CENTER ON BUDGET AND POLICY PRIORITIES

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FRAMING THE CHOICES

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Summary

The improving health of the U.S. economy is starting to produce strong revenue growth for state governments. In the fourth quarter of 2004, state tax revenues grew by 7.8 percent. According to the Rockefeller Institute of Government this was the seventh straight quarter of revenue growth that exceeded inflation, following eight consecutive quarters of revenue growing at or below inflation.

Nevertheless, states are not out of the woods. Total state revenues between 2000 and 2004 were $184 billion below the amount needed to continue funding services at the 2000 level. In order for states to return to their 2000 service levels by 2007, state revenue would have to grow by an average of 9.8 percent per year – a significantly higher rate than current growth.

One reason why this $184 billion revenue gap was so large is that the economic downturn was both longer and deeper than the previous downturn, in the early 1990s. The current fiscal crisis has lasted five years in the majority of states compared to only three years for the fiscal crisis of the early 1990s. The greater depth of the current fiscal crisis is reflected in the fact that state revenue reached a 24-year low of 4.6 percent of the economy during this downturn, compared to a low of 4.8 percent during the previous downturn.

But another reason states face such a large revenue gap is that they did much less to bolster their revenue systems during the recent downturn than during the downturn of the 1990s. During that earlier downturn, states enacted tax increases that totaled 9.6 percent of state revenue. During the recent downturn, state tax increases were less than half as large, at 3.8 percent of revenue.

As a result, states have relied heavily on service cuts to close budget gaps. In fact, during the recent downturn states were three times more likely to rely on spending cuts to close deficits than on revenue increases. In the early 1990s, the mix of solutions were more even — about one-third of the gaps were closed using tax increases, about one-third were closed with spending cuts, and the remainder of the gaps were filled with reserves and other measures.

Moreover, a number of states have enacted "backloaded" tax cuts in recent years that have not fully taken effect but will cost states roughly $4.4 billion a year over the next few years. Several other states are considering *new* tax cuts that if enacted in their original form would cost them roughly $2.2 billion a year.

While the recent growth in state revenues may create the impression that states can afford to let these backloaded tax cuts take effect or enact new tax cuts, the state fiscal situation remains tenuous. State revenues remain far below the levels that would be needed to restore services cut in recent years. In addition, the federal government is likely to shift more costs to state governments over the next few years as it seeks to address its own budget problems. States also face structural revenue problems caused by outdated tax systems that do not keep up with changes in the economy. For all these reasons, state policymakers should be extremely cautious about taking steps that would weaken state revenues.

Revenues Hit Historically Low Levels During the Economic Downturn

During the recent economic downturn state tax revenues reached historic lows. In fiscal year 2004, actual revenue as a share of the economy reached a 24-year low of 4.6 percent. This figure is well below both the 24-year average of 4.9 percent and below the lowest level reached during the recession of the 1990s of 4.8 percent.[1]

Despite the dramatic revenue decline, some state policymakers may conclude that cutting taxes now is a prudent policy because state tax revenues are growing more strongly again. In the fourth quarter of 2004, state tax revenues grew by 7.8 percent; according to the Rockefeller Institute of Government, this was the seventh straight quarter of revenue growth that exceeded inflation following eight consecutive quarters of revenue growing at or below inflation. That may sound like strong revenue growth, but restoration of services cut during the downturn would require even stronger growth.

Figure 1 illustrates the problem that states face. The top line assumes that the cost of state government grows at approximately 5.6 percent a year and that revenue has to grow as much to fund the cost of government. This growth rate is based on the average annual growth rate of state expenditures between 1989 and 1999, a period which included both a recession and a period of economic growth. Historically, the 1990s were a period of modest growth in government, largely because health care costs did not grow especially fast that decade.[2] Thus this is a conservative estimate; the actual revenue growth required to restore services in the current period might be higher.

The bottom line of the graph shows actual tax collections for 2000-2004, which fell about $184 billion below the amount needed to continue funding services at the 2000 level. The dotted bottom line shows the growth needed to return by 2007 to funding state services at the 2000 level. Due to the dramatic drop-off in revenue, states will need to experience average revenue growth of 9.8 percent in fiscal years 2005, 2006 and 2007 simply to make up the ground lost during the downturn.

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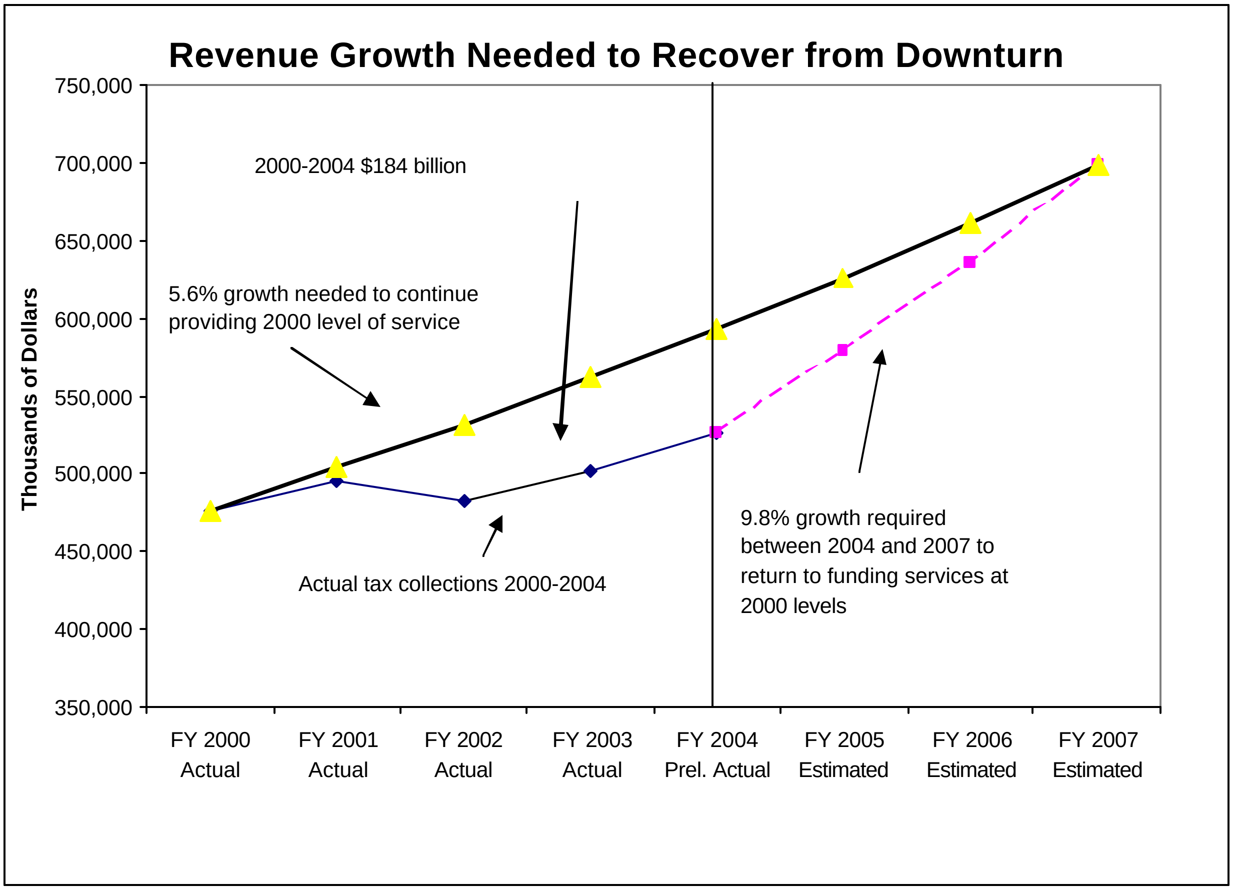
[1] Analysis is based on comparing National Association of State Budget Officers (NASBO) data with gross domestic product data from the Bureau of Economic Analysis data.

[2] Elizabeth C. McNichol and Kevin Carey, *Did States Overspend During the 1990s?* Center on Budget and Policy Priorities, October 15, 2002.

Figure 1



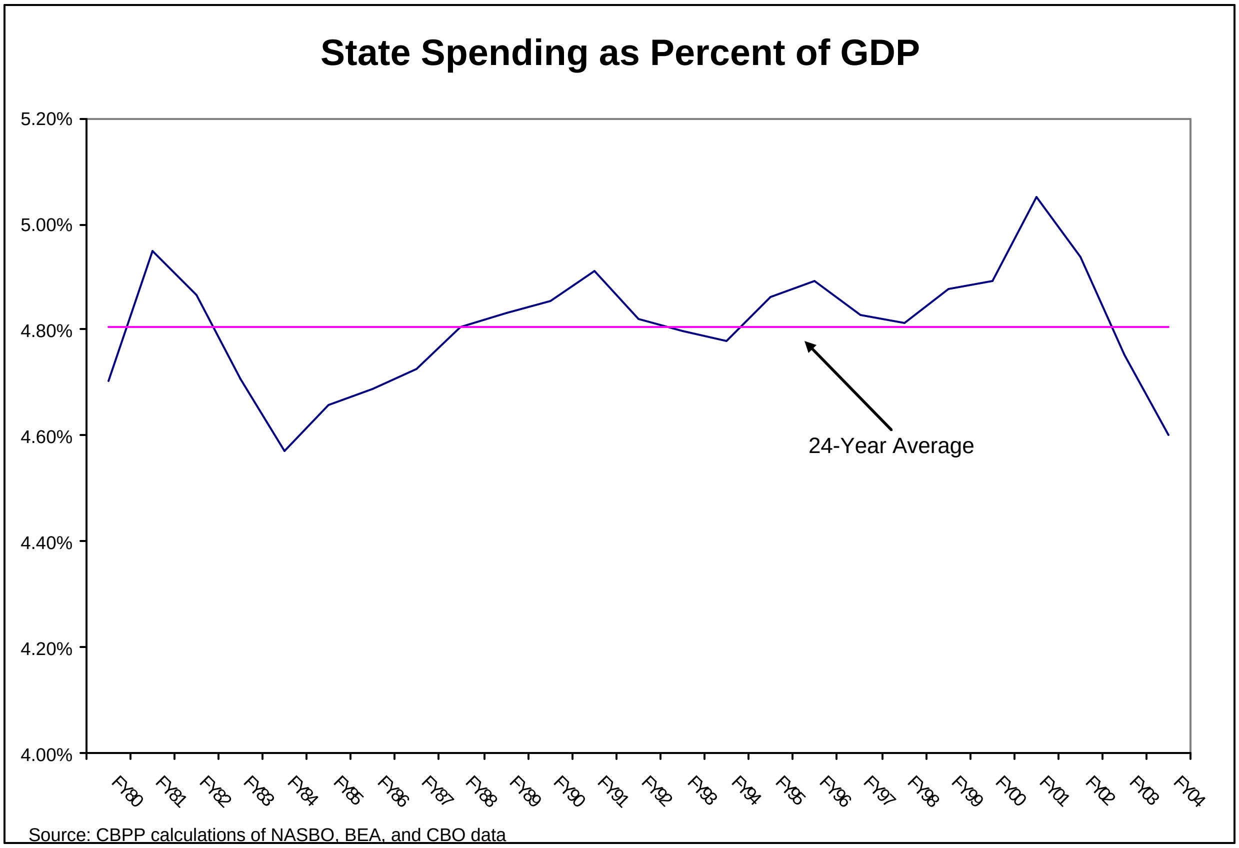
Revenue Decline Led to Deep Service Cuts During the Fiscal Downturn

The current fiscal crisis is longer and deeper than the state fiscal crisis of the early 1990s, and states responded differently to this crisis than the previous crisis. The current fiscal crisis has lasted five years, FY 2002 through FY 2006, compared to only three years for the fiscal crisis of the early 1990s.[3] As noted above, the current fiscal crisis is deeper than the one in the early 1990s, as reflected in the fact that revenue dipped to 4.6 percent of the economy during this downturn versus a low of 4.8 percent during the previous downturn.

States also have been much less willing to raise taxes to close budget gaps during this fiscal crisis than during the crisis of the early 1990s. During the three-year fiscal crisis of the early 1990s, states enacted tax increases that totaled 9.6 percent of revenue. In the first four

[3] At least 26 states project shortfalls for FY 2006 averaging roughly 7.3 percent to 8.3 percent of their general fund spending. The combined deficit is approximately $32 billion to $36 billion. See Elizabeth C. McNichol, *State Fiscal Crisis Lingers: Cuts Still Loom*, Center on Budget and Policy Priorities, February 15, 2005.

Figure 2



years of the current fiscal crisis, states have enacted tax increases that totaled only 3.8 percent of revenue, less than half the total of the previous fiscal crisis.

As a result, states have relied heavily on service cuts to close budget gaps. In fiscal year 2001, state spending as a share of the economy grew as the softening of the economy had a delayed impact on state revenues and budgets. Since then, state spending has declined significantly. In fiscal year 2004 spending as a percent of the economy was at its lowest level since mid-80's and is significantly below the 24-year average of 4.8 percent (see Figure 2).[4]

In the recent downturn states used expenditure cuts, far more than any other budget balancing option, to address budget deficits. On average, states were three times more likely to rely on spending cuts to close deficits than on revenue increases. In the early 1990s, the mix of solutions were more even — about one-third of the gaps were closed using tax increases; about one-third was spending cuts; and the remainder with reserves and other measures.[5]

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[4] Elizabeth McNichol and Makeda Harris, *Many States Cut Budgets as Fiscal Squeeze Continues*, Center on Budget and Policy Priorities, April 26, 2004.

[5] Elizabeth McNichol, *State's Reliance on Spending Cuts and One-Time Measures to Close Their Budget Gaps Leaves Programs at Risk*, Center on Budget and Policy Priorities, July 29, 2004.

The revenue decline and unwillingness to raise taxes resulted in budget cuts that affected a broad array of government services, including key services such as health care and education. For example,

- **K-12 education cuts.** Spending on elementary and secondary education has not kept up with inflation or enrollment increases. School districts in 35 states got less money, in real per-pupil terms, from state revenue in fiscal year 2004 than they did in fiscal year 2002. In 17 states, the declines exceed five percent. [6]

- **Higher education cuts and tuition increases.** State support for higher education has been cut. States budgeted $63.0 billion from general funds on higher education for fiscal year 2005, down from $67.7 billion (in 2005 dollars) in 2002, a 7 percent decline.[7] One result of these higher education cuts is higher tuition. The College Board reports that average tuition and fees at four-year public universities in the 2004-05 school year were higher than any other year on record, even after factoring out inflation. Average tuition and fees are 35 percent higher than they were four years ago after adjustment for inflation.[8]

- **Health care cuts**. During the depths of the fiscal crisis, states made cuts to Medicaid and the Child Health Insurance Program that caused more than one million people to lose eligibility for health insurance coverage. In some states the lingering affects of the fiscal crisis combined with an unwillingness to raise revenue are resulting in additional service cuts. For example, Tennessee is in the process of eliminating health insurance coverage for 323,000 adults. Some 100,000 Missourians would lose coverage under legislation currently pending in the legislature, as would 40,000 people under legislation pending in Ohio. At the same time, other states have made health care a priority and have found the resources to restore cuts made to Medicaid during the depths of the fiscal crisis. For example, Washington recently adopted a budget that includes tax increases and restores some previous cuts to benefits and eligibility. In addition, Illinois is moving forward with an expansion of coverage for parents.

Past and Present Tax Cuts Threaten Restoration of Services

According to a Center on Budget and Policy Priorities' analysis of state fiscal notes and National Conference of State Legislatures survey data, more than $4.4 billion in state tax revenue is at risk under current law, if back-loaded tax cuts are implemented as scheduled. Moreover, the resumption of revenue growth may tempt additional states to enact new tax cuts, even if such tax

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[6] Andrew Reschovsky, *The Impact of State Government Fiscal Crisis on Local Governments and Schools*, Robert M. La Follette School of Public Affairs, University of Wisconsin-Madison, December 2003.

[7] CBPP calculations of data from the Center for the Study of Education Policy, Illinois State University, http://coe.ilstu.edu/grapevine/table4_05.htm.

[8] The College Board, *Trends in College Pricing 2004*, Oct. 19, 2004

cuts are not affordable. Some states are planning or considering new tax cuts at a time when revenues have not returned to adequate levels.

These scheduled and potential tax cuts, in combination with a number of other negative factors confronting states, could reduce the level of revenues below what states need to adequately fund state services. Without adequate revenues, states cannot reverse the substantial cuts enacted over the last three years, much less meet new and emerging needs. In such areas as K-12 education, higher education, health care, child care, and others, funding in many states has fallen behind the costs of providing services and rising workloads.

Back-loaded Tax Cuts

Over the next several years, several states will implement additional tax cuts that have been enacted but have not yet been accounted for in state budgeting. The practice of enacting tax cuts to take effect in a fiscal year beyond the year(s) for which a legislature is writing a budget is known as "back-loading." This practice allows policymakers to avoid paying for a tax cut at the time it is enacted, instead leaving it to future budget-writers to account for the lost revenue. If states implement all the back-loaded tax cuts that are scheduled to take effect in the next several years, the aggregate cost to states will total $4.7 billion.[9]

Examples of particularly large, back-loaded tax cuts include:

- In Georgia an increase in the retirement income exclusion begins phasing in as of 2006; it will have an annual cost of $255 million when full implemented in 2008.

- Montana begins phasing in several personal income tax changes this year, that carry a total annual cost of almost $40 million when fully implemented in 2006.

- In New Mexico, personal income tax rate reductions and an increase in the deduction for capital gains have been phasing in since 2003 and will be fully implemented in 2009. The changes will result in a reduction of $277 million in annual revenue by 2009.

- Michigan began phasing out its single business tax in 1999. It is scheduled to be eliminated in 2009 resulting in an estimated annual revenue loss of $2.2 billion by 2009.

- Pennsylvania began phasing out its capital stock and franchise tax in 2000. It is scheduled to be phased out in 2011 with an estimated annual revenue loss of $1.5 billion by 2011.

[9] A few states are scheduled to implement phased-in tax *increases*. Netting those against the phased-in tax cuts reduces the aggregate tax cut to $4.4 billion. Please note that for the tax cuts that began phasing-in prior to 2005, the revenue loss figure reflects the additional revenue loss from the remaining increments of the tax cut. The revenue loss figures do not include the amount of revenue loss that has already occurred.

In addition, a more subtle, but still damaging, form of this tradeoff is occurring in Oklahoma. Oklahoma's legislature passed, and voters ratified, a tax package that included a cigarette tax increase and a package of income tax cuts, including a reduction in the tax on capital. Initially the cigarette tax increase is expected to raise more money than the capital-gains tax cut will lose, with the overage to be spent on new health care commitments. Smoking rates are projected to decline, however. Eventually, the cigarette tax increase will no longer be raising enough money to cover the lost revenue from the capital gains cut, much less fund the health care expenditures.

New Proposed Tax Cuts

Despite facing large deficits and the need to restore funding to services cut during the downturn, there is growing evidence that state policymakers are looking to again start cutting taxes. Several governors have proposed tax cuts or are advocating "tax reform" plans that could reduce long-run revenue growth. For example,

- Mark Sanford, the governor of South Carolina, proposed reducing the top personal income tax rate from 7 percent down to 4.75 percent at an annual cost of $960 million by fiscal year 2016 when fully phased-in. However, the South Carolina Senate rejected the governor's proposed personal income tax reduction. Instead the governor and the legislature agreed on a bill to lower the income tax rate that some 300,000 small businesses pay from 7 percent to 5 percent at a cost of $128 million over four years.

- Governor Mitt Romney of Massachusetts proposed cutting the personal income tax rate from 5.3 percent to 5.0 percent at an annual cost of $550 million. On a separate track the governor proposed closing some corporate tax loopholes that could generate about $170 million, clearly insufficient to cover the cost of the income tax reduction. The Massachusetts House rejected the governor's income tax rate reduction proposal. The Governor's corporate loophole closing proposal continues to move through the legislature.

- Jeb Bush, governor of Florida, proposed recurring tax cuts that, when fully implemented in fiscal year 2007, would cost $422 million per year. The tax cuts include the phase-out of the intangibles tax and repeal of the beverage "by-the-drink" tax. He has also proposed a one-time sales tax holiday with a cost of $35.5 million. As part of the FY 2006 budget negotiations, Florida House and Senate leaders have agreed on $230 million in tax cuts. The legislators agreed to reduce the intangibles tax by half and included sales tax holidays for school and hurricane supplies. The agreement does not include the repeal of the beverage "by-the-drink" tax.

- Governor Taft of Ohio has proposed a tax plan that will result in net loss of revenue of at least $400 million by 2010 and will slow the long run growth of revenue by reducing income taxes and raising cigarette and alcohol taxes. The Ohio house has endorsed most of the Governor's tax plan and has included the repeal of the tangible personal property tax on business furniture and fixtures which, when fully implemented in 2011, would add $450 million to the total cost of the tax cut plan.

New Proposed Tax Increases

On the other hand, some governors recognize the tenuous nature of state fiscal conditions and have proposed tax increases to ensure that adequate funding is available to provide basic public services. For example,

- Governor Mitch Daniels of Indiana proposed a one-year 1 percent surcharge on taxable income over $100,000 which would increase revenue by $290 million in FY 2006. The final budget agreement between the governor and the legislature does not include the governor's proposed income tax surcharge or any other tax increases.

- Mike Easley, governor of North Carolina, proposed a tax increase package that extends a temporary sales tax increase and increases the cigarette tax, but allows a temporary increase in the top personal income tax rate to expire, among other things. The package is estimated to raise just over $1 billion in FY 2007. The North Carolina Senate is developing a tax increase plan that may include, among other things, a continuation of the temporary sales tax increase, a cigarette tax increase and a proposal to create a state lottery.

- Governor Jodi Rell of Connecticut proposed tax increases of $140 million in fiscal year 2006 and $158 million in fiscal year 2007. The majority of the revenue comes from increased cigarette taxes. The Connecticut General Assembly's Joint Finance, Revenue and Bonding Committee did not pass the Governor's proposed cigarette tax increase. Instead, the Committee passed a bill which would add four new higher rates under the personal income tax and extend the corporation business tax surcharge for the next three years. The new income tax rates are projected raise $800 million in FY 2006 and FY 2007. The business tax surcharge is projected raise $62 million in FY 2006, $47 million in FY 2007, and $16 million in FY 2008.

- The Washington legislature approved a tax bill, supported by the Governor, that would, among other things, increase the state's liquor tax by $1.33 a gallon, increase the cigarette tax by 60 cents per pack and apply the state sales tax to canned meat, extended warranties and other items. Legislators also reauthorized taxes on estates worth more than $2 million. All of the revenue increases included the FY 06-07 biennial budget are projected raise about $530 million.

States are Facing a Variety of Fiscal Pressures

The state fiscal crisis is entering its fifth year as over half the states work to close fiscal year 2006 deficits. States continue to face fiscal difficulties due to the historic drop in revenue that occurred between 2002 and 2004. Even as revenues begin to grow more strongly, states will continue to struggle to gain the ground they lost during the depths of the economic downturn.

In addition to the fiscal problems caused by the cyclical nature of the economy, many states are beginning to feel the pressure from structural revenue problems caused by outdated tax systems that have failed to keep pace with changes in the economy such as the shift from a goods-focused economy to a service-focused economy. Enacting additional tax cuts at this time is likely to exacerbate these growing structural problems.

States are also facing the prospect of a dramatic cost shift from the federal government to state governments. The fiscal year 2006 budget proposed by President Bush includes dramatic budget cuts that would impact states and localities. By 2010, federal grants to states and localities provided through discretionary programs would decline by nearly $22 billion. The cumulative reduction over the five-year period from 2006 to 2010 would amount to $71 billion.

Congress recently approved its own blueprint for the federal budget known as the Budget resolution. Although the Congressional Budget resolution does not specify by how much individual programs are to be cut, it does propose to cut total funding for domestic discretionary programs by nearly as much as the President does. It would be virtually impossible to hold spending to that level without substantial cuts in grants to states and local governments.

State policymakers must consider all of these pressures as they make fiscal policy choices over the next several years. The prudent fiscal course would be to strengthen state revenue systems so that state governments can continue to provide an adequate level of services that will help to strengthen state economies.