CENTER ON BUDGET AND POLICY PRIORITIES

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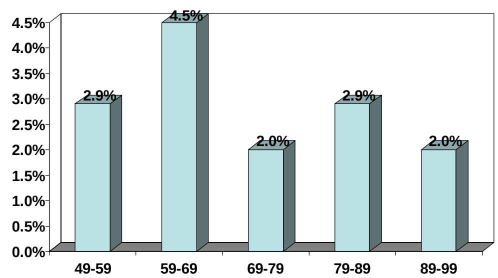
DID STATES SPEND THEIR WAY INTO THE CURRENT FISCAL CRISIS?

Some have argued that the fiscal crisis that states face is largely the result of a massive spending increase by states during the 1990s. Relying on revenue increases or additional federal fiscal relief to resolve this crisis, according to this view, would merely reward irresponsible behavior and encourage continued overspending. This report examines the basis of that claim.

State Spending Grew More Slowly During the 1990s than in Previous Decades

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

Average Annual Percent Change in Real Per Capita State Own-Source Spending



Source: CBPP Calculations of Dept. of Census and BEA data.

Most of the growth in state spending that did occur during the 1990s was in education, healthcare, and corrections — areas where costs were rising, need was growing, and/or voters were demanding improvements. After accounting for inflation, *nine out of ten* new state dollars went into these three areas.

- **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, a number of states undertook new educational initiatives (such as reducing class size, equalizing funding among school districts, and increasing accountability), many of which had significant costs.

- **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.

- **Corrections** increases largely reflected the growth in the prison population. The number of prisoners under state jurisdiction nearly doubled from 1989 to 2000.

States also built up their rainy day funds during the 1990s, raising 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 1990s.

Steep Revenue Declines Are the Main Cause of States' Current Problems

The major cause of the current state fiscal crisis is a steep drop in revenues, which have fallen twice as far as during the recession of the early 1990s.

State revenues have declined relative to the same quarter of the prior year in each of the last seven quarters, according to inflation-adjusted data collected from state revenue departments by the Rockefeller Institute of Government. 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. State tax revenues continued to decline in fiscal year 2003.

One reason for the revenue decline is the economic downturn, especially the stock market decline. Another is the ongoing erosion of state tax bases as services, which states generally do not tax, become an increasing portion of overall economic activity. The tax cuts that many states instituted in the 1990s also played a role in reducing state revenues. Some 27 states have raised taxes since 2001 however, these tax increases have not been sufficient to offset the earlier cuts.

States also are making broad and significant cuts in services. Simply to maintain its current level of services, a state must increase spending each year by at least enough to compensate for the effects of inflation and population growth. (For example, inflation makes school textbooks more expensive, and a growth in the school-age population requires states to buy more of them.) In some areas, such as health care, state outlays must rise even faster just to keep up. Nominal spending in most states has either declined or has not increased enough to compensate for inflation and population growth, so states have been forced to cut services. Given the continuing sluggishness of the economy, these cuts are almost certain to become both deeper and more widespread in the months ahead.

Conclusion

The current fiscal crisis is not the result of massive overspending by states. State spending grew during the 1990s, but more slowly than in previous decades and primarily in education, health care, and corrections, all areas with rising costs, need, and/or public demands for improved services. Rather, the current fiscal crisis is a *revenue* crisis, for which even states with the most well-stocked reserve funds were unprepared.

If the federal government fails to provide fiscal relief, states will be forced to close their budget shortfalls entirely through spending cuts and various kinds of revenue increases. Both types of measures not only risk harming vulnerable populations such as poor, elderly, and disabled individuals but also will take money out of the economy, undermining stimulus efforts undertaken at the federal level.