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Revised November 8, 2006

STATE BUDGETS: ON THE EDGE?

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Summary

States are in considerably better fiscal shape than they have been since 2001. State revenues have grown rapidly over the last year, in marked contrast to the sluggish growth or declines in revenues between 2001 and 2004. For many states, however, a return to budget deficits may not be long in coming. Fiscal conditions appear unstable in at least 24 states, and in 12 of these states — home to about one-third of the nation's population — budget deficits had to be closed in Fiscal Year 2007 or are projected for later years. Many states risk a rapid return to deficits unless they recognize that some of their current "surplus" revenues are only temporary and thus should not be used to fund ongoing tax cuts or spending increases.

Of the 24 states facing potential budget trouble:

- Three states (**Michigan**, **New Jersey**, and **Rhode Island)** did not share in the general state fiscal health of the last year. Unlike the vast majority of states, these states faced projected FY 2007 deficits. These gaps were closed in the adopted budgets. Nevertheless, the underlying fiscal problems in these states compounded by the effect of new or accelerated tax cuts in Rhode Island and Michigan leave them at risk.

- Nine states (**California**, **Connecticut**, **Maine, Maryland**, **New Mexico**, **New York, South Carolina, Vermont,** and **West Virginia.)** are projecting deficits for years beyond 2007. Three of these states also would be showing a deficit for 2007 if they were not using surpluses from the current or previous fiscal year to fill in the gap between projected revenue and projected expenses for 2007. (See Table 1.)

- Another twelve states (**Arizona, Illinois, Iowa, Minnesota, Nebraska, North Carolina, Ohio, Oklahoma, Oregon, Texas, Washington** and **Wisconsin**) are similarly in precarious fiscal condition because of inappropriate use of one-time funds for tax cuts or ongoing expenditure increases, enactment of back-loaded tax cuts, or similar problems that affect the state's longer-term fiscal health.

TABLE 1A: 9 STATES WITH PROJECTED GAPS FOR FY2008 AND BEYOND				
	Amount in millions (Percent of General Fund)			**Source**
California	$4,600.00 4,800.00	(4.6%) (4.6%)	FY08 FY09	Legislative Analyst's Office
Connecticut	$359.6 536.1	(2.3%) (3.4%)	FY08 FY09	Office of Fiscal Analysis
Maine	218.4 314.7	(7.3%) (10.3%)	FY08 FY09	Office of Fiscal and Program Review
Maryland	$1,094.0 $1,359.0	(8.1%) (9.6%)	FY08 FY09	Department of Legislative Services
New Mexico	$4.0 $152.6	(0.1%) (2.9%)	FY08 FY09	Legislative Finance Committee
New York	$3,166.0 $5,405.0	(6.2%) (10.3%)	FY08 FY09	Division of Budget
South Carolina	$296.5 $402.0	(4.9%) (6.4%)	FY08 FY09	Office of State Budget
Vermont	53.1	(1.8%)	FY08	Governor's Budget
West Virginia	+$53.3 $138.2	+1.3% (3.4%)	FY08 FY09	Department of Revenue

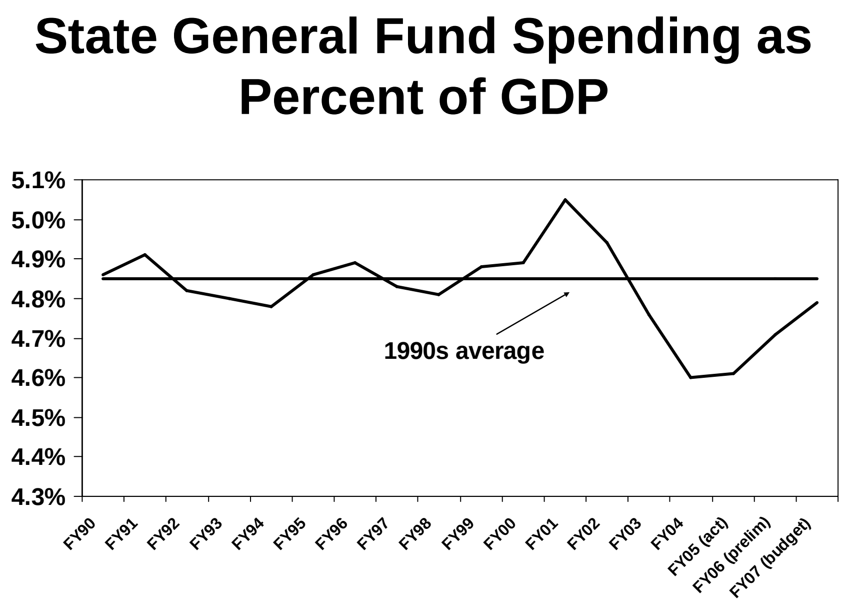
Some states that do not appear on this list may also face deficits beyond 2007. Many states do not project or publish estimates of future-year surpluses or deficits and it this is difficult to assess their long-term fiscal health.

The 24 states identified here have a variety of problems. **Maryland, Michigan** and **New Jersey** are feeling the effects of past tax reductions that have proven to be unaffordable, as well as a number of past years in which on-going expenditures or new programs were based on one-time or unsustainable revenue streams. **California, Connecticut, Maryland, Oklahoma, Nebraska, New York, Texas**, **Washington** and **Wisconsin** are using one-time funding sources or surpluses to fund ongoing tax cuts or expenditure increases, and so may find themselves in a similarly difficult fiscal position in the future. **Arizona, Iowa, Michigan, Nebraska, New York, Ohio, Oklahoma and Rhode Island** have enacted tax cuts that are being phased in over a number of years. While revenues are sufficient to balance the FY 2007 budget, problems are likely to develop when the state faces the full costs of the tax cuts in future years.

Connecticut, Illinois, New Jersey, and **Oklahoma** have used underfunding of state pension obligations as a way to balance operating budgets. These obligations ultimately have to be made whole, potentially creating holes in future budgets. **Maryland** a number of years ago passed a costly education reform that is phasing in without any revenue stream to support it. These and other fiscal problems of the 24 states are detailed below.

The budget surpluses states reported for FY2006 and FY2005 can give the misleading impression that a state's fiscal health is strong — and that new tax cuts or expenditures are affordable — when this is not the case. Mid-year surpluses occur when revenues come in stronger than the state

FIGURE 1



Source: CBPP calculations of NASBO, BEA, and CBO data, FY06 and 07 growth based on preliminary results of CBPP survey

estimated when the budget was enacted; the presence of a surplus does not mean that a state has an ongoing revenue stream that exceeds funding needs. When such one-time surpluses are used to fund core budgets, or used to justify expenditure increases or tax cuts, states generally are creating deficits in future years.

These current and projected deficits, and the budget actions that could endanger future fiscal health, come against the backdrop of many states that have never fully recovered from the recent fiscal crisis. State expenditures fell substantially relative to the economy during the recession, and they still have not been restored; expenditures remain below their average during the 1990s. (See Figure 1.) In over half the states, general fund spending for FY 2007 — five years into the economic recovery — remains below pre-recession levels as a share of GDP. A significant portion of state reductions in education funding, higher education, health coverage, and child care that were made during the downturn have remained in effect. There is a need in a number of states for restorations of these important public services and programs — arguably before states contemplate further tax reductions — but it is important that the restorations take place in a fiscally responsible and sustainable manner.

States' Actions Will Determine How Soon Their Fiscal Health Is Restored

Some factors that are endangering states' fiscal health — such as local economic doldrums or reduced federal assistance — are out of the control of state policymakers. But state policy influences many aspects of state fiscal conditions.

- States can distinguish between on-going revenue streams and temporary or one-time revenues or surpluses. States should support their ongoing budgets with ongoing revenues. One-time funds can be used for one-time expenditures, such as capital improvements, or can be placed in rainy day funds to be used in the next economic downturn.

- States that need to restore service reductions made during the fiscal crisis or to increase expenditures to meet emerging needs such as education funding reform should assure that an on-going revenue stream is available to support the additional expenditures.

- States that need to close a current or projected deficit should consider all of their options, including increasing ongoing revenues. States that enacted deep tax cuts in the late 1990s and early 2000s should be particularly concerned about whether they currently have a revenue stream that can sustain an appropriate level of expenditures.

- States that used delays in payments, accelerations of tax collections, or other "gimmicks" to balance their budgets during the recession could use surpluses or one-time revenues to finance a return to normal practices. This will make for more transparent budgeting that correctly matches the timing of revenues and expenditures. And it also would leave open the possibility of using the timing-shift mechanism again at some time in the future if circumstances make that necessary.

- States should maintain adequate rainy day funds to reduce the use of severe budget cuts and "gimmicks" during economic downturns.

- States should avoid enacting multi-year phase-ins of tax cuts or of large expenditure increases; it is difficult to predict future fiscal conditions, and such multi-year phase-ins often assume overly optimistic scenarios of future ability to pay for them. Alternatively, such phase-ins could have "triggers" to stop them when they are unsustainable under current fiscal conditions.

- States should avoid using employee pension funds as a "bank" from which they can borrow — either directly or by delaying payments — during economic downturns. The pension funds always have to be repaid, and states rarely have enough revenue growth to make the repayments in future years without causing other budget disruptions. Particularly now, with the population aging and pension costs increasing, states will have great difficulty in compensating for missing funding.

Budget Gaps Projected in Survey of Legislative Budget Offices

A recent survey of legislative fiscal directors confirms the uncertainty of the future fiscal health of the states. In March 2006, the National Conference of State Legislatures surveyed state legislative fiscal offices. As part of this survey they asked if the state was projecting a gap between ongoing revenues and ongoing spending in the near future. This survey found that almost half the states estimate that available revenues will fall short of projected expenditures in one or more of those years — FY2007, FY2008 or FY2009. [a] (Of the remaining states, nine states do not prepare out-year projections or did not respond while some 18 states reported that they do not expect gaps in FY2008 or FY2009.)

[a] State Budget Update, March 2006, National Conference of State Legislatures, April 2006

- States should routinely prepare multi-year revenue and current services spending projections in order to flag future budget gaps early. This gives state policymakers time to thoughtfully consider alternative ways to restore fiscal health.

The remainder of this paper discusses the fiscal health of the 23 states in more detail. These descriptions illustrate the impact of state actions on their future fiscal health.

Michigan, New Jersey and Rhode Island Faced Deficits in FY2007

Unlike the vast majority of states, three states faced projected deficits in their fiscal year 2007 budgets. These states closed these gaps but remain in uncertain fiscal health.

Michigan faced a gap between expected revenues and spending of $408 million (4.5 percent of the budget) for fiscal year 2007, according to the governor's proposed budget. One of the major reasons for this gap was slow revenue growth (less than one percent) that resulted in part from the economic troubles of manufacturers including carmakers and in part from the impact of tax cuts — some that were enacted in better times and some that were enacted last year. For example, the Single Business Tax has been gradually reduced and was cut again last year; income tax rates also have been reduced in recent years. The low revenue growth fell far short of the amount needed to support projected growth in the cost of programs and services. Michigan balanced its FY2007 budget with a patchwork of measures including appropriating $110 million of carry-over funds from FY2006, eliminating General Fund support for the School Aid Fund, recognizing anticipated revenues associated with Medicaid third party cost recovery efforts and the expansion of the HMO payment base on which Medicaid provider taxes are calculated, and recognizing one-time revenues related to the sale of state property. Michigan's future fiscal health remains very uncertain because policy-makers just voted to eliminate one of the state's main revenue sources — the Single Business Tax — by the end of calendar 2009, two years earlier than previously scheduled. To date no replacement revenue source has been identified although several proposals have been advanced.

In his budget proposal, the governor of **New Jersey** projected that the state's Fiscal Year 2007 budget was out of balance by $4.8 billion (15.7 percent of the budget.) Ongoing revenues were projected to fall far short of the cost of maintaining current services. This gap was the result of the way the state balanced its budget over the past decade. While the budget as enacted was in balance, the future remains uncertain.

New Jersey was one of only six states that reduced state taxes by more than 10 percent of revenue during the 1990s. The budget gap is partly the result of the continuing impact of the tax cuts of the 1990s. A report by New Jersey Policy Perspective in March 2005 estimated that New Jersey lost more than $24 billion during the 1990s as a result of sales tax and income tax rate cuts. A report the Center issued in early 2005 found that the states that passed the largest tax cuts during the 1990s wound up with the greatest problems during the fiscal crisis of the early 2000s. Indeed, New Jersey faced one of the worst fiscal crises in the nation, with a 2004 deficit equal to nearly 20 percent of the budget.

TABLE 1B: 15 OTHER STATES AT RISK FOR FUTURE PROBLEMS	
Arizona	Full cost of tax cuts deferred to future years. Revenue growth that persistently lags spending growth.
Illinois	Chronic under-funding of public employee pensions
Iowa	Use of one-time funds for permanent spending and tax cut. Full cost of tax cuts deferred to future years
Michigan	Upcoming elimination of Single Business Tax compounded by revenue growth that lags spending growth
Minnesota	Forecasts underestimate cost to maintain existing services.
Nebraska	Use of surplus for permanent tax cuts
New Jersey	Use of one-time funds for tax cuts and permanent spending, under-funding of public employee pensions
North Carolina	Expiring temporary tax increases
Ohio	Full cost of tax cuts deferred to future years
Oklahoma	Use of one-time funds for tax cuts and permanent spending and chronic under-funding of public employee pensions
Oregon	Kicker provisions require tax refund rather than increase in reserves
Rhode Island	Phased-in tax cuts
Texas	Use of one-time funds for permanent spending
Washington	Use of one-time funds for permanent spending
Wisconsin	Phased in tax cuts, use of one-time funds for permanent spending and small balance

As it was reducing taxes, New Jersey did not cut back on expenditures. Rather, it expanded spending by increasing state employee pensions, giving tax credits and other benefits to businesses and expanding property tax rebate programs—all without the funds to support them.

During the fiscal crisis, budget solutions included drawing down fund balances and other temporary measures including forgoing contributions to the state's public employee pension funds. They also included securitizing both the state's tobacco settlement and anticipated receipts from cigarette tax increases (that is, taking the current value of its future stream of revenue from these sources and spending it now rather than in the future), refinancing debt and taking money from various trust funds. The state did restructure corporate income taxes in 2002 and raise tax rates on households with $500,000 or more in income in 2004 to provide more stable long term revenue, but these actions did not fully compensate for its earlier tax reductions — making all the one-time measures necessary to achieve budget balance.

In FY 2007, to bring in much needed revenue, the state has raised its sales tax rate from 6 percent to 7 percent and expanded its base to services not previously taxed. It raised its cigarette tax rate to $2.575 per pack from $2.40. It imposed a 4 percent surcharge on a corporation's tax liability and increased the minimum corporate business tax from $500 to an amount ranging up to $2,000 depending on the corporation's gross receipts in New Jersey. All of these measures are permanent now.

New Jersey enacted a $42.4 billion budget (including $10.3 billion in federal funds) on July 8, 2006. Although the state's budget was considered balanced when enacted, many of the under-lying problems that created the deficit continue. It remains to be seen if the on-going revenue from the FY 2007 tax increases will be sufficient to balance future budgets.

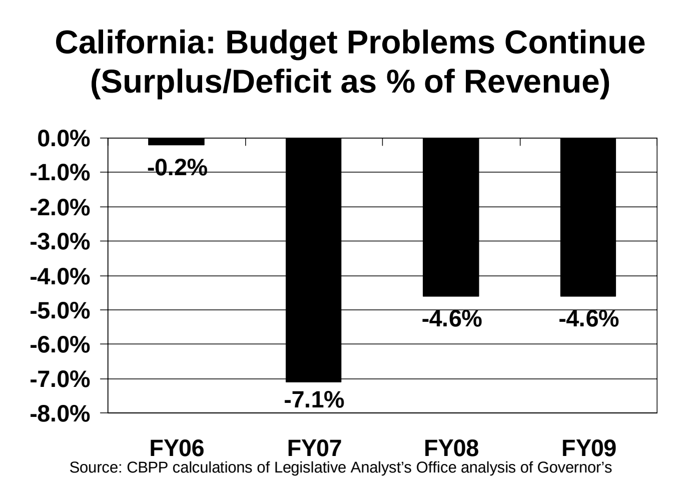
According to the Governor's budget, **Rhode Island** faced a gap of $222 million (6.9 percent) between projected revenues and spending in FY2007. Subsequent revenue estimates reduced this amount by $57 million but a large gap (5.1 percent) remained. The governor pointed to slow revenue growth combined with increased expenses for social service programs including a reduced federal Medicaid matching rate, state aid to local governments, and public employee costs as the reason for this gap. The slower revenue growth is due in part to the increasing cost of the Historic Structures Tax Credit — an income tax credit of up to 30 percent of qualified rehabilitation costs for individuals and businesses that was expanded in 2002. This cost the state $84.6 million in foregone revenue in the current fiscal year, the cost is projected to grow to $260 million by 2011. In addition, unlike in most states, Rhode Island's FY2006 revenues were coming in below original estimates.

In late June, the Rhode Island legislature adopted a budget for FY2007. The budget was balanced by incorporating improved revenue projections along with cutbacks in cash assistance, personnel reductions and a tax amnesty program. The budget also includes a significant income tax cut that will be phased in over the next five years. Projections for FY2008 and FY2009 have not been prepared for the adopted budget, but, the spending levels in this budget are similar to those in the governor's original budget proposal which was expected to result in operating deficits of from 3 percent to 4 percent for those years. The addition of an income tax cut that will grow in cost each year is likely to worsen structural gaps in the Rhode Island budget.

At least Nine States are Projecting Deficits for FY2008 and Beyond

California is one of the states that recently made news when revenue collections came in above original estimates. The state plans to carry over some of these revenues to balance its future budgets. In an analysis of the enacted FY2006-07 budget, the Legislative Analyst's Office, found that while revenues are significantly higher than the estimates used in the fiscal year 2006 budget, the state will continue to face operating deficits in the current budget (2006-07) and beyond. Operating shortfalls of $4.6 billion (approximately 4.6 percent) in FY2007-08 and $4.8 billion (4.6 percent) in FY2008-09 are projected.

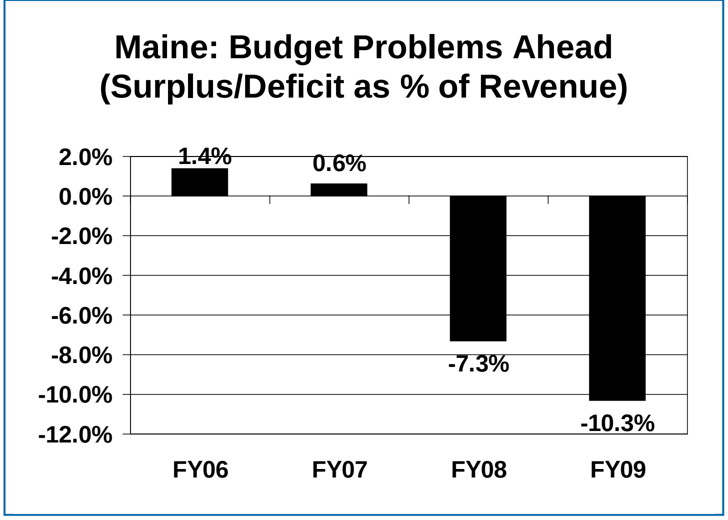
FIGURE 2



Source: CBPP calculations of Legislative Analyst's Office analysis of Governor's budget proposal as revised in May 2006

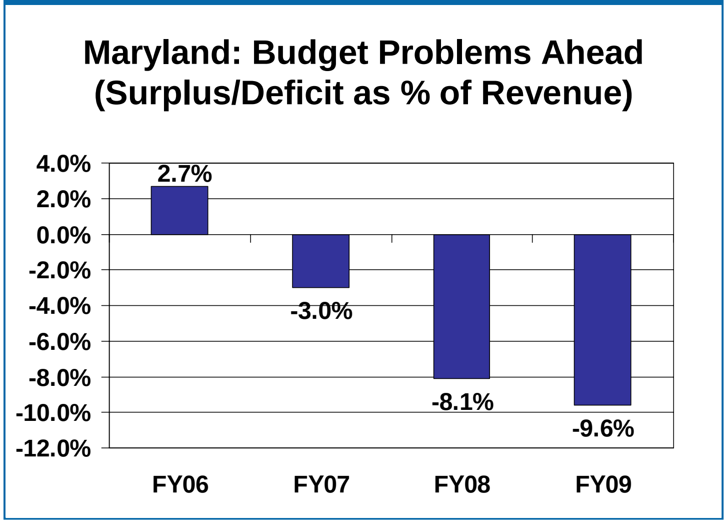
Connecticut ended fiscal year 2006 with a $1 billion surplus, some of which will be used to fund spending in FY2007. These carry-over funds will run out next year and, despite revived revenue growth, the legislature's Office of Fiscal Analysis projects budget gaps for fiscal years 2008 and beyond. The adopted budget which includes tax cuts and program expansions, would result in deficits of $359.6 million (2.3 percent) in FY2008 and $536.1 million (3.4 percent) in FY2009 according to projections by the Office of Fiscal Analysis. These figures understate Connecticut's problems as they do not include the cost of restoring the programs that were cut significantly in 2002 and 2003 and also fail to take into account some longer term obligations such as reducing the state's unfunded pension liability and high debt.[2]

FIGURE 3



The **Maine** legislature's Office of Fiscal and Program Review regularly prepares estimates of the state's structural budget balance. The most recent report — prepared in June 2006 — finds a large gap between projected spending and available revenues in fiscal years 2008 and 2009. Maine's General Fund revenues are projected to grow an average of 2.5 percent per year, well below average, while spending is projected to increase by 5.5 percent per year. One reason for the relatively slow revenue growth projected is slower economic growth in FY2008 and FY2009 according to the Maine Revenue Forecasting Committee. On the spending side, the state is increasing its support for local schools significantly between 2005 and 2006. The Office of Fiscal and Program Review estimates that General Fund spending will exceed expected revenue by $218.4 million (7.3 percent of revenues) in FY2008 and by $314.7 million (10.3 percent) in FY2009.

FIGURE 4

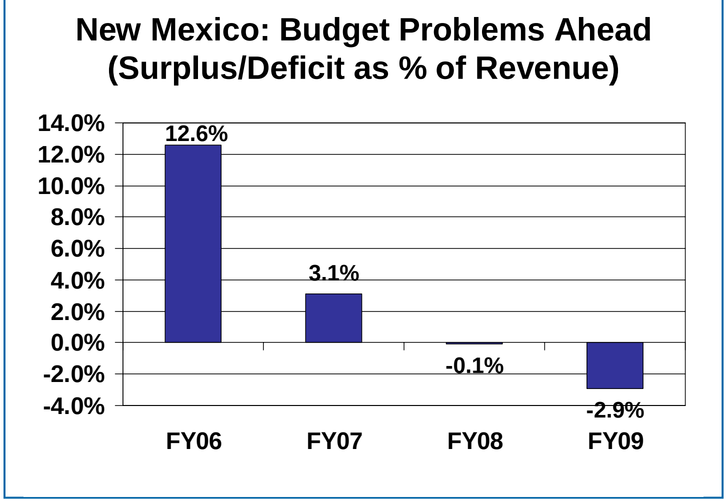


The **Maryland** Department of Legislative Services' most recent analysis of the state's structural budget balance found that the revenue growth that resulted from an improved economy restored balance to the state's budget in fiscal years 2005 and 2006. They also found that projected spending growth for fiscal year 2007

[2] For more information see *It's Past Time to Put Connecticut's Fiscal House in Order,* Connecticut Voices for Children, March 2006 available at www.ctkidslink.org/pub_detail_273.html.

will outpace revenue growth, resulting in a structural gap of about $219 million (1.7 percent). This gap will be filled by carrying over the state's FY 2006 fund balance. But the problem worsens the next year when the state faces a gap of $1 billion (7.4 percent) between ongoing revenues and ongoing spending under the provisions of the budget adopted by the legislature. According to the Department's analysis this gap will continue to grow after FY2008. One reason for this growing gap is the cost of a major education reform program that is being phased-in over a number of years. At the time of its adoption, no accompanying revenue increase was enacted. In addition, the state continues to feel the effects of the ten percent income tax reduction enacted in the 1990s.

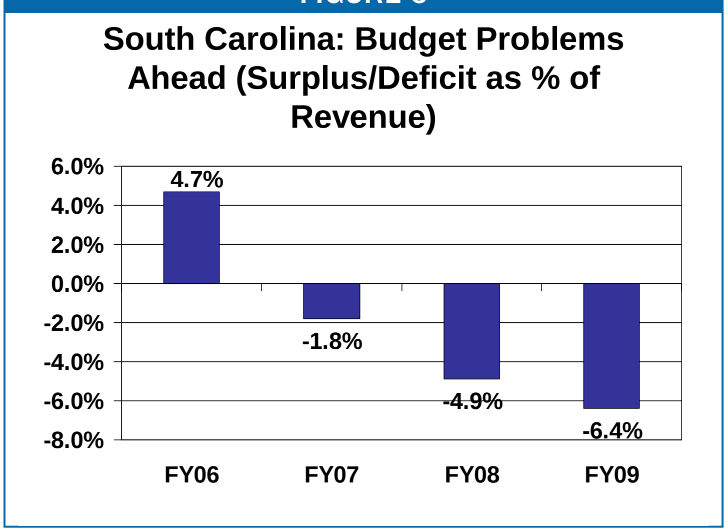
FIGURE 5



The **New Mexico** Legislative Finance Committee's projections of recurring revenues and recurring spending for the state find a very small shortfall in fiscal year 2008 followed by larger gaps of $152.6 million (2.8 percent) in FY2009 and $212.4 million (3.7 percent) in FY 2010. These projected gaps are the result of slowing in the growth of state revenues — due in large part to the personal income tax cuts enacted in 2003. Currently, high oil and gas prices have boosted state revenues and allowed the state to build up reserves. If energy prices moderate and revenue growth returns to more normal levels, New Mexico will face a gap between ongoing spending and ongoing revenues.

In **New York**, revenues came in over original projections for FY2005 and FY2006, allowing the state to generate a surplus of $2 to $3 billion in FY2006. The bulk of that surplus, however, was attributable to the temporary tax increases that were enacted in 2003 and which expired during or at the end of the 2006 fiscal year. The FY2007 budget recently adopted by the Legislature (initially over the Governor's veto and ultimately through a series of budget amendments negotiated with the Governor) included tax cuts with an ultimate cost of $2 billion a year, a variety of service cuts originally proposed by the Governor, and several programmatic expansions such as a tuition assistance program for needy part-time students. The Governor's Budget Division estimates that

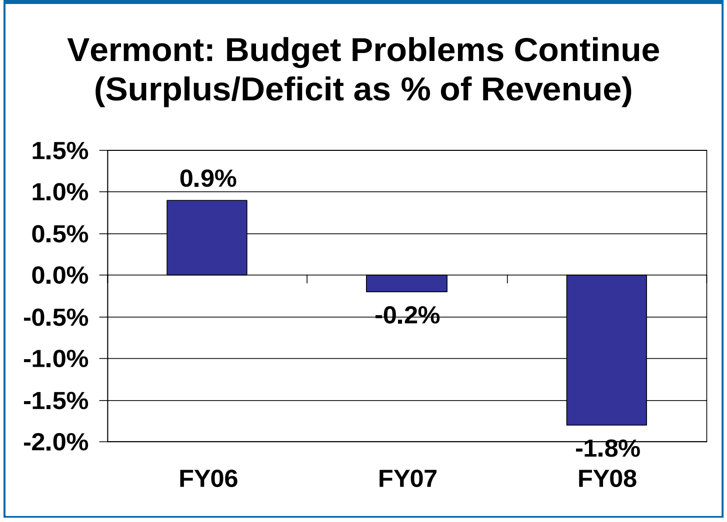
FIGURE 6



the budget as amended will result in out year budget gaps of 6.4 percent of revenues for FY2008 and 10.3 percent of revenues for FY2009.

An analysis of the **South Carolina's** long-term fiscal health prepared in late 2005 by the Office of State Budget as part of the annual budget process found that the state faces gaps between projected revenues and spending beginning in FY2008. These widening gaps result from the fact that the cost of maintaining services is projected to grow by about 5 percent per year while revenues are expected to grow by only about 3 percent per year. This mismatch could result in continuing problems especially as the state funds the ambitious property tax reduction program enacted in 2006.

FIGURE 7



Vermont divides its budget into a number of different funds. In order to get an accurate picture of the state's general fiscal health it is necessary to look at the condition of the state's general, education, and transportation funds as well as key special funds. Although these funds are technically separate, money for programs like Medicaid comes from both the general fund and special funds. For FY2007 and FY2008, the governor projects balance or small surpluses in the state's general, transportation and education funds and deficits in the Medicaid special fund. When all these funds are taken into account, the state's budget is projected to be close to balance for FY2007 but faces a deficit of $53 million (1.8 percent) for FY2008 according to projections included in the governor's budget. The actual gap may be significantly larger than this. The legislature's fiscal office estimates a budget gap of two to three times this size for FY2008 when additional spending commitments in education, transportation and health are taken into account.

Earlier this year, the **West Virginia** Budget Office prepared a five year financial plan for the state that projects revenues and spending from FY2007 to FY2011. Revenue growth is expected to be below average over the next few years (approximately 2.2 percent per year) as a result of slower growth in energy prices, and the structure of the West Virginia tax system. The Budget Office projection finds that on-going spending will exceed revenues beginning in FY2009. They estimate that the state will face a gap equal to 3.4 percent of the budget in FY2009 and that the gap will grow — doubling by FY2011.

Budgetary Balance is Precarious in Many Other States

A number of other states are in similar situations to the ones described above. This report cannot include specific estimates of future budget gaps because such figures are not available in most of these states. But these states are at just as high a risk of budget deficits in the future as a result of these fiscal policy decisions.

Arizona used a combination of budget cuts and a number of one-time measures, including payment delays and borrowing from other state funds, to balance its general fund budget during the fiscal crisis that eased in FY2006. Because revenues came in higher than anticipated in FY2006, the state had sufficient revenues to fund the Budget Stabilization Fund, leave a balance in the General Fund going into FY2007, and reverse many of the one-time fixes that were used to balance to budget in the past. This could have served to significantly improve the fiscal balance of the state's budget, but, the recently-adopted FY2007 budget includes a number of large tax cuts, including a phased-in reduction in personal income taxes that will cost $156.1 million in FY2007 and more than $330 million a year when fully phased in, and the three-year elimination of a statewide property tax which will cost the General Fund $200 million per year. The combination of these new tax cuts, tax cuts passed in 2005 that are still being phased in, and the need to restore programs cut during the fiscal crisis puts the future fiscal health of the state in jeopardy.

Illinois used a number a number of temporary measures to balance its budget during the fiscal crisis including skipping or delaying pension fund contributions. As a result, the state's pension system is significantly underfunded. For example, in FY2006, Illinois paid $1.2 billion less than the state owed to the pension fund. Despite an improved economy, the governor's proposed FY2007 budget appears balanced in part because it continues to underfund the state's pensions. These short-sighted maneuvers have left the state budget in a precarious situation. The state's fiscal problems are exacerbated by the fact that even in good times the state's revenue growth fails to keep pace with economic growth.

In July, the **Iowa** State Auditor reviewed the recently adopted state budget and warned that while the adopted budget is balanced, Iowa is danger of budget deficits in the near future. State Auditor Vaudt cited a number of concerns including the use of $160 million of the FY2006 surplus to fund FY2007 property tax credits, under-funding of Medicaid and transfers from special funds to balance the general fund. He projects that future revenue growth will lag behind the spending growth needed to fill in for the use of one-time revenues to balance the FY2007 budget as well as fund new initiatives and growth in education spending. The problem will be compounded by the fact that the tax cuts for retirement income enacted this year are being phased in over a number of years and will serve to slow future tax growth.

At the end of the 2006 legislative session, **Minnesota** was projected to have a $737 million surplus for the next biennium (2008-09.) This projection is overly optimistic, however, as the Department of Finance is prohibited by law from assuming that inflation will increase the cost of state services over time in most areas of state spending. If the impact of inflation were taken into account the surplus would be reduced by $954 million in 2008-09. Budget decisions made in the 2006 legislative session reduce available 2008-09 resources by another $459 million. And, the November 2006 ballot will include a constitutional amendment that would require that all revenues from the motor vehicle sales tax be dedicated to transportation purposes. The combined impact of this measure, if it passes, 2006 budget decisions, and the impact of inflation would be a deficit of approximately $390 million in 2008-09.

In the legislative session just ended, **Nebraska** responded to renewed economic growth by adopting a number of tax cuts including a reduction in the personal income tax as a result of adjusting income tax brackets and adopting a state EITC, a property tax cut for farmland, and a sales tax exemption for contractor work on individual homes. These are estimated to reduce revenues by

$100 million annually. The state's legislative fiscal office estimates that these tax cuts combined with the spending in the adopted budget will result in a gap between spending and revenues beginning in FY2008.

In **North Carolina**, the revenue available for the FY2007 budget was projected to be $695 million more than the amount needed to maintain current services. This would appear to give the state the ability to reduce taxes or expand services. A closer look, however, reveals that all but $63 million of this 'surplus' is made up of non-recurring revenues. In addition, two tax reductions are scheduled to take place automatically in 2007 when a temporary half-cent sales tax increase and an additional top tax bracket will expire. Taken together, these mean that North Carolina's fiscal situation is not nearly so rosy as it would appear. The final budget adopted in July relies heavily on temporary revenues. The North Carolina Budget and Tax Center estimates that recurring spending will exceed recurring revenues by more than $1 billion in FY2008.

Last year, **Ohio** responded to the improved economic situation by enacting multi-year cuts in its personal income tax and corporate franchise tax. Income tax rates will be cut by 21 percent over the next five years. The income tax reduction cost the state $340 million in FY 2006; the cost will increase to $2 billion a year by FY2010 when it is fully phased in. The changes to the corporate franchise tax reduce revenue by $202 million in FY2006 rising to a loss of $1.1 billion by FY2010. The state retained the one-half cent temporary increase in the sales tax adopted during the fiscal crisis and increased the cigarette tax. These offset the cost of the tax cuts for two years, but there will be a net tax reduction beginning in FY2008 and growing over the subsequent two fiscal years. As a result, state revenue growth will slow over the next five years. In addition, the reduced reliance on income taxes and increased reliance on taxes that grow more slowly relative to the economy, such as tobacco and sales taxes, will likely cause budget gaps in the future.

Oklahoma is another state that has chronically underfunded its public employee pensions. The state's teacher retirement fund is among the worst funded in the nation. Despite these and other spending pressures, the recently adopted FY 2007 budget eliminates the state's estate tax, slashes the personal income tax, and further expands retirement income exemptions. These tax cuts — which will cost over $500 million per year when fully phased in — will make it significantly harder for the state to meet future obligations.

In order to balance its last biennial budget without tax increases, **Oregon** cut spending significantly to meet the state's conservative revenue estimates. Because of the continuing economic uncertainty at the time the state prepared its two-year budget, these estimates were appropriate. Since the budget was adopted, however, state revenues have recovered and are coming in above estimates. In many states this would give the state the ability to replenish state rainy day funds or restore some programs cut when the budget was adopted. In Oregon, a constitutional provision prevents this from happening. When state personal or corporate income tax collections come in 2 percent or more above estimates — no matter how conservative those initial estimates were — the state is required to refund all the collections above the original estimate to taxpayers. As a result, Oregon – a state with very slim reserves and no rainy day fund — is not able to build reserves and is left at risk for future downturns.

Above Average Revenue Growth Needed to Restore Budgets

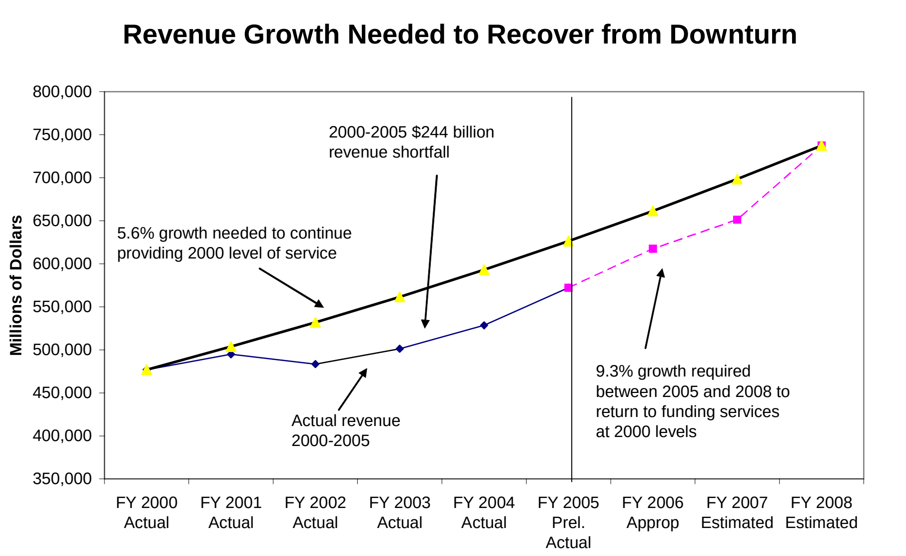
Figure 1 compares the revenues needed to sustain public services at their fiscal year 2000 level with actual revenues from 2000 to 2005 and projected revenues through 2008. The top line assumes that the cost of state government grows at approximately 5.6 percent a year. This growth rate is based on the average annual growth rate of state expenditures between 1989 and 1999. Historically, the 1990s were a period of modest growth in government, largely because health care costs did not grow especially fast that decade. Thus this is a conservative estimate; the actual revenue growth required to restore services in the current period is likely to be higher.

The bottom line shows revenues. As would be expected, revenues during the economic downturn dropped well below the level required to sustain expenditures. The bottom line of the graph shows actual general fund revenue collections for 2000-2005, which fell about $244 billion below the amount needed to continue funding services at the 2000 level.

Less expected, however, has been the length of time it has taken revenues to recover after the recession. The dotted bottom line shows the growth needed to return by 2008 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 9.3 percent in fiscal years 2006, 2007 and 2008 simply to make up the ground lost during the downturn.

State taxes have been growing at an annual rate in the range of seven to 11 percent since early 2004. Those rates are extraordinary, and likely unsustainable. Normally, state revenues may be expected to grow at an average annual rate of five percent to six percent.

FIGURE 8



Source: CBPP calculations of NASBO data

Long-standing Flaws Remain in State Tax Structures

Many states risk chronic gaps between revenues and necessary expenditures in coming years because of structural weaknesses in their tax systems. These weaknesses are largely independent of the cyclical budget problems caused by economic downturns. Thus, even though states are now enjoying expanded revenues due to the economic recovery, they could face serious budget problems in coming years if their structural issues are not addressed.

A prime cause of structural deficits is that most states have failed to respond to the economy's shift from goods to services, which make up a growing share of all economic activity. That shift has cut into state sales tax revenues, since most states do not tax services. The rapid growth in Internet purchases is also hurting sales tax revenues, since states generally cannot collect taxes on these purchases.

State income taxes have weakened in recent decades as well. Corporate income tax revenues have shrunk by nearly half as a share of total state revenues over the past two decades, as a result of obsolete state corporate tax policies and corporations' increasingly aggressive tax-avoidance schemes.

Many states' personal income tax systems have become "flatter" as a growing share of taxpayers have moved into the top tax bracket (usually because the state failed to update its brackets to reflect rising incomes). In 19 states plus the District of Columbia, households with taxable income of $30,000 are in the same bracket as those with taxable income of $300,000. In addition, the extra tax breaks many states give to the elderly — regardless of income — are becoming increasingly costly as the population ages.

Other important causes of state structural deficits include federal restrictions on state taxing authority (such as the federal ban on state taxation of Internet access fees) and state budget requirements that limit revenues (such as tax and expenditure limits).

In states with structural deficits, revenues do not grow at the same rate as the cost of government. As a result, these states are unable to continue providing their current level of services, let alone respond to voters' demands for new investments in education and other areas.

In May of 2005, the Center examined each state's susceptibility to structural problems by analyzing ten factors that lead to structural deficits. The analysis found widespread problems: more than half of the states have at least seven of the risk factors, and *no* state has fewer than four.

States appear to have worsened their structural problems during the fiscal crisis. Donald Boyd of the Rockefeller Institute at the State University of New York, Albany recently updated his analysis of the balance between future state and local revenue growth and spending growth. When he looked at this balance in 2002 — the height of the fiscal crisis — he found that in 44 out of the 50 states normal spending growth would outstrip normal revenue growth. His most recent analysis completed in 2005 when the fiscal crisis was waning painted an even grimmer picture with structural imbalance projected for all 50 states. The states with the largest projected gaps were Wyoming, Alabama, Louisiana, Mississippi, Tennessee, Nevada, Texas, Oregon, Washington and Missouri.

Texas lawmakers met in a Spring 2006 special session to change school financing in the state. The major focus was school property tax reduction starting in FY2007. Texas is like many other states in that 'surplus' funds are available. Before the special session, the state's comptroller announced that General revenue collections will be $8.2 billion higher than General Revenue spending budgeted through FY2007. The state used much of these unanticipated revenues to permanently cut school property taxes, putting Texas in a very precarious fiscal situation. Tax increases — from a cigarette tax hike and reformed franchise tax — enacted during the special session are not expected to generate enough revenue to pay for the school property tax cuts on an ongoing basis. In addition, the state cut its General Revenue spending significantly in 2003 in order to balance the budget with the original revenue estimates. Using "surplus" funds for property tax cuts rather than to restore state services means that Texas's unmet needs will continue to grow; legislators will have to either raise revenues in the future to finance the ongoing costs of the property tax cuts or reduce spending in other areas of the budget. In June 2006, the 2008-09 budget cycle got underway with the governor instructing that agency budget requests reflect 10 percent reductions in General Revenue spending for many services.

Washington state's recently adopted budget is balanced for the current 2006-2007 biennium but an Office of Fiscal Management analysis of the next four years indicates a future gap between projected spending and available revenues. In May, OFM projected the gap to equal $955 million (5.8 percent of the state budget) by FY2011. Since then, revenue collections have improved by $500 million for the current biennium. If revenues remain higher than originally expected, the FY2011 gap will be reduced significantly but is unlikely to be eliminated. Even under this improved scenario, projected growth in state revenues is not sufficient to fund the future costs for cost of living raises for teachers, public employee pensions, and to restore funds "borrowed" from the health services account.

Wisconsin is another state that has not traditionally maintained a Rainy Day fund. According to projections by the Wisconsin Legislative Fiscal Bureau, as of the end of the current two-year budget, the state's reserves will total just $11 million (less than 0.1 percent of the budget.) This is even less than the meager 0.5 percent of budget balance that is required by law in Wisconsin. While Wisconsin is not projecting a deficit, its budget is in very precarious balance. The Legislative Fiscal Bureau estimates that $239 million in one-time measures were used to balance its current budget. An April 2006 Fiscal Bureau memo calculates that because of the one-time measures used to balance the current budget, coupled with deferred tax cuts and phased-in spending , Wisconsin will need more than $1.5 billion in general fund revenue growth in the 2007-09 budget, simply to maintain existing spending commitments (without factoring in inflation or caseload growth).

APPENDIX: GAP CALCULATIONS

1. SIZE OF GAP IN MILLIONS (ONGOING SPENDING MINUS ONGOING REVENUES)					
	FY06	FY07	FY08	FY09	SOURCE
California	-139.0.0	-6,647.0	-4,600.0	-4,800.0	Legislature's analysis of adopted budget
Connecticut	675.3	160.8	-359.6	-536.1	Legislature's analysis of adopted budget
Maine	39.4	16.5	-218.4	-314.7	Legislature's analysis of adopted budget
Maryland	330.0	-389.0	-1,094.0	-1,359.0	Legislature's analysis of adopted budget
New Mexico	679.5	164.2	-4.0	-152.6	Legislative finance committee budget proposal
New York	855.0	1,182.0	-3,166.0	-5,405.0	Division of Budget
South Carolina	275.9	-107.0	-196.5	-402.0	Office of State Budget
Vermont	24.66	-6.25	-53.1		Governor's proposed budget
West Virginia		0.3	53.3	-138.2	Governor's budget

2. SURPLUS/GAP AS PERCENT OF REVENUES				
	FY06	FY07	FY08	FY09
California	-0.2%	-7.0%	-4.6%	-4.6%
Connecticut	4.6%	1.1%	-2.3%	-3.4%
Maine	1.4%	0.6%	-7.3%	-10.3%
Maryland	2.7%	-3.0%	-7.4%	-8.7%
New Mexico	12.6%	3.1%	-0.1%	-2.9%
New York	1.8%	0.0%	-6.2%	-10.3%
South Carolina	4.7%	-1.8%	-4.9%	-6.4%
Vermont	0.9%	-0.2%	-1.8%	
West Virginia		0.0%	1.3%	-3.4%