CENTER ON BUDGET AND POLICY PRIORITIES

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STATE FISCAL CRISIS LINGERS
Cuts Still Loom

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As state legislatures write their budgets for the 2005-06 fiscal year, many are considering cutting services or raising new revenues in order to bring their budgets into balance. At least 26 states now project shortfalls averaging roughly 7.3 percent to 8.3 percent of their general fund spending. The combined deficit is approximately $32 billion to $36 billion. Additional states likely will release shortfall projections in the coming weeks and months.

These shortfalls generally are smaller than shortfalls of the last several years. From 2001 to 2004, aggregate shortfalls exceeded $250 billion, and deficits for fiscal years 2003 and 2004 each reached the $75 billion to $80 billion level. Nearly every state cut spending, raised taxes, and/or drew down reserve funds to bring budgets into balance. The new deficit figures, though less severe, indicate that the sharp drop-off in revenues that precipitated the worst fiscal crisis in decades continues to threaten public services, even though revenues have begun to turn around.

Unlike the federal government, most states must balance their budgets. So a projected deficit typically means a state must increase revenues, reduce spending, or take other measures before it can adopt a budget. Although it is still early, state officials and outside experts in about half the states already are forecasting shortfalls for the new fiscal year, which in most states begins July 1.

Large deficits for the upcoming 2006 fiscal year are projected in California ($6.7 billion, according to the legislature's nonpartisan analyst), Texas ($4.9 billion, according to an independent analysis), New York (as much as $4 billion, according to the governor's budget office), New Jersey ($4 billion, according to informal predictions by state officials), and Ohio ($1.4 billion, according to an independent analysis). As a share of state budgets, some of the largest shortfalls appear to be occurring in New Jersey (15 percent), Mississippi (16 percent or more), and Texas (about 17 percent). The accompanying table shows shortfall estimates for 24 states where credible estimates are available.

Why are deficits continuing?

Revenue growth has begun to increase in the states. But revenues are growing from the extremely depressed level they reached in the depths of the fiscal crisis. Total state tax revenues in fiscal year 2004 equaled about 4.4 percent of GDP, down from 4.7 percent in 2001. This means that state services cannot approach the levels provided prior to the fiscal crisis unless revenues grow even faster than current rates. This is because to reach prior levels of services, revenue growth would need both to cover the normal year-to-year increase in the cost of services such as health care and education that are now provided, and to rise sufficiently to allow some service restorations.

Another reason deficits continue despite revenue growth has to do with the way states balanced their budgets in the years of the fiscal crisis. Many states used one-time measures to prop up budgets, such as drawing down reserve funds or transferring balances from special funds, borrowing through the issuance of bonds, making accounting adjustments, postponing expenditures, and using the federal fiscal relief. Those one-time revenues generally are no longer available for fiscal year 2006 budgets. So revenue growth must be sufficiently rapid both to cover the normal year-to-year growth in the cost of services and replace those one-time revenues. Again, in most states revenue growth is not that strong.

Outlook for funding services

The large shortfalls are threatening state services. Many states have already made deep cuts over the last several years. For instance, two-thirds of states reduced K-12 school funding in real per-capita terms from 2002 to 2004. Some 23 states have scaled back state-subsidized child care for working families. States eliminated health insurance for more than one million individuals, including many children, parents, seniors and people with disabilities. Tuition at most state colleges and universities has risen dramatically due to cuts in state funding. If the projected deficits do materialize, additional cuts to these types of services are likely.

Some states boosted revenues through tax increases during the fiscal crisis. But some of those tax increases, such as those in Ohio and New York, are set to expire next year, which will make it even harder for those states to recover. Other states are reimposing tax cuts that were postponed during the fiscal crisis.

Some states are not projecting shortfalls at all. Virginia, for example, enacted a tax package in spring 2004 to raise new revenue and close tax loopholes. As a result of the tax increase, spending cuts, and better-than-expected economic growth, the state is projected to have a surplus by the end of fiscal year 2006.

States Projecting Budget Shortfalls for Fiscal Year 2006

	Estimated shortfall	Shortfall as share of 2005 general fund spending
Alabama	$300 million to $400 million	5% to 7%
Arizona	$477 million	7%
California	$6.7 billion to $8.6 billion	8% to 11%
Colorado	$263 million	5%
Connecticut	$672 million to $1.2 billion	5% to 9%
Illinois	$1.4 billion	6%
Indiana	$636 million	6%
Iowa	$221 million	5%
Louisiana	$300 million to $400 million	4% to 6%
Maine	$322 million	12%
Maryland	$319 million	3%
Massachusetts	$300 to $800 million	1% to 3%
Michigan	$500 million to $900 million	6% to 10%
Minnesota	$485 million to $700 million	3% to 5%
Mississippi	$600 million to $1.0 billion	16% to 27%
New Hampshire	$150 million	11%
New Jersey	$4 billion	15%
New York	$4.2 billion	10%
North Carolina	$1.1 billion	7%
Ohio	$1.4 to $2.0 billion	6% to 8%
Oregon	$500 million	10%
Rhode Island	$164 million	6%
South Dakota	$17 million	2%
Texas	$4.9 billion	16.6%
Washington	$1.1 billion	9%
Wisconsin	$810 million to $940 million	7% to 8%
Total	**$31.8 to $36.2 billion**	**7.3% to 8.3%**

Notes on sources and methodology.

— Most of the shortfall projections in this table were collected (or, in a few cases, calculated) in January and early February 2005 by the members of the State Fiscal Analysis Initiative (www.statefiscal.org) — a network of independent nonprofit organizations that track state finances. Other projections were collected by Center on Budget and Priorities staff from publicly available sources. In general terms, a shortfall is defined as the amount by which the projected cost of continuing current state services exceeds projected state revenue.

— The exact methodologies for arriving at these estimates vary. For instance, some but not all shortfall estimates account fully for the rising costs of services that result from normal inflation and other factors. Where more than one reasonable estimate is available, a range is reported; for example, in Connecticut, the governor's official estimate is $1.2 billion, but the legislature's Office of Fiscal Analysis estimates the shortfall at $670 million.

— For states where shortfalls are reported for two years combined, the figure shown here is the FY 2006 figure only if it is available, or it is one-half the two-year figure if no single-year figure is available.

— Only states with available shortfall estimates are shown here. In a number of states, a shortfall is widely expected, but dollar amounts for those shortfalls are unavailable; those states (which include Kentucky, and Missouri among potentially others) are excluded from this table. As discussed in the accompanying text, a few states, such as Delaware, Hawaii, Virginia, and Wyoming, expect to end FY2006 with a surplus; such states are not shown in this table. Further details and citations are available upon request from the author.

— This table should not be considered exhaustive and estimates are subject to change. Efforts will be made to update this table as additional data become available.