# State Responses to Tight Fiscal Conditions

**Short-Term Fixes May Backfire if the Economy Does Not Soon Recover; Cyclical Downturn Masks Structural Problems in Some States**


*Kevin Carey*

*Liz McNichol*

*Iris J. Lav*



Center on Budget and Policy Priorities

The **Center on Budget and Policy Priorities**, located in Washington, D.C., is a non-profit research and policy institute that conducts research and analysis of government policies and the programs and public policy issues that affect low- and middle-income households. The Center is supported by foundations, individual contributors, and publications sales.



## Authors


*Kevin Carey* joined the staff of the Center on Budget and Policy Priorities in May 2001, as a policy analyst with the State Fiscal Project.

*Liz McNichol* is director of the Center on Budget and Policy Priorities' State Fiscal Project. She has worked for many years on state and local fiscal policy and oversees the Center's work on state fiscal issues.

*Iris Lav* is deputy director of the Center on Budget and Policy Priorities and manages the Center's state-level work on fiscal, safety net, and outreach programs and also directs the Center's policy work on federal tax issues.


## Acknowledgments


The authors would like to acknowledge Center staff member Robert Zahradnik and Center intern Benjamin Nichols for their contributions to this paper.

The Center on Budget and Policy Priorities is grateful to the Ford Foundation, the Annie E. Casey Foundation, the Charles Stewart Mott Foundation, and the Open Society Institute for their designated support of the Center's State Fiscal Project and the State Fiscal Analysis Initiative. Their support made this work possible.

August 2001
Center on Budget and Policy Priorities
820 First Street, N.E., Suite 510
Washington, DC 20002
(202) 408-1080
E-mail:center@cbpp.org
Web: www.centeronbudget.org

## Summary

This year many states faced the tightest fiscal conditions they have seen in a decade. A slowing economy has resulted in reduced revenue growth as expenditures in areas such as health and education continue to increase. While not all states have experienced problems, a review of state experiences in fiscal year 2001 and projections for fiscal year 2002 show that the signs of fiscal distress are widespread.

In two-thirds of the states, revenues are below original projections. A recent survey conducted by the Rockefeller Institute of Government found that by the middle of FY 2001, the inflation-adjusted growth rate of state revenues had fallen to its lowest level in five years. In addition, spending is exceeding projections in many states. A March report by the National Conference of State Legislatures found that 31 states had expenditures above projections for FY 2001.

Federal actions will increase the fiscal problems states are experiencing. The recently enacted federal tax cuts will result in state income and estate tax revenue reductions in most states, beginning in most cases in FY 2002 or 2003. The squeeze on federal domestic discretionary spending that likely will be necessary to finance the federal tax cuts may also result in reduced grants to states over time.

While the current downturn is mild compared to the early 1980s and 1990s, the potential exists for the decline to continue or deepen. In that context, it is useful to examine the actions states have taken to date to cope with this slowdown, and consider how the states might fare if the slowdown is prolonged or worsens. In addition, analysis of the strategies used and decisions made in the states that are feeling the effects first may yield lessons for states that have not yet been affected by tighter fiscal times.

When revenue growth declines, state policymakers are forced to make tough choices about how to balance their budgets. They can reduce spending, raise taxes, spend down reserves, or rely on short-term fixes. Each of these choices has implications for the public who rely on government programs. If decisions about revenue and spending are not made in a thoughtful way, the consequences can be especially severe for low-income and other vulnerable populations who are often the hardest-hit by a slowing economy.

***If decisions about revenue and spending are not made in a thoughtful way, the consequences can be especially severe for low-income and other vulnerable populations who are often the hardest-hit by a slowing economy.***

A number of states are using short-term strategies and temporary expedients to close fiscal gaps. For example,

- California, Indiana, Kentucky, Michigan, Mississippi, Ohio, and Washington have begun to tap the rainy day funds that have been put away for such a purpose and other reserves to balance their budget.

- Similarly, Tennessee and Wisconsin are using one-time, non-recurring revenues to fund ongoing expenditures.

- States such as Texas and Indiana are using what might be termed “accounting gimmicks”, such as moving expenditures that normally would be made in one fiscal year to the subsequent year. This means that revenues must be found in the subsequent year to cover both the deferred expenditure and normal, ongoing expenditures.

- Perhaps the ultimate "gimmick" was used by New Hampshire and Virginia in enacting their new budgets; these states simply increased revenue estimates to justify tax and budget decisions.

Use of these budget balancing measures can be a double-edged sword. To the extent that a state's fiscal problems are simply the result of a short-term economic slowdown, use of fund balances or other budget adjustments can be a prudent method of maintaining vital services until revenue growth rebounds. When an economic decline and resulting fiscal deficit are prolonged beyond a single year, however, such tactics can make the second or third year of a downturn more difficult to manage when one-time funds are no longer available and the costs of delayed expenditures come due.

Moreover, in some states the fiscal imbalance has causes that go beyond temporary economic circumstances. If a state's fiscal problems are a function of more serious problems, such as a long-term imbalance between the growth rate of revenue and the growth in the cost of basic programs, short-term budget fixes often delay the realization that difficult choices must be made.

States sometimes respond to tight fiscal circumstances by raising taxes, either temporarily or permanently. In 2001, state tax activity was mixed. Some states have raised or are proposing to raise new taxes. Seven states have enacted legislation that will increase revenues by more than one percent of their operating budgets. They are: Arizona, Indiana, Maine, Nevada, New Hampshire, West Virginia, and New Jersey. At the same time, other states enacted permanent tax cuts or one-time tax rebates that reduced state revenues by more than one percent, including tax reductions in Idaho, Pennsylvania, Oregon, and Minnesota. It remains to be seen if these tax reductions will prove affordable if the economy continues to stagnate or declines.

In general, the economic slowdown appears to have elevated the level of debate regarding

***If a state's fiscal problems are a function of more serious problems, such as a long-term imbalance between the growth rate of revenue and the growth in the cost of basic programs, short-term budget fixes often delay the realization that difficult choices must be made.***

taxation. A few states with tax structures that are less responsive to economic growth have debated fundamental changes to their system of raising revenues. In Tennessee, for example, there was both substantial support and opposition for augmenting the state's traditional sales and property taxes with an income tax that is somewhat more progressive and more likely to mirror the overall growth in the economy. Budget shortfalls in North Carolina have prompted policymakers to consider proposals to close corporate income tax loopholes, add an additional income tax bracket for wealthy taxpayers, create a state lottery, and implement a state sales tax coupled with an earned-income tax credit to offset its regressive effects.

A number of states implemented spending cuts this year, either to balance their FY 2001 budgets or to close projected budget gaps in FY 2002 and 2003. In some cases cuts were targeted at "counter-cyclical" programs such as Medicaid, which tend to increase in cost as economic growth declines. Indiana and Kentucky both enacted budgets with Medicaid appropriations that were less than the estimated cost of providing services, forcing those states to consider cost-cutting measures for their Medicaid programs. Other states, including Ohio, Mississippi, and South Carolina, enacted broad, across-the-board spending cuts by applying a uniform percentage reduction to a variety of budget line items. Both these strategies run the risk of reducing vital services to vulnerable populations at the same time that economic circumstances make those services most needed.

Unforeseen revenue and budget shortfalls highlighted the need in a number of states for better budget information. While the weakening economy was a primary culprit in budget shortfalls, some states may have inadvertently over-reached in cutting taxes and increasing spending during the economic expansion of the 1990's, in part because they lacked long-range budget forecasts and revenue analysis that would have better revealed the ultimate cost of those policies to the state's bottom line. The creation and dissemination of more comprehensive, accurate budget information can contribute to a more informed public debate and allow for more prudent long-range tax and budget policy.

## Introduction

The tenor of state government finance has changed over the past year. Many states that experienced vigorous, sustained increases in tax revenue during the 1990s are now facing declining or even negative rates of revenue growth. As state fiscal climates change, so too do the strategies necessary for managing state budgets. While the focus of state fiscal policy in the mid-to-late 1990s may have been on balancing the need for investments and new programs with the desire to cut taxes and build state reserves, the weakening economy brings a new set of issues. State budgetmakers are challenged to maintain service levels for existing populations in an environment where expectations outweigh resources by a significant degree.

This paper provides an overview of state fiscal conditions and budget decisions in 2001, a more in-depth examination of how four states reacted to those conditions, and a discussion of some of the issues that state policymakers will face as they work to ensure that their states continue to meet their obligations to all citizens, including the most vulnerable, in leaner fiscal times.

## Current Status of State Fiscal Conditions

Many states experienced contentious budget deliberations in 2001, in some cases forcing legislatures into special sessions. Negotiations were hampered by fiscal pressures stemming from slowing revenue growth and unanticipated expenditures. Of the 48 states that considered budget legislation in 2001, seven were unable to pass FY 2002 budgets prior to the beginning of that fiscal year.[1]

### Revenues

The general trend among states has been a decline in the rate of revenue growth. At least 27 states revised their FY 2001 revenue estimates downward or did not meet expected revenue targets, while 21 states have lowered their initial revenue forecasts for FY 2002. Revenue forecast downgrades have been as small as $58 million (Arkansas) and as large as $4.6 billion (California) over a two-year period.

A recent report from the Rockefeller Institute of Government indicated that overall inflation-adjusted state revenue growth rates in the second and third quarters of FY 2001 were at the lowest levels in five years. Sales tax revenues grew at the lowest level since the last recession. In six states — Alabama, Maine, Michigan, North Carolina, Ohio, and Wisconsin — revenues during the first three quarters of FY 2001 actually declined from the same time period in FY 2000.[2]

A few states bucked the trend. Fast-growing states like Colorado and New Mexico, whose economies are less dependent on manufacturing, continue to experience strong revenue growth, while rising energy prices have increased revenues for resource-rich states including Alaska and Texas.

## Indiana Fails to Address a Structural Budget Deficit

At the end of FY 1999, Indiana had a year-end balance of over $2 billion. Equaling 23 percent of revenues, it was at that time one of the largest surpluses of any state. Since then, a combination of structural budget deficits, stagnant economic growth, and a lack of remedial action by policymakers has dramatically changed Indiana's fiscal outlook. The state's net fund balances will be virtually depleted by the end of FY 2003, with an ongoing deficit between revenues and expenditures of almost $600 million a year. The circumstances and decisions that led Indiana to this point are representative of the issues faced by many states in 2001.

The first signs of Indiana's current fiscal problems can be found in the budget passed for FY 2000 - 2001. That budget, combined with significant tax cuts, produced an imbalance between revenues and expenditures of $400 million per year. This was followed by a national economic slowdown that was particularly hard on the industrial Midwest. In December 2000, forecasters in Indiana cut their state revenue estimate for FY 2001, which in turn reduced expected revenues for FY 2002 and 2003. As a result, budget writers in the 2001 General Assembly were faced with the task of satisfying constituencies accustomed to the strong revenue growth of the 1990s in light of declining revenue growth and shrinking fund balances. An April update to the revenue forecast that further cut the estimate of FY 2001 - 2003 revenues made the situation more difficult. Governor Frank O'Bannon proposed an increase in cigarette taxes to close the budget gap, but the proposal received little legislative support.

The final budget compromise included no new revenue sources or significant spending cuts. Instead, it combined a series of fund balance transfers and payment delays with a Medicaid appropriation that fell short of projected expenditure needs to keep the state financially solvent through the end of FY 2003. The State Budget Agency's projection of revenues and expenditures for FY 2002 - 2003 shows a variety of one-time funds being depleted to shore up the general fund: $375 million from lottery and gambling revenues, $104 million from the state's Medicaid reserve, $175 million from a school funding reserve, and $53 million from the rainy day fund. Indiana also plans to delay $556 million in FY 2002 - 2003 payments to schools, universities, and local units of government until after the end of the biennium. Meanwhile, the Medicaid appropriation was set $140 million below the projected cost of providing services. Policymakers were, however, able to find room in the budget for $70 million in local pet projects for individual legislators.

Indiana is projected to end FY 2003 with a cash balance of $616 million and a delayed payment liability of $556 million - a net balance of $60 million. The next state budget cycle will begin with a deficit between ongoing revenues and ongoing expenditures of almost *ten times* that amount — $594 million. Citing the state's fiscal problems, the governor let the 2001 budget bill become law without his signature, and announced a seven percent across-the-board cut for many agency budgets in FY 2002.

The unwillingness of Indiana policymakers to address a yawning budget gap in 2001 may have serious long-term consequences for the state. Court-ordered restructuring of the property assessment system and mandated increases in Medicaid costs will add to the state's fiscal pressures. Other than delaying and adjusting a previous tax cut that had ballooned in cost, the 2001 General Assembly took no actions to remedy the state's long-range fiscal problems. Rather than use the fund balances accumulated during good times to facilitate the transition to long-term budget stability, policymakers pushed those decisions into future years where, absent a miraculous turnaround in revenue growth, the circumstances will be more dire. If a budget is a fiscal roadmap, Indiana appears to have charted a course directly toward a financial crisis.

The problem of slowing revenue growth has caused dissension among policymakers in some states with regard to the level of anticipated revenues. For example, while the New Jersey State Treasurer estimated that revenue collections for FY 2001 and FY 2002 would be $948 million below previous projections, the New Jersey Office of Legislative Services predicted a shortfall of $1.6 billion. No reconciliation was made between those estimates. In compliance with state law, the legislature used the treasurer's estimates for its FY 2002 - 2003 budget. If revenue collections turn out to be closer to the Office of Legislative Services projection, a mid-year correction may be in the offing.

In addition to revenue problems caused by the slowing economy, most states will lose revenue due to the recent tax cuts passed by the federal government. The federal tax cut includes a phased-out repeal of the estate tax, costing states approximately $6.5 billion per year once the impact is fully felt in 2005. Most states will begin to lose revenues as a result of this change in FY 2002 or 2003. Because most states rely on federal definitions of income as the starting point for their state income tax, the federal income tax cuts will also result in future state revenue reductions. In addition, the squeeze on federal domestic discretionary spending that may be necessary to finance the tax cuts may result in reduced grants to states over time.

## Expenditures

At the same time that state revenue growth is slowing, many states are experiencing expenditure growth that is higher than projections. A recent National Conference of State Legislatures report indicated that 31 states had expenditures above projections in FY 2001.[3] Medicaid cost overruns were reported in 23 states, while other states cited increased costs for K-12 education and corrections. A survey conducted by the National Association of State Budget officers reported an average growth rate in Medicaid expenditures of 9.8 percent in FY 2001.[4] A subsequent NCSL survey of 40 states that passed FY 2002 budgets reported an FY 2001 Medicaid growth rate of 14 percent. These rates are significantly higher than the rates of growth states have experienced in recent years.

***In addition to revenue problems caused by the slowing economy, most states will lose revenue due to the recent tax cuts passed by the federal government.***

As a response to declining revenue growth and rising expenditures, a number of states cut their FY 2001 budgets during the fiscal year. Three of the largest cuts were in North Carolina, Virginia and Alabama — $330 million, $470 million, and $264 million respectively.[5]

## Budget Surpluses and Deficits

For many states, the basic problem driving budget discussions in 2001 was an imbalance between revenues and expenditures. More money was going out of state coffers than was coming in, reducing the amount of future funds available for appropriations and driving down the level of current fund balances and reserves. A recent report indicated that 33 states saw their fund balances decline from FY 2001 to FY 2002. Aggregate state balances, including both general funds and rainy day funds, declined by 22 percent, while balances as a percent of spending fell from 11.4 percent to 8.2 percent.[6]

In these circumstances, it is often difficult to discern the nature of the problem that must be solved. Deficits may be *temporary* imbalances between revenues and expenditures caused by fluctuations in the business cycle, or *permanent* imbalances caused by a long-term gap between the projected increase in revenues and the projected cost of government services. Temporary imbalances related to the ups and downs of the economy are generally referred to as *cyclical* deficits. Permanent imbalances caused by tax systems that don't raise enough money over the long run to support expenditures are called *structural* deficits. Fiscal policies that might be appropriate for addressing cyclical deficits will not necessarily improve structural deficits.

Cyclical deficits or surpluses change from year to year, as the business cycle moves from expansion to stagnation or recession and back again. Structural deficits, on the other hand, have a number of possible causes, including:

- Revenue structures that are overly reliant on types of taxes with growth patterns that tend to lag behind the overall growth in the economy.

- Rapid growth in spending areas, often driven by population increases.

- Previous tax reductions or expenditure increases that were phased in over time, so that their true cost was not realized until years after passage.

- Unnoticed rapid growth in "tax expenditures" — tax breaks for specific groups that erode the revenue base and usually are not listed as state expenses along with budget line items.

The challenge states faced in writing budgets in 2001 was to evaluate whether the gap between revenues and expenditures was the result of a cyclical downturn or the result of an underlying structural deficit. Some states may be experiencing budget deficits that are both cyclical *and* structural in nature — the downturn in the economy is exacerbating a pre-existing, underlying revenue shortfall.

This distinction has broad implications for prudent fiscal policy. To the extent that states are simply experiencing short-term, cyclical budget deficits, the wisest course of action may be the implementation of temporary budget-balancing measures designed to bridge the gap between the current downturn and an anticipated recovery. On the other hand, if some or all of a state's budget deficit is structural in nature, its policymakers may have a more difficult set of choices to evaluate in moving the state to a position of long-term fiscal stability. While it is extremely difficult to quantify the degree to which a fiscal deficit in any given state is cyclical or structural, states that share some of the structural problems listed above are likely to have at least some structural component to their deficits. The probability that many states have some structural aspects to their deficits is useful to keep in mind as the actions states have taken to close their budget gaps are discussed in some detail in the next sections.[7]

***Some states may be experiencing budget deficits that are both cyclical and structural in nature — the downturn in the economy is exacerbating a pre-existing, underlying revenue shortfall.***

## 2001 State Tax and Budget Actions

As noted, the fiscal landscape for state fiscal actions in 2001 was characterized by declining revenue growth and increasing expenditure needs. The economic slowdown was more severe in some parts of the country than in others, and not all states were forced to implement measures to address budget shortfalls. For those that did experience problems, budget actions fell into three categories: short-term budget balancing measures, tax increases, and spending cuts.

### Use of Rainy Day Funds, Accounting Gimmicks, and Other Short-Term Measures

Politicians are generally reluctant to fix gaps between tax revenues and program expenditures by increasing taxes or cutting programs. As signs of fiscal stress first appear, they often

## Virginia : Phantom Revenues Allow Expensive Tax Cut to Occur

The 2001 legislative session in Virginia was marked by efforts to revise the FY 2001 - 2002 budget in light of declining revenue growth and increasing expenditure needs. The difficulties of budget reform were exacerbated by political pressure to continue implementing an expensive reduction in car taxes, and the state was ultimately unable to enact mid-biennium adjustments to the budget.

A legislative analysis released prior to the 2001 session showed revenue growth falling below projections while the need for expenditures in Medicaid and other areas exceeded appropriations. These problems combined to create a budget gap that would ultimately amount to $690 million. Virginia is also currently in the process of implementing a $1.2 billion phased-in reduction of its car tax. The reduction includes a "trigger" provision that was designed to delay implementation if revenues grow slower than estimates. The report of slower revenue growth meant that the car tax cut might have to be delayed. In light of these issues, Governor James Gilmore released a revised FY 2001 - 2002 budget in December 2000.

In order to balance the budget, continue the car tax cut, and fund $140 million in new spending, the governor's proposal included budget gimmicks, budget cuts, a plan to finance capital projects with debt instead of cash, and additional revenue sources. The primary budget gimmick was designed to keep the car tax cut on track by including $460 million in revenue from the proposed sale of the state's stream of future tobacco settlement receipts — a process called "securitization" — in the revenue estimate used to determine whether or not the phase-in of the car tax would continue. The governor's securitization plan was rejected by budget writers in both the House and Senate once the session began, but by that time the effect of including the securitization plan in the revenue estimate had already occurred; the next phase of the car tax cut was triggered on January 1, 2001. By contrast to the continuation of the car tax cut, a previously enacted phased-in reduction in the sales tax on food was halted because of the fiscal gap, despite the fact that it was far less expensive than the car tax cut and concentrated relatively more tax relief on lower-income taxpayers. Two state legislators subsequently filed suit against the governor, charging that the inclusion of securitization proceeds in the revenue estimate was unconstitutional.

The Virginia House and Senate were ultimately unable to agree on a revised budget proposal. Differences centered around continuation of the car tax cut, with the House pushing for full implementation while the Senate argued to scale back the cut due to the economic slowdown. Both the regular legislative session and a special emergency session concluded without a budget agreement. As a result, the state was forced to continue operating under the original budget containing the $690 million budget gap, which consisted of a $420 million revenue shortfall and $270 million of projected overspending on mandatory programs. No additional discretionary spending, such as pay raises for state employees and teachers, was enacted.

The governor then released a budget-balancing plan that addressed only the $420 million revenue shortfall; the plan did not include actions to address the $270 million in overspending. The governor's plan included $500 million in budget cuts ($80 million more than needed), over half of which affect agencies that provide critical services in the areas of affordable housing, community development, the environment, and public safety. The additional car tax cut, at a cost of $300 million per year, was not changed. Because no new budget was enacted, the governor's plan was implemented.

A recent analysis indicates that Virginia's fiscal problems may not be confined to the current biennium. A study released by the business group Virginia Forward in 1999 projected annual budget deficits as high as $3.5 billion by 2006. A recent update to the analysis raised that amount to $4.3 billion. Clearly, the fiscal challenges that were not met in 2001 may continue in Virginia for years to come.

turn instead to short-term measures to balance state budgets. To the extent that budget deficits are cyclical and relatively short-lived, these strategies can be an important component of stabilizing budgets and maintaining important public services. If the economic slowdown is prolonged or if the deficits are structural, however, short-term solutions can lead to long-term problems.

One of the first options states employ in the face of declining revenue growth is the use of money that has been set aside for precisely that reason, the rainy day funds. These funds have been created by most states in recognition of a basic fact of state fiscal conditions; while tax revenue growth tends to mirror changes in the economy, the need for state expenditures tends to grow more steadily. For example, the same number of children need to be educated whether the economy and revenues have slumped or not. In addition, the need for some state programs runs *counter* to changes in the business cycle. For example, welfare and social service programs may require *additional* funding as a slowing economy depresses earnings, employment, and revenues. Prudent use of rainy day funds and other fund balances can be an essential tool to maintaining needed services.

A number of states withdrew money from reserve balances in FY 2001, or plan to withdraw money from rainy day funds or other reserve accounts in FY 2002. Examples include the following:

- California's efforts to make up a $3.7 billion difference between general fund revenues and expenditures in FY 2002 include using balances carried forward from FY 2001 and transferring over $1 billion from various special funds to the general fund.

- Indiana subsidized its general fund with $52.6 million in interest that would have accrued to its rainy day fund, $375 million in unspent lottery and gaming funds, $175 million from a school funding reserve account, and $100 million from a Medicaid reserve account.

- Washington withdrew $52 million from its rainy day fund in FY 2001. In FY 2002 - 2003, Washington is projected to withdraw another $93 million from its rainy day fund, and utilize $439 million in general funds carried forward from FY 2001.

- Mississippi made an $85 million draw from its rainy day fund.

- Kentucky drew money from its rainy day reserve during FY 2001 and expects another draw in FY 2002.

- Ohio made a $150 million transfer from its rainy day fund, and authorized an additional $188 million transfer.

- Michigan withdrew $77 million from its rainy day fund in FY 2001 and plans to withdraw an additional $155 million in FY 2002.

The wisdom of using reserve balances depends on the nature of the budget deficit that is being supported. To the extent that they are used as designed — to offset *cyclical* deficits — fund balances and rainy day funds are of great benefit in stabilizing state budgets. On the other hand, if they are used to delay addressing *structural* deficits, fund balances can exacerbate long-term financial problems. For example, Indiana was

***Texas artificially reduced FY 2001 appropriations by moving a month's worth of Medicaid payments for nursing home care and other purposes from the last month of FY 2001 into the first month of FY 2002*.**

***Virginia circumvented a provision that made further car tax cuts dependent on adequate revenues by artificially inflating revenue estimates, triggering a car tax reduction that will put pressure on a weakening revenue stream.***

faced with a potential FY 2002 - 2003 budget in which expenditures exceeded revenues by over $1.2 billion. Policymakers cited a slowing economy as the culprit, and elected to use the one-time fund balances listed above. However, budget documents published at the end of the 1999 legislative session — before the economic slowdown — project a deficit between revenues and expenditures of $400.8 million in FY 2000 and $409.2 million in FY 2001. The fact that Indiana was consistently spending more than it was taking in *prior* to the economic slowdown indicates that its budget problems are both cyclical *and* structural.

Indiana's fund balances could have been used as a short-term revenue source to ease the pain of implementing a long-term budget-balancing solution involving enhanced revenues and reduced spending. No such reforms were enacted. As a result, Indiana is projected to end the FY 2002 - 2003 budget cycle with an annual gap between revenues and expenditures of $593.6 million. The annual revenue shortfall will be larger than in FY 1999 and FY 2000, while the state's total general fund balance, including rainy day fund reserves, will have declined from over 23 percent of revenues at the end of FY 1999 to only 0.6 percent of revenues at the end of FY 2003.[8] This is an example of fund balances being used to forestall difficult fiscal decisions, potentially increasing the severity of those choices in the future.

Another strategy that is employed in the face of fiscal crisis is the use of one-time budget "gimmicks" that artificially enhance revenues or decrease expenditures for the purpose of improving financial statements or complying with balanced budget requirements. For example:

- In 1999, Texas artificially reduced FY 2001 appropriations by moving a month's worth of Medicaid payments for nursing home care and other purposes from the last month of FY 2001 into the first month of FY 2002, with the expectation that the gimmick would be reversed by the 2001 legislature. However, declining revenue growth created a tight fiscal climate in 2001, and Texas was unable to undo the gimmick as planned. Instead, the delayed payment was implemented again, for FY 2003. The next legislature in Texas will be forced to account for these delayed costs.

- Indiana made regular appropriations to schools and universities for FY 2002 and 2003, but plans to delay $556 million of those payments until some time after the end of FY 2003. If a robust economic recovery does not occur by the time those payments come due, Indiana will be hard-pressed to make the delayed payment along with its normal school aid.

- Virginia circumvented a provision that made further car tax cuts dependent on adequate revenues by artificially inflating revenue estimates, triggering a car tax reduction that will put pressure on a weakening revenue stream. As a result, two state legislators filed suit against Governor James Gilmore, charging that the inclusion in the revenue estimate of assumed proceeds from the sale of future tobacco settlement proceeds — a sale that never actually occurred — was unconstitutional.

- Iowa borrowed $40 million from a tobacco settlement-funded health care endowment to pay for a raise in teachers' salaries. Next year, the legislature will have to look elsewhere for continued funding for this pay level, a task that will be especially difficult if the economy remains weak.

- New Hampshire's Senate voted to increase its revenue estimate by $60 million in order to "balance" its budget, even though it had no economic basis for increasing revenue projections. While Governor Jeanne Shaheen objected the increased estimate, the final enacted budget reflected the Senate revenue amount.

- Tennessee's legislature passed a budget bill that applied $560 million of tobacco fund revenues to the FY 2002 budget. Citing this use among other reasons, the governor of the Tennessee vetoed the budget bill. The veto was subsequently over-ridden.

- Wisconsin sold future tobacco settlement receipts for an up-front payment of $1.3 billion, of which $450 million will be used to cover ongoing expenses in the biennial budget. This action will deprive Wisconsin of the flow of tobacco settlement revenue in future years.

- Maine deferred the distribution of reimbursements for business personal property taxes.

Some would argue that most budget gimmicks are meaningless in the long run — the revenues and expenditures will eventually occur, one way or the other. But the decisions made as a result of the gimmicks are not meaningless — they serve to give the appearance of additional resources, enabling states to make tax and spending decisions that would have otherwise been "unaffordable." In order to maintain long-term fiscal stability, states must balance the short term benefits of these strategies, such as immediate funding for education and human services, with the longer-term consequences.

While the use of short-term measures may be appropriate to avoid severe cuts to necessary programs, state policymakers can reduce future problems by reversing those measures in the future. For example, Minnesota reversed a previously enacted budget gimmick by repealing an accelerated sales tax collection provision. When gimmicks are used, policymakers should consider putting in place measures to reverse the gimmicks at a set time in the future. This can prevent a temporary measure from developing into a standard procedure.

Alternatively, temporary tax increases could be used in place of these types of gimmicks to cover short-term gaps in revenue. Temporary tax increases are more "transparent" than many of these budget gimmicks and can easily be set to expire at a specific time in the future.

## Tax Policy: Short-Term and Long-Term

For some states, the use of fund balances and temporary budget gimmicks was not enough to balance the budget. They were faced with the need to make changes to revenue streams and program expenditures. While raising taxes is never easy from a political standpoint, some states were able to do so in 2001. Tax changes took the form of both short-term policies, which can include one-time rebates of unanticipated revenues or temporary tax increases to cover budget shortfalls, and long-term policies, which encompass permanent changes to state tax structures.

At least seven states implemented tax increases that will increase operating revenues by at least one percent:

- In November 2000, Arizona voters approved a sales tax increase of 0.6 percent, raising $480 million per year for education.

- Indiana scaled back and temporarily suspended a new business property tax credit that had vastly exceeded expected costs, saving $280 million over two years.

## How Today's Budget Gimmick Creates Tomorrow's Budget Crisis

Some states chose to balance their budgets in 2001 by employing budget gimmicks such as the delay of state expenditures from one fiscal year into the next. The following example demonstrates how such actions can create serious budget problems in the future.

Consider a hypothetical state with a balanced FY 2001 budget, in which both revenues and expenditures equal $1 billion. In this example, when the state begins to put together its FY 2002 budget, spending needs are projected to increase by five percent from FY 2001. Next, assume that the recent economic slowdown has reduced projections of revenue growth to only two percent during that same time period. Thus, the state is projected to need a five percent increase in spending in FY 2002, for a total of $1.05 billion, but it will receive only a two percent increase in revenues, for a total of $1.02 billion. The state has a budget gap equal to the difference between $1.05 billion and $1.02 billion, or $30 million.

Rather than find new revenues or cut spending, the state chooses effectively to budget $1.05 billion in spending for FY 2002, but actually delay $30 million in FY 2002 expenditures until FY 2003. Such a delay could be accomplished in a number ways, such as moving a regular monthly payment to local governments from the last day of FY 2002 to the first day of FY 2003. This has the short-term effect of reducing FY 2002 expenditures to $1.02 billion. On paper, expenditures are equal to revenues for the year. How will this strategy affect the formulation of the following year's budget, FY 2003?

If expenditure needs continue to increase by five percent per year, the FY 2003 budget will be five percent greater than the FY 2002 budget of $1.05 billion, equaling $1,102,500,000. The need to make the delayed payment from FY 2002 will add $30 million to that amount, for a total FY 2003 budget of $1,132,500,000. Thus, for the FY 2003 budget to balance, revenues would need to grow from $1,020,000,000 in FY 2002 to $1,132,500,000 in FY 2003, *an 11 percent increase*. The annual growth rate of state revenues would have to be *more than five times greater than the previous year*, increasing from two percent in FY 2002 to 11 percent in FY 2003. Such an increase is highly unlikely.

If revenue growth rates do not rebound in FY 2003, and instead stay at the two percent level, FY 2003 revenues would equal only $1,040,400,000. The FY 2003 difference between revenues and needed appropriations would be $92.1 million. In this case, the annual budget gap would *more than triple* from $30 million in FY 2002 to $92.1 million in FY 2003.

Clearly, budget gimmicks such as payment delays can lead to serious fiscal problems in future years. Instead of such gimmicks, state policymakers should consider more responsible short-term alternatives, such as using rainy day funds or enacting temporary tax increases.

| | **FY 2001** | **FY 2002** | **Percent Change** | **FY 2003** | **Percent Change** |
|---|---|---|---|---|---|
| Needed Budget | $1,000,000,000 | $1,050,000,000 | 5% | $1,102,500,000 | 5% |
| Payment Delay | $ 0 | ($ 30,000,000) | | $ 30,000,000 | |
| Actual Spending | $1,000,000,000 | $1,020,000,000 | 2% | $1,132,500,000 | **11%** |
| Revenues | $1,000,000,000 | $1,020,000,000 | 2% | $1,040,400,000 | 2% |
| Balance | $ 0 | $ 0 | | **($ 92,100,000)** | |

- In order to fund ongoing obligations in its operating budget, Maine raised its cigarette tax by 20 cents per pack (from 74¢ to 94¢) and the prepared food sales tax by two percent (from five percent to seven percent).

- Nevada is increasing corporate filing fees and rental car fees, raising $52 million over two years.

- New Hampshire increased the business enterprise, business profits, and intrastate communications services tax rates, adding $170 million to revenues over the biennium.

- West Virginia will tax video poker machines, raising at least $72 million per year.

- New Jersey passed both tax increases and tax cuts in 2001. It closed an income tax loophole related to limited liability partnerships and corporations, increasing revenues by $840 million over two years. Partially offsetting this revenue increase was an acceleration of the ongoing New Jersey Saver Rebate for property tax payers, and an increase in the maximum homestead rebate for the elderly and disabled from $500 to $750. The combined cost of these tax cuts over the biennium is projected to be $588 million, leaving a net tax increase of $252 million.

A number of other states passed tax smaller tax increases on items including cigarettes, motor fuel, food, and alcoholic beverages.

While the general focus of state budget policy in 2001 was on closing the gap between revenues and expenditures, some states continued to implement cuts in certain taxes. This is reflective of how the economic slowdown has affected states to different degrees across the nation, and also of a desire in some areas to continue tax cuts despite fiscal difficulties. In some cases, states provided one-time tax rebates of funds that had accumulated early in the FY 2000 - 2001 biennium, before revenue growth began to decline. States that enacted permanent tax cuts or temporary tax rebates that reduced state revenues by at least one percent include the following:

- Idaho reduced revenues by $95 million, primarily through cuts in corporate and personal income tax rates.

- Pennsylvania's tax cuts of $235 million per year will lower the capital stock and franchise tax and increase the number of low-income families exempt from the personal income tax.

- Oregon's "kicker" law (see description below) will result in a $255 million one-time tax rebate.

- Minnesota enacted both a one-time $791 million sales tax rebate and a $949 million property tax cut that will reduce taxes by more than 10 percent for all property types.

The scope and diversity of state tax policy implemented in 2001 highlights one of the byproducts of tight fiscal times — states are often more likely to engage in discussions of tax changes when their tax structures are not producing sufficient revenue growth to maintain spending. For example, there was vigorous debate in Tennessee in 2001 regarding the possibility of creating a new state income tax.

Tennessee's revenue growth during the economic expansion of the 1990's lagged behind that of many other states. One reason that was identified for the state's slow revenue growth was its tax structure, which currently includes a high sales tax and no income tax. Sales taxes can be attractive politically — they raise large amounts of revenue, and they feel less coercive than income taxes, because people only have to pay them when they affirmatively decide to buy something. However, sales taxes have significant drawbacks. Because the sales tax is levied primarily on goods and not services in most states, it only captures a limited, declining share of total economic activity. Thus, the revenues it

***The closeness of the vote and the intensity of the debate in Tennessee show how fiscal crises increase the potential for significant tax policy change.***

generates lag behind the overall growth in state economies.[9]

Since economic growth results in a need for increased state expenditures in order to cover the rising costs of providing the same quality and quantity of services each year, it is important that state revenue structures are as responsive to economic growth, as measured by personal income growth, as possible. Otherwise, sizeable gaps between expenditures and revenues can appear. For a state's revenue structure to grow at the same rate as personal income, it must include taxes such as an income tax that grow at the same or greater rather than personal income and offset the weaker growth of other revenue sources. Compared to the sales tax, other tax options, such as income taxes, have the advantage of providing more robust long-term revenue growth and of increasing the progressivity of a state's overall tax structure.

Some lawmakers recognized that a reformed tax structure could alleviate Tennessee's fiscal problems. Governor Don Sundquist proposed a flat 3.75 percent income tax, but political opposition to implementing an income tax was strong. After coming within a handful of votes of passing an income tax, the Tennessee legislature ultimately concluded its budget deliberations without creating a significant new revenue source, relying instead on tobacco settlement revenues to balance the budget. That budget was vetoed by the governor, but the veto was subsequently overridden by the legislature. The closeness of the vote and the intensity of the debate in Tennessee show how fiscal crises increase the potential for significant tax policy change.

Slowing revenues have also caused policymakers to re-examine the wisdom of "automatic" tax changes. The current experience in Oregon demonstrates why statutory tax rebates can hinder states in prudently managing the transition from strong to weak growth in revenues. Even though Oregon predicts declining revenue growth in FY 2002 - 2003 and beyond, it is rebating unanticipated revenues above the amount forecast two years earlier that were collected in the FY 2000 - 2001 biennium. All the revenues above the forecast are "kicked" back to taxpayers if the revenues exceed the forecast by two percent or more. The automatic tax cut — known as the "kicker law" — prevents Oregon from saving those funds for a rainy day. Changing fiscal times highlight the need for informed management rather than reliance on tax rebate "triggers" that lag real-world circumstances.

### Expenditure Policy

Some states chose spending reductions as a means to close their budget gap. Policymakers were generally reluctant to implement steep spending cuts, given the uncertain nature of the economic slowdown. Nevertheless, the overall level of appropriation growth in FY 2002 was significantly lower than in 2001.[10]

To the extent that budgets were cut, a popular budget cutting strategy was the use of uniform, across-the-board reductions in budget line items. This approach gives an appearance of fairness, but at the expense of the kind of good government that comes from thoughtful decision-making. If budgeting is defined as the allocation of resources based on a rational consideration of needs and priorities, uniform across-the-board cuts can be characterized as essentially the *absence* of budgeting. Despite these drawbacks, some states implemented broad-based spending cuts for FY 2002.[11]

- Mississippi's governor, who cut spending in FY 2001, asked state agencies to spend

## Texas Revenues Unlikely to Meet Future Service Needs

The revenue structure in Texas is disproportionately reliant on the sales tax. As a result, state revenues in Texas consistently lag behind economic growth in the state, as measured by personal income. Combined with the effects of recent tax cuts, slow revenue growth will make Texas hard-pressed in the future to support adequate public services for a rapidly growing population.

Texas was among the many states that cut taxes during the recent period of strong state revenue growth. The 1997 and 1999 Texas legislatures implemented tax cuts that reduced projected revenue in FY 2002 - 2003 by $2.6 billion. The FY 2000 - 2001 budget included a Medicaid appropriation that was $550 million lower than actual costs, and was further artificially reduced by moving regular payments for nursing homes and other services from the last month of FY 2001 to the first month of FY 2002. Meanwhile, the Texas comptroller's official revenue forecast projected that state economic output would drop from an average annual growth rate of 6.4 percent per year in 1998 - 1999 and 5.4 percent in 2000 - 2001 to 4.1 percent in 2002 - 2003. Policymakers writing the FY 2002 - 2003 budget were constrained by slowing economic growth, lower tax revenue growth, and the need to first compensate for the shortfall in appropriations for FY 2001.

The starting-point budget proposal released by the Legislative Budget Board in January 2001 reflected the limited availability of resources; it increased general revenue expenditures by only 5.4 percent over two years. Public education was increased only 1.4 percent, while economic development was cut 0.7 percent. A revenue update issued by the comptroller in May noted that seven of ten leading economic indicators in Texas pointed toward a weaker economy. The final budget compromise funded a modest increase in higher education and created a state health insurance subsidy for public school employees, but little else. Non-pension state expenditures for public schools actually declined, continuing a trend of pushing a larger share of education costs onto the local property tax. Despite limited funds, another tax cut was passed. Delayed until after the end of the biennium, it will cost $1.6 billion from FY 2007 - 2011.

In the long run, the Texas budget is fundamentally hampered by an imbalance between the growth of revenue and the need for expenditures. Unlike most states, Texas has no income tax, relying instead on a relatively high sales tax. Because sales taxes apply to only a fraction of economic activity, they tend to grow at a slower rate than the economy as a whole. The Austin-based Center for Public Policy Priorities, a non-profit organization, estimates that the state would generate an additional $9.8 billion in the FY 2002 - 2003 biennium if its revenues had grown at the same rate as personal income since 1994. The state's own House Research Organization noted that the FY 2002-2003 biennial revenue projections fall $1.5 billion below the amount necessary for appropriations to keep pace with personal income growth.

The revenue problem is coupled with a budget problem; demographic trends point to a continually increasing population in Texas, with a commensurate need for additional services for education, health, public safety, and infrastructure. A Legislative Budget Board report projects that annual K-12 student enrollment will increase by over 544,000 students between 2001 and 2009. It also projects 77,000 more students in public universities, 48,000 more aged and disabled persons and 145,000 more children on Medicaid, and 20,000 more inmates in prison.

While Texas does not appear to face the possibility of an immediate fiscal crisis, its future fiscal outlook is not good. The state already ranks among the bottom of all states in terms of per-capita public expenditures. If policymakers fail to change the revenue system, public services in the future may decline from their already-low level, rather than improve.

***Some states have employed the risky practice of budgeting funding for human services programs at a level below forecasts of actual costs.***

no more than 95 percent of their allocation for the first half of the FY 2002 budget.

- South Carolina implemented a one percent budget cut for many state agencies.

- Ohio implemented a 1.5 percent budget cut that excluded some expenditures on education, public safety, and mental health.

- Indiana's governor announced across-the-board seven percent cuts for many programs in FY 2002.

- Trying to soften a $300 million revenue shortfall, the governor of Iowa announced a four percent cut of state positions through early retirements, elimination of vacancies, and layoffs.

Some states have also identified human services programs as prime candidates for reduction, particularly the Medicaid program. Human services programs are counter-cyclical. They often appear to be contributing to fiscal crises because declining economic circumstances increase the need for these programs and their cost just as the declining economy dampens revenue growth. Human services programs may also enjoy less political support than programs that serve a broader base of taxpayers, such as K-12 education. Some states have employed the risky practice of budgeting funding for human services programs at a level below forecasts of actual costs. Indiana under-funded its Medicaid appropriation compared to estimates of the cost of continuing current services by $140 million over the FY 2002 - 2003 biennium. This may force consideration of program cuts during the year. Medicaid expenditures in Kentucky are projected to exceed appropriations by $280 million over the biennium. As a result, Kentucky has implemented a moratorium on most new health care spending and will not give Medicaid providers an annual rate increase.

Not all states were forced to slow the rate of spending growth. A few states that have not been hurt by the economy or that have raised taxes to support spending continued to implement new initiatives and program expansions:

- Hawaii increased its FY 2002 general fund budget by 11.9 percent over FY 2001.

- New Mexico increased its general operations budget by approximately 10 percent in FY 2002.

- The Rhode Island FY 2002 budget is 9.8 percent larger than FY 2001.

- Maine increased the income eligibility level for its CHIP program, Cub Care, from 185 percent of the federal poverty level to 200 percent of the federal poverty level.

## Budget Transparency

States employed a variety of approaches to balancing budgets in 2001, but none of those strategies were easy to implement. As policy-makers were confronted with the reality of a tight fiscal environment and forced to make difficult choices, many questions were raised about the circumstances that led to the fiscal situation. Legislators accustomed to dividing large revenue gains among constituents wondered how their state's fiscal conditions could have changed so quickly. In many cases, sufficient information did not exist to provide satisfactory answers. Many states do not provide citizens, advocates, and lawmakers with sufficient access to accurate, timely, meaningful information regarding tax and budget issues.

States that provide such information can be said to have budget processes that are *transparent*, meaning that the people have a clear

## Minnesota: Long-Term Cost Estimates Allow Evaluation of Affordability

While Minnesota experienced the declining rates of revenue growth felt by many states in 2001, it was still able to implement both one-time and permanent tax cuts within the context of a long-term balanced budget. Nevertheless, reaching the final budget was contentious, and some observers felt that the continued emphasis on tax reductions came at the expense of needed investments in public services.

In each year from 1997 to 2000, Minnesota implemented tax cuts ranked among the ten largest nationwide. The 2001 legislative session began with proposals for more of the same. Forecasters projected a $924 million surplus for the end of the fiscal year, which Governor Jesse Ventura proposed to be used exclusively for a one-time sales tax rebate. The governor's fiscal package also included permanent cuts in income, property, and sales taxes. His spending proposals were much less ambitious, limited to a two year increase of $709 million — less than the $737 million his Department of Finance had identified as being necessary to accommodate a two percent annual adjustment for inflation.

A February downgrade to the FY 2002 - 2003 revenue forecast made budget decisions more difficult. The House and Senate sparred over the relative size of spending increases and tax reductions, and the budget debate dragged into a special session. As the end of the fiscal year grew near, the possibility of a government shutdown increased. Finally, a compromise was reached on June 28. It included a one time sales tax rebate of $791 million and a permanent net property tax cut of $949 million. The property tax reduction replaced the state-directed general education levy with state funds, reduced property tax levies, and enhanced an existing property tax circuit-breaker for homeowners. The cuts were offset by $592 million in revenue from a new statewide property tax on businesses, the future growth of which would be dedicated to education. Spending increases were modest; programs in the "family and childhood education" budget category received no additional general fund money.

The 2001 tax reduction continued a trend of aggressive tax cuts in Minnesota. When the tax cut passed in 2001 is fully implemented in FY 2004 - 2005, it will reduce state general fund revenues by $1.95 billion over two years, using up 75 percent of the projected budget surplus of $2.61 billion. If declining economic growth continues and revenues fail to meet forecast amounts, these tax reductions may cause fiscal difficulties. The state economist sounded a cautious note in the announcement of the 2001 sales tax rebate, saying, "...the national numbers are not looking good....don't count on a rebate check in 2003."

It is important to note, however, that in cutting taxes Minnesota used sound budget management practices. The sales tax rebate was made in the context of the short-term cyclical budget surplus. While the state might have been better served by saving those one-time funds to protect against future revenue downturns, the state is not obligated to grant similar reductions in the future if excess funds fail to appear. The permanent tax reductions, on the other hand, were made in the context of the long-term structural surplus, which takes into account projected revenue growth and program costs. By distinguishing between windfall revenues and ongoing surpluses in varying the permanency of tax reductions, Minnesota has lowered the chance of debilitating fiscal crises. Minnesota also enjoys the benefits of a progressive income tax, which is more responsive to growth in the economy than sales or property taxes. And it showed responsibility in reversing a previously enacted budget gimmick involving accelerated sales tax collections.

Minnesota's recent focus on tax reduction as the first option for use of new tax revenues generated by strong economic growth may be at odds with those who would prefer that a greater percentage of available dollars be dedicated toward improving government services. But its disciplined approach to budgeting in assuring the long-term affordability of tax and spending decisions should serve as a model for other states to follow.

view of the fiscal choices before them and the consequences of the decisions that are made. A transparent process facilitates discussion of the costs and benefits of government programs, allows long-term analysis of the effect of tax changes on the state's balance sheet, and gives lawmakers the ability to make rational, informed decisions on behalf of their constituents.

A comparison of two states highlighted in this report provides a useful illustration of budget transparency. Minnesota and Indiana are both located in the Midwest and have similar population size. Their approaches to budgeting, however, differ substantially. Minnesota utilizes a four-year timeframe for analyzing budget proposals, a timeframe that includes projections of future inflation and population growth in estimating government spending. Proposals to increase expenditures and reduce taxes are considered in the context of the state's structural budget surplus — the long-term difference between revenues and needed expenditures. Minnesota also itemizes the cost of previous tax cuts in a biennial "tax expenditure report." These measures help ensure that tax and spending decisions made in the present don't undermine the state's fiscal condition in the future.

Indiana, on the other hand, uses only a two-year revenue forecast window, without long-term expenditure projections that take into account specific demographic changes. Tax cuts passed in 1999 were based not on the expectation of a long-term structural surplus but simply on the year-end balance in the general fund. The governor stated at the time that the standard for fiscal prudence in tax cutting would be maintaining a specific threshold general fund balance at the end of the biennium. Indiana also fails to provide any tax expenditure reporting.

Minnesota's budget process is significantly more transparent than Indiana's; lawmakers and the general public have more information about the consequences of tax and budget policy choices, and the information is presented over a longer time frame. While budget transparency is by no means the only factor influencing state fiscal conditions, it is worth noting that Minnesota was able to fund both a one-time sales tax rebate and a permanent property tax cut for FY 2002 - 2003, while Indiana struggled with a serious budget shortfall.[12] To the extent that states identify a lack of budget transparency as either a source of budget difficulties or an impediment to their resolution, they may wish to implement budget process reforms that will ensure better information and analysis in the future.

***Many states do not provide citizens, advocates, and lawmakers with sufficient access to accurate, timely, meaningful information regarding tax and budget issues*.**

## Conclusion

The economic slowdown of 2000 and 2001 followed a period of sustained, robust growth in state revenues. Many state policymakers confronted the consequences of declining economic growth for the first time. The variety of strategies employed by states in light of these circumstances reflects the diverse nature of state fiscal structures and political philosophies. Most states faced several crucial public policy issues in formulating fiscal policy. States had to determine if budget shortfalls were the result of short-term economic circumstances or long-term structural imbalances between revenues and expenditures. Given their evaluation of that issue, they then had to decide whether the appropriate response was found in short-term budget balancing measures, tax increases, or cuts in expenditure growth. Some states appear to have resolved these issues prudently; others may face more difficult decisions in the future. To the extent that the current economic slowdown continues, state fiscal actions in 2001 will provide valuable lessons for future state policymakers as they work to maintain fair, responsive, and effective systems of taxation and government service.

## Notes:

1.  The fiscal year in 46 states begins on July 1 and ends on June 30.  Fiscal years in Alabama and Michigan begin on October 1 (the same as the federal government), in New York on April 1, and in Texas on September 1.  The year designates the calendar year in which the fiscal year ends; hence, fiscal year 2001 in most states began on July 1, 2000 and ended on June 30, 2001.

2.  Rockefeller Institute of Government, *State Revenue Report June 2001*

3.  National Conference of State Legislatures, *State Fiscal Outlook for 2001: February Update.*

4.  National Association of State Budget Officers, *The Fiscal Survey of States June 2001*.  Costs are being driven by factors including higher enrollments and increased price and utilization of prescription drugs.

5.  Ibid.

6.  National Conference of State Legislatures, *State Budget and Tax Actions 2001.*

7.  A recent study of state finances identified structural deficit issues of varying degrees in most states. National Education Association Research, *The Outlook for State and Local Finances*, 1998.

8.  Indiana State Budget Agency, General and Property Tax Replacement Fund Combined Statement of Net Actual and Estimated Unappropriated Reserve, FY 2001 - 2003.

9.  Sales taxes also place a disproportionate burden on people who can afford least afford to pay taxes. Lower-income people pay a higher percentage of their income in sales taxes than do upper-income people, making the sales tax regressive.

10.  National Conference of State Legislatures, *State Budget and Tax Actions Preliminary Report 2001.*

11.  Budget amounts are collected from a variety of sources, including state budget documents and media reports.  Budget changes cited here include both nominal changes from previous appropriations and changes relative to proposed or baseline current services budgets, depending on how each state reports its changes.  Thus, caution should be exercised in comparing the actions of one state with another.

12.  It should also be noted that revenues generated by Minnesota's tax system, with its multiple rate, progressive income tax, grow somewhat more rapidly relative to the economy than tax revenues generated by  Indiana's tax system, which has a flat rate income tax.