CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org http://www.cbpp.org

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NEW ESTIMATES SHOW STATE FISCAL CONDITIONS CONTINUE TO WORSEN
State Deficits Show Need for Congress to Assist, Rather Than Undermine, State Efforts to Balance Budgets

by Nicholas Johnson, Iris J. Lav and Kevin Carey

As Congress continues to debate federal stimulus legislation, state fiscal conditions across the country are worsening. As recently as a few weeks ago, total state budget deficits were estimated to equal $15 billion. Now state budget officials estimate that state deficits equal or exceed $40 billion, an amount that includes $35 billion in revenue shortfalls and higher-than-expected spending on countercyclical programs such as Medicaid, plus an additional $5 billion in unanticipated spending on homeland security. Because not all states have estimated the size of their budget deficits, and because state economies are expected to worsen, the National Governors Association projects that shortfalls for the current fiscal year could rise to $50 billion.

The projected state shortfall is greater in both absolute and percentage terms than the state shortfalls experienced as a result of the recession of the early 1990s.

- During the worst year of the state fiscal crisis in 1992, state deficits were about $19.5 billion, an amount equal to 6.5 percent of states' budgets.
- The present shortfall of $40 billion equals 7.8 percent of projected spending and, according to NGA, could rise to $50 billion or nearly 10 percent in this fiscal year.
- Additional state shortfalls are expected in the next fiscal year, which begins in most states on July 1, 2002, since even if the recession ends it is unlikely that high unemployment rates will decline substantially by then. Unemployment rates generally continue to rise after the end of a recession; the last recession, for instance, ended in March 1991 but unemployment rates did not peak until June 1992, 15 months later.

This new information increases the importance of Congress providing net fiscal relief to states. If Congress fails to act aggressively to ameliorate state fiscal conditions or — even worse — if the federal government exacerbates state deficits by enacting stimulus legislation that erodes states' tax bases, which causes them to lose tax revenue, federal stimulus efforts will be greatly diminished by the worsening state fiscal crisis.

States are required to balance their budgets, so they must close their deficits by enacting tax increases, spending reductions, or a combination of the two. If the federal governments provides $100 billion in economic stimulus measures in the current fiscal year and states enact

$50 billion in spending cuts and revenue increases, fully half of the stimulative effect of the federal package would be offset by state actions. If only $75 million of the federal package provides an immediate stimulus effect in this fiscal year, the state fiscal crisis could wipe out two-thirds of the desired impact.

Two provisions of the federal stimulus package in particular will have great impact on whether the final stimulus package helps or hurts states.

- The "bonus depreciation" provisions included in the stimulus proposal passed by the House of Representatives would reduce states' income tax revenue and add to state budget deficits by more than $5 billion in the current fiscal year and similar amounts in the next two fiscal years. A smaller depreciation provision in the Senate Finance Committee-passed package would add $2 billion in the current year to state shortfalls.

- By contrast, the proposal included in the Senate Finance package to increase temporarily the federal share of Medicaid expenditures would reduce state budget deficits by $5 billion in the current fiscal year. The House package contains no similar provision that would offset its much larger depreciation provisions or provide any state fiscal relief.

- For a final stimulus package to alleviate state fiscal conditions, the increased Medicaid assistance must exceed the negative effects on state revenues of the bonus depreciation provisions. For example, if Congress reduces state revenue $5 billion by enacting a bonus depreciation provision similar to the House-backed legislation, it would need to increase Medicaid assistance by more than $5 billion to provide any net fiscal relief to the states.

If the temporary increase in the federal share of Medicaid costs provides more revenue to states than they lose from bonus depreciation, then the accelerating decline in state fiscal conditions will be alleviated, states will enact fewer tax increases and spending cuts, and the economy will benefit. If, on the other hand, Congress fails to provide net fiscal relief to states, state budget deficits will be even larger, and the economy will suffer as a result.