently decoupled from the federal provisions; the other states together are in jeopardy of losing $2.2 billion in FY 2003 and $3.4 billion in FY 2004.[15]

Expanding sales taxes to include currently untaxed services – All but a handful of states rely on a general sales tax to provide a significant portion of state revenues. The sales tax itself, however, is not applied to all sales in most states. Many services are exempt from state sales taxes. For example, people who purchase movie tickets or memberships in health clubs often pay no sales tax on the transaction. Some states charge sales tax on the parts used in automotive repair, but not the labor involved in making the repairs. Because services are growing as a percentage of all economic activity, the base of economic activity on which states rely for tax revenues is shrinking, causing sales tax revenues to grow more slowly than the economy as a whole.

States can address the problem of a slow-growing tax base and raise new revenues to combat budget deficits by expanding the sales tax to include more services. This would allow policymakers to boost sales tax revenues without increasing the sales tax rate. Increasing the scope of the sales tax to include more services can help solve both the short term problem of recession-induced budget deficits and the longer-term problem of a slow-growing revenue base.

Conclusion

States fiscal conditions have been hit hard, with revenue losses not seen in at least two decades. In response, states have been forced to implement numerous cuts to public services, slashing the growth in spending to levels far below historical norms and implementing a range of reductions in services such as child care, public education, and health insurance. Moreover, states were only able to maintain a small growth in spending by relying heavily on one-time budget-balancing measures such as spending down rainy day funds and delaying payments to local schools until future years. Once those measures are exhausted, policymakers will be forced

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[14] For a detailed description of potential loophole closings, see Michael Mazerov, *Closing Three Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States*, Center on Budget and Policy Priorities, April 2002.

[15] Elizabeth C. McNichol and Daniel Tenny, *States are Decoupling from the Federal Estate Tax Cut*, Center on Budget and Policy Priorities, revised 10/2/02.

to choose between implementing further harmful cuts to public services and raising new revenues to fill the shortfall. States have a number of options available to raise new revenues, including temporarily raising income taxes for upper-income taxpayers, preserving revenues from the estate tax, expanding the sales tax to include more services, and closing corporate tax loopholes. These revenue options can help close budget deficits that have been created primarily by revenue losses and prevent further harmful cuts in public services.