No fiscal relief in sight: Although state revenues have begun to rebound, next budget year might be toughest yet for Midwest's legislatures

By Tim Anderson [1]
Wednesday, November 10, 2010 at 11:25 AM

All signs are pointing to a revenue rebound for most states in the Midwest in fiscal year 2011. However, thanks in large part to a loss in federal funding, state lawmakers will face perhaps their biggest fiscal challenge yet in crafting FY 2012 budgets.

Stateline Midwest, Volume 19, No. 10 - November 2010 [2]

After two years of unprecedented declines, state tax revenues are finally headed in an upward direction.

Nationally, tax collections rose during the first two quarters of 2010, according to an October study done by the Rockefeller Institute of Government [3]. And state-level data for the region show positive revenue growth during the first few months of the new fiscal year, which for all Midwestern states except Michigan began in July.

These encouraging signs, though, are tempered by what remains a fiscal reality in many states: The worst budget crisis in recent memory isn’t over, and some of the most difficult decisions on taxes and spending might still lie ahead.

“In terms of state finance, the conditions are still pretty horrific,” says Donald Boyd, a senior fellow at the Rockefeller Institute and co-author of the study. “Things will probably be as bad this coming year as they were last year.”

In fact, conditions likely will be even worse, according to Jon Shure, deputy director of the State Fiscal Project at the Center on Budget and Policy Priorities.

“Even though revenues are picking up, the budget hole for states just gets bigger [in FY 2012],” he says. That is because of the steep decline in federal assistance that states will face in the coming year.

According to the Center on Budget and Policy Priorities, enhanced federal aid for states (from the American Recovery and Reinvestment Act of 2009 and from legislation passed this summer) amounted to about 34 percent of states’ projected budget shortfalls between fiscal years 2009 and 2011. This funding will mostly be gone in FY 2012.
“Some of the decisions that we would have had to deal with then [without the additional federal aid], we’re going to have to deal with now,” says Nebraska Sen. Lavon Heidemann, chair of the Unicameral Legislature’s Appropriations Committee.

He expects the biggest political and budget fight to center on K-12 education. The Recovery Act pumped $234 million into Nebraska’s schools, and with that money no longer available, the Legislature faces the prospects of having to make at least what will be perceived as a cut in education funding.

Heidemann says other painful decisions will have to be made as well, as his state slogs its way through an unusually long period of revenue stagnation. He notes that Nebraska’s average annual revenue growth has historically been 5.3 percent. Over the past five years, tax collections have grown by a half percent.

“As far as revenue goes, we are still scraping near the bottom,” he says.

The same is true across the country.

Not only is revenue growth modest (there was a year-over-year increase of 2.3 percent in the second quarter of 2010, the Rockefeller Institute report found), states are having to climb out of huge holes: Tax collections have fallen by between 12 and 15 percent over the past few years, Boyd says. In most states, revenues peaked in FY 2008, and it remains unclear when they will return to those pre-recession levels.

Not only is revenue growth modest (there was a year-over-year increase of 2.3 percent in the second quarter of 2010, the Rockefeller Institute report found), states are having to climb out of huge holes: Tax collections have fallen by between 12 and 15 percent over the past few years, Boyd says. In most states, revenues peaked in FY 2008, and it remains unclear when they will return to those pre-recession levels.

**Spending cuts or tax hikes?**

Some states’ economic and fiscal conditions are much more severe than others’. According to an October report of the Center on Budget and Policy Priorities, eight states in the Midwest have already projected budget shortfalls for FY 2012. Illinois has by far the largest deficit in the region, both in terms of the amount of the gap ($17 billion) and its percentage of the previous year’s budget (52.3 percent, highest in the nation).

Michigan also stands out for its economic and fiscal woes. That state’s revenue levels peaked in FY 2000, and a recent Senate Fiscal Agency analysis predicts yet another tough budget year for lawmakers.

Not only was Michigan’s FY 2010 budget balanced with the help of temporary federal funds, the Legislature relied on onetime revenue sources (a tax amnesty program and new accounting rules for unclaimed property, for example). On top of that, a temporary increase in the income tax is set to expire, and Michigan’s newly elected governor, Rick Snyder, has called for a $1 billion cut in the state’s business tax.

Most of the Midwest’s nine newly elected governors, in fact, have proposed tax cuts or pledged not to raise taxes. More spending reductions, then, would seem the most likely avenue that states take to balance their budgets.

Indiana Republican Sen. Luke Kenley believes this approach has worked well so far in his state.
“We had been talking for years about size-of-government issues and how to find more efficiencies, but the recent [budgetary] pressures forced us to act,” the chair of the Senate Appropriations Committee says.

He cites three examples of how the state has responded: Demanding more accountability from state agencies and challenging them to do more with less, overhauling how child services are delivered, and reviewing cost savings and policy changes within the state’s corrections system.

“The question we’re asking right now is, Have we reached a maximum level of efficiency?” Kenley says.

“Can we do more, or are we going to start cutting into muscle and bone? If so, then you really have only three choices. Eliminate programs that you decide you can no longer deliver, hope for a revenue increase or produce a revenue increase.”

Across the country, state leaders will face similar choices.

“I would expect more severe actions to be taken,” Boyd says, noting that the election season is over and that states are simply running out of stopgap measures.

In Nebraska, Heidemann says, the idea of a tax increase has not gained any traction among lawmakers, at least yet.

“We’ve spent the last four years cutting out the fat in state government, and now we’re going to be faced with cuts that I think are going to alarm some people,” Heidemann says.

But he adds that a super-majority of legislators would have to approve an increase, because Republican Gov. Dave Heineman would veto any proposed tax hikes.