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STATES ARE CUTTING LOW-INCOME PROGRAMS IN RESPONSE TO FISCAL CRISIS: LESS COUNTER-PRODUCTIVE OPTIONS ARE AVAILABLE

by Kevin Carey and Iris J. Lav

Executive Summary

State fiscal conditions, already in decline prior to the September 11 attacks, are rapidly approaching a state of crisis. According to the National Conference of State Legislatures, revenues in 43 states are below estimates and 36 states have already planned or implemented cuts in public services. The National Governors Association estimates that total state budget deficits nationwide for the current fiscal year will exceed \$40 billion. With no immediate prospects for fiscal recovery, a number of state legislatures have already taken steps to cut spending, raise taxes, and spend down reserve funds. More such actions are highly likely during the 2002 legislative session.

As states begin to cut spending in response to their fiscal stress, programs that serve low-income populations are being reduced throughout the country. More than two-thirds of the states have already taken steps to cut spending on programs that serve low-income residents.

- Some 19 states have already made specific, identifiable cuts to low-income and human services programs. Among these states, 17 have cut health care programs, ten have cut income support or employment support programs such as child care and job training, and 17 have cut other social service programs.
- Another eight states have implemented broad, percentage-based reductions in agency budgets that include agencies serving low-income populations.
- At least eight other states are currently considering budget cuts to low-income and human services programs proposed by their governors. Of those proposals, seven target health care programs for reductions, five propose cuts in income or employment support programs, and seven target other social service programs.

Specific state examples include **Washington**, where the governor has proposed budget cuts that disproportionately target human services; **Florida, Illinois, Indiana, and Oklahoma**, where significant reductions in Medicaid spending were implemented; and **Kentucky and Michigan**, which cut TANF spending.

Since almost every state has some form of a balanced budget requirement, state policymakers cannot manage fiscal crises by financing ongoing expenditures through borrowing. Instead, they are often forced to choose between spending cuts and tax increases, actions that can,

to varying degrees, hinder economic recovery. Both spending cuts and tax increases are contractionary — that is, both take money out of the state economy and can exacerbate the recession.

Cutting low-income programs is among the *most* contractionary actions states can take. Economists note that lower-income people tend to spend most or all of every dollar they receive. As a result, reducing programs that provide income support or essential services to low-income people tends to reduce consumption, and thus state economic activity, by the full amount of the spending reduction. There are other alternatives, as discussed below, that can have a lesser negative effect on the economy.

Moreover, economic downturns naturally increase the need for programs that serve low-income households. These programs are called “automatic economic stabilizers” because spending on these programs automatically goes up (absent legislative intervention) when people lose jobs and income. Recent data indicate the automatic stabilizers are working. Enrollment and spending for unemployment insurance, the food stamp program, TANF, and Medicaid are rising rapidly. By meeting these growing needs, states can help support consumer spending by providing resources to the households most likely to spend immediately the financial assistance they receive.

States that are currently working to balance their budgets could take different paths that do not cut low-income programs or undermine the automatic stabilizers. A number of other policy options exist, all of which have been recently utilized as components of state budget balancing actions.

- Some states have explicitly protected low-income programs from budget reductions. Budget cuts in **Colorado** and **Ohio**, for example, specifically excluded Medicaid funding.
- Other states have drawn down on state “savings,” which add dollars to the state economy and can help improve economic activity. Lawmakers in **Arizona** and **Massachusetts** chose to use rainy day funds and other fiscal reserves to forestall larger program reductions.

Other states have looked at the revenue side of the budget.

- States including **Florida** and **Virginia** have delayed new tax cuts that were scheduled for 2002.
- Policymakers in **Alabama**, **North Carolina** and **Ohio** raised new taxes to help balance their budgets.

When a state raises taxes — particularly taxes on higher-income people who tend to save a portion of their income — state economic activity usually is not reduced by the full amount of the tax increase. Rather, some of the funds to pay the increased taxes come from reducing current consumption and some come from reducing savings. In contrast to cutting spending on low-income programs, tax increases can be structured to have a smaller negative impact on a state's economy. A recent paper by economists Peter Orszag and Nobel Prize winner Joseph Stiglitz noted that tax increases on higher-income families may be the least damaging mechanism for closing state fiscal deficits in the short run. Reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, are likely to be more damaging to the economy in the short run.

While closing budget gaps will not be easy, states can meet the growing needs of people hurt by the current recession by adopting a balanced package of revenue enhancements, targeted spending reductions, and use of available fund balances.

State Fiscal Problems Have Grown To Crisis Proportions

States are now experiencing the worst fiscal crisis in at least 20 years. The current recession has reduced revenues and increased expenditure needs in states across the nation. Deteriorating economic conditions are increasing fiscal pressure on both sides of the state income statement – rising unemployment is eroding tax revenues as people earn and spend less, while the need for programs that provide employment support, income support, health care, and other economic assistance is increasing as residents lose jobs, health coverage, and income.

While the events of September 11 worsened economic conditions across the country, state budgets were already under significant stress prior to the attacks. Total state revenues in the July to September 2001 quarter declined from the same quarter in 2000, the first such year-to-year drop in over ten years, despite the fact that the terrorist attacks affected only the last two weeks of the thirteen week quarter.¹ For many states, the post-September 11 downturn appears to have changed their fiscal health from bad to very bad, or worse. As a result, the National Conference of State Legislatures reports that 43 states are experiencing revenue shortfalls.

The weakened economy is also increasing the need for public services. In a recent survey, nineteen states reported expenditures over budgeted levels.² The Medicaid program was frequently cited as a source of fiscal pressure, as rising health care costs have combined with swelling unemployment rolls to increase expenditure needs beyond forecast levels. States also are struggling to meet the costs of additional security in the wake of the terrorist attacks. The National Guard has been called out in many states to provide additional security at airports,

¹ Rockefeller Institute of Government, *State Revenue Report December 2001*.

² William Pound, *The Fiscal State of the States*, The New York Times, January 14, 2002.

power plants, bridges, and borders. In **California** alone, the governor's security director has estimated additional post-September 11 state and county security costs of \$142 million in 2001. The National Governors Association estimates that states may spend an additional \$4 billion this year on security.

The result of widespread revenue shortfalls and burgeoning expenditure needs has been a proliferation of state budget deficits. Two-year shortfall estimates as high as \$9 billion in **New York** and \$15 billion in **California** have been reported. (The California shortfall is reduced to \$12.4 billion when the use of \$2.6 billion in general fund reserves is taken into account.³) States including **Florida, Massachusetts, New Jersey, Virginia, Washington, and Wisconsin** have estimated FY 2002 budget gaps of more than \$1 billion. The National Governors Association now estimates that aggregate state budget deficits in FY 2002 will be at least \$40 billion and could approach \$50 billion, which is nearly ten percent of total spending.⁴ By contrast, during the last recession state deficits peaked at \$19.5 billion, only 6.5 percent of 1992 state budgets. Clearly, most states are now in the position of having to make difficult fiscal choices.

The ability of states to manage their finances in this downturn is hampered by the fact that almost all states work under some form of a balanced budget requirement. Unlike the federal government, states cannot maintain service levels by running budget deficits financed through borrowing. As a result, the primary policy options available to states involve some combination of cutting spending and/or raising taxes — actions that in varying degree reduce overall economic activity and potentially exacerbate the economic downturn that caused the fiscal crisis. The degree to which a state emphasizes spending cuts or tax increases, and the extent to which those actions are balanced with spending down financial reserves and utilizing other short-term budget balancing measures, will determine the impact on a state's residents and on its economy.

Programs Serving Low-Income Households Are Growing in Need and Importance

In choosing among fiscal policy options and deciding upon the specific nature of individual program cuts and revenue enhancements, state policymakers have a number of concerns and factors to consider. For a number of reasons, maintaining funding for low-income programs should be high on policymakers' priority lists.

³ In this report, deficits are measured as the difference between original and revised forecasts — before any actions that have been taken to close the deficits. Thus, in order to be comparable to other states, this report cites an FY 2002-2003 shortfall of \$15 billion in California for the 2002 fiscal year. The \$15 billion amount includes the difference between the state revenue forecast for the 2002 fiscal year made when the state's 2001-2002 Budget Act was originally enacted, and the revised forecast prepared by the state Legislative Analyst's Office in November 2001. The \$12.4 billion amount represents the \$15 billion revenue shortfall minus the assumed use of \$2.6 billion in general fund reserves.

⁴ National Governors Association, *States Face Unprecedented Budget Shortfalls*, December 10, 2001.

Low-income programs are most likely to *grow* in need when economic conditions decline. Just as spending for defense programs naturally increases in times of war, spending on programs for families in poverty naturally increases in times of recession. Rising unemployment is causing families to lose income and health insurance, increasing the need for social programs. A number of recent indicators demonstrate these growing needs.

- The ranks of the unemployed increased from 5.7 million to 8.2 million workers from November 2000 to November 2001, the largest one-year increase since 1982. Recent data also indicate that the number of people experiencing long-term unemployment is increasing significantly — the number of workers unemployed for more than 27 weeks increased by 280,000, or 32 percent, from October 2001 to November 2001, the largest one-month increase since such data collection began in 1948.
- Medicaid spending increased by 18 percent from October 2000 to October 2001. The year-over-year increase in November 2001 was 14.5 percent, also well ahead of predictions.
- Participation in the federal food stamp program increased from 17.85 million people in September 2001 to 18.44 million in October 2001, an increase of almost 600,000 people in just a single month.
- In the federal fiscal year ending in September 2001, state spending on the TANF program, which provides cash assistance and work support to low-income families with children, increased by over 20 percent from the previous year. Between March 2001 and September 2001, thirty-three states reported increases in TANF caseloads.

In addition to serving as a safety net for workers and families affected by the recession, low-income programs also serve as “automatic economic stabilizers,” helping the economy as a whole. In economic downturns there is a vicious cycle in which rising unemployment and lost income leads to reduced consumer spending, which in turn reduces demand for goods and services. Companies respond by further cutting back production and implementing additional layoffs, furthering the downward economic spiral. Both unemployment insurance and similar income support programs for people ineligible for UI help arrest this process by replacing a portion of lost wages, allowing families to continue at least some of their prior consumption. Similarly, programs that maintain or replace health insurance help individuals access health care and help prevent a downturn in the health sector of the economy.

The programs that act as automatic economic stabilizers tend to rise in cost, sometimes quite rapidly, during a recession. This makes such programs a tempting target for spending cuts when state officials are searching for savings to bring the budget back into balance, but such actions are counterproductive. As economists Peter Orszag and 2001 Nobel prize winner Joseph

Stiglitz have noted, “Reductions in transfer payments to lower-income families would generally be *more* harmful to [a state’s] economy than increases in taxes on higher-income families, since lower-income families are more likely to spend any additional income than higher-income families.”⁵ (See box on page 7.)

In other words, programs that assist those most affected by the economic downturn can be among the most effective and efficient means of economic stimulus, because they provide funding to the people who are most likely to inject those funds immediately back into the economy. The costs of these programs recede when the economy recovers, minimizing the long-term fiscal impact on states.

Some States Have Already Cut Programs for Low-Income Households

Despite the benefits of meeting the growing needs of low-income families, some states are considering or have implemented mid-year reductions in low-income programs as they struggle to balance their budgets. Low-income programs are being targeted for a number of reasons. Unlike other budget line items, low-income programs often can be unilaterally cut by the governor, without legislative action. By contrast, appropriations for items like debt service and public employee pensions are often subject to fixed, statutory distribution schedules. Distributions to public schools are generally made on a pre-determined formula basis, while funding for items like transportation is often generated by special dedicated tax revenues that are unavailable for other uses. Other state expenses may be locked in by contractual arrangements that cannot be easily broken. Thus, low-income programs may suffer a disproportionate share of budget reductions simply because they are administratively the easiest to cut. Actions in states that have already moved to weaken the safety net, either through legislative action or through executive budget cuts or proposed governor’s budgets, include the following:

- A special legislative session in **Arizona** concluded in December 2001 with FY 2002 budget cuts that included \$1.8 million from programs to reduce child abuse, \$1.2 million from pre-natal care and home services for new mothers, and \$5 million from a program to promote healthy families.
- The **Arkansas** Department of Health Services took administrative actions to reduce state Medicaid expenditures in FY 2002 by approximately \$13 million. The cutbacks include eliminating a program for people with high medical expenses, which will affect 13,000 people, and ending or modifying coverage for disabled children who require home health services, which will affect 3,000 children.

⁵ Peter Orszag and Joseph Stiglitz, *Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-productive than the Other During a Recession?*, Center on Budget and Policy Priorities, November 6, 2001.

Why Budget Cuts May Be More Harmful to the Economy Than Tax Increases During a Recession

When states enter recessions, revenue naturally falls and expenditures rise, producing budget deficits. Because almost every state has some form of balanced budget requirement, states often have to use some combination of raising taxes and cutting spending to fix their fiscal problems. These actions can potentially hinder economic recovery. In order to lessen such “pro-cyclical” effects, state policymakers often focus on finding a combination of budget-balancing measures that is least harmful to the economy.

Economist Peter Orszag and recent Nobel Prize winner Joseph Stiglitz point out that the adverse impact of a tax increase on the economy may be smaller than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption. For example, if taxes increase by \$1, consumption may fall by 90 cents and saving may fall by 10 cents. Since a tax increase does not reduce consumption on a dollar-for-dollar basis, its negative impact on the economy is reduced in the short run. By contrast, some types of spending reductions would reduce demand in the economy on a dollar-for-dollar basis and therefore would be more harmful to the economy than a tax increase.

Within the sphere of tax increases, the impact on the economy depends primarily on the extent to which the tax increase will be paid out of funds that would have been spent or funds that would have been saved. A recent Congressional Budget Office report noted that, “As a general proposition, higher-income households save more of their income than do lower-income households. Although occasionally some data emerge to indicate otherwise, a large accumulation of evidence continues to show that as a household’s income rises, the proportion of that income that is consumed falls.”^a The more that tax increases are focused on those with *lower* propensities to spend (that is, on those who spend less and save more of each additional dollar of income), the less damage is done to the weakened economy. Since higher-income families tend to have lower propensities to spend than lower-income families, the least damaging approach in the short run involves tax increases concentrated on higher-income families.

Similar reasoning applies to budget cuts that reduce transfer payments to low-income families. Because lower-income families are more likely to spend any additional income they receive than higher-income families, reductions in transfer payments to lower-income families would generally be more harmful to the economy than increases in taxes on higher-income families.

For states interested in the impact of policy options only on their own economy, rather than on the national economy, the arguments made above are even stronger. Government spending that would be reduced if direct spending programs are cut is often concentrated among local businesses. By contrast, the spending by individuals and businesses that would be affected by tax increases often is less concentrated among local producers – since part of the decline in purchases that would occur if taxes were raised would be a decline in the purchase of goods produced *out of state*. This is particularly true for expenditures by high-income families, who appear to consume relatively more goods and services produced in other regions of the country (or abroad) than lower-income families do.

The conclusion is that, if anything, tax increases on higher-income families are the *least* damaging mechanism for closing state fiscal deficits in the short run. Reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, are likely to be *more* damaging to the economy in the short run.

^a *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, Congressional Budget Office, January 2002.

Adapted from Peter Orszag and Joseph Stiglitz, *Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-productive than the Other During a Recession?*, Center on Budget and Policy Priorities, November 6, 2001.

- Budget reductions proposed by the governor of **California** for FY 2002 include \$742 million from human services programs including reductions in the CalWORKS program and suspension of cost of living adjustments for a number of programs such as foster care payments and supplemental security payments.
- The **Florida** legislature met for two special sessions before passing \$1 billion in cuts to the state budget, which included \$48.6 million from Medicaid services to individuals, \$5 million from long-term care programs, \$4.7 million from child protection programs, and \$2.4 million from home and community services for the elderly.
- In response to falling revenues, the governor of **Illinois** made cuts to FY 2002 Medicaid expenditures, including \$90 million from hospitals that serve high percentages of low-income patients.
- **Indiana** has taken steps to cut Medicaid funding by \$251.1 million through eligibility restrictions and reductions in spending on services including pharmacy drugs, nursing homes, and dental care.
- Executive budget cuts in **Kentucky** included \$5.9 million from the TANF program, \$1 million from welfare-to-work programs, and \$8.5 million from health services.
- The governor of **Maine** has proposed a budget-balancing plan that includes Medicaid cuts of \$5.2 million from funding for hospitals, \$4 million from delaying expanded coverage, \$4.1 million from nursing homes, and \$2 million from group homes.
- **Massachusetts** enacted a budget fix that cut child care services by \$15.8 million, the Department of Social Services by \$13.1 million, the Department of Mental Health by \$11 million, the Department of Mental Retardation by \$7.7 million, and a pharmacy program for seniors by \$1.3 million.
- Budget cuts implemented by the governor of **Michigan** include \$1.5 million from TANF welfare-to-work programs, \$2.8 million from adolescent and child health care services, and \$6.5 million from long-term care services.
- The governor of **Minnesota** has released a budget-balancing plan with program cuts that include \$1.9 million from state child care grants, \$6.1 million from hospital services, and \$1.7 million from economic support programs including job-training for food stamp recipients. The plan also calls for cancelling new programs that would expand treatment of breast and cervical cancer for women

without health insurance and expand prescription drug coverage for low-income seniors and persons with disabilities.

- The governor of **Washington** included \$246 million in cuts to human services programs as part of his budget-balancing proposal — more than the reductions in higher education, K-12 education, natural resources, and general government combined. While human service programs comprise 32 percent of the state’s general fund budget, they account for 43 percent of the governor’s proposed reductions.
- States that have implemented across-the-board budget reductions that include most or all programs that serve low-income people include **Idaho, Mississippi, and South Carolina.**

States Have a Range of Options Available to Avoid Low-Income Cuts

While balanced-budget requirements limit states’ options, there remain a variety of choices available that can help states avoid cuts in low-income programs. States can target spending cuts to programs that have external revenue sources and are not experiencing rapid increases in cost. They can also delay scheduled tax cuts, increase other taxes, spend down reserve funds, and selectively use other short-term budget balancing measures. Each of these options is discussed in further detail below.

States Can Target Spending Cuts to Programs That Have External Revenue Sources and Are Not Experiencing Rapid Increases in Cost

States have so far taken three approaches to making spending cuts. Some have picked among individual budget line items, reducing or eliminating some while leaving others intact. Other states have applied uniform percentage reductions to most or all state programs. And some states have adopted a hybrid of the first two approaches, beginning with a policy of uniform cuts and then excluding a number of programs from reductions.

The one-size-fits-all approach of uniform cuts does not take account of how the current recession has altered the need for state expenditures. States that want to avoid an across-the-board approach can consider the relative sensitivity of program needs to changing economic conditions. Public schools, for example, generally do not experience significant cost increases during a recession — the number of students in school and the cost of educating them doesn’t appreciably change when economic conditions deteriorate. By contrast, many human services programs are highly sensitive to economic downturns. Rising unemployment can dramatically increase the number of people needing health insurance, job training, and other forms of public assistance. These programs need *more* money, not less.

Policymakers may also want to consider the relative capacity of different state programs to withstand temporary revenue losses. Some programs are entirely dependent on ongoing state appropriations, while others enjoy some combination of significant external revenue raising capacity and substantial financial reserves. For example, many public universities receive the majority of their funding from sources other than direct state appropriations, including student tuition, federal funding, and private donations. They also carry significant year-to-year financial reserves. In many states, public universities can partially offset the negative effects of temporary budget cuts with a combination of budget reserve transfers and fee increases. Other government programs are partially or wholly funded by user fees that can be increased when new revenues are required. By contrast, many human services programs operate on essentially a month-to-month cash basis, with no ability to draw on reserves or raise revenues from other sources. For these programs, significant budget cuts will necessarily result in public service reductions at a time when the demand for those services is increasing.

Program cuts also differ substantially in their impact on federal revenues flowing to a state. State Medicaid programs, for example, receive an average of 57 percent of their funding from the federal government through matching payments, with lower-income states receiving a substantially higher amount. Therefore, every dollar in state Medicaid cuts produces an average additional loss of between \$1.00 and \$3.00 in federal revenues, magnifying the negative impact of Medicaid cuts on health care services and total economic activity.

Few states have adopted completely uniform budget reduction policies; most have prioritized among programs to varying degrees. States that have taken steps to exclude fast-growing human services programs from budget reductions or accommodate the growing needs of human services programs include the following:

- Budget reduction plans implemented in **Colorado, Nebraska, and Ohio** made cuts in many programs, but excluded Medicaid services from cutbacks.
- The governor of **Hawaii** took steps to help part-time workers in danger of losing their ongoing TANF assistance by lowering from 32 hours to 20 hours the minimum number of hours of work needed to be eligible for benefits, retroactive to December 1, 2001.
- **California, the District of Columbia, and Virginia** recently took steps to increase unemployment insurance benefits. Maximum weekly benefits were increased from \$268 to \$368 in Virginia, while California moved to increase its benefit levels by \$220 over five years, beginning in January 2002. The District of Columbia increased benefit levels from 50 percent to 75 percent of the previous wages of unemployed individuals.

The Federal Government Can Help States By Increasing Medicaid Matching Rates

Almost every state has a balanced-budget requirement. These requirements often force state policymakers to take budget-balancing measures during recessions, such as raising taxes and reducing spending, that are contractionary in nature – reducing overall economic activity and potentially exacerbating the economic downturn. While some states can take non-contractionary measures such as spending down reserve funds, most states do not have reserves large enough to solve their budget problems.

The federal government, by contrast, is not required to balance its budget every year. It can do what states cannot – increase spending in the short term through borrowing if necessary. Thus, one of the best things the federal government can do to counteract a recession is support state budgets, helping states avoid contractionary tax and budget policies.

One way the federal government can mitigate the state fiscal crisis is to increase the amount of money the federal government provides for the federal-state Medicaid program. For each state, the federal government pays a percentage of all Medicaid costs, ranging from 50 percent to approximately 80 percent. States with lower per-capita income have a higher Medicaid matching rate than states with higher per-capita income; states that are relatively wealthy receive less federal assistance than states that are not.

There are a number of reasons why increasing Medicaid matching rates would be beneficial.

- *Rising Medicaid costs are contributing to state fiscal crises.* Health care costs are increasing rapidly, while rising unemployment is increasing the number of people eligible for Medicaid services. Medicaid spending grew by 11 percent last year, and may increase even faster this year if current conditions persist.
- *Some states are already cutting Medicaid services.* Despite the increased need for health-insurance for low-income persons, some states have responded to budget pressures by reducing Medicaid spending. Florida, Illinois, Indiana, and Oklahoma are among those that have already taken steps to reduce Medicaid costs, and other states may follow suit.
- *Increasing matching rates would provide simple, immediate fiscal relief.* The process of reimbursing states for Medicaid costs is already well-established. Changing matching rates would create no federal bureaucratic complications, and would create no restrictions on states in terms of how they use the funds freed up by greater federal Medicaid reimbursement.

The economic stimulus bill passed by the U.S. Senate Finance committee in November 2001 would provide effective state fiscal relief by increasing Medicaid matching rates. It would temporarily increase matching rates by 1.5 percent for FY 2002, and provide an additional 1.5 percent increase for states whose unemployment rates exceed the national average. It would also permit the 29 states whose Medicaid matching rates are being reduced this year to use last year's rates instead. In total, these provisions would provide \$5.1 billion in immediate federal fiscal relief for the states. (The net fiscal relief would be approximately \$3 billion, since other provisions in the bill would reduce state revenue.) As state fiscal conditions continue to worsen and the threat of budget cuts increases, the need for the federal government to enact immediate, effective fiscal relief for the states intensifies.

States Can Delay or Cancel New Tax Cuts

One of the first options that can be considered in revising state fiscal plans is the cancellation of new budget items that are no longer affordable. The impact of scaling back proposals that have yet to be implemented can be less severe than cutting established programs. As noted above, governors in **California** and **Minnesota** have proposed delaying or cancelling plans to expand low-income programs. This approach can even more appropriately be applied to unimplemented plans on the revenue side of the budget. A number of states have new tax cuts that were not scheduled to begin until January 1, 2002 — tax cuts that may no longer be affordable given the unexpected downturn in the economy. Some of these cuts were enacted early in 2001, while others are part of multi-year tax reductions enacted in prior years. All can be reconsidered given recent circumstances, particularly if the alternative is reductions in needed public services. The following states are among those that have already delayed or are considering a delay of new tax cuts.

- The state general fund sales tax rate in **California** will automatically be restored to its 2000 level of 5% when a .25 percent reduction tied to reserve levels expires.
- In a special session in **Connecticut**, legislation was enacted to delay the phase-out of the state inheritance tax, saving \$15 million.
- In the **Florida** special session, legislation was enacted to delay a scheduled January 1, 2002 reduction in the state intangible personal property tax, saving \$128 million.
- The governor of **Maine** has proposed delaying scheduled indexed increases in state income tax brackets until 2004, saving \$6.9 million.
- The governor of **Michigan** has said that the state's budget difficulties will likely lower state financial reserves to a level that would trigger a halt to the next step of a phase-out of the state's single business tax, which would cost \$116 million.⁶
- In a special legislative session in **Nebraska**, legislation was enacted to delay the implementation of a business tax credit until January 1, 2003.
- A scheduled reduction of the **Oklahoma** personal income tax rate from 6.75 percent to 6.65 percent was automatically reversed because of falling revenues; instead the rate was *increased* on January 1, 2002, to 7.00 percent.
- The governor of **Rhode Island** has proposed freezing the phase-out of the state's car tax, which would save \$19 million in FY 2003.

⁶ The Detroit News, January 9, 2002.

- The governor of **Virginia** has announced that the state cannot afford to proceed with the next step in the phase-out of its car tax, scheduled for January 1, 2002, saving \$46 million in FY 2002.

Other states that have new tax cuts scheduled to be implemented that could be suspended include the **District of Columbia, Maryland, Massachusetts, and New York.**

States Can Raise New Revenue

Just as many states chose to lower tax rates when revenues exceeded expectations in the mid-to-late 1990s, they may now choose to counter-balance revenue losses with revenue raising measures. Some have argued that state tax increases during economic downturns are inherently unwise, because they will harm the economy. But when the alternative to a tax increase is spending cuts, a tax increase may be less harmful to the economy than lowering spending. If a state reduces spending, each dollar cut from the budget generally reduces demand in the economy by the full dollar, since most government expenditures are made within the state. By contrast, if taxes are increased, and especially if taxes are increased on higher-income taxpayers, a portion of the tax increase will reduce demand and a portion will reduce savings. Reducing savings does not harm the economy during a recession. As economist Joseph Stiglitz recently wrote, "In the short run (which is the period of concern during a downturn), the adverse impact of a tax increase on the economy may, if anything, be *smaller* than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption." (See box on page 7.)

While tax increases may be preferable to spending cuts, not all tax increases are equally desirable. For the same reasons it is important to avoid cuts in programs that serve low-income households, it is also important to avoid revenue enhancement policies that disproportionately burden low-income taxpayers. Nearly all state budgets are funded in large part by one or both of two major taxes — the personal income tax and the general sales tax. These taxes differ substantially in the burden they impose on taxpayers — sales taxes are regressive taxes, with low-income taxpayers paying a higher share of their income in sales taxes than upper-income taxpayers. By contrast, the income tax is the *least* regressive state tax. The trend in state tax decisions over the last ten years, however, has reflected a movement toward greater regressivity. States raised both progressive taxes and regressive sales taxes when times were bad in the last recession, but cut largely progressive income taxes when times were good during the subsequent expansion and left most of the increases in regressive taxes in place.⁷ States have an opportunity to avoid repeating this policy cycle now that hard fiscal times have come again. To the extent that sales taxes hikes are unavoidable, they can be accompanied by specific policies to offset the

⁷ Nicholas Johnson and Daniel Tenny, *The Rising Regressivity of State Taxes*, Center on Budget and Policy Priorities, January 2002.

negative effects on low-income taxpayers, such as enactment or expansion of low-income tax credits.

During the last recession, in the early 1990s, some 28 state tax increases of five percent or more were enacted in the three years surrounding the economic downturn.⁸ During the first nine months of 2001, tax increases exceeding one percent were enacted in eight states, most notably in **North Carolina**, where sales and income taxes were increased to address serious budget problems.⁹ A number of states have recently taken steps to create new revenue sources or shore up their state revenue base. A variety of approaches have been proposed or utilized, including the following:

- *Closing corporate tax loopholes.* **Ohio** lawmakers passed legislation in November 2001 to raise \$41 million over two years through corporate tax changes, while **North Carolina** recently passed a budget and tax package that includes \$165 million in loophole closings. Legislators in **Alabama** passed an \$85 million corporate tax increase in December 2001 as part of a plan to prevent cuts in school funding.
- *Preventing losses in estate tax revenues.* **Minnesota, Rhode Island, and Wisconsin** elected not to conform to the new federal estate tax law enacted earlier this year, preventing a corresponding reduction in state revenues.
- *Targeting income tax rate increases to upper-income taxpayers.* **North Carolina** recently responded to its fiscal crisis by increasing taxes on higher-income residents, creating a new 8.25 percent tax bracket on taxable income over \$120,000 for single taxpayers and \$200,000 for married couples. The governor of **Indiana** released a plan that includes a new 4.4 percent tax bracket on income over \$90,000 per year. The leader of the **California** Senate proposed temporarily creating a new 10 percent bracket for single taxpayers with income between \$130,000 and \$260,000, and an 11 percent bracket for income over \$260,000. New brackets for married couples would be established at twice those amounts.
- *Broadening the sales tax base to include selected untaxed services.* The governor of **Minnesota** has proposed broadening the base of the sales tax as a means of balancing the state budget, while policymakers in **Florida** and **Oklahoma** are considering a broad expansion of the scope of the sales tax as part of major tax restructuring proposals. The specific design of base-broadening initiatives will in large part determine their impact on low- and moderate-income taxpayers.

⁸ Steven Gold, ed., *The Fiscal Crisis of the States*, Georgetown University Press, 1995.

⁹ Arizona, Indiana, Maine, Nevada, New Hampshire, New Jersey, North Carolina, and West Virginia raised tax and / or fees by an amount equal to at least one percent of revenues.

As noted above, tax increases on higher-income residents — which could include the types of income tax changes **North Carolina** has enacted and **California** and **Indiana** are considering, and retaining the estate tax as well some corporate income tax increases and some taxes on services — are among the actions states can take to balance their budgets that are least damaging to state economies in a recession. Upper-income taxpayers are most likely to respond to tax increases with a combination of reduced savings and reduced consumption, in contrast to lower-income taxpayers, who are likely to respond to tax increases with a dollar-for-dollar reduction in spending. For this reason, tax increases on upper-income taxpayers are less likely to reduce overall consumption than tax increases on lower-income taxpayers, making such policies more consistent with economic stimulus efforts.

States can also tailor tax decisions to their specific economic and budget circumstances. While some states continue to suffer from long-term structural gaps between tax revenues and needed expenditures, most states' shortfalls are at least partially a function of cyclical, short-term revenue losses tied to the recent decline in the economy. Since the problem is temporary, tax increases need not be permanent. Just as states have implemented temporary slowdowns in spending through measures like hiring freezes, they can implement temporary tax increases that are set to expire when the economy recovers.

States Can Draw Down Rainy Day Funds

Many states chose to use a portion of the increased revenues that accrued in the 1990s to establish or augment “rainy day funds,” which are financial reserves set aside in good economic times for use in offsetting the revenue losses that occur during economic downturns. Now that the rainy day has arrived, some state policymakers are trying to decide if the time has come to tap these funds.

Many states have thus far taken a cautious approach to using rainy day funds, preferring to withhold some or all of their reserves for a future — presumably “rainier” — day. This conservative approach may result from the fact that most rainy day fund balances are inadequate to fully protect the state against the full brunt of the recessionary downturn.¹⁰ Realizing that their reserve funds won't fully solve the problem, some states appear reluctant to use them at all, for fear of a future situation where revenue shortfalls continue and reserves have been depleted.

This approach can have a negative effect on public services, if holding back reserves forces states to cut programs. Rainy day funds were specifically designed to prevent debilitating cuts to public services at the very time the services and programs are needed most. It makes little sense to save money as a means of preventing possible cuts in the future if doing so means ensuring definite cuts in the present. Once a state is reasonably certain that it has a budget deficit

¹⁰ Iris J. Lav and Alan Berube, *When It Rains, It Pours: A Look at the Adequacy of State Rainy Day Funds and Budget Reserves*, Center on Budget and Policy Priorities, March 1999.

problem, it can use rainy funds to maintain needed services in the short-term while devising a long-term solution to close whatever remaining budget gap it has.

In addition, rainy day funds are for many states the only available policy option for providing immediate counter-cyclical stimulus to the state economy. Taking money out of savings and injecting it into state programs will increase overall economic activity in the state. The frequently-used alternative — reduced state spending — can have the opposite effect, helping to contract the state economy.

States may also be concerned that reducing reserve levels will negatively affect their credit ratings. But this will not be the case if the use of reserves is accompanied by a comprehensive plan to balance revenues with expenditures needs. As a recent Standard & Poor's report on state fiscal conditions noted, "Use of reserves is not a credit weakness in and of itself. These reserves are accumulated in order to be spent during times of budget imbalance and extraordinary economic events."¹¹

A number of states have already moved to spend down some of their financial reserves:

- A special session in **Arizona** resulted in a budget-balancing plan for FY 2002 that included transfer of \$119 million from the state's \$340 million budget stabilization fund.
- The governor of **Indiana** has proposed using \$219 million of the state's \$526 million rainy day fund to help close a biennial budget deficit of over \$1.3 billion.
- The governor of **Maine** has proposed using \$98.3 million of the state's \$103 million rainy day fund to help balance the state's budget.
- The final FY 2002 budget in **Massachusetts** included a transfer of \$805 million from the state's budget stabilization fund and other reserves.
- The governor of **Michigan** implemented a budget balancing plan for FY 2002 that includes transferring \$350 million from the state rainy day fund.
- The governor of **Minnesota** has proposed using the state's \$653 million budget reserve to help close a \$1.95 billion budget gap.
- Lawmakers in **Ohio** passed a deficit reduction plan that included using \$411 million from the state rainy day fund.

¹¹ Standard and Poor's, *"The State of the States"*, October 2001.

- The governor of **Washington** included use of \$150 million in reserve funds in his plan to fill a \$1.25 billion two-year budget gap.

States Can Selectively Use Short-Term Budget Balancing Measures

Some states have combined substantive changes to their tax and expenditure policies with accounting changes or budget “gimmicks” that serve to improve the state’s income statement on a short-term basis. Some of these strategies are purely cosmetic, such as shifting a large distribution of funds or collection of a tax payment from the last day of one fiscal year to the first day of the next. Others involve more substantive changes to the timing of revenues and expenditures. States including **Wisconsin** have helped balanced their budgets in the short-term by “securitizing” revenues accruing from the settlement of their lawsuit with tobacco companies. Securitization is a financial transaction that involves selling the rights to all future proceeds from the tobacco lawsuit to investors, in exchange for a one-time, up-front payment of an amount that is substantially smaller than the sum of all future payments. Other states, including **Massachusetts** and **Alabama**, have delayed contributions to pension funds or restructured debt, reducing costs in the short term but increasing overall costs in the long term.

States may wish to tread carefully in using these budget-balancing techniques. Preventing immediate cuts to public services may well require the use of some short-term accounting changes, some of which are generally accepted as legitimate fiscal strategies. Changing the financing of construction projects from cash appropriations to long-term bonds, for example, is consistent with sound fiscal management practices. But over-reliance on budget gimmicks can seriously jeopardize states’ abilities to achieve long-term budget stability. To the extent that such measures are intended to be temporary, they should be accompanied by specific plans to reverse them in the future. Otherwise they may become fixtures in the state budget, reducing the ability of future policymakers to respond to fiscal crises.

States Can Balance Their Efforts By Utilizing A Number of Different Policy Options

Most states have addressed budget problems through executive action, electing to postpone more comprehensive legislative consideration of tax and budget issues until the beginning of the 2002 state legislative session. However, a few states have enacted comprehensive budget-balancing plans in November and December of 2001:

- **Florida** lawmakers, faced with a \$1.3 billion budget deficit, reconvened for two special budget sessions in the fall of 2001, eventually reaching agreement on a package that included an 18-month delay in the phase-out of taxes on ownership of stocks and bonds, saving \$128 million. While some lawmakers pushed for

aggressive use of rainy day funds, the final package balanced the budget largely through the use of \$1 billion in budget reductions.

- A \$1.1 billion revenue shortfall caused legislators in **Massachusetts** to revise earlier FY 2002 budget plans. Some suggested that a scheduled reduction in the state personal income tax, slated to drop from 5.6 percent to 5.3 percent on January 1, should be reconsidered in light of the predicted revenue shortfall, but acting Governor Jane Swift announced that she would veto any such measure. Lawmakers ultimately approved a budget that relied on a combination of spending cuts and use of financial reserves. Some \$805 million was transferred from the state's budget stabilization fund and other reserves, while \$536 million was cut from initial FY 2002 budget proposals.
- To close a projected two-year shortfall of \$1.5 billion in **Ohio**, the legislature adopted a plan that included \$658 million in spending cuts implemented by cutting state agency budgets by six percent. Medicaid and K-12 education appropriations were excluded from the reductions. Corporate tax loopholes were closed and authority was granted to join a multi-state lottery, raising \$344 million in new revenues. The balance of the deficit was closed with \$241 million from the state rainy day fund and \$260 million in re-directed tobacco settlement revenues.

When considered along with legislative actions in Iowa and Nebraska, which consisted almost exclusively of spending cuts, the actions of state legislatures thus far during this recession appear to indicate a strong emphasis on spending cuts as the primary means of balancing state budgets.