Reality Check

The "Red" States

How Governors Ended Up with Huge Deficits

A Century Foundation GUIDE TO THE ISSUES

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Reality Check

In fiscal year 2004, the fifty states collectively faced an estimated $70 billion shortfall between revenues and expenditures—the highest ever. Although the economy has begun to improve, thirty-three states still have projected budget shortfalls for the 2005 fiscal year. Recent rises in revenue collections simply are not keeping up with the soaring cost of Medicaid, education, and state pensions. For example, both Virginia and Maryland had stronger than expected revenue growth, but rising costs will more than consume these new revenues.[1]

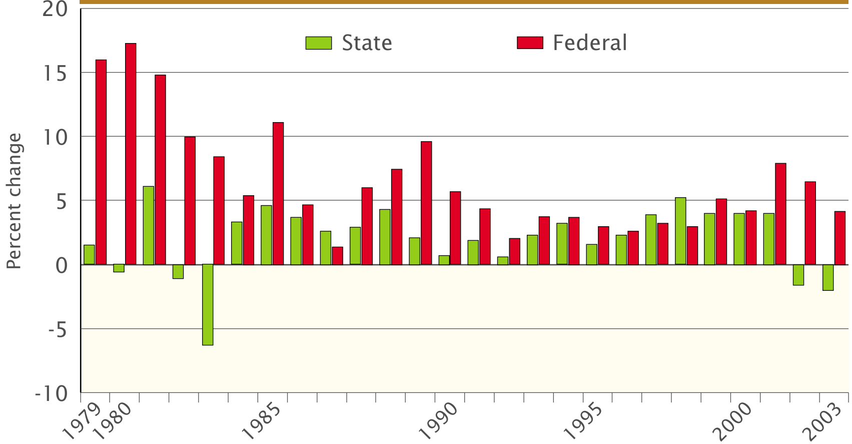
Today's deficits, which are forcing most states to cut services or raise taxes significantly, have led to a great deal of finger-pointing and have fostered a number of myths. In debates over responsibility for the deficits, it has been asserted that states spent their way into a fiscal mess; that earlier state tax cuts had little to do with these deficits; that state budgets are bloated with plenty of wasteful spending that is easy to cut; that the huge federal tax cuts have little connection to the state deficits; and that other federal legislation enacted during the Bush administration is unrelated to the fiscal problems plaguing the states. All of those claims are demonstrably wrong.

1. James Dao, "States' Tax Receipts Rise, Leading to Some Surpluses," *New York Times,* May 4, 2004, p. A14.

State Spending Is Not the Main Culprit

There is no basis for the claim that state government profligacy generated today's deficits. Figure 1 shows that state spending at the end of the 1990s was not growing at unprecedented rates. In fact, state spending grew more slowly at the end of the 1990s than it did a decade earlier: the average, inflation-adjusted rate of increase for state spending from 1985 to 1989 was 3.6 percent; from 1995 to 2000, spending increased at an average real rate of only 3.4 percent. In all but two years since 1990, state spending increased at a lower rate than federal spending.

Figure 1. Percent Changes in State and Federal Expenditures, 1979–2004



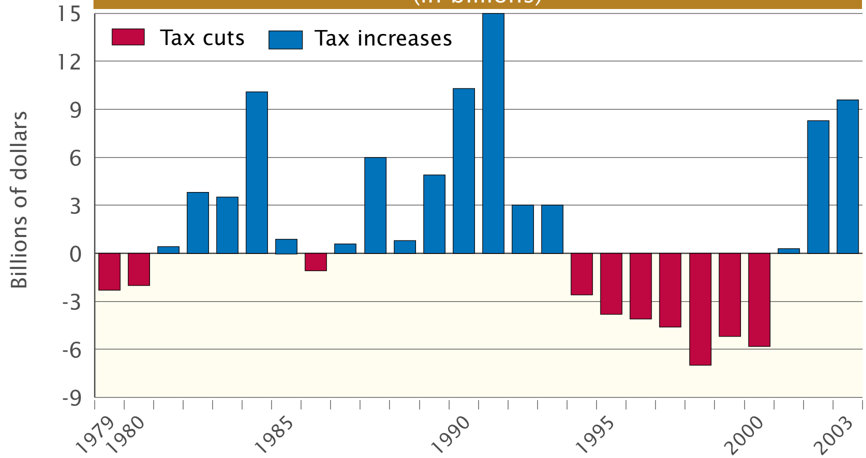
Source: The Fiscal Survey of States, National Governors Association and National Association of State Budget Officers, Washington, D.C., December 2003, Table 2, p. 4, available online at http://www.nasbo.org/Publications/fiscsurv/fsfall2003.pdf.

Most of the increased spending paid for governmental functions that demanded resources that regularly outpaced inflation. Health care costs, a burden states bear primarily through their contributions to the Medicaid program for low-income individuals and nursing home residents, continued to grow faster than the consumer price index. Education spending grew above the inflation rate as well, mainly because of growing student populations and increased teacher salaries.

The Chickens Coming Home to Roost: Excessive State Tax Cuts

If recent state spending is not out of line with past rates of expenditure growth, where did the money go? Figure 2 shows that the end of the 1990s was the longest period of sustained state tax cutting in recent history. The fifty states collectively enacted tax cuts every year from 1994 to 2000, with the largest cuts coming in the later years. Of course, some tax cuts are entirely appropriate and beneficial. For

Figure 2. Annual State Tax Increases/Cuts, 1979–2004 (in billions)



Source: The Fiscal Survey of States, National Governors Association and National Association of State Budget Officers, Washington, D.C., December 2003, Table 6, p. 11, available online at http://www.nasbo.org/Publications/fiscsurv/fsfall2003.pdf.

example, Georgia removed the sales tax on food during this period, relieving a tax burden that fell the heaviest on low-income residents.

However, as tax cuts continued to accumulate in the second half of the 1990s, the revenue base of the states fell, and their fiscal positions became highly vulnerable to an economic downturn. The cumulative effect of cutting taxes throughout the decade was to leave states with at least $33 billion less in revenue annually than they would have had otherwise. The total budget shortfalls the states faced in 2002—$40 billion—were almost equal to the tax cuts they enacted during the 1990s.[2]

In the early 1990s, the states, weathering a fiscal crisis, were forced to increase taxes. This produced revenue streams that, if they had been left in place, would have enabled the states to build sufficient reserves to cushion the blow of a recession. As the economic picture brightened, however, they resorted to permanent tax cuts instead of temporary tax rebates. As the economic boom ended in fiscal year 2000, they had $48 billion in reserves—equivalent to 10.4 percent of expenditures, the highest percentage ever. Only a year later, though, they had

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2. *The Fiscal Survey of States,* National Governors Association and National Association of State Budget Officers, Washington, D.C., May 2002, available online at http://www.nasbo.org/Publications/fiscsurv/may2002.pdf, p. 1.

spent 20 percent of reserves—and the recession had barely begun. By 2003, state reserves totaled just 3 percent of expenditures, but this percentage masked large problems in states such as Connecticut, Oregon, Texas, and California, which had either negative balances or balances close to zero.[3]

The "Wasteful Spending" Red Herring

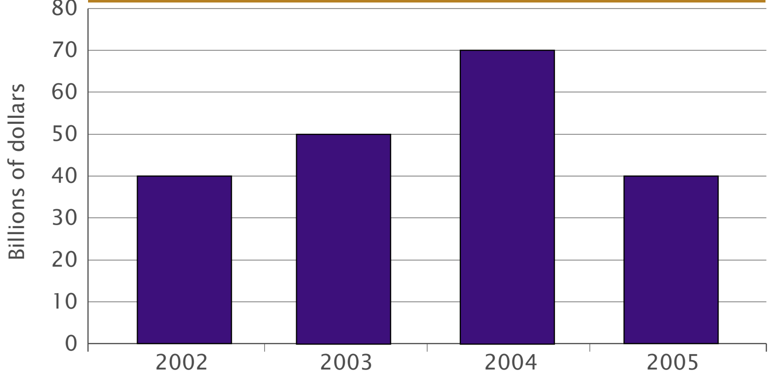
Some conservatives have argued that the state fiscal crises are an opportunity for cutting the fat out of budgets. However, the states had to close budget gaps in excess of $40 billion for each one of the past three fiscal years. The shortfall for 2004 alone amounted to 14 percent of cumulative state budgets. These adjustments compelled significant reductions in basic services such as health care, education, and road repair. For example, the school year in Oregon was cut by up to twenty-four days this past year. In Texas, 170,000 children will lose coverage when the State Children's Health Insurance Program is terminated for budgetary reasons. And 19,000 parents will lose Medicaid in Connecticut, where the state is

3. *The Fiscal Survey of States,* December 2003, Table 8, p. 13.

raising the minimum-income barrier from 100 to 150 percent of the poverty rate.[4] Figure 3 shows the overall magnitude of the shortfalls.

The state budget crisis has been exacerbated by many costs that cannot be cut without painful results, including Medicaid and public education. While education has long been a key component of state budgets, over the past fifteen years Medicaid has become a key driver of state budgets. According to the National Conference of State Legislatures, from fiscal year 1991 to 2001, state spending on Medicaid increased 149 percent. By contrast, education spending increased 90

Figure 3. Cumulative State Budget Shortfalls in Billions of Dollars, 2001–2004

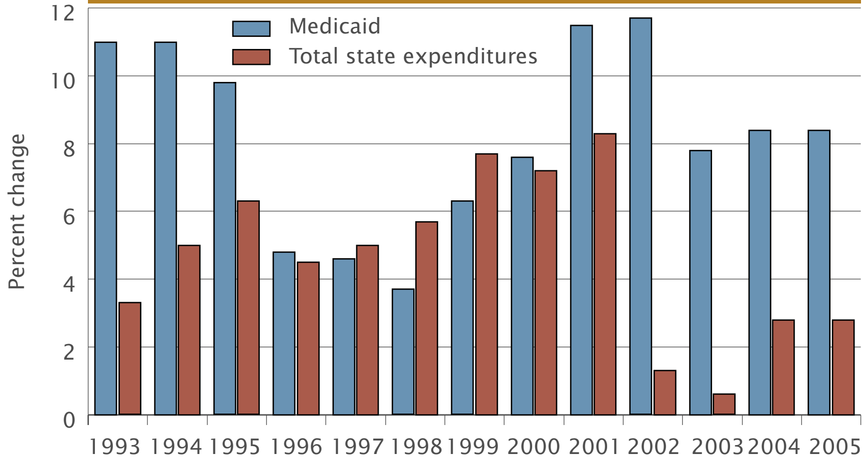


Source: Iris J. Lav and Nicholas Johnson, "State Budget Deficits for Fiscal Year 2004 Are Huge and Growing," Center on Budget and Policy Priorities, Washington, D.C., revised January 23, 2003; Iris J. Lav, "Federal Policies Contribute to the Severity of the State Fiscal Crisis," Center on Budget and Policy Priorities, Washington, D.C., revised December 3, 2003.

4. See Iris J. Lav, "Federal Policies Contribute to the Severity of the State Fiscal Crisis," Center on Budget and Policy Priorities, Washington, D.C., revised December 3, 2003, available online at http://www.cbpp.org/10-17-03sfp.pdf.

percent during this period. Figure 4 shows the annual percentage change in Medicaid compared to the annual change in state expenditures. Almost every year, except in the mid- to late-1990s, Medicaid spending has grown at rates far higher than overall state spending. This dynamic is likely to continue for the next decade, as Medicaid spending is projected to grow at an annual rate exceeding 8 percent. With Medicaid spending already almost 21 percent of state spending (up from only 18 percent a decade earlier), state budgets will continue to be squeezed unless they have a robust tax structure that produces stable revenues.

Figure 4. Annual Percent Change in Medicaid Spending and Total State Expenditures



Source: "NASBO Analysis: Medicaid to Stress State Budgets Severely into Fiscal 2003," National Association of State Budget Officers, Washington, D.C., March 15, 2002, available at http://www.nasbo.org/Publications/PDFs/medicaid2003.pdf; *The Fiscal Survey of States,* National Governors Association and National Association of State Budget Officers, Washington, D.C., April 2004, available at http://www.nasbo.org/Publications/fiscsurv/2004/fsapril2004.pdf.

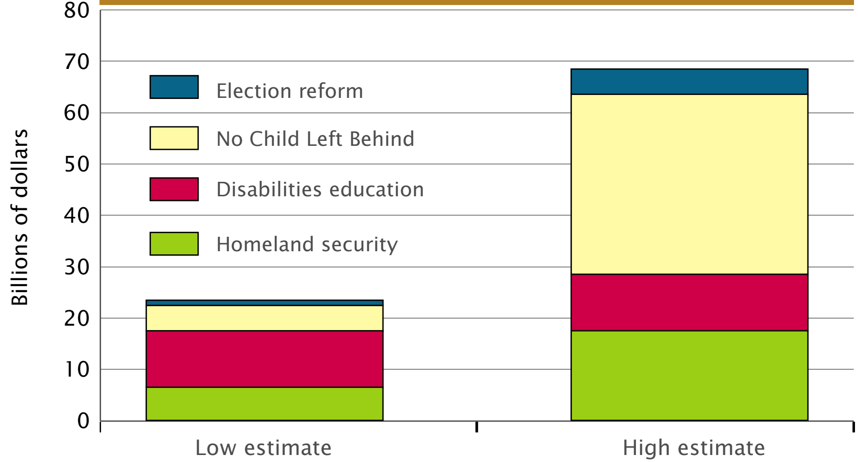
How Bush Administration Policies Worsened State Budgets

The Bush tax cuts have affected state tax collections directly because of the links between state and federal tax policies. For example, most states' estate tax rates are tied to the federal rates. Federal policy also is prohibiting states from levying fees on Internet access. Also, states cannot collect sales tax on Internet and mail-order transactions unless the vendor has a physical presence in the buyer's state. Together, these two lost sources of revenue are costing states up to $66 billion over the years 2002–2005.[5] Additionally, the Bush cuts have eliminated the taxes that individuals paid on dividend payments they received from corporations, which likely will reduce state receipts by more than $4 billion per year. States will have to raise other taxes or cut spending to make up for this lost revenue.[6]

5. Iris J. Lav and Andrew Brecher, "Passing Down the Deficit: Federal Policies Contribute to the Severity of the State Fiscal Crisis," Center on Budget and Policy Priorities, revised May 12, 2004, available online at http://www.cbpp.org/5-12-04sfp.pdf.
6. John Springer, "Dividend Tax Cut: Ineffective Stimulus Now, Bigger Deficits Later," Center on Budget and Policy Priorities, Washington, D.C., revised January 21, 2003, available online at http://www.cbpp.org/1-10-03tax.htm.

In the past three years, new federal legislation has imposed a range of new “unfunded mandates”—program requirements that have no federal funding attached—on the states. As Figure 5 shows, four new programs—election reform, the No Child Left Behind Act, education for children with disabilities, and homeland security—have imposed annual costs on state and local governments of between $23 billion and nearly $70 billion. (These estimates vary based on the assumptions used for future spending.)

Figure 5. Estimated Costs of a Sample of Unfunded Mandates on States



Source: Iris J. Lav, “Federal Policies Contribute to the Severity of the State Fiscal Crisis,” Center on Budget and Policy Priorities, Washington, D.C., revised December 3, 2003, available online at http://www.cbpp.org/10-17-03sfp.pdf; “A Brief Overview of State Fiscal Conditions and the Effects of Federal Policies on State Budgets,” Center on Budget and Policy Priorities, Washington, D.C., revised February 27, 2004, available online at http://www.cbpp.org/10-22-03sfp4.pdf.

The "Black" States

Nevada and Virginia are examples of states that made smart choices that enabled them to move from the red to the black. What do they have in common? They addressed the revenue side of the budget equation, raising taxes and fees in order to ensure that as the economy grows, there will be adequate revenues to address growing needs related to education and health care. Often, these tough choices involved reversing the tax and fee cuts made in the late 1990s. Fortunately, fixing the errors of the past can ensure that states have full coffers in the future.

Prepared by Thad Hall, Century Foundation Program Officer.

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