Long-Term Budget Stability Amidst Fiscal Crisis: What Can States Do to Better Navigate the Next One?

By Nick Samuels

While recent economic news suggests that the short-term cyclical fiscal hemorrhage is healing, long-term structural challenges still exist that must be examined to enable states to weather the next fiscal storm. State officials will have the opportunity and challenge to pursue durable strategies that will improve fiscal stability.

The fiscal dilemma that has dogged states for nearly three years is strikingly similar to their experiences in the early 1980s and 1990s. The economy flourished and budgets boomed, but an ebb in the cycle afflicted revenues, this time with spectacular speed and severe effects. While revenues plunged, spending pressures continued to build, particularly from Medicaid. In response, states cut spending dramatically, raised taxes, and tapped the budget reserves that, fortunately, they built up during the preceding period of prosperity. While recent economic news suggests that the short-term cyclical fiscal hemorrhage is healing, long-term structural challenges still exist that must be examined to enable states to weather the next fiscal storm. State officials will have the opportunity and challenge to pursue durable strategies that will improve fiscal stability. Budget officers will be at the forefront of the challenge to pursue such policies that reach the goal of sound financial management.

The Current State Fiscal Situation

Even as the national economy shows signs of improvement, the current state fiscal picture largely mirrors that of the last two years: states are scrambling to keep their budgets in balance. While some states are seeing positive signs in their revenue (or at least are seeing less negative ones), in others revenues remain sluggish, budget gaps are lingering, and spending pressures persist, particularly from Medicaid and other health care. States are confronting these challenges through means similar to previous years: they are enacting austere growth budgets, increasing taxes and fees, drawing from reserves and reorganizing programs.

States Have Curtailed Spending Dramatically

After relatively high rates of expenditure growth during the boom years, states have curbed spending significantly. Between fiscal 2002 and fiscal 2003, general fund spending increased by only 0.6 percent nominally, and based on enacted budgets is expected to grow only 0.2 percent between fiscal 2003 and fiscal 2004, according to the National Association of State Budget Officers (NASBO)'s *Fiscal Survey of States* (the latter figure reflects the smallest spending increase since 1979, the first year that NASBO began tracking such data). By comparison, general fund spending increased by 8.3 percent in fiscal 2001, and between fiscal 1979 and fiscal 2004, spending has grown at an average annual nominal rate of 6.2 percent (or roughly 2 percent in real terms). To curtail spending to such an extent reflects drastic action. Incredibly, 40 states cut their budgets in fiscal 2003 (also the most since 1979) by a net $11.8 billion, resulting in 21 states ending the year with negative spending growth compared to fiscal 2002. For fiscal 2004, 13 states passed negative growth budgets compared with the previous year. Already, roughly halfway through the fiscal, 12 states have made budget cuts that total $2 billion.

As tight budgets began to set in, states tried to protect certain priority programs—such as K-12 education, Medicaid, aid to cities and towns, and public safety—from budget cuts. Many states exempted K-12 education from budget cuts altogether. However, with the fiscal crunch enduring, many of these programs also have been subjected to cuts and are in jeopardy of additional reductions the longer it takes for overall economic recovery to translate into improved state finances. Based on NASBO's most recent *State Expenditure Report*, elementary and secondary education reflect 21.6 percent of total state spending; Medicaid accounts for 20.8 percent; higher education is 11.2 percent; transportation is 8.2 percent of total state spending; corrections reflects 3.6 percent; public assistance is 2.1 percent; and "all other" spending accounts for 32.6 percent of the total. Within the general fund specifically, elementary and secondary education account for 35.4 percent of all spending; Medicaid 16 percent; higher education is 12.6 percent; corrections reflects 6.9 percent of all

general fund spending; public assistance is 2.3 percent; transportation accounts for 0.7 percent; and "all other" is 26.1 percent.

States have used a variety of other tools to stop the flow of red ink, as well. In fiscal 2003, 32 states made across-the-board budget cuts, 25 tapped their rainy day funds, 16 states laid off employees, 13 states offered early retirement, and 13 reorganized programs to achieve some budget savings. They have also taken advantage of low interest rates and refinanced state debt, implemented hiring freezes, securitized their tobacco settlement funds, deferred payments, made one-time transfers from other funds and undertaken tax amnesty programs.

Revenues Suffered Severely in 2003, Hopeful for 2004

Revenue collections in most states were grim once again in fiscal 2003, echoing an economy sputtering to recover. With the economic times still tough—employment decreased during seven months of the fiscal year, for example—collections of sales, personal income and corporate income taxes were below budgeted estimates in 31 states in fiscal 2003. Overall collections of those three taxes were 6 percent lower than the amounts states budgeted for with sales taxes missing their targets by 2.9 percent, personal income taxes off by 9 percent and corporate income taxes 3.7 lower. However, halfway through fiscal 2004, states are cautiously optimistic. That hopefulness is fueled partly by an economy that finally seems to have started to recover robustly, partly by lower revenue estimates, and partly by tax increases states included in their fiscal 2004 budgets.

For fiscal 2004, 36 states enacted net tax and fee increases, totaling $9.6 billion. The largest increases were in sales taxes ($2.6 billion), personal income taxes ($2.3 billion) and fees ($1.8 billion). Additionally, states enacted $3 billion in revenue measures that do not affect taxpayer liability, such as extending a tax credit for another year or deferring a tax increase or decrease.

Balances Gave States a Much Needed Cushion

States substantially strengthened their financial reserves during the late 1990s economic boom. Those funds have played a crucial role in balancing budgets and avoiding budget cuts and tax increases even more severe than the ones states have had to apply. Total balances—states' ending balances and the amounts in their budget stabilization (or rainy day) funds—totaled a net $48.8 billion at their peak in fiscal 2000, equal to 10.4 percent of expenditures. The situation three years after the bubble burst is much different. Reflecting a nearly 70 percent drop from their height, total balances in fiscal 2003 were $15.2 billion or 3.1 percent of expenditures (5 percent generally is considered to be a healthy level of reserves).

Looking Forward: Can States Prepare for the Next Fiscal Crunch?

States know that they will have to endure cyclical ups and downs and, as they learned during the fiscal crunch of the early 1990s and indeed, the currently subsiding downturn, healthy reserves and a willingness to make difficult decisions are necessary. However, beyond regular cyclical highs and lows, other factors play into the condition of state finances. These include revenue estimation uncertainty, expenditure estimation uncertainty, unpredictable federal tax policy, unpredictable federal mandates, unpredictable court decisions, unpredictable voter decisions, and even natural disasters or events such as the 2001 terrorist attacks.

Uncertainty is Certain

A degree of uncertainty is inherent to budgeting. For example, states must use economic forecasts in their budget process, and such projections contain uncertainty and even error. While states seek to limit the amount of uncertainty, its intrinsic nature in the budget process means that both favorable outcomes (such as the unanticipated revenue growth of the late 1990s) and unfavorable ones (such as states' more recent experiences) are magnified. This means that during periods of economic expansion, particularly such as the recent boom, states tend to adopt spending and taxing patterns that they cannot sustain during slowdowns or contractions. Conversely, during such slowdowns, states tend to react by changing their spending and taxing behavior to a mode that generates surpluses. A 3 percent budget shortfall may trigger cuts of more than 3 percent, for example. Several other factors lead to this:

- Required spending on some areas that cannot be cut, such as many non-optional parts of Medicaid, other entitlement benefits, or functions such as elementary education that are politically difficult to cut;
- The procedural and administrative difficulties of changing fiscal patterns mid-year;
- The impact of various carryovers from previous years;

- The affect of one-time measures in future years, such as the costs that result from delayed maintenance, the use of reserve funds to address structural imbalances, or issuance of debt that incurs interest costs over time.

Uncertainty and the boom-bust nature of budgeting also means that, when times are tight, some areas are burdened more heavily than others. Several budgetary "untouchables" exist, including debt service, spending that is required by formula such as much of Medicaid, and contributions to employee health and retirement plans. At least at the beginning of the recent state budget crisis, states also tried to exempt K-12 education and some other services from cuts. The result of such untouchables is that, after accounting for the protected areas, the budget must be balanced on less than 100 percent. When spending and tax changes are made, they tend to have a greater impact on future years than on the year in which they are made. Thus, budget-correcting actions that are accurate one year may be an over-correction (or an under-correction) in the next.

Budget uncertainty also has psychological impacts on decisionmakers. When their models seem too optimistic, revenue forecasters may react with ones that are overly pessimistic. Similarly, during a booming economy it can become difficult to build in an accurate degree of pessimism (as the rapid economic decline after 2000 proved).

Responding to Uncertainty

State budget officials long have understood the hazards of revenue and expenditure estimating, the perils of business cycles and their impact on the budget. Different states have different degrees of flexibility in their budget processes that determine how they can confront a budget shortfall. For example, states have different options available for how they can treat funds left over in an agency's budget; in some, they are subtracted from previously estimated spending, in others appropriated funds are compared to available resources, and other states use still other methods. Revenue volatility also varies between states, just as the strengths and weaknesses of their economies do. For example, a state that relies heavily on corporate and personal income taxes and has an economy dominated by recession-prone manufacturing may have a more unpredictable revenue stream than a state with a large percentage of retired persons and that relies on sales taxes.

Depending on demographics and how functions such as school aid or Medicaid are structured, expenditure instability between states varies, too. In some states, school aid payments are based on factors such as enrollment that are unknown until after the start of the fiscal year. A supplemental appropriation may be necessary if enrollment exceeds earlier expectorations. Such differences among states mean that no national rules about balances and budget reserves are applicable; instead, states in fiscal crisis must look at their specific circumstances and the tools available to them within their own budget process and laws.

Regardless of states' different processes and economies, budget shortfalls usually are dealt with in a crisis atmosphere. During a budget shortfall or when the ink turns from red to black as the fiscal situation begins to improve, the budgetary strategies may seem straightforward. The basic options that states choose from during budget shortfalls are tax increases, spending reductions, drawing on reserve funds and borrowing. During more thriving budget periods, when revenues exceed baseline expenditures, states may choose the opposite: cutting taxes, increasing spending, reinforcing reserve funds and paying off debt. However, the political pressures and the management atmosphere during those times are more starkly different. When revenues drop, immediate pressure exists to take action. During more robust times, that pressure does not exist, and it becomes possible to more deeply set goals, build strategies and plan around them. When fiscal times are tough, actors requesting additional funding understand being told "no" – even as they protest that the decision will hurt programs. Conversely, when treasuries are flush with revenue, budget requests multiply out of proportion to the funds available.

Conclusion: Lessons to Learn

There is no time better to plan for the next downturn than when memories of fiscal trouble and budget shortfalls are fresh. The challenge is to limit cyclical effects as much as possible and avoid spending higher than average revenues on on-going functions, especially because the dramatic drop in revenues during the past two years was worse than anyone predicted. This situation signals not only that states should focus on the cyclical nature of the economy, but that they also should examine structural reforms that will benefit them in the long term.

About the Author

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