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The Fiscal Crisis of the States
Recession, Structural Spending Gap, or Political "Disconnect"?

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Four years after the 2001 recession, states still face serious fiscal challenges. Despite billions in new revenue, California, for example, has proposed a wide array of spending freezes and cuts in after-school programs. In Ohio, the legislature is debating large spending reductions for cities, counties, and libraries. Nebraska is cutting corrections and human services, while tapping reserves to avoid greater cuts. Missouri has proposed large layoffs in mental health, parks, and other programs. Pennsylvania is eying fare increases and service reductions for mass transit.

The problem is not simply that state governments were hit hard by the recession or that state recovery has been slow. Despite improved revenue in the past two years, budget time in most states remains a grim exercise. Even the rebounding national economy will do little to alleviate a long-term state fiscal crisis.

The financial trends are clear. The existing, built-in financial demands of the states' current responsibilities are growing more rapidly than their revenue. The greatest pressures come from health care and education, which account for the majority of state spending and are likely to continue growing faster than the economy as a whole in both the short and long term. The National Conference of State Legislatures reports that although "more money is flowing into state coffers," for many states "it's not expected to be enough to relieve health and education funding pressures."[1] Sure enough, real per-capita state spending increased 0.9 percent overall in 2003, driven by a 7.4 real per-capita increase in medical vendor payments. But real per-capita spending was down by more than 10 percent in corrections, general financial administration, housing and community development, judicial purposes, libraries, natural resources, parks, sewers, and solid waste.[2]

These trends may be exacerbated by the 2006 federal budget. President Bush has proposed cuts to federal Medicaid contributions and other programs that are highly troubling to state governors and legislatures.[3]

Whatever version of the federal budget passes, however, states will continue to have difficulty balancing their budgets. Unless we citizens make a fundamental change in our political thinking – increasing the state taxes we are willing to pay, or readjusting expectations about the services we want states and local governments to

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Table 1: The Impact of the Three Most Recent Recessions on Real, Per-Capita GDP and on State Tax Revenue[6]

Recession Period	Change in Real Per-Capital GDP	Change in Per-Capita State Tax Revenue
1980 - 82	-3.0%	-2.0%
1990 - 91	-1.8%	-3.5%
2001	-0.7%	-7.4%

provide, or making some fundamental changes in intergovernmental responsibilities – we should expect the tough fiscal times to continue for years to come.

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Antecedents of Crisis

A variety of factors have contributed to the states' current problems. Many argue that the states' fiscal crises are the states' own fault because they either spent too freely or cut taxes too much.

Indeed, the extraordinary boom of the late 1990s allowed states to cut taxes as a percent of their gross state product and, at the same time, to increase per-capita spending. In every year from 1994 to 2000, the net result of all state tax-code changes was a reduction in revenue. The cumulative impact of these state tax cuts was a net 8.2 percent reduction in revenue below what it would have been without these changes. During the late 1990s, only the few states that levied significant taxes on dividends and/or capital gains saw revenue grow faster – albeit briefly – than the economy as a whole.[4]

Nonetheless the Rockefeller Institute reports that state tax revenue across second quarters – when states set their tax filing date – grew 57 percent from 1994 to 2000, including a whopping 11.4 percent increase in 2000.

More than a Recession

The recession of 2001 brought with it — as recessions always do — an immediate strain on state budgets. Slowed income growth, stagnant sales, and declining capital gains diminished state revenue. At the same time, state spending rose to meet unemployment claims and increased needs for social services.

Compared to past recessions, however, the latest downturn was relatively shallow and brief; yet state fiscal pain has been deep and lasting. Unlike earlier recessions, state revenue failed to fully rebound even after the downturn was officially over. As shown in Table 1, the early 1980s recession stretched across 22 months and was more than four times as severe as measured by the drop in gross domestic product (GDP); yet its impact on state revenue was far less than the milder nine-month recession of 2001. Moreover, the 2001 recession's impact has lingered. In fiscal year 2003, 21 states spent less than they had during FY 2002.

The Rockefeller Institute of Government reports that in the third quarter of 2003, state tax revenue grew for the first time since the recession and continued to grow through the

first quarter of 2004.[7] Despite these recent gains, at the start of 2005 "state revenue remains about 8 percent below its 2000 peak after adjusting for inflation and population growth."[8]

Although states on balance did increase taxes in response to the recession of 2001 and its aftermath, the increases have been uneven and tentative. In FY 2002, the National Association of State Budget Officers reports, 12 states even cut their personal income tax rates — for a net loss to state government of $671 million. By FY 2004, state tax-law changes were producing a net revenue increase of $9.5 billion. States, however, have not raised taxes as much in the wake of the 2001 recession as they did in response to the recession of 1990-1991, when in only two years (FY 1991 and FY 1992), the states added $25 billion in taxes.

"The current state fiscal crisis will not disappear as the economy improves."

Instead of raising taxes, states have sought to hike a variety of public "fees" and implement temporary revenue diversions. The College Board, for example, reports that tuition and fees at public universities and two-year colleges jumped 14 percent for the 2003-2004 academic year. As a stopgap measure, states have used the payments that they receive from the tobacco settlement to shore up their budgets. The General Accounting Office reports that states expected to use 54 percent of their tobacco revenue to balance their FY 2004 budgets. Fourteen states have sold or "securitized" their future tobacco revenue much like they sell bonds against future revenue.

The Structural Spending Gap

Longer-term trends have elevated state spending for decades. Even when adjusted for inflation, median per-capita expenditures (in 2002 dollars) increased by over 70 percent from $2,590 in 1983 to $4,450 in 2002.[9]

During the lowest point in the recent recession, states struggled to keep budgets from rising. After adopting their FY 2003 budgets, states faced costs that were growing faster than revenue and made additional cuts totaling $14.5 billion that year. Twenty-eight states implemented across-the-board spending cuts, 20 employed furloughs, eight used early retirement, and 17 made layoffs. Despite these efforts, in FY 2003, 31 states still spent more from their general fund than they had during FY 2002.

The current state fiscal crisis will not disappear as the economy improves because two of state government's primary responsibilities —health care and education — are likely to continue consuming more and more of the economy's GDP, and thus more of the states' budgets. Consider:

- Education and health services comprise a growing portion of the nation's labor force. In 1960, one of every 18 non-agricultural employees worked in these sectors. Today, the number has grown to one in eight.
- The nation's per-capita expenditures for health care have grown faster than inflation. From 1980 through 2002 the consumer price index increased by 137 percent, while per-capita expenditures on health care grew by 479 percent.
- As a share of GDP, the nation's expenditures for health care have almost tripled since 1960, growing from 5.1 percent of GDP in 1960 to 14.9 percent of the economy in 2002. The Center for Medicare and Medicaid Services projects that by 2014 health care will consume 19 percent of GDP.
- School enrollment rates for adults aged 18-19 have increased from 48 percent in

1970 to 63 percent in 2002; among adults aged 20-24 enrollment rose from 21 to 34 percent. And enrollment among 3-4 year-olds increased from 21 percent to 55 percent over the same period.[10]

The growth of health and education costs within the national economy is mirrored in state budgets. By FY 2003, elementary and secondary education accounted for 22 percent of state spending, higher education for an additional 11 percent, and Medicaid had risen from 8 percent in 1985 to 21 percent. Thus, FY 2003 education and Medicaid consumed 55 percent of the states' budgets.[11]

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Many people believe that this growth in spending is acceptable — even desirable. The difficulty comes when the individual and collective desire for services exceeds individual and collective willingness to pay for them. This appears to be the case given the recent rejection of candidates who consider raising taxes, the difficulty of squeezing greater productivity out of human services, and the continuing desire for more of these services.

Health and Education Pressures

For three key reasons, health care and education demand an increasing share of our economy and are likely to do so for the foreseeable future. First, like other service-sector activities, health care and education have been unable to improve their productivity as rapidly as the manufacturing sector. With slower rates of innovation and efficiency gains, the relative costs of health and education increase over time. Second, as individuals become better off, they seek to acquire more health care and education as a percent of personal expenditures. Finally, technology creates increasing demand for health care and education.[12] The research-and-development component of health care keeps innovating new — and expensive — treatments, thus further increasing the desire to consume health services. Similarly, worldwide advances in production techniques place employees with low levels of education at an increasing disadvantage in the U.S. and global economy. To be competitive, workers must master increasingly complex skills through more and more years of education.

As citizens demand more and higher quality health care and education, they drive up the aggregate costs of these services. At the same time, they are also demanding lower tax rates. The result is a growing gap that some have labeled a "structural problem" of state government. Others protest that this is really a political problem: a lack of connection between our collective desire for public services and our willingness to pay the corresponding taxes. Whether one thinks the problem is structural or political — whether the solution is less spending or more taxes — the gap is real, and it isn't going away. Current program arrangements make escalating costs inevitable.

Hidden Cost Drivers

One reason for the steady rise of state spending is that major health and education programs have operated differently in practice than originally conceived, and will likely become increasingly costly in the future. Cost-cutting measures, including more stringent enrollment criteria, held increases in Medicaid spending between 2000 and 2003 to below the rate of increase for private-sector health insurance.[13] But long-term costs for custodial care through Medicaid are the fastest-growing component of health care costs. Similarly, states have been saddled with rising costs from federal legislation for special education that never

delivered on its financial promises – a situation that many state officials fear is being repeated with federal No Child Left Behind (NCLB) legislation.

Medicaid's Budget Buster

In 1965, Congress enacted two major health-care programs: Medicare, a federal program (administered by the Social Security Administration) to provide health insurance for the elderly and disabled, and Medicaid, an intergovernmental program funded by both the federal government and states (and administered by the states) to provide health insurance for the poor. Over time,

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the distinction between these programs has blurred: The size of the elderly population has grown significantly, and many of the elderly are also poor.

Medicaid is the fastest growing component of state budgets. Back in 1990, state officials were alarmed by the program's escalating costs that consumed 13 percent of their budgets. Despite continuous campaigns to control costs, the share grew to 22 percent in fiscal year 2004, overtaking K-12 education as the largest component of state budgets.[14] Moreover, in recent years the growth rate in Medicaid enrollment has accelerated. From December 1997, enrollment grew 29 percent in only five years, surging 19 percent between December 2000 and December 2002. Even if states cut other programs or raise revenue, they will have to confront the reality that annual increases in Medicaid costs will absorb much of these budget savings.[15]

Medicaid has been saddled with much of the nation's growing costs for long-term custodial care, a substantial cost that its architects did not anticipate. The federal Medicare program does not cover nursing-home services and other forms of long-term custodial care, since they are not defined as "medical" services. Medicaid, however, does cover such services for people who are indigent. As a consequence, it has become common practice for elderly individuals to enter a nursing home, spend all of their retirement resources on this custodial service, become officially indigent, and thus become eligible for Medicaid's coverage of their further nursing-home costs. This was not ever envisioned, discussed, or debated in 1965 when Congress created the two health programs.

A large and growing component of Medicaid expenditures currently goes for long-term care, over half of which is for nursing-home care. The rest goes for community and home care. Indeed, of the nation's total spending on nursing homes, Medicaid pays for half. All told, a full 35 percent of the $206 billion spent on Medicaid went to long-term care for the elderly, blind, and disabled by FY 2000.

Moreover, expenditures for nursing-home care have grown significantly in recent years and will continue to grow in the future. From 1990 to 2002, the nation's expenditures for nursing homes nearly doubled — from $52.7 billion to $103.2 billion. In the same period, the states' share of Medicaid's nursing home costs doubled from $10.2 billion to $20.5 billion. The Center for Medicaid and Medicare Services predicts that it will double again by 2013 – to $41.1 billion.

As the nation's population continues to age, therefore, Medicaid's built-in costs for long-term custodial care will continue to rise — and continue to be a larger and larger component of state expenditures. The one quarter of Medicaid's beneficiaries who are elderly or disabled

receive nearly three-quarters (70 percent) of the benefits. The number of elderly is increasing and the number of very elderly (those over 85 years) is increasing even more rapidly. The pressures to improve the quality of long-term care may neutralize the pressures to control costs, if not override them.

Elementary and Secondary Education

The federal government provides only 8 percent of the nation's funds for public K-12 education but its two biggest education programs — $9 billion for special education, and $14 billion for education for the disadvantaged — are precisely the programs that most concern the states.

"Since 1998, Congress has prevented forty states from imposing taxes on Internet access."

In 1975, when Congress enacted the first federal legislation on special education, the states thought they had a deal. Although the federal government's contribution would start at a modest 5 percent, the "state entitlement" was to increase to 40 percent by FY 1982. Congress has never come close to fulfilling its end of the bargain. For FY 2006, the administration has proposed funding that would maintain the federal government's commitment at about 19 percent.[16]

This helps explain why state officials are so wary of the No Child Left Behind Act. Legislators in Ohio, Utah, and Virginia even threatened not to participate. Their reasoning was clear: The federal government is providing little money but imposing stringent requirements. Indeed, to receive its allocation of federal funds, a state has to add numerous new expenditures to its own budget. For example, a study done for the Ohio Department of Education concluded that implementing No Child Left Behind would cost the state $1.49 billion over the next decade, with the federal government providing only $44 million, leaving the state to fund the remaining $1.44 billion.

Indeed, many in state and local government charge that Congress claims credit for pleasing important constituencies while leaving the states and municipalities to pick up the bill.

What Can be Done?

How might the states' structural fiscal problems be dealt with? One set of options requires federal initiative: The federal government could provide states with greater funding, either as general revenue or by taking greater responsibility for particular programs. It could relax restrictions on state taxation authority. The federal government could also provide funding for any new requirements or restrictions it imposes on the states. More ambitiously, it could reallocate broad fiscal responsibilities in the federal system.

In the spring of 2003, Congress did provide $20 billion in financial relief to state governments for fiscal years 2003 and 2004. It designated $10 billion to increase the Medicaid reimbursement formula and half for general relief. Congress did not, however, renew this funding in 2005.

Instead, the proposed budget for 2006 reduces the relative size of state and local grants. According to the Center on Budget and Policy Priorities, such grants in 2006 would amount to 3.4 percent of GDP, as compared to 3.5 to 3.6 percent of GDP in the previous three years.[17] Outside of Medicaid, federal grants to state and local government would decline in 2006 by $10.7 billion or 4.5 percent. Some kinds of federal cost-sharing would effectively be capped; and federal Medicaid spending, which currently approaches $200 billion per year, would be reduced by a net $45 billion over 10 years.[18]

By contrast, the National Governors Association has called on the federal government to assume responsibility for long-term care from Medicaid.[19] Doing so would not, as a single measure, eliminate the structural gap in state budgets. Nevertheless, it would free up states to provide other Medicaid services for the non-elderly indigent as well as to improve education and other public programs. Similarly, the National Association of State Legislatures has requested that the federal government fully fund the costs of the No Child Left Behind Act.[20]

Congress could also — at little or no cost to its own programs or revenue — let states shore up their own tax systems. The states' most obvious problem is that their sales taxes are still based on the outdated assumption that purchases occur in a direct physical exchange between a retailer and customer. An increasing number of exchanges are instead transacted at a distance — with orders placed and products or services delivered by mail, over the phone, or via the Internet. By the Census Bureau's measure, E-commerce continues to grow rapidly, comprising tens of billions of dollars in largely tax-exempt sales.[21] Congress has not helped states to provide easier ways to tax mail orders or Internet sales across state borders. Moreover, since 1998 Congress has prevented forty states from imposing taxes on Internet access. Firms providing Internet access or interstate sales surely would prefer not to be taxed. And they will continue to lobby Congress aggressively.

Whether any of these forms of federal assistance are politically feasible in the current political climate is an open question. If not, the states will likely continue to grapple with difficult fiscal problems for the foreseeable future, faced with the difficult choice of significantly reducing state (and local) public services or imposing increased taxes and fees within the existing state fiscal structure. ■

Endnotes

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5. The National Bureau of Economic Research dates the 2001 recession as beginning in March and ending in November. http://release.nber.org/july2003.html.

6. Donald Boyd, *The Current State Fiscal Crisis and its Aftermath*, Publication #4138 (Washington, D.C.: Kaiser Commission on Medicaid and the Uninsured, September 2003), p. 2. Boyd adjusted the data for legislative changes.

7. Nicholas W. Jenny, "State Tax Revenue Growth Gains Momentum," The Rockefeller Institute State Fiscal News, vol. 4, no. 3, May 2004, p. 1, Figure 1. These growth comparisons are from the same quarter in the previous year and are adjusted for both inflation and legislative changes in tax laws.

8. Donald Boyd, "New Year's Report 2005: State and Local Governments Face Continued Fiscal Pressure," The Rockefeller Institute State Fiscal Studies Program, (Jan 2005), p. 2.

9. State spending as a percent of Gross State Product and per capita calculated from Bureau of Economic Analysis and the Census Bureau.

10. *The Condition of Education 2004* (NCES-077) U.S. Dept. of Education, National Center for Educational Statistics (Washington, D.C), Table 1-1.

11. Nick Samuels, National Association of State Budget Officers, personal communications, June 17, 2004.

12. In the manufacturing sector, technology can improve employee productivity, increase the performance of the product, or create an entirely new product. In health care, technology tends to mostly produce entirely new products that contribute to rising expectations for the performance of the health-care sector.

13. John Holahan and Arunabh Ghosh, "Understanding the Recent Growth in Medicaid Spending, 2000-2003," *Health Affairs*, January 26, 2005.

14. The National Association of State Budget Officers reports in its 2004 Fiscal Survey of the States that the top four components of total state spending are: Medicaid, 21.9 percent; K-12 education, 21.5 percent; higher education, 10.5 percent; and transportation, 7.9 percent.

15. Medicaid is also the most costly intergovernmental program for the federal government. In FY 2004, it accounts for $177 billion — or 42 percent — of the federal government's contributions to state and local programs. See, *Budget of the United States Government: Fiscal Year 2005*, Historical Table 12.3.

16. U.S. Dept. of Education, "Fiscal Year 2006 Budget Summary – February 7, 2006," available at http://www.ed.gov/about/overview/budget/budget06/summary/edlite-section2b.html

17. Iris J. Lav, "Deep Cuts in Federal Grants in 2006 Budget will Squeeze States and Localities," February 9, 2005, available at http://www.cbpp.org/2-7-05sfp.pdf The reduction would be greater if one-time fiscal relief payments from the federal government during 2002 to 2004 had been included. See also Kaiser Commission on Medicaid and the Uninsured, "Medicaid Financing Issues – Intergovernmental Transfers and Fiscal Integrity," *February 2005.*

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