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THE STATE FISCAL CRISIS: EXTENT, CAUSES, AND RESPONSES

By Liz McNichol

Summary

While much public attention has been paid in recent weeks to the fiscal crisis confronting states across the nation, reports differ as to the seriousness of the crisis, its causes, and the steps that states are taking to address it. This report briefly summarizes certain facts about the issue.

- The current state fiscal crisis is severe. States are facing budget deficits of approximately \$100 billion that must be closed over the next several months — \$25 billion in deficits for the current fiscal year and between \$70 and \$85 billion for the fiscal year that begins in June. These new budget gaps are on top of the \$50 billion gap states closed when they enacted their fiscal year 2003 budgets.
- These budget gaps are not the result of irresponsible spending decisions by the states during the 1990s. In fact, the response of the states to the economic growth of the 1990s was restrained by any standard of comparison. During the economic boom years of the 1990s, states built their reserves and cut taxes. State spending did increase, but at a modest rate. The pace of state spending growth during the 1990s was low by historical standards and state government grew no faster than the private sector during the decade. After accounting for inflation, nine out of ten new state dollars went to education, healthcare or corrections – areas where costs were rising, need was growing and/or the voting public was demanding improvements in services.
- The major cause of the current state fiscal crisis is a steep drop in revenues. State revenues have declined relative to the same quarter in the prior year for the last six quarters. Revenues for the crucial April-June quarter of fiscal year 2002 were about 13 percent below the same period in fiscal year 2001. The recent revenue decline was twice as steep as that seen by the states in the recession of the early 1990s.
- This drop in revenues resulted from a number of factors including the effects of the economic downturn and especially the decline of the stock market, the

continuing effects of state tax cuts of the 1990s, the ongoing erosion of state tax bases due to their failure to adapt to the changing U.S. economy and the effect of federal tax policies.

- One clear indication of the severity of this crisis is the magnitude of the spending reductions that states are considering to close these gaps. These affect all areas of state spending including education, health care, child care, corrections, and aid to localities. State general fund spending (the category of spending that typically is subject to year-to-year appropriations) declined by 1.0 percent from fiscal year 2001 to 2002 after adjusting for inflation and population growth and is projected to decline another 2.3 percent from 2002 to 2003. Some 37 states cut spending, adjusted for population and inflation, between 2001 and 2003. It is likely that the decline in spending will be greater when the books are closed on 2003 and greater still in fiscal year 2004.
- States would be well-served to take a balanced approach to addressing the budget gaps they face. With prospects for assistance from the federal government uncertain, many governors have recognized that the only way to avoid devastating spending cuts is to include revenue-raising as part of the solution to the current fiscal crisis.
- Four out of five of the budgets that have been submitted by governors this year include revenue-raising measures. Half of the nation's governors have proposed tax increases.
- There are many revenue-raising options available to states. For example, states can use temporary measures such as income tax surcharges, or raise revenues through corporate tax reform, or sales tax base-broadening. States that cut taxes during the 1990s may want to reassess and reverse some or all of those tax cuts. States can protect themselves from unintended revenue losses by "decoupling" the relevant parts of their tax code from the effects of recent federal changes that reduce state revenues.

Current State Budget Gaps Are the Most Severe in Decades

States are facing budget deficits of approximately \$100 billion that must be closed over the next several months — \$25 billion in deficits for the current fiscal year¹ and between \$70 and \$85 billion for the fiscal year that begins in June. These new budget gaps are on top of the \$50 billion gap states closed when they enacted their fiscal year 2003 budgets.

The fiscal year 2004 gaps alone, which represent between 14.5 percent and 18 percent of total state spending, are twice as deep as the gaps states faced during the recession of the early 1990s.

¹ National Conference of State Legislatures, State Budget Update, February, 2003.

Because virtually all states have balanced budget requirements and thus cannot run operating deficits (unlike the federal government), they must close budget gaps for this and future years through some combination of spending cuts and revenue increases.²

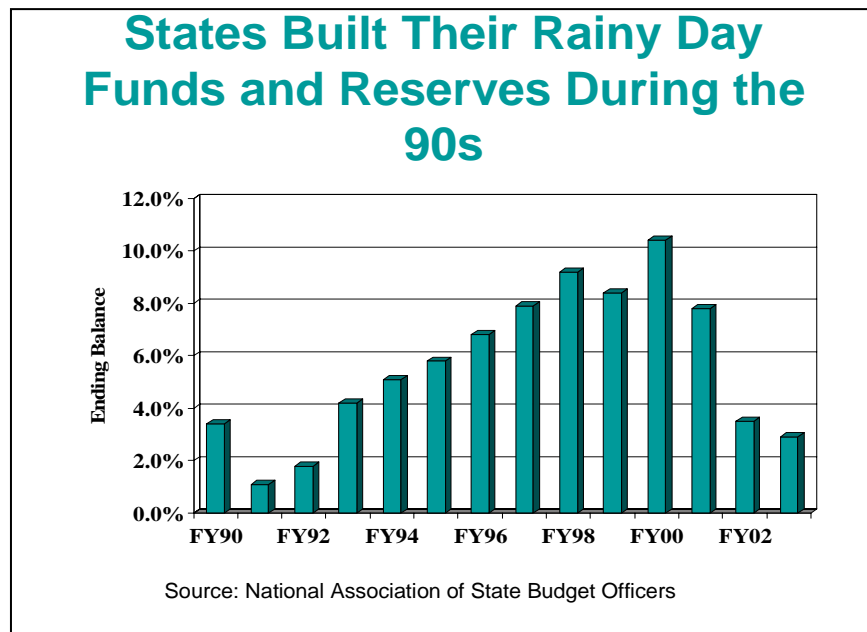
Did State Actions in the 1990s Contribute to the Fiscal Crisis?

It has been argued that the current state budget crisis is largely the result of a massive spending increase by states during the 1990s. In fact, the response of the states to the economic growth of the 1990s included a mix of tax cuts, reserve accumulations, and moderate spending increases. Spending growth was concentrated in education, healthcare and corrections – areas where costs were rising, need was growing and/or the voting public was demanding improvements in services. The pace of state spending growth during the 1990s was low by historical standards and state government grew no faster than the private sector during the decade.

States Built Substantial Rainy Day Funds During The 1990s

Over the course of the 1990s, states increased total reserves to their highest level in twenty years. By the end of fiscal year 2000, states had total year-end balances (which includes both general fund balances and rainy day funds) of almost \$50 billion or 10.4 percent of expenditures. Prior to the last recession of the early 1990s, states had total balances of only \$12.5 billion or 4.8 percent of expenditures. As a result, states were better prepared for this economic downturn than they were for the recession of the early 90s.³ (See Figure 1.)

Figure 1



² All states except Vermont are required by statute or constitution to adopt a balanced budget. State laws differ over how long a budget can remain out of balance if revenue or spending estimates change once a budget has been adopted.

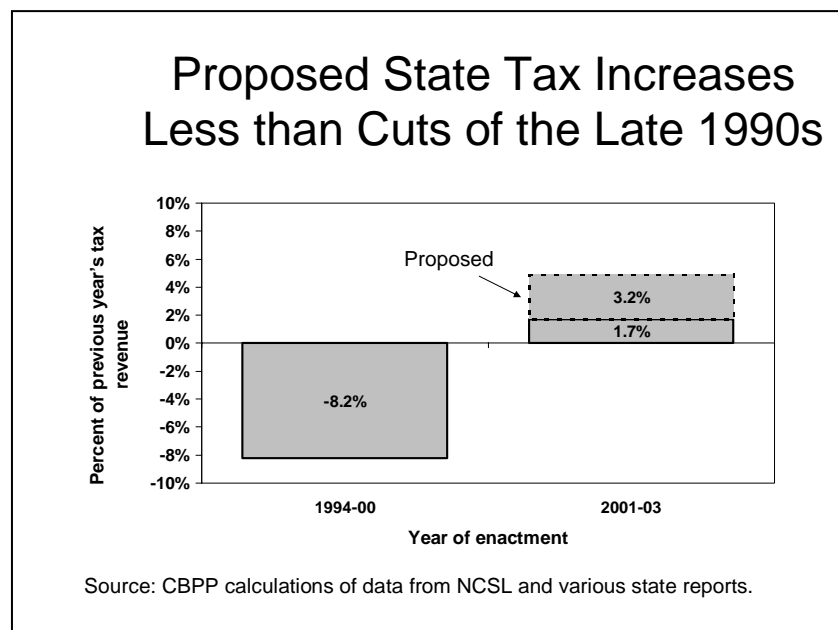
³ National Association of State Budget Officers (NASBO), Fiscal Survey of the States, November 2002.

These reserves have served to ameliorate some of the effects of the economic downturn on revenue. However, despite being large by historic standards, state rainy day funds have not been large enough to offset budget gaps in most states.

Most States Enacted Significant Tax Cuts During The 1990s

From roughly 1994 through 2000, state revenue collections grew rapidly as a result of unusually high levels of economic activity, particularly personal consumption and capital gains realizations. Most states used some of the increased revenues that resulted from this economic expansion to cut taxes. From 1994 to 2001, nearly every state cut taxes and most of the tax cuts were substantial. In 43 states net tax cuts exceeded one percent of total state revenues, and most were much larger than one percent. Aggregate net tax reductions from 1994 to 2001 equaled about 8.2 percent of state tax revenues. (See Figure 2.)

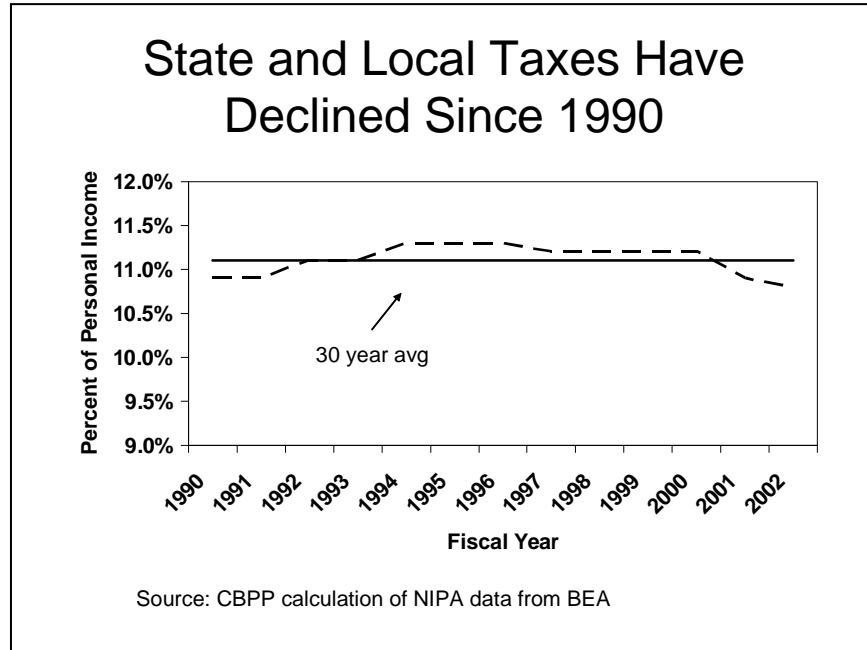
Figure 2



Unfortunately, many states used those *temporary* levels of revenue growth to finance *permanent* tax cuts. The tax cuts enacted during the 1990s are currently costing states more than \$40 billion per year.

Not surprisingly, the states that enacted the biggest tax cuts in the 1990s are in the biggest fiscal trouble now. The ten states that enacted the largest tax cuts in the 1990s faced a median budget gap equal to 13 percent of state spending when they initially considered their fiscal year 2003 budgets. By contrast, the median budget gap in 2003 for the ten states that cut taxes the *least* was only one percent.

Figure 3



State and local tax revenue is now at its lowest level since the double-dip recession of the early 1980s. By 2002, state and local tax revenue made up a smaller share of personal income than in 1990 and was below the thirty year average. (See Figure 3.) If states merely raised taxes back to the average level, collections would increase more than \$30 billion – enough to eliminate over one-third of the budget deficits states now face.

Thus far, the net increase in taxes due to changes in 2001 and 2002 is very small relative to the tax cuts enacted in the 1990s — only 1.7 percent of taxes. Even if all tax increases proposed by governors in 2003 were enacted, total tax increases would amount to well under two-thirds of the total tax cuts enacted during the 1990s.

State Spending Grew Only Modestly During The 1990s

While state spending grew in real (i.e., inflation-adjusted) terms during the 1990s, it did so at a *slower* rate than in previous decades.

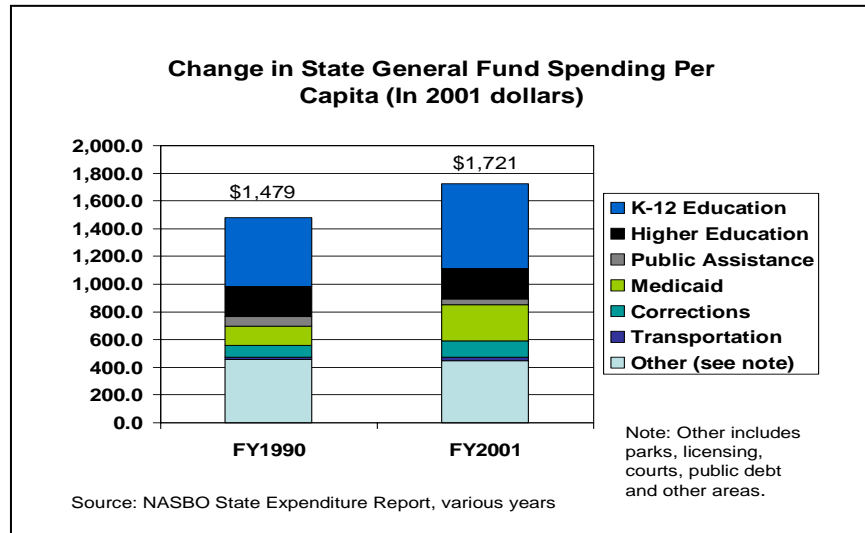
After adjusting for inflation, the amount that states spent per resident, using funds that states raised from their own sources, increased by an average of 2.0 percent per year between 1989 and 1999. This is well below the 2.9 percent average annual spending growth for the 1949-1999 period and the growth of 2.9 percent seen during the 1980s.

Most of the growth in state spending that did occur during the 1990s was in three areas: education, healthcare and corrections. (See Figure 4.)

- Education increases were driven in part by the fact that the school-age population grew faster than the general population and that school costs grew faster than general inflation. In addition, in response to public demands, a number of states

including California, Maryland, Tennessee and Wisconsin, undertook initiatives to reduce class sizes, improve teacher training and make other improvements in schools, many of which had significant costs.

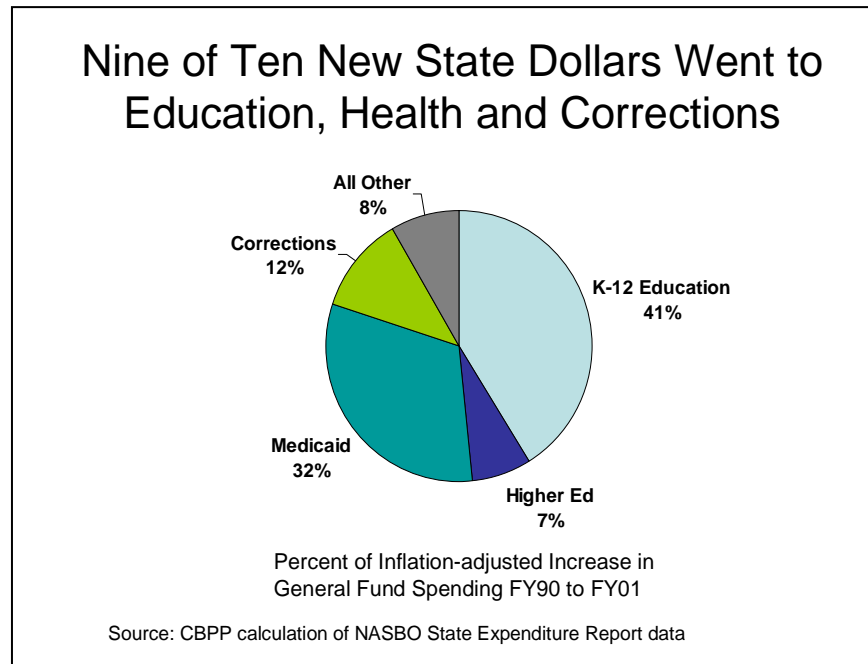
Figure 4



- Moreover, increased spending on education in many states resulted from the desire and/or a legal mandate to finance schools more equitably. For example, Connecticut, Kentucky, New Hampshire and Ohio are among the states that were required by the courts to make education funding more equitable. This resulted in increased state spending on education as states invested more in poor school districts and shifted some of the financing of schools from the local to the state level.
- Health care increases were largely driven by the fact that health care costs grew almost twice as rapidly as general inflation and that Medicaid enrollment rose among disabled individuals and the elderly, two groups with expensive health care needs. In addition, states expanded health care coverage among low-income children and pregnant women.
- State governments were not unique in facing increases in health care spending. According to data from the Centers for Medicare and Medicaid Services, the percent of GDP spent on health services rose from 11.3 percent to 13.1 percent between 1989 and 1998. The increase in health costs and in demand for health services affects state governments disproportionately because health spending makes up a larger share of government budgets than those of individuals and companies.
- State corrections spending grew during the 1990s, with states spending more both to operate existing prisons and to build new ones. The need for prison space grew significantly as stiffer penalties and other policy changes, as well as technological advances that improved the ability of law enforcement officers to apprehend

criminals, increased incarceration rates. Between 1989 and 2000, the number of prisoners under state jurisdiction almost doubled, from 253 per 100,000 population in 1989 to 432 per 100,000 population in 2000. After adjusting for inflation, state spending per prisoner actually declined between 1990 and 2001.

Figure 5



- At the same time that spending was increasing in these areas, state spending on public assistance declined as caseloads dropped. In addition, although state spending on higher education grew, the rate of growth was slower than the increase in costs as states shifted more of the cost of public colleges and universities to students through increased tuition.

The vast majority of new state spending during the 1990s went to education, health care and law enforcement. After adjusting for inflation, nine out of ten dollars of increased state spending was in one of these areas. (See Figure 5.)

Another reason state spending in general rose faster than inflation during the 1990s was that state governments assumed new responsibilities that formerly had been handled by federal and local governments.

- For example, during the 1990s, the federal government failed to increase funding for existing block grants for certain social services and some health programs sufficiently to cover states' rising costs in these areas effectively shifting responsibilities from the federal to the state level.

Tax and Spending Limits like Colorado's Do Not Guarantee Fiscal Health

Some have suggested that states should adopt strict tax and expenditure limits as a way to restrain spending and avoid future fiscal crises. The specific model that is often recommended is Colorado's "TABOR" amendment, a package of constitutional provisions that severely limits the state's ability to raise and spend revenue. TABOR is perhaps the nation's most restrictive tax and expenditure limit. Colorado's limit, however, has most certainly not made the state a model of fiscal health. In the 1990s, the Colorado limit forced the state to enact large and (as it turned out) unaffordable tax cuts. As a result, TABOR has worsened the state's fiscal crisis, contributed to damaging spending cuts, forced the state to borrow against its own fiscal future, and lowered the state's bond ratings.

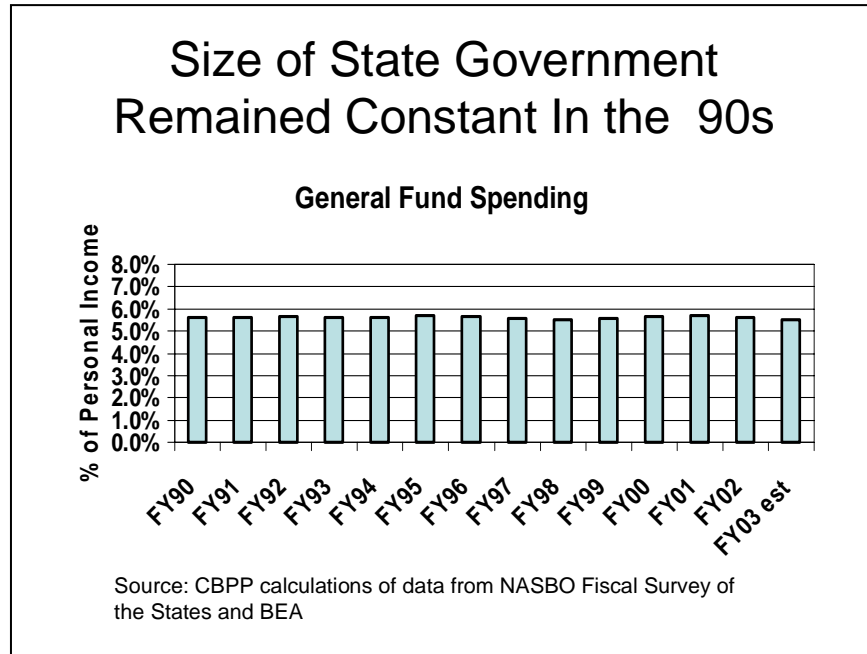
- Colorado's fiscal situation is worse than those of many other states. For 2003, the state is struggling to close a \$1 billion deficit, equal to about 20 percent of total spending — among the largest deficits in the nation. The outlook for 2004 is no better.
- The state's fiscal plight has led bond rating agencies to downgrade the state's bond rating and credit outlook in recent months; analysts specifically blamed TABOR for making the fiscal crisis worse. The bond-rating agencies are not the first outside observers to recognize the havoc TABOR is playing with Colorado's finances. In a pair of studies in 1999 and 2001, *Governing* magazine ranked Colorado's finances as among the worst-managed in the country, again due to TABOR.

- Because of gaps in federal Medicare coverage, the responsibility for a significant share of the health care costs of seniors and people with disabilities has been shifted from Medicare — the federal insurance program for seniors and people with disabilities — to Medicaid — the joint federal-state insurance program for low-income people — and, thus, moved from being a completely federal responsibility to a joint state and federal responsibility. For low-income individuals fully enrolled in both programs, Medicaid pays for services that Medicare does not cover — like prescription drugs and long-term care — and also covers the deductibles, coinsurance and premiums that Medicare assesses beneficiaries. Some 35 percent of all Medicaid expenditures are on behalf of dual eligibles. As a result of these factors, state Medicaid expenditures on behalf of the elderly and disabled rose more rapidly during the 1990s than did Medicare spending for the same population.
- State spending also increased during the 1990s to reimburse localities for the costs of state-mandated cuts in local taxes such as property taxes and motor vehicle taxes.

This growth in state spending occurred during a period of great growth in the economy of the United States as a whole. Personal income and the country's private and public output as measured by Gross Domestic Product grew significantly. In times when states are neither expanding nor scaling back their responsibilities, state spending can be expected to grow at about the same rate as the economy, which means that the ratio of total state spending to total personal

income (a common measure of the size of state economies) would remain roughly constant. Between 1990 and 2001 state government grew no faster than the rest of the economy. Since 2001 state spending has grown more slowly than the economy. Thus, the size of state government relative to the economy as a whole has declined since 1990. (See Figure 6.)

Figure 6



Since the start of the economic downturn in 2001, state spending has declined significantly. Data from the National Association of State Budget Officers show that state general fund spending – the category of spending that typically is subject to year-to-year appropriations – declined 1.0 percent after adjusting for population and inflation and is projected to decline 2.3 percent in FY03.

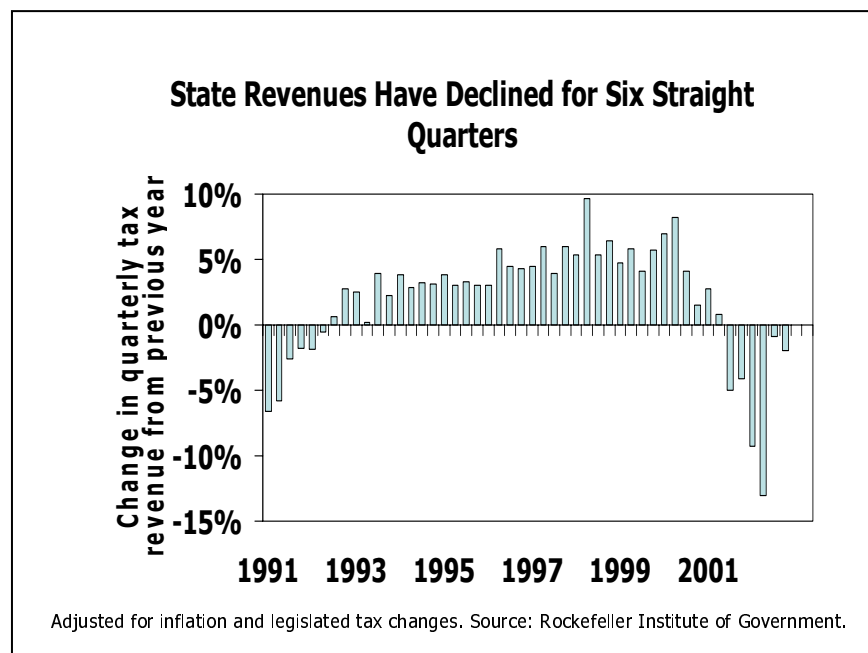
Moreover, the projected cut for fiscal year 2003 reported by NASBO is based on state budgets enacted last spring. Large additional budget gaps have opened up since then, and governors have begun making mid-year cuts that will reduce spending below the appropriated levels. The actual decline will be larger when the full extent of the budget-cutting measures used to close gaps that developed after enactment of the 2003 budgets are known.

This same trend is evident in patterns of employment growth. State government employment as a share of total employment actually declined during the last decade. As of January 2003, state employees made up 3.8 percent of total employment, a lower percentage than at the start of the decade in 1990 and equal to the level of thirty years ago. The current fiscal crisis has caused states to cut their payrolls for most state functions. Total state employment in areas other than education declined by 20,000 over the last 12 months.

Current State Fiscal Problems Are The Result Of Unprecedented Revenue Declines

If states did not overspend during the 1990s and built reserves to historic levels, why are they facing such deep fiscal stress now? The major cause of the current state fiscal crisis is a steep drop in revenues. According to data collected from state revenue departments by the Rockefeller Institute of Government, state revenues have declined relative to the same quarter in the prior year for the last six quarters. (See Figure 7.) Revenue in each quarter of FY2002 was well below the same quarter of the previous fiscal year — about 13 percent below in the crucial April-June quarter which is the most important quarter for tax receipts. The recent revenue decline was twice as steep as that seen by the states in the recession of the early 1990s. Thus far, state revenues have not rebounded and begun to grow again in real terms even from the low levels of fiscal year 2002.

Figure 7



This drop in revenues resulted from a number of factors including the effects of the economic downturn and the bursting of the stock market bubble, the continuing effects of the state tax-cutting of the 1990s, the ongoing erosion of state tax bases due to their failure to adapt to the changing U.S. economy and the effect of federal tax policies on state revenues.

Revenues Reduced by Economy, Tax Cuts

One reason that state revenue declines are so large now is that the revenue increases of the late 1990s were so large. The stock market was booming, capital gains realizations were at all-time highs, consumption was soaring as savings rates fell — all of which pushed up revenues. As we now know, that wasn't sustainable. When the stock market fell and the recession began, state revenues fell abruptly.

Unfortunately, as discussed above, many states used those *temporary* levels of revenue growth in the 1990s to finance *permanent* tax cuts. The tax cuts enacted during the 1990s are currently costing states more than \$40 billion per year, exacerbating the drop-off in revenues due to the economic slowdown.

Long-Standing Problems Have Eroded State Tax Bases

In addition, states are feeling the effect of long-standing problems with their tax systems. A long-recognized flaw in state revenue systems is that revenues fail to keep pace with economic growth. As the National Governors Association and the National Conference of State Legislatures have reported, the gradual erosion of state revenues relative to growth occurs largely because of the substantial reliance on sales and excise taxes; items subject to those taxes in most states are declining in the long term as a share of total consumption. In addition, state corporate income taxes as a share of corporate profits have steadily declined over several years, partly reflecting corporations' ability to restructure their finances to avoid state taxes. State income taxes do the best job of keeping pace with economic growth over the long term, but they typically are not structured to compensate fully for the gradually declining revenue from other tax sources. As a result, over a period of several years, state tax bases tend to decline as a share of the economy, meaning that states over the long term must raise taxes or ratchet down spending to keep budgets in balance. The unusual economic circumstances that existed in the late 1990s masked these problems, but their impact is now adding to state fiscal woes.

Federal Actions Have Reduced State Revenues

Federal actions also have eroded state tax bases. State revenues have been reduced by federal tax cuts as well as state tax cuts. Because of the linkages between state and federal tax codes, cuts in federal taxes often have the side effect of reducing state revenue. The consequences for states are particularly significant now because large federal tax cuts are being implemented (and further large tax cuts have been proposed) at the same time that the economic downturn has depressed state revenues.

For example, the phaseout of the federal estate tax, contained in the 2001 tax legislation, had the potential to cost states \$75 billion through 2013. Also, the 2002 economic stimulus legislation contained a temporary change in business depreciation rules that had the potential to cost states \$14 billion over the provision's three-year life. In both cases, some states have protected themselves against these revenue losses by "decoupling" the relevant parts of their tax codes from the effects of the federal tax changes. Other states have not decoupled, however, and are losing revenue on a temporary or (in the case of the estate tax) permanent basis.

Moreover, the Administration's proposed fiscal year 2004 budget contains proposals for additional tax cuts that would cost states another \$64 billion over ten years.

All of these factors taken together resulted in the revenue declines that caused the state fiscal crisis.

States Are Responding to the Crisis by Cutting Spending and Raising Taxes

Vital state services are now at risk as states strive to balance their books. States for the most part have drawn down their reserves. By the end of fiscal year 2003, fund balances including rainy day funds will total less than 3 percent of state budgets and much of those remaining reserves are unlikely to be drawn down because of procedural barriers to their use. State must now rely primarily on spending cuts and tax increases to balance their budgets.

States Are Cutting Spending

It has been argued that the current state fiscal situation does not constitute a “crisis” because states are responding by merely slowing the growth of spending rather than instituting actual spending cuts. The reality is that state spending has already declined in real terms and is likely to decline further.

Data from the National Association of State Budget Officers show that state general fund spending – the category of spending that typically is subject to year-to-year appropriations – declined 1.0 percent after adjusting for population and inflation and is projected to decline 2.3 percent in FY03.

Moreover, the projected 2.3 percent cut for fiscal year 2003 is based on state budgets enacted last spring. As noted above, large additional budget gaps have opened up since then, and governors have begun making mid-year cuts below the appropriated levels. Thus it is likely that the decline in real general fund spending will be greater when the books are closed on 2003 and greater still in fiscal year 2004.

- Some 38 states – three states out of four – cut spending, adjusted for population and inflation, between 2001 and 2003. No areas of state spending have been spared from these cuts.
- Budget cuts already enacted or proposed in governor’s budgets could eliminate Medicaid coverage for 1.7 million people.
- At least 11 states have implemented or are planning mid-year reductions in K-12 education spending for the 2002-03 fiscal year; these cuts are resulting in layoffs of teachers and other staff and in reductions in the length of the school year. Further cuts are likely for FY 2004. Some 16 states have increased tuition for some or all of their state colleges and universities by more than 10 percent for the current school year and at least six states have instituted unusual mid-year increases this spring.
- States are cutting child care subsidies, corrections budgets, aid to localities and are reducing state workforces.

The claim that states are *not* cutting spending is based on the fact that the total funds appropriated by all states unadjusted for inflation and population growth continue to rise from year to year. Comparing nominal spending totals does not accurately measure states' ability to continue providing their current level of services. That ability is steadily eroded both by inflation (which increases the number of dollars needed to provide a given service to a given individual) and by population growth. Population growth — especially growth in specific expensive-to-serve populations such as school-age children and the elderly — increases the number of individuals who must be served.

In addition, many state programs are designed to be counter-cyclical: their costs rise during economic downturns as they assist families that have lost jobs or income. States also may be required to take on new costs as the result of federal policies and mandates, which further increases the cost of maintaining current services.

So the appropriate test is not whether states are increasing nominal spending but rather whether they are maintaining or cutting existing programs and services. Cutting is what is now happening across states. Moreover, in a number of individual states — most notably California — the budget gap is so large that the state is cutting spending in nominal terms as well as real terms.

States Are Also Raising Revenues

Many state governors are trying to moderate the spending cuts that would be required to close their budget gaps by also proposing tax and other revenue raising measures. Of the 48 budgets that have been submitted so far this year, four out of five include revenue-raising measures. Half of the nation's governors have proposed tax increases.

These increases, which cover income taxes, sales taxes, corporate taxes, and/or excise taxes and include both raising rates and broadening tax bases, have been proposed by governors of both parties and in all regions of the country. (One sign of the seriousness of the current situation is that several of the governors who have proposed tax increases built their public identities in part on lowering taxes.)

Nevertheless, even if all the proposed tax increases were approved, the combined tax increases passed during the current downturn would raise state revenues by just over \$20 billion per year, about *half* of the more than \$40 billion states are losing each year from the tax cuts they passed during the 1990s.

Nor are the tax increase proposals large enough to close states' budget gaps. The tax increases California's governor is proposing would close only one-quarter to one-third of the state's budget gap; proposed tax increases in New York and Ohio would close less than one-sixth and about one-half of those states' gaps, respectively.

What Impact Will State Actions Have on the Economy?

In order to balance their budgets in the current fiscal crisis, with most of their reserves depleted, states face a choice: They can cut services or they can protect public services by raising taxes.

Opponents of tax increases often argue that increasing taxes will reduce economic growth. The effect of taxes on economic growth is an area where misperceptions and misinformation abound. It is important to remember that taxes exist to fund government services such as education, transportation, and law enforcement, and these services have a large impact on economic performance. Economic research into the long-term tradeoff between taxes and public expenditures suggests that public expenditures can contribute as much, if not more, to economic growth as low taxes.

There is a large body of literature that has carefully studied the impact of taxes on economic growth using a variety of measures with controls for characteristics of states other than tax levels. These well-designed studies of the effect of taxes on economic growth find that the impact of taxes on economic growth is very small and exists only if you hold everything else — including the level of government services — equal. In addition, business executives, in hundreds of surveys, have placed taxes lower on the list of important location factors than such factors as labor availability, costs and training; access to markets; access to raw materials; transportation costs; public services; and quality of life.

Careful studies of the relationships between taxes, spending, and job growth show that undermining a state's educational system, its infrastructure, or other services vital to businesses and workers over the long run can do more damage than maintaining or increasing taxes.¹

In addition, state budget-cutting could have a short-term impact on the economy's ability to recover from the current downturn. Although the economic perils of tax increases are often touted by their opponents, spending cuts could actually be more damaging to the nation's economy than tax increases.

As Nobel Prize-winning economist Joseph Stiglitz and Peter Orszag of the Brookings Institution have pointed out, a \$1 reduction in state public-sector spending typically results in a \$1 reduction in a state's economic activity. A \$1 increase in taxes, by contrast, is likely to result in a smaller reduction in a state's economic activity, because to some extent the tax increase would be financed out of reduced savings, or from reduced out-of-state consumption. This is particularly true of tax increases on higher-income individuals, because such individuals are most likely to have access to savings.

Stiglitz and Orszag conclude: 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 than tax increases focused on higher-income families. In any case, in terms of how counter-productive they are, there is no automatic preference for spending reductions rather than tax increases.

¹ See, for example, Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review*, March-April 1997, reprinted in *State Tax Notes*, June 23, 1997, pp. 1883-95; Robert G. Lynch, *Do State and Local Tax Incentives Work?*, Economic Policy Institute, Washington, D.C., 1996; Timothy Bartik, *Who Benefits From State and Local Economic Development Policies?*, W.E. Upjohn Institute for Employment Research, Kalamazoo, Michigan, 1991.

Conclusion

States face the largest budget gaps they have seen in decades. Closing these gaps will be difficult for a number of reasons: the national economy remains sluggish, states already have used up their least-painful measures to balance their budgets in fiscal years 2002 and 2003, and federal tax cuts are threatening to reduce state revenues still further.

The fact that the fiscal crisis is *not* the result of massive overspending by states during the 1990s also complicates their task. Generally speaking, states did not undertake large, unwise, and unaffordable spending initiatives that now can be scaled back or eliminated to restore budget balance.

States would be well-served to take a balanced approach to addressing the budget gaps they face. As many governors have recognized, the only way to avoid devastating spending cuts is to include revenue-raising as part of the solution to the current fiscal crisis.

There are many revenue-raising options available to states. States that did undertake large, unaffordable tax cuts during the 1990s may want to reassess and reverse those tax cuts. Temporary tax increases such as a temporary income tax surcharge can raise substantial revenue to allow preservation of important services while the economy temporarily depresses state revenues.

Revenue-raisers such as corporate or sales tax base-broadening can both provide additional resources during the current revenue shortfall and serve to strengthen state tax bases for the future by addressing long-standing structural problems.

In addition, states can protect themselves against revenue losses due to federal actions such as the estate tax repeal by “decoupling” the relevant parts of their tax codes from the effects of the federal tax changes.

For More Information

The Center's State Fiscal Project has prepared a number of reports that provide additional detail on the topics discussed in this paper. These papers which can be found on the section of the Center's website: www.cbpp.org include the following:

Background:

The State Fiscal Crisis Was Not Caused by Overspending by Elizabeth McNichol
<http://www.cbpp.org/4-9-03sfp.htm>

State Budget Deficits for Fiscal Year 2004 are Huge and Growing by Iris J. Lav and Nicholas Johnson
<http://www.cbpp.org/12-23-02sfp.htm>

The State Tax Cuts of the 1990s, the Current Revenue Crisis, and Implications for State Services by Nicholas Johnson
<http://www.cbpp.org/11-14-02sfp.htm>

State Responses:

States are Making Deep Budget Cuts in Response to the Fiscal Crisis by Nicholas Johnson
<http://www.cbpp.org/3-19-03sfp.htm>

Many Governors are Proposing Tax Increases and Other Revenue Measures by Nicholas Johnson
<http://www.cbpp.org/2-6-03sfp.htm>

Revenue Options:

Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States by Michael Mazarov
<http://www.cbpp.org/4-9-02sfp.htm>

Expanding State Sales Taxation of Services: Options and Issues by Michael Mazerov
<http://www.cbpp.org/3-24-03sfp.htm>

Using Income Taxes to Address State Budget Shortfalls by Elizabeth McNichol
<http://www.cbpp.org/2-11-03sfp.htm>

State Rainy Day Funds: What to Do When it Rains by Bob Zahradnik and Nicholas Johnson
<http://www.cbpp.org/1-31-02sfp2.htm>

States Can Retain Their Estate Taxes Even as the Federal Estate Tax is Phased Out by Elizabeth McNichol
<http://www.cbpp.org/1-31-02sfp.htm>

Role of the Federal Government:

The State Fiscal Crisis is Impeding Economic Growth: Federal Aid to States Would be Most Effective Stimulus by Iris J. Lav

<http://www.cbpp.org/2-18-03sfp.htm>

President's Tax Proposals Would Reduce State Revenues by \$64 Billion Over 10 Years by Iris J Lav

<http://www.cbpp.org/2-4-03sfp.htm>