Another Long Winter

The State Fiscal Crisis in Its Third Year

A Union of Professionals

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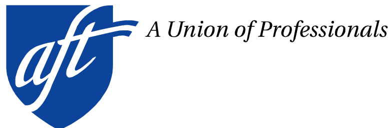

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Preface

Since the summer of 2001, state government has faced a fiscal crisis of historic proportion. Real per capita spending by states has dropped by 5 percent since the start of this crisis. The aggregate size of the budget gaps closed by legislatures so far is estimated at about $200 billion. Coming at a time when demand for services for public safety, economic development, education, healthcare and environmental protection are at an all-time high, this crisis is the most important issue facing state and local governments. Although there are signs the crisis is abating, states are facing additional gaps of $40 billion in the coming legislative season.

Already there have been major program cuts. In K-12 education, these cuts have undermined efforts to help children meet more challenging academic standards. Access to higher education is becoming more difficult as tuition at public institutions soars. And cuts are undermining the quality of education those institutions can offer. More than 1 million adults and 500,000 children will be denied healthcare benefits as a result of cuts to Medicaid and related programs. First responders are being laid off, and state officials talk of lacking the capacity to react appropriately to changes in terrorist threat levels. With more cuts to come, those of us who rely on state and local government for public services face another long winter.

The AFT research and information services department has prepared this report to help you put the cuts to state and local governments in perspective. The report outlines the damage done to vital services. It also analyzes the roots of the fiscal crisis. A bad economy, poor decision-making by state leaders when times were good and rising demand for and cost of public services are all part of the equation. But to a very great extent, it is the policies of the Bush administration and the Congress that have fueled the fiscal crisis.

The report also includes three case studies prepared for the AFT by state-based fiscal policy experts that outline the effect the budget cuts have had on public services and programs in New York, Washington and Wisconsin. Each state has been affected by the crisis in a different way and has made a different series of decisions in reaction to it. The case studies provide an in-depth view.

Another Long Winter is designed to help AFT leaders and members understand the extent of the crisis, the scope of the cuts and their impact on services performed by our members and received by our families. The report underlines the important role the public sector plays in providing economic opportunity and essential services, and it documents the real harm that is brought about by poor fiscal policies.

Executive Summary

State governments, which are responsible for most of the public services we rely on daily—from education to healthcare—are in the third year of an unprecedented fiscal crisis. Twenty-one of the hardest-hit states already are reporting that for fiscal year 2005, they will have to close budget gaps equal to roughly 9 percent of expenditures. This follows a record-setting shortfall states faced when creating budgets for the current (2004) fiscal year. The National Conference of State Legislatures estimates the cumulative three-year shortfall at $200 billion. To put this in perspective, state governments spend just over $1 trillion a year out of all funds. Real per capita state spending has declined by 5 percent during this crisis. The effect on states is serious and pervasive.

Much of the responsibility for this problem can be placed squarely at the feet of the Bush administration. One recent report finds that federal policies have, over the duration of this fiscal crisis, cost state and local governments $185 billion. Federal tax changes and pre-emptions have weakened state tax bases and undercut the ability of states to raise their own revenues. Inadequate funding of new federal mandates for state spending is the other direct component of these costs. But beyond the direct effects, the grim facts of the economic recovery—continued joblessness and rising healthcare costs in particular—cast a long shadow on states. The bottom line: Demand for public services will continue to rise, and states will have diminished resources to meet them. Moreover, the Bush administration's fiscal irresponsibility, inefficiently stimulating the economy by creating massive deficits to fund tax breaks for the wealthiest among us, robs states of hope that the federal government will be able to play a constructive role in the future. The nation's current course bodes ill for state and local government.

Real Cuts, Real Consequences

The last budget season (FY 2004) saw state leaders scrambling to fill budget gaps. After using gimmicks and spending down their savings, legislators and governors began making ever-harder choices limiting access to health services, and cutting aid to colleges and universities, thereby driving up tuition and fees. Public sector workers were laid off, and a variety of programs cut, including some that benefit America's neediest families and children. Some states resorted to tax increases to balance sinking budgets. The budget gaps were closed, but states left themselves with almost no margin to meet the next round of challenges. Sixteen states started this fiscal year with reserves equal to less than 1 percent of their budgeted expenditures. Moreover, many of the gimmicks states used last year (such as deferring required spending to the next fiscal year) merely papered over the scope of the problem. So, although there

are signs that the budget gaps states will face this year will be lower than the ones they faced last year, the hard choices are cumulative.

Cuts to Public Workforces: A Drag on the Economy and a Loss of Services

Public sector employment traditionally has been an important counterweight to the private sector job market. In 2003, however, both the public and private sectors shed jobs, with public sector job losses being smaller than the massive losses seen in the private sector. But given the economy's problems with job creation, the concomitant job losses could not come at a worse time. The federal tax cuts, which the Bush administration sold by claiming they would create 5.5 million jobs, or 306,000 jobs a month, are not working. In December 2003, only 1,000 new jobs were created. The failure of the administration's tax cut to spur job creation is a major stumbling block to the sort of economic recovery that would increase state revenue and reduce the demand for state services. Policies that ensure job destruction in the public sector seem particularly unwise when the private sector is struggling to create new jobs.

In addition to undermining overall economic performance, a shrinking public sector workforce also means shrinking services. Longer lines at motor vehicle bureaus, larger class sizes in public schools, fewer police on the beat are all part of the cost. Job losses also mean diminished morale among those workers who are left to carry the load. Cuts to benefits, pay freezes or pay cuts as have occurred in many states also have a negative effect on the public sector workforce.

Budget Cuts Mean Dashed Dreams

The budget cuts have been a bitter pill for many Americans, particularly the poorest among us. For children struggling to meet higher standards, and educators striving to meet the challenges of the federal No Child Left Behind Act, the cuts have been particularly hurtful. For example, in 2002, summer school programs for students struggling to meet standards were cut in districts in at least 22 states. In 2004, a number of states again cut programs for at-risk students. In Massachusetts, Gov. Mitt Romney oversaw a fiscal year 2004 cut to funding for child nutrition, early literacy, kindergarten and remediation. There is little relief from the federal government in sight. The No Child Left Behind Act's FY 2004 appropriation is $6 billion short of the authorized amounts to cover mandated state programs, and as much as $35 billion below some estimates of what will be needed to fully implement the act (U.S. House of Representatives Appropriations Committee, Democratic Staff, 2003).

State support for higher education bore the brunt of initial budget cuts. In nine states, spending on higher education has declined more than 10 percent. Cuts

of nearly $1 billion were made mid-year in FY 2003, and budgets for FY 2004 fell more than $3 billion below FY 2003 levels. Students are finding they can't get into required courses in time to graduate, forcing extension of their college years. Tuition hikes have been staggering, with increased fees and more rounds of tuition increases likely as the state fiscal crisis continues.

Budget cuts also mean that those dependent on Medicaid—the nation's largest health insurance program—are seeing their coverage diminish or disappear. Pharmacy controls, lower provider payments, reduction in benefits, and cuts in eligibility are among the most common cost-cutting methods used by states. The effect of these cuts is often greater than the actual savings to a state because the federal formula provides a minimum of a 50 percent match for each Medicaid dollar a state spends—which means that when a state cuts a program by $1 of its own funds, at least $1.50 in services will be eliminated. Yet, states have made many deep cuts to Medicaid services.

Hope for a Brighter Spring?

There are signs that the crisis in state finances has peaked. State revenues, after declining for eight straight quarters, have started to rise slowly thanks in large part to legislated tax increases. Some news reports go so far as to claim the fiscal crisis is over. States will face net budget gaps of $40 billion in FY 2005, about half the aggregate gap states faced last year. Smaller budget gaps are indeed better than larger ones. But they are a sign that the storm is diminishing, not ending. Moreover, the effect of these gaps is cumulative. The smaller gaps still must be added to the $200 billion in budget gaps that legislators have had to close since the crisis began. With state lawmakers already having taken most of the easy steps, many states will face particularly tough choices. Much remains to be done to repair the damage inflicted on states and local government. It will be another long winter.

Three factors will limit the ability of states to move to a brighter spring. One is the obsolescence of state revenue systems. States need to broaden their tax bases and become more responsible about corporate taxation. The second is faster rising long-term demand for and cost of state services. With healthcare cost increases in the double digits, this is a major concern. The third factor is the fiscal policy of the federal government. Federal mandates, such as the requirements made by the No Child Left Behind Act, on states and school districts will impose new costs for compliance that must be funded. The federal tax cuts remain a problem because state tax codes, in a variety of ways, are directly linked to the federal tax code, which limits a state's ability to raise its own revenue. These challenges are the fiscal and policy ingredients of another long, cold winter and must be overcome at both the state and federal levels before a brighter spring can arrive.

The State Fiscal Crisis in Its Third Year

Introduction

States are now in the third year of a fiscal crisis worse than anything experienced since the Great Depression. Since the start of the crisis, real per capita spending has declined by 5 percent (Johnson and Zahradnik, 2004). Even with some signs of economic recovery on the horizon, a variety of analysts concur that it will be some time before state finances fully recover (see for example Boyd, 2003a; Jenny 2003a, NGA, 2003a).[1] A survey of state legislators provides little hope that things will improve until 2005, when FY 2006 budgets are prepared (Pew Center on the States, 2003). Last year, states faced aggregate budget gaps of at least $78 billion when attempting to complete their FY 2004 budgets (NCSL, 2003a).[2] States face budget gaps for FY 2005 of $40 billion (Johnson and Zahradnik, 2004). These are gaps in budgets that already have been whittled down by previous years' cuts. The aggregate budget gap is likely to top $50 billion. To put this in perspective, state governments spend just over $1 trillion a year out of all funds.

The effect on states is serious. One budget officer for a Great Lakes area state said early last year: "We've become just like a family facing hard times, sitting at the kitchen table and deciding which bills have to be paid now and which can wait." Another way to put states' current financial predicament in perspective is to compare it to the impact the last recession had on states. According to the National Conference of State Legislators (NCSL), the largest budget gap states faced at the peak of the previous recession (1991-92) was $20 billion. Even adjusting for inflation, the gap states faced for FY 2004 was more than twice as large, and the gap for FY 2005 is comparable.

A handful of states—led by New Mexico—have not faced these sorts of fiscal pressures. But in many states the gaps were large, with the worst off facing aggregate budget gaps equaling one-fifth of their total budgets. The 10 states with the largest budget gaps to close when preparing their FY 2004 budgets are detailed in Table 1.

The picture is at least as bleak for local governments. Douglas Palmer, mayor of Trenton N.J., speaking this past fall at the Forum on State and Local

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[1] For example, in November of 2003, the National Governors Association warned: "While the worst is over, the problem will continue in most states for the next 9-15 months…." (NGA, 2003a).

[2] The National Conference of State Legislatures' report did not contain information from several states. In addition, some states, including North Dakota, did not report having any budget gaps despite signs to the contrary. The peak budget gaps for FY 2004 may have been closer to $90 billion.

Government Fiscal Challenges, described how the economic recession and two federal tax cuts had forced mayors to "choose between the solvency of our budgets and the quality of life in our communities" (Palmer, 2003). Palmer also noted that in FY 2004, congressional appropriations left cities $10.6 billion below the funding level needed to maintain their current level of services. Cuts to local law enforcement total hundreds of millions of dollars at a time of heightened security needs. Underfunding of the No Child Left Behind Act imposes additional burdens on localities. Cities, towns, counties and school districts are a second front in this fiscal crisis.

The budget cuts that state and local governments are making strain their ability to provide important public services, undermine quality of life and limit opportunities for our citizens. The fiscal crisis is also slowing progress toward an economic recovery. This report analyzes the causes of this fiscal crisis and describes the effects it is having on important public services and our economic well-being. A poor economy and decisions by states leaders must take some blame for the crisis. But in a variety of ways, policies set in Washington, D.C., have hindered overall economic recovery, hamstrung states' abilities to collect adequate revenue, jeopardized federal support for state services, and placed additional burdens on state and local government. In every aspect of the fiscal crisis examined here, there is either something the federal government has done to exacerbate the situation, or something it has failed to do to ameliorate it. A recent report by the Center on Budget and Policy Priorities estimates that federal policies have, over the length of the fiscal crisis, cost state and local governments $185 billion (Lav, 2003). This roughly equals the total amount of shortfalls generated during the fiscal crisis. Moreover, the administration's FY 2005 budget will not alleviate these problems and likely will aggravate them (Lav, 2004). The budget calls for real cuts of $6 billion in discretionary grant programs for state and local government in FY 2005 and larger cuts in succeeding years. It proposes to make permanent previously enacted tax cuts that are sapping states' own source revenue (Greenstein and Kogan, 2004). The administration also proposes to add a new deduction for healthcare costs that will remove billions of dollars from the state income tax base in a manner that primarily will benefit upper income taxpayers and do little to help most of the uninsured (Park and Greenstein, 2004).

Running Out of Easy Answers

When the crisis first became apparent, states used one-time solutions and in some cases resorted to budget gimmicks to close deficits. Although balanced-budget requirements typically do not allow states to spend more than they take in, some states have found creative ways to close the gap. For example, by the end of 2003, at least 20 states, the District of Columbia and New York City had sold future tobacco settlement revenue for up-front cash (Campaign for

Tobacco Free Kids, 2004). These transactions often include a deep discount. Wisconsin, for example sold almost $6 billion in future settlement revenues in 2002 for a payment of $1.6 billion (Center for Tax and Budget Accountability, 2002). South Carolina sold $2.3 billion of revenues it would have received over the following 25 years for $934 million in 2001. New Jersey sold all of its $8 billion in future payments for $3 billion up front.

States also are saving money in the near term by allowing the fund balances of their public employee pension programs to drop. At the start of the fiscal crisis these state pension programs were flush—funded at 106 percent of their long-term obligations (Nesbitt, 2003).[3] This was another benefit of the booming stock market. Pension fund performance was so good that many states were able to lower their contributions. But just when the stock market turned down, leaving pension funds in a worse position, states' ability and willingness to restore their contributions dwindled. In fact, many states added to the problem by further reducing their contributions or even raiding the fund. Indiana, for example, took $215 million from its pension funds to balance the budget (*USA Today*, 2003a). The net result of poor investment performance and state-neglect is that state pension holdings now are estimated to be worth only 85 percent of what is needed to meet long-term obligations. In 2000, less than one-third of state pension funds were underfunded. Now more than three-quarters are. Nine states have unfunded pension liabilities that exceed the total state budget. No one is in danger of losing his or her pension check this month as a result of these shifts, but by sacrificing the long-term health of pension systems now, states are committing themselves to additional costs down the line.

There are times when it is appropriate for pension funds to be part of the solution to a fiscal crisis. For example, New York City's unions played a vital role in leading the city out of its fiscal crisis in 1975 by purchasing city bonds. As the late AFT president Albert Shanker (then president of the United Federation of Teachers) said: "When the boat is sinking you don't quibble, you try to save the boat" (Schierenbeck, 2003). But the long-term security of the funds must be balanced against the short-term benefits to ensure a state or locality's fiscal health.

[3] The Wilshire Report (Nesbitt, 2003) is the source for all data on pension trends in this section of the report.

Table 1: States with the largest FY 2004 budget gaps					
State	Gap in millions of dollars	Gap as percent of budget	State	Gap in millions of dollars	Gap as percent of budget
Alaska	$ 896	36%	New Jersey	$ 4,600	19%
California	$ 26,100	30%	Oregon	$ 850	17%
Arizona	$ 1,500	25%	Maine	$ 486	17%
New York	$ 9,300	24%	Wisconsin	$ 1,999	16%
Kansas	$ 980	22%	Minnesota	$ 2,376	16%

Source: National Conference of State Legislatures—for 50-state table see Appendix I.

Another short-term solution employed by almost every state was to spend from reserves. In 2001, states had $48 billion in reserves. The most recent survey of the National Association of State Budget Officers and the National Governors Association found that states had just $6.4 billion in cash on hand going into FY 2004, just 13 percent of what they had at the start of the crisis (NGA and NASBO, 2003). States, again like families in hard times, have been relying on their savings and hoping that things will get better. When the fiscal crisis first hit, Maryland was particularly creative—spending down 40 separate funds including ones earmarked for kidney dialysis patients and the 911 telephone system. Tapping into rainy day funds is a perfectly appropriate response to the fiscal crisis; no one can deny that these are stormy times. The greater concern, however, is that states are in danger of wiping out their savings before the weather clears. Sixteen states now have reserves equal to less than 1 percent of their budgeted expenditures.

States also are using so-called budget gimmicks that delay the reckoning or hide the real size of budget gaps. The most common gimmick is to change the date when a state payment is due so that it falls in the next fiscal year. Thus, rather than making payroll on June 30, the check is sent July 1. New Jersey and Minnesota were two of the states that used a version of this gimmick in payment to school districts to help balance their FY 2004 state budgets. Texas shifted $2 billion in payments into the FY 2005 budget to close its budget gap.

Each of these efforts helps balance states' books in the near term and have saved services and preserved jobs for working families. But they also have added to the longer-term challenges by diminishing fiscal resources and allowing the structural problems that underlie the crisis to build. States' dependence on easy answers also has damaged their credit ratings, further undermining states' ability to climb out of the hole. California, Colorado, Illinois, Kentucky, New Jersey, North Carolina and Wisconsin all have had their

credit ratings drop since 2001, and Standard & Poor's has issued negative credit outlooks for 11 other states (*Washington Post*, 2003a).

Table 2: State ending fund balance as a percent of budget FY 2000 to FY 2003

State	FY 2000 balance as percent of budget	FY 2003 balance as percent of budget	Change 2000 to 2003
Alabama	2.0	2.1	0.1
Alaska	120.9	86.7	-34.2
Arizona	10.2	1.0	-9.2
Arkansas	0.0	0.0	0.0
California	13.7	-5.9	-19.6
Colorado	13.3	3.4	-9.9
Connecticut	5.0	0.4	-4.6
Delaware	15.0	12.1	-2.9
Florida	11.6	5.4	-6.2
Georgia	18.2	6.9	-11.3
Hawaii	8.7	1.6	-7.1
Idaho	13.0	0.9	-12.1
Illinois	6.6	2.1	-4.5
Indiana	15.3	2.2	-13.1
Iowa	13.0	5.2	-7.8
Kansas	8.7	0.0	-8.7
Kentucky	6.9	2.0	-4.9
Louisiana	-0.4	2.8	3.2
Maine	19.2	0.0	-19.2
Maryland	16.8	5.3	-11.5
Massachusetts	9.1	1.4	-7.7
Michigan	15.4	0.0	-15.4
Minnesota	18.5	1.3	-17.2
Mississippi	7.8	1.8	-6.0
Missouri	4.3	4.9	0.6
Montana	15.9	0.5	-15.4
Nebraska	19.5	2.3	-17.2
Nevada	18.9	7.2	-11.7
New Hampshire	2.3	-4.8	-7.1
New Jersey	10.2	0.4	-9.8
New Mexico	5.6	6.4	0.8
New York	3.1	2.5	-0.6
North Carolina	0.3	3.0	2.7
North Dakota	7.8	0.2	-7.6
Ohio	6.2	0.2	-6.0
Oklahoma	9.6	1.0	-8.6
Oregon	7.7	4.3	-3.4

Table 2 (continued): State ending fund balance as a percent of budget FY 2000 to FY 2003			
State	FY 2000 balance as percent of budget	FY 2003 balance as percent of budget	Change 2000 to 2003
Pennsylvania	8.9	0.0	-8.9
Rhode Island	7.3	3.6	-3.7
South Carolina	11.1	0.8	-10.3
South Dakota	4.8	10.6	5.8
Tennessee	3.3	0.0	-3.3
Texas	14.0	NA	NA
Utah	6.6	0.6	-6.0
Vermont	4.8	1.7	-3.1
Virginia	10.9	2.4	-8.5
Washington	12.1	3.0	-9.1
West Virginia	8.4	1.9	-6.5
Wisconsin	7.4	-2.6	-10.0
Wyoming	41.4	5.3	-36.1
Average	12.4	4.0	-8.4

Real Cuts, Real Consequences

States began to run out of easy answers in 2002 and by 2003 were having to make serious spending cuts. More than 25 states made across-the-board budget cuts, and most also made workforce changes. Some states were forced to lay off workers, but more imposed hiring freezes, pay freezes, early retirement programs or other changes. The pace accelerated as 2004 budgets were being prepared. Three-quarters of states responding to a National Conference of State Legislatures survey reported across-the-board budget cuts, and more than half reported that further personnel actions would be taken. These FY 2004 numbers reflect final budgets at the start of the fiscal year. As the year progresses, states will make adjustments depending on revenue performance and cost increases for programs such as Medicaid. So far, however, FY 2004 budget performance appears on target, with states having only $2.5 billion in additional gaps as of November 2003 (NCSL, 2003b).

Table 3: State budget cuts for FY 2003 and FY 2004		
	2003	2004
Across-the-board cuts	28/50	31/43
Personnel actions (layoffs or furloughs)	27/50	23/43

Sources: NASBO and NCSL.

Cuts to Public Workforces: A Drag on the Economy and a Loss of Services

As a recent Economic Policy Institute Report has noted, 2.4 million private sector jobs have disappeared since the recession began, the largest sustained loss of jobs since the Great Depression. More worrisome for those hoping for a meaningful recovery is that almost 1 million of these jobs were lost after the official end of the recession in November 2001 (Jobwatch.org. 2003). There are now more than 8 million unemployed persons in the labor market, and the unemployment rate increased from 4 percent in 2000 to 6 percent in 2003 (Economic Policy Institute, 2004). A further ominous sign is that the number of workers who have left the labor market is increasing. Since the end of the recession, one out of every 150 persons in the labor force has not only been out of work but has stopped looking for work. The federal tax cuts, which the Bush administration sold by claiming they would create 5.5 million jobs, are not working. In fact, now that the tax cuts have been enacted, the administration is backing off this projection. The administration's failure to create jobs is a major stumbling block to the sort of economic recovery that would increase state revenue and reduce the demand for state services.

The public sector workforce, on the other hand, made slight gains in 2001 and even into 2002, making it one of the brighter sports of the economy. However, statistics from the Department of Labor from the start of the school year point to a reversal of that trend. In August 2003, the public sector workforce shrank by 26,000 jobs, mostly in local government. These cutbacks were necessitated by diminished state and federal aid. The lost jobs represent 28 percent of overall job loss in the nation for that month. In September, the job loss accelerated with 44,000 additional jobs in education being lost. Approximately 175,000 public sector jobs have been cut since February 2003 (Labor Research Association, 2003).[4] Continuation of this trend in the public sector is likely to further weaken the recovery.

A shrinking public sector workforce also means shrinking services. Budget cuts proposed by Alabama Gov. Bob Riley, for example, will shrink prosecutorial staff by hundreds, which will delay murder trials in that state by 18 months (*Decatur Daily News*, 2003). Layoffs can have far-reaching effects. In summer 2003, Pittsburgh laid off 102 police officers, forcing the city to disband its SWAT and mounted units and reassigning those officers to patrol tasks. Each job lost exacts a price in service and diminished capacity (*Pittsburgh Post Gazette*, 2003).

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[4] This is for the period through Sept. 1, 2003.

Personnel changes also can have long-term consequences for the public sector workforce. No matter what workforce reductions are implemented—early retirement incentives, attrition or layoffs—the result is that more work is spread among the remaining employees. Resulting workload issues undermine morale and can lead to even greater loss of experienced or highly trained staff. Cuts to retirement benefits, pay freezes or pay cuts as have occurred in many states also have a negative effect on retention. When coupled with dramatically increasing healthcare costs for employees, pay freezes mean actual pay cuts. The tight private sector job market might limit the impact of these changes in the short term, but in the long term, both retention and the morale of the workforce are put at risk (AFT, 2003).

Cuts to K-12 Education

Education is the single largest component of state budgets, accounting for roughly 36 percent of general fund spending (NGA, 2003b). State contributions are also the most important single source of education funds, accounting for just under 50 percent of all funds spent on public education. The remaining funds come from local taxes and federal aid (U.S. Department of Education, 2003). Over the last decade, states have played a leading role in raising standards and in increasing expectations for education performance (Loeb and Carnoy, 2003). States also have been key in creating programs for class size reduction, early childhood education, and after-school and summer school programs designed to help students meet higher standards.

Yet the fiscal crisis has left states and school districts without the dollars necessary to reach these goals. Starting in 2002, local school districts began making budget cuts. For example, summer school programs for students struggling to meet standards were cut in districts in at least 22 states. Now, all too often, the cuts to programs that benefit those students who are most at risk of failing are being made at the state level.

Massachusetts is a case in point. Budgetary pressures have forced cuts to a number of programs that were geared specifically to help poor and at-risk children. The first round of cuts came soon after the election of Gov. Mitt Romney in 2002. Almost immediately after his inauguration, Romney cut $12 million for an early literacy program, $10 million for school readiness and $3 million in school breakfast programs. For the 2004 fiscal year, $150 million in basic state aid to school districts was cut, as was funding for child nutrition, early literacy and kindergarten. Massachusetts also slashed $40 million from its program to help struggling students pass the state's high school exit exam, which accounted for 80 percent of the program's total funding. This remediation program was key in helping to increase the number of students who passed the exit exam. Compared to 1998 scores, fewer students in 2003

failed the test, and 23 percent more of the student population met the proficient or advanced standard in English language (Massachusetts Department of Education, 2003). Cutting the programs that helped obtain these results when the federal government is increasing the stakes and the scrutiny for school performance is self-defeating.

Table 4: State cuts to programs designed to help at-risk children reach higher standards	
Colorado	Funding cuts mean 1,900 fewer students will attend prekindergarten.
Florida	High school graduation requirements have been reduced.
Georgia	State aid for advanced placement fees has been cut. Class size reduction for grades 4-12 has been suspended as has the state's reading program.
Massachusetts	Funding for school breakfast programs, early childhood education and remediation for students struggling to take the state's high school exit exam has been cut. The class size reduction program has been eliminated.
Minnesota	Early childhood family education funding was cut 20 percent. Compensatory education, school readiness, special education funding and the school breakfast program took cuts as well, and Head Start was funded at $3.2 million under the governor's recommendation. Three additional instructional days added in 1997 were eliminated.
Texas	As many as 170,000 students are no longer eligible for the Children's Health Insurance Program (CHIP).
Washington	Class size reduction programs have been cut.

Sources: AFT Research and Information Services; National Education Association.

The federal No Child Left Behind Act (NCLB), signed into law in January 2002, was supposed to build on previous state efforts to increase accountability. The law federalized the performance expectations for America's public schools, added to the consequences for schools that are unable to meet these expectations, and required states and school districts to perform a variety of new tasks, some of which are quite costly. NCLB has been called the most sweeping federal involvement in education in our nation's history. An analysis prepared for the Ohio legislature found that the state faced up to $1.5 billion in new annual costs if it was to reach its performance goals (Ohio Department of Education, 2004). In its first year, some new federal money was provided to help districts meet these challenges, and the targeting of available funds to districts serving poor students was improved. However, these efforts are dwarfed by the developments in state and local finance, prompting calls from many—including the AFT—for increased federal funding. Still, the latest budget numbers from Capitol Hill indicate that whatever improvements will be made in funding Title I of NCLB will be accomplished at the expense of other federal education programs that states and school districts rely on. The presence of NCLB's greater requirements and expectations, coupled with little prospect of

new federal dollars and a bleak budget outlook, means that the promises of the law will not be kept.

Higher Education

Support for public higher education accounts for about 13 percent of state general fund expenditures. Traditionally, state support for higher education bears the brunt of initial budget cuts during fiscal crisis. Public universities and colleges are seen as having their own means of raising money through higher tuition, and they have their own reserves to fall back on. But the cuts that already have been implemented are severe and undermine the quality of services provided to students. If a fiscal crisis is particularly bad, as this one is, or persists, as this one has done, public colleges can be harmed for years to come. For example, the City University of New York has yet to recover all of the faculty lines it lost in the 1973 fiscal crisis. In nine states, funding for higher education has declined more than 10 percent since the start of the fiscal crisis. The resulting budget cuts are devastating. Illinois community colleges have laid off faculty and staff and scaled back course offerings. Massachusetts colleges report higher class sizes as a result of layoffs, and an early retirement program has decimated experienced faculties. Institutions are relying more than ever on lower-paid part-time faculty.

One result of these cuts is a dramatic increase in tuition, which puts additional pressure on families already struggling to send children to college. Fewer students will be able to afford to enroll, and it will make it harder for students to complete their degrees in four or five years because required courses are oversubscribed and not being offered frequently enough. Some of the increases are mind-boggling. The tuition hike at the University of Arizona in 2003-04 was 40 percent. The State University of New York, following years of work to hold down tuition, also has seen a major hike in tuition (*Washington Post*, 2003b).

Table 5: Budget cuts and sample tuition increases for public higher education in states with largest real declines in spending					
State	FY 2002 Spending	FY 2004 Budgeted Spending	Real Decline	Sample Tuition Increases 2002-03	
Colorado	$ 769,697	$ 591,513	23%	University of Colorado at Boulder	12.9%
Virginia	$ 1,659,643	$ 1,311,244	21%	University of Virginia	8%
Massachusetts	$ 1,034,892	$ 849,044	18%	University of Massachusetts at Amherst	15%
Missouri	$ 991,244	$ 835,254	16%	University of Missouri, Columbia	16%
Oregon	$ 691,408	$ 586,200	15%	University of Oregon	1%
South Carolina	$ 870,781	$ 748,105	14%	University of South Carolina, Columbia	20%
West Virginia	$ 398,727	$ 355,892	11%	West Virginia University	9.5%
Wisconsin	$ 1,215,200	$ 1,091,299	10%	University of Wisconsin, Madison	9%
Oklahoma	$ 809,873	$ 731,950	10%	University of Oklahoma	27%
Minnesota	$ 1,418,687	$ 1,285,618	9%	University of Minnesota, Twin Cities	13%

Source: Sheeo/NASULGC.

Medicaid

Medicaid is a public health insurance program that provides coverage to 51 million low-income Americans. One in nine Americans is covered by Medicaid, and the program pays for nearly half of all nursing home care (Smith, et al., 2003).[5] It is a vital component of our nation's healthcare system. Responsibility for Medicaid is shared by the federal government and the states, with the federal government matching state Medicaid expenditures based on a formula that takes into account per capita income (GAO, 2003). Medicaid accounts for 15 percent of state general fund expenditures. Following elementary and secondary education, it is the largest component of state spending.

In the early 1990s, Medicaid spending had an average annual growth rate of 27 percent, which prompted analysts to dub it the "Medicaid Monster." This growth rate was driven by a surge in healthcare costs and by an increase in enrollment brought on by recession. Then, in the mid-1990s, the Medicaid

[5] Most of the specific information on Medicaid used here comes from this invaluable report, which was created by the Kaiser Commission on Medicaid and the Uninsured.

growth rate declined substantially—providing a boost to state coffers. In the period 2000-02, double-digit growth returned—again because of rising healthcare costs and increased enrollment. Medicaid costs grew by more than 9 percent in 2003—the return of the "Medicaid Monster." Private sector health insurance premiums grew between 10 percent and 13 percent per year in the same period; these spending increases were directly related to the increase in healthcare costs in general. But with overall state budgets tightening or shrinking, 10 percent growth in the states' second-largest spending area puts enormous pressure on the entire budget. States are making cuts or implementing other cost-control measures in Medicaid.

The effect of these cuts is often greater than the actual savings to a state because the federal formula provides at least a 50 percent match for each Medicaid dollar a state spends. This means that when a state cuts a program by $1 of its own funds, at least $1.50 in services will be eliminated.

Table 6: Medicaid cost-containment strategies

Cost-containment strategy	Number of states adopting for FY 2003	Number of states planning for FY 2004
Provider payments	50	49
Pharmacy controls	46	44
Benefit reductions	18	20
Eligibility cuts	25	21

Source: Kaiser Commission on Medicaid and the Uninsured.

The most common strategy to contain costs in both FY 2003 and FY 2004 was to cut or freeze provider payment rates for several types of provider. These are the payment rates for hospitals, doctors or nursing homes. Although freezes were most common, 10 states actually cut hospital rates for FY 2004. Six states cut nursing home rates, and five states cut payment rates for managed care organizations. Cutting the payment rate naturally makes Medicaid unattractive to healthcare providers, and state officials responding to a Kaiser Commission on Medicaid and the Uninsured survey expressed fear that access to healthcare providers would diminish as a result of these changes.

A major reason for the increase in healthcare costs is the expansion in the range of effective pharmaceuticals available and increases in the costs of these drugs. Seventeen percent of prescription drug spending in America is through the Medicaid program. States have taken a variety of approaches in attempting to control drug costs; they range from limiting the number of prescriptions per patient per month to requiring the use of generics to seeking supplemental rebates from pharmaceutical companies. The most popular cost-containment strategies include mandating that certain prescription drugs can be prescribed

only with prior authorization from the state. States also are negotiating better prices for particular drugs and placing them on "preferred drug lists."

There are a set of services within Medicaid (such as podiatry, psychological counseling, chiropractic, prosthetics and circumcisions for newborns) that states can choose to cover. For 2003 and 2004, some states have taken steps to limit the scope of these services and thereby limit costs. In some cases, limits also have been placed on the number of visits to a physician and on the length of hospital stays that will be covered. For example, Texas has "eliminated eyeglasses, hearing aids, chiropractic services, podiatry and some mental health services for all adults in the state" (Smith et al., 2003). Connecticut, Massachusetts and Utah also have eliminated a broad array of services.

In the last two years, more than half the states have taken steps to restrict eligibility for Medicaid. In some instances, such as Massachusetts' removing coverage for more than 30,000 long-term unemployed workers, the move has been temporary. But in other states, the cuts show no signs of being restored. Oklahoma and Oregon, for example, have eliminated programs for the "medically needy." The medically needy are those whose income normally would make them ineligible for Medicaid but whose medical expenses become so large that, once accounted for, they reduce a person's income to a level that makes the person eligible. The effects are stark. In Oklahoma, 1,000 senior citizens, 6,500 other adults and 800 children have lost health insurance and access to prescription drugs.[6] Colorado and Massachusetts have removed legal immigrants from the Medicaid rolls. All told, the Center on Budget and Policy Priorities estimates that nationwide more than 1 million adults have lost health insurance as a result of these cuts (Ku and Nimalendran, 2003).

Perhaps even more troubling are the cuts to the Children's Health Insurance Program (CHIP). Some states are freezing enrollment and turning away children who meet state program guidelines. Florida now has more than 40,000 children on a waiting list (Ross and Cox, 2003). Other states are increasing eligibility requirements for the program. For example, Minnesota removed eligibility for uninsured children whose family income was between 150 percent and 170 percent of the poverty line. Approximately half a million children will lose out on health insurance as a result of cuts (Ku and Nimalendran, 2003).

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[6] Recent changes to Medicare may help senior citizens regain coverage for prescription drugs in 2006 or provide them with $600 worth of support this year. This will be cold comfort for those relying on more expensive treatments.

Will Things Get Better?

There are signs that the crisis in state finances has peaked. After declining for eight straight quarters, state revenues have started to rise slowly. The economy, too, is showing signs of recovery. As it improves, tax collections will increase, and demand for some public services like Medicaid will grow at a slower rate. Nevertheless, there are disturbing weaknesses in both the economic and revenue data. Tax revenues are only growing because states have passed tax increases. Had states not taken this action, revenue would continue to lag (Jenny, 2003b). As for the economic numbers, weak job performance—as mentioned earlier—continues to cast a shadow on the economic recovery. It is unlikely, even in the event of a full-blown recovery that state finances will regain their 1990s' dynamism. Three factors affect this. One is the obsolescence of state revenue systems. The second is rising long-term demand for and cost of state services. The third—and potentially most troubling—is the fiscal policy of the federal government.

Problems in State Taxation

State tax revenues account for 53 percent of their total revenue, with the rest largely coming from the federal government. Three of the main pillars of state tax systems—the sales tax, the personal income tax and the corporate income tax—face major challenges that are undermining their stability and limiting their long-term revenue potential. Without working either to fix these problems or to offset them, states' fiscal recovery will be halting.

The boom years of the late 1990s created major spike in income tax collections. This was due in part to low unemployment, but capital gains from the booming stock market was the main contributor. In 2001, capital gains fell by 50 percent, and it is unlikely that there will be a return to the previous rate of growth anytime soon. Even if the stock market completely turned around, the carryover of capital losses from the 2001 crash will limit the taxable income from capital gains for years to come. And state income taxes will be sapped even further if Congress enacts some version of the Bush administration proposal to exempt dividends from taxation.

State sales tax collections pose problems of their own. First, growth in sales tax revenue has been heavily dependent on consumers' willingness to spend far more than they save. If consumers ease off on spending, sales tax revenues will decline. Second, the sales tax applies to less and less of our spending. This is the result of an increased use of services—ranging from dry cleaning and hair cutting to tax preparation, legal and medical services—that generally are not covered by the sales tax. Thirty years ago, about two-thirds of family economic activity was covered by state sales taxes. Now, about one-third is so covered. As

this trend continues, the power of the tax diminishes (Minnesota Department of Revenue, 2001).

The rise of the Internet also has undermined the sales tax. States cannot compel retailers in other jurisdictions to collect sales tax for them, so sales tax typically is not collected on transactions by electronic retailers such as Amazon.com. Electronic services are typically not subject to the tax either. All told, this will soon cost the states more than $40 billion a year in lost revenue (Donald and Fox, 2001). As more consumers shop online, the sales tax will continue to suffer. States are working together to create a system to make it simpler for electronic retailers to collect sales taxes. And states are hoping Congress will authorize implementation of this system, but legislators—prodded by anti-tax conservatives—have thus far been reluctant to take action.

Finally, weaknesses in states' corporate income tax structures have undermined their strength. In 1979, corporate income taxes accounted for almost 11 percent of total state revenue. In 2000, this figure had dropped to just over 6 percent. A growing cottage industry in legally avoiding corporate taxes is one cause. Using the provisions of different state tax codes, financial advisers help corporations move revenue from high-tax to low-tax jurisdictions. For example, Delaware does not charge corporate tax on profits from the sale or lease of trademarks or intellectual property. Many companies have created subsidiaries, based in Delaware, to hold their trademarks and patents. A company then pays the subsidiary (which is part of the parent company itself) for the use of the patents. Any income used to pay the subsidiary is treated as an expense for the parent, and not as taxable profit.[7] The scheme is akin to individuals avoiding income tax by shifting their wallet from the right pocket to the left and deducting the value of the contents of the wallet as a business expense, except that for corporations it is legal. There are other similar loopholes (Mazerov, 2003).

Companies also use their mobility to play off one state against another or others. By threatening to move to a different state or offering to expand within a state, corporations often make deals for preferential tax treatment. Such expenditures cost states untold billions. Best estimates are that states spend $15 billion to $16 billion a year on these incentives (Corporation for Enterprise Development, ND). Illinois recently gave Boeing more than $50 million in tax breaks to lure some of the company's operations from Washington state to Illinois (McCourt et al., 2003; see also Leroy and Hinckley, 2002).

[7] The most famous example of this is Geoffrey Inc., the subsidiary of Toys R Us that owns the corporate symbol Geoffrey the Giraffe. Toys R Us pays Geoffrey Inc. to use the giraffe symbol and does not count this money paid to its own subsidiary as taxable revenue in any state. Geoffrey Inc. shows it as revenue in Delaware where it is not subject to tax.

The Federal Government

At the start of 2001, the federal government was forecasting a $5.6 trillion *surplus* during the 10 year period from 2002-11. Following a series of costly tax cuts, the nation is now likely to run *deficits* exceeding $3.5 trillion during this same period, resulting in a swing of $9 trillion from what was predicted at the start of 2001. Interest payments on the debt during this period are likely to cost $2 trillion more than projected in the forecast made in early 2001. The securities and investment firm Goldman Sachs now calls the nation's long-term budget outlook "terrible, far worse than the official projections suggest" (Dudley and McKelvey, 2003). The International Monetary Fund recently issued a report stating that our deficits "pose significant risks for the rest of the world" and that "room for maneuver is narrowing quickly" (Mulheisen and Towe, 2004).

The poor financial health of the federal government has major ramifications for state finance. Through programs such as Medicaid, the federal government supplies more than $280 billion in state funding. More than 27 percent of state general fund revenues come directly from the federal government. The federal government also provides an additional $35 billion a year in direct aid to local governments (U.S. Census Bureau, 2003). Simply put, unsustainable deficits at the federal level, over time, will demand some combination of shrinking federal spending and rising federal taxes. The effect will be to create pressure for reducing federal aid to state and local government.

Further, the federal economic policies have not been a particularly effective stimulus and have failed to create jobs. The result is a weak economic recovery that is hampering state efforts at fiscal revival. Finally, federal tax changes that affect state tax systems in the long term, particularly the elimination of state estate taxes and changes to the marriage penalty, are sapping states' own revenue sources. The potential for changes to the definition of dividends for purposes of taxation would be an additional blow. (See Appendix I: Who Caused the Fiscal Crisis? Federal Tax Cuts.)

Increasing Demand for and Cost of Public Services

Public services are expensive and getting more so. Broad demographic shifts will affect both college attendance and demand for services for senior citizens. In a recent report from the Brookings Institution, Alice Rivlin notes that state responsibilities are outrunning their resources (Rivlin, 2002). These demands will slow states' return to fiscal health.

As the “baby boom echo” (children of the baby boomers) works its way through the school system, enrollments are expected to stabilize over the next several years. But based on previous patterns, costs are still expected to rise. Even as enrollment grew in the 1990s, so did spending per pupil. In most states, real teacher salaries did not grow, even though per-pupil spending did. As a result, many attribute this spending increase to the rising costs for meeting federal special education mandates (Rothstein, 1997). This is a continuing problem in school finance. The No Child Left Behind Act created new requirements that threaten to increase costs even further. As the children of the baby boom echo enter college and as college education becomes more important for workplace success, demand for higher education will increase dramatically.

Spending on public safety is another area in which states will find it difficult to economize. State spending for correctional institutions increased by 42 percent in the 1990s (solely the result of an increased number of persons incarcerated) while actual spending per prisoner fell by 18 percent (Boyd, 2003b). Some of this reduction in spending may be a result of efficiencies rising from facility modernization, or economies of scale arising from the major growth in the prison population. It means that prisons may not have much room to make additional cuts. And the continuing effect of mandatory sentencing requirements means that there will be little relief in this area of the budget. Homeland security and public health are other areas where demands for service are almost certain to increase during the next several years. Already, states are finding it difficult to make the investments needed for homeland security. (See Appendix I: Who Caused the Fiscal Crisis? Federal Mandates.)

Although the Congressional Budget Office predicts that Medicaid enrollment growth will slow as the economy recovers, costs and utilization of services will increase; Medicaid is expected to grow at an average 8.5 percent annual rate for the rest of the decade.

Conclusion: A Brighter Spring?

Continued weak state finances are exerting a drag on the economy, which is hampering the nascent recovery. And the federal government—through a series of tax cuts—has limited its own options in providing aid to the states. It is clear that the federal policy of stimulating the economy through tax cuts has not been the most effective course. Because the tax cuts raise our long-term debt picture, they are likely to push interest rates upward. This will cause a slowdown in investment and may undermine the housing market, which has been the single brightest spot in the economy of late. Many economists have

argued that the potential effect the administration's tax cuts will have on interest rates might endanger economic growth rather than stimulate it.[8]

Moreover, skewing the tax cuts toward the wealthiest Americans is a poor stimulus. Individuals with high incomes are less likely to put new money from tax cuts into circulation because they already have been able to buy the goods and services they need. This is why some economists have argued for a tax cut geared toward working families. Because they do have unmet needs, such families are far more likely to spend each dollar of the tax cut. Using this logic, a Congressional Budget Office study noted: "Consequently, tax cuts that are targeted toward lower-income households are likely to generate more stimulus dollar for dollar of revenue loss—that is, be more cost-effective and have more bang for the buck—than those concentrated among higher-income households" (CBO, 2002).

Sadly, the administration's FY 2005 budget continues this trend. For example, even though the elimination of taxes on estates worth more than $1 million has been made permanent, tax incentives to help families with incomes under $50,000 save for retirement have not been extended (Greenstein and Kogan, 2004). New tax benefits to help with the purchase of health insurance are structured so that they will provide about a 10 percent or 15 percent discount for those in the 10 percent and 15 percent tax brackets—and no help to those not paying federal income tax. Ninety percent of uninsured Americans are in these categories. The benefit does provide somewhat more substantial tax relief to those in the 35 percent tax bracket, who already are likely to be covered by insurance (Park and Greenstein, 2004).

The numbers on job creation highlight the degree to which this approach has failed to stimulate economic growth. The administration predicted it would create 5.5 million jobs by the end of 2003. Only 221,000 new jobs have been added—well short of the administration's projections. Given that roughly 100,000 new jobs are needed each month to keep up with new entrants to the workforce, these jobs are not enough to meet new demand, let alone provide relief for those already unemployed (Jobwatch.org, 2004).

Providing aid to the states in the form of spending on homeland security, education and healthcare would be a way to create a more effective stimulus. Many prominent economists have suggested just this response instead of the

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[8] For example, Nobel Laureate George Akerlof said: "… because the tax cuts are long term and permanent, it's very likely that instead of being a stimulus, they will act as a damper on the economy. If the tax cuts are implemented, they will cause deficits, which in turn will raise long-term interest rates, which will actually cause an economic contraction. The net effect is likely to be negative rather than positive" (*UC Berkeley News*, 2003).

administration's tax cut proposal. Noting that poor state fiscal climates in bad economic times lead to cuts in programs like Medicaid just when they are most needed, Brookings Institution scholar Alice Rivlin has called for Congress to create a permanent program for countercyclical revenue sharing. Rather than acting in an ad hoc way, Congress would have a permanent mechanism for providing aid to the states during times such as these (Rivlin, 2002). Felix Rohatyn, former head of the Municipal Assistance Corporation of New York, seeing that the fiscal crisis is trickling down to local government, has called for $75 billion in aid to localities as an economic stimulus (U.S. Conference of Mayors, 2003).

Finally, the federal government could help states by protecting them from the harmful revenue effects of future tax cuts. States will lose billions in revenue if, for example, the federal government exempts dividends from its definition of taxable income. Federal action to allow the states to collect sales tax on electronic commerce would be another important step.

States also have a role to play in easing their fiscal problems. Creating adequate reserves and modernizing their revenue systems are not easy political tasks. But accomplishing them will serve states well—not just this spring but for many seasons and years to come.

Appendices

Appendix I: Who Caused the Fiscal Crisis?

Prepared by AFT Research and Information Services

The State Role

Poor state government fiscal practices helped create the fiscal crisis in two ways: overzealous tax cutting and poor savings habits. As the U.S. economy boomed in the 1990s, states reaped enormous windfalls. In retrospect, it seems obvious that these gains were not sustainable, but state governments acted as though the boom would continue and reduced taxes across the board. The total annual value of state tax cuts passed in the years 1994-2001 was $40 billion (Orzag, 2003). Adequate revenue from this smaller tax system was possible only while the good times continued. When the boom went bust, taxes in many instances simply were too low to generate adequate income for states.

During the 1990s, states also did not put enough money in rainy day funds. This is not a complete indictment of states, because reserves at the start of the fiscal crisis in 2001 were equal to 10 percent of state general fund expenditures. Five states (Arkansas, Colorado, Illinois, Kansas and Montana) do not have rainy day funds at all. Four states cap their rainy day funds at less than 5 percent. Some states also have rules requiring the quick replenishment of rainy day funds even if the fiscal conditions that prompted their use have not improved. Such provisions undermine the logic of having a fund at all (Zahradnik and Ribiero, 2003).

Federal Mandates

The impact federal mandates in the No Child Left Behind Act will have on states and school districts has been discussed. NCLB is just one program where federal action is putting pressure on states. Homeland security measures—from protecting infrastructure to preparing a reaction to biological attacks—are also straining state resources. For example, costs to New York City for overtime when the nation's terror alert system is at code orange are $5 million more per week than during a code yellow. The total cost for heightened security measures in U.S. cities is $70 million per week (*Business Week*, 2003). Other services suffer as personnel are taken away from their regular tasks, which is an additional cost not captured by these statistics. Some states are even considering not responding to heightened terror alert status because of the costs involved (*USA Today*, 2003b). Against this backdrop, the federal government has come up with limited aid to help state and local governments offset homeland security costs. At the same time, general aid to local

governments has fallen, and mounting federal deficits mean that this problem will not be solved anytime soon.

Federal Tax Cuts

State tax codes, in a variety of ways, are directly linked to the federal tax code. This means that changes in federal tax codes also can change state tax codes. Through these links, recent federal tax cuts have cost states billions in lost revenue since the fiscal crisis began. The changes that have done the most harm in the short term are the elimination of the federal inheritance tax, the changes to federal corporate depreciation schedules and the change to the marriage deduction.

When President Bush signed into law the phaseout of the federal inheritance tax in 2001, he also was signing into law an accelerated phaseout of state inheritance taxes.* The net potential loss to the states, according to the Center on Budget and Policy Priorities will be almost $5 billion in 2004. Six states already had their inheritance tax structured to protect against such a change, and 12 have taken action to delink their estate taxes from the federal change, but most have not had the political will to do so.

One economic stimulus the administration sought to apply in the wake of Sept. 11, 2001, was an acceleration of corporate depreciation, which would allow companies to take tax write-offs on new investments at a faster rate. Because states typically use the federal depreciation schedule for their own corporate tax, most states also had the same provision apply to their corporate tax. The cost to states in 2004 could have been more than $10 billion if states did not protect themselves by delinking their tax codes. The administration came back with a second round of depreciation in 2003 that cost the 16 states that did not delink an additional $1 billion in 2004. Table A1 shows the potential threat various federal tax cuts have on the states. Many states did delink from at least some of these changes, helping to close those budget gaps. But even so, political capital was used that could have gone to finding other ways to save money or raise real new revenue.

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* The federal government provides a credit to payers of this tax for payment of inheritance taxes to state governments up to a certain amount. Many states simply have their estate tax pegged to this federal credit. When the federal credit disappeared, so did their estate tax revenue.

Table A1: Effect of federal tax changes on states' own source revenues (in millions of dollars)						
State	Misc. 2004 Changes	Estate Tax 2004	Depreciation 2004	Budget Gap*	Potential Revenue Loss Caused by Federal Tax Changes	Has State Protected Itself from These Losses?
Alabama	$ 110	$ 28	$ 41	NA	$ 179	No
Alaska	$ 2	$ 2	$ 52	$ 896	$ 56	Partially
Arizona	$ 9	$ 41	$ 81	$ 1,500	$ 131	Partially
Arkansas	$ 6	$ 14	$ 40	$ 0	$ 60	Partially
California	NA	$ 511	NA	$ 26,100	$ 511	Partially
Colorado	$ 82	$ 45	$ 65	$ 398	$ 192	No
Connecticut	$ 12	$ 87	$ 74	$ 1,942	$ 173	Partially
Delaware	$ 60	$ 23	$ 15	$ 196	$ 98	No
District of Columbia	$ 4	$ 32	$ 29	$ 143	$ 65	Partially
Florida	$ 251	$ 419	$ 124	NA	$ 794	No
Georgia	$ 23	$ 70	$ 132	$ 735	$ 225	Partially
Hawaii	$ 4	$ 10	$ 15	$ 110	$ 29	Partially
Idaho	$ 3	$ 6	$ 23	$ 160	$ 32	Partially
Illinois	$ 37	$ 197	$ 270	$ 3,600	$ 504	Partially
Indiana	$ 16	$ 20	$ 134	$ 750	$ 170	Partially
Iowa	$ 6	$ 26	$ 48	$ 413	$ 80	Partially
Kansas	$ 46	$ 23	$ 42	$ 980	$ 111	Partially
Kentucky	$ 10	$ 25	$ 55	$ 198	$ 90	Partially
Louisiana	$ 74	$ 20	$ 42	$ 600	$ 136	No
Maine	$ 4	$ 17	$ 22	$ 487	$ 43	Yes
Maryland	$ 16	$ 42	$ 88	$ 853	$ 146	Partially
Massachusetts	$ 29	$ 111	$ 200	$ 3,000	$ 340	Partially
Michigan	$ 71	$ 96	$ 47	$ 1,250	$ 214	No
Minnesota	$ 20	$ 29	$ 41	$ 2,376	$ 166	Partially
Mississippi	$ 4	$ 15	$ 52	$ 90	$ 60	Partially
Missouri	$ 91	$ 86	$ 81	$ 1,000	$ 242	No
Montana	$ 20	$ 5	$ 40	$ 116	$ 41	No
Nebraska	$ 4	$ 13	NA	$ 380	$ 49	Yes
Nevada	$ 0	$ 23	$ 65	NA	$ 23	Partially
New Hampshire	$ 3	$ 9	$ 74	$ 148	$ 44	Partially
New Jersey	$ 28	$ 101	$ 15	$ 4,600	$ 325	Partially

Table A1 (continued): Effect of federal tax changes on states' own source revenues (in millions of dollars)						
State	Misc. 2004 Changes	Estate Tax 2004	Depreciation 2004	Budget Gap*	Potential Revenue Loss Caused by Federal Tax Changes	Has State Protected Itself from these Losses?
New Mexico	$ 37	$ 14	$ 29	$ 0	$ 80	No
New York	$ 79	$ 341	$ 124	$ 9,300	$ 965	Partially
North Carolina	$ 132	$ 67	$ 132	$ 2,000	$ 344	Partially
North Dakota	$ 13	$ 3	$ 15	$ 0	$ 28	No
Ohio	$ 30	$ 18	$ 23	$ 1,700	$ 187	Partially
Oklahoma	$ 27	$ 0	$ 270	$ 300	$ 63	No
Oregon	$ 82	$ 24	$ 134	$ 850	$ 182	Partially
Pennsylvania	$ 29	$ 35	$ 48	$ 2,403	$ 316	Partially
Rhode Island	$ 3	$ 12	$ 42	$ 174	$ 29	Partially
South Carolina	$ 7	$ 27	$ 55	$ 400	$ 77	Partially
South Dakota	$ 0	$ 5	$ 42	$ 54	$ 11	Partially
Tennessee	$ 5	$ 5	$ 22	NA	$ 91	Partially
Texas	$ 16	$ 192	$ 88	$ 3,700	$ 461	Partially
Utah	$ 41	$ 17	$ 200	$ 80	$ 90	No
Vermont	$ 4	$ 7	$ 47	$ 30	$ 19	Partially
Virginia	$ 22	$ 68	$ 117	$ 1,100	$ 192	Partially
Washington	$ 0	$ 59	$ 41	$ 1,000	$ 59	Yes
West Virginia	$ 57	$ 10	$ 65	$ 250	$ 88	No
Wisconsin	$ 18	$ 42	$ 16	$ 1,999	$ 164	Partially
Wyoming	$ 0	$ 4	$ 32	$ 0	$ 4	Partially
Total	$ 1,660	$ 3,094	$ 4,132	$ 78,361	$ 8,886	

Sources CBPP/NCSL; AFT Research and Information Services.

Appendix II: Summary of New York State's 2003-04 Budget

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Jan. 1, 2004

In January 2003, Gov. George Pataki presented his executive budget proposal for state fiscal year 2003-04 and projected a two-year budget gap (for the remainder of the 2002-03 fiscal year and 2003-04 combined) of $11.5 billion. While his proposal to close this gap included securitization of the tobacco settlement and some tax and fee increases, the proposal relied on spending cuts to close more than half the gap.

The budget proposal called for $6.4 billion in spending cuts and restraint. Because the budget gap estimate is based on a baseline budget which assumed that spending needed to grow by $4.6 billion to maintain the current level of government services, maintaining the same nominal level of spending for a program contributes to closing the budget gap. Against the budget baseline, the executive budget called for a $1.3 billion cut in school aid, a $1 billion cut in Medicaid, a $1 billion cut in government operations, a $1 billion cut in local assistance and about $1 billion cut in other programs. The remaining $1.1 billion in spending cuts/restraint were savings from debt restructuring and the use of federal funding sources to supplant state support.

While the governor insisted that he would not use "job-killing taxes" to close the budget gap, he proposed to increase dozens of different fees and miscellaneous charges. He also proposed $600 million in tax increases, primarily the elimination of the exemption from sales tax on clothing and footwear priced under $110, reimposition of a hospital and homecare assessment, insurance tax changes and a one-year cap on School Tax Relief (STAR) benefit increases.

The budget proposed to use $3.8 billion of the total $4.2 billion in proceeds from the securitization of the tobacco settlement to close the remainder of the two-year $11.5 billion gap. When the 2002-03 fiscal year came to a close on March 31, 2003, without a deal to go forward with the tobacco settlement securitization, the state closed the remainder of the 2002-03 budget gap by postponing $1.9 billion in payments until the current fiscal year.

In May 2003, the Legislature enacted its own budget proposal for FY 2003-04. By then, the two-year budget gap had grown to $12.6 billion, due to revenue and spending re-estimates. Despite the growth in the size of the gap, the Legislature

proposed a much more balanced approach to balancing the budget, relying almost equally on revenue increases ($3.4 billion), spending cuts ($4.2 billion) and the tobacco securitization proceeds ($3.8 billion). In addition, the Legislature was able to count on approximately $1 billion in federal fiscal relief to close the entire $12.6 billion gap.

The governor vetoed 118 spending additions and the Legislature’s bill to raise state taxes, authorize transitional borrowing and allocate school aid. Within 20 hours, in an unprecedented move, the Legislature overrode every one of the governor’s vetoes.

While much of the attention focused on the Legislature’s $2 billion in additional revenue actions, including a temporary increase in the income tax rates for high income New Yorkers (the first income tax rate increases since 1971) and a temporary 0.25 percent increase in the state sales tax, the Legislature, like the governor, relied heavily on spending cuts and spending restraints to close the budget gap. School aid was still $500 million below the baseline and about $200 million below the previous year’s spending. Despite significant restorations, spending on government operations and local assistance was still $1.2 billion below the baseline. State funding for SUNY was reduced by $183 million, forcing a $950 per year increase in tuition, the first such tuition increase since 1995. Many programs designed to help welfare recipients enter the labor force also suffered funding cuts. For example, funding to provide transportation assistance was cut by a third, from $7.5 million to $5 million; funding for basic education was cut from $5 million to $3 million, and funds for drug abuse screening and treatment were cut in half (from $5 million to $2.5 million).

The Division of the Budget’s Oct. 28, 2003, mid-year update to the 2003-04 financial plan reported that the “current fiscal year is balanced” but warned that out-year revenue shortfalls are “roughly $5 billion to $6 billion in 2004-05 and $8 billion in 2005-06.” Again the budget gap seems to be a moving target with regular revenue and spending re-estimates emerging from the Division of the Budget. In addition, there are considerable disagreements between the Budget Division and the professional staffs of the Legislature's fiscal committees regarding the amount of money that the legislatively initiated revenue increases are likely to generate during this fiscal year and the extent to which the state economy will recover from the latest recession in time to enhance revenues available for next year’s budget.

While the projected budget gap for 2004-05 ($5 billion to $6 billion) is substantially smaller than the $12.6 billion gap that was closed earlier in 2003,

there are several factors that will make the 2004 budget negotiations as difficult, if not more difficult, than the 2003 negotiations.

- First, in the struggle to balance its budget over the past few years, the state has exhausted most of its reserve funds and used up most, if not all, of its major "one-shots." For example, most of the tobacco securitization proceeds have been exhausted. At best, the state will have about $400 million in additional revenue from this source to use to close next year's gap.

- Second, since the Legislature enacted a three-year temporary income tax increase earlier this year, it is unlikely that this least regressive and most productive source of additional revenues will be tapped again in 2004. This means that the focus of next year's discussions of revenue options will likely be on important but less productive revenue-raising options such as closing corporate tax loopholes.

- Third, Gov. Pataki, Senate president Joe Bruno and Assembly speaker Sheldon Silver have all made public pronouncements vowing not to raise taxes to close the 2004-05 budget gap. On Oct. 15, 2003, Gov. Pataki brought the two majority party legislative leaders in for a private meeting to jump-start the state budget process. The *Albany Times Union* reported, "Assembly Speaker Sheldon Silver said Tuesday that he would oppose raising taxes to close a projected revenue shortfall of between $5 billion and $6 billion in the next fiscal year (*Albany Times Union*, 2003). The Manhattan Democrat said the state should look elsewhere to balance its books in fiscal 2004-05, which begins on April 1, 2004." It is also possible that revenue increases that have other economic benefits (such as closing corporate loopholes to even the economic playing field) would be more acceptable than tax rate increases.

The real budget choices facing the state will not be clear until the governor proposes his 2004-05 executive budget on or before Jan. 20, 2004. At that time, legislators and the public will know if unacceptable service cuts and increases in local property taxes will be necessary to balance the state budget without state revenue increases.

Appendix III: Summary of Washington State's 2003-05 Budget

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Jan. 1, 2004

Going into the 2003 legislative session, Washington state faced a projected shortfall of $2.7 billion in its operating budget. Democratic Gov. Gary Locke and the Republican-controlled Senate refused to consider any general tax increase. The Democratic-controlled House considered a number of revenue alternatives. But with no support from the governor, the House was unable to agree on a revenue package that included significant new taxes. In the end, the state adopted a $44.8 billion operating budget for 2003-05, including a $23.08 billion general fund appropriation. The budget gap was solved largely by cutting spending by $2.2 billion—including nearly $1 billion in compensation-related reductions. Revenue increases—from increasing liquor prices, increasing penalties on late taxes, reducing the holding period for unclaimed property and increasing federally matched nursing home fees—amounted to $209 million. In addition, $309 million was transferred among various funds. The Legislature approved new spending on business incentives for Boeing and other select industries.

The scale of Washington's deficit was about average for the states. With no income, capital gains or corporate income tax, Washington did not experience as steep a drop in revenues during this recession as many states with more progressive tax structures. But with the collapse of high tech and tens of thousands of layoffs in aerospace, the recession has hit the Northwest particularly hard. Washington's unemployment rate has been first or second in the country. This, along with the still painful blow of Boeing's decision to move its corporate headquarters to Chicago in 2001, has led moderates of both parties to accept the business lobbyists' argument that taxes and labor protections are bad for the business climate, and both must be reduced to make the state competitive.

Although the recession and an underlying structural deficit were the major causes of the 2003 budget problem, exacerbated by skyrocketing healthcare costs, citizens' initiatives of the past several years received much of the blame in public discussions. A series of tax-cutting initiatives has nearly eliminated the motor vehicle excise tax as a significant source of revenue and limited annual increases in property tax collections to 1 percent. At the same time, initiatives mandating new spending passed by even larger margins, including approval of annual COLAs for public school employees (I-732), new money to

districts for student achievement (I-728), an increase in tobacco taxes to fund expansion of the Basic Health Plan for low-income workers (I-773) and approval of a union and collective bargaining for homecare workers (I-775). In the end, the governor and the majority of legislators chose to honor the spirit of the tax-cutting initiatives, and overturned the education and health initiatives.

The 2003-05 budget has increased nominal K-12 spending by $223 million, but the Legislature sliced nearly $600 million from anticipated K-12 spending. The bulk of the savings came from suspending the two voter-approved initiatives that required higher investments in education. Beginning teachers did get a pay raise, but even that modest gain was offset by higher out-of-pocket healthcare costs. Losses in K-12 included:

- **New student achievement funds.** Initiative 728 passed with a 72 percent majority in 2000, providing school districts with new money for reduced class size, early learning and other student achievement strategies. Under the initiative, funding to districts was scheduled to increase from $211.67 to $450 per student in 2004-05, and to increase with inflation thereafter. As amended by the Legislature, funding will instead increase to $254 per student in 2004-05, and ramp up in increments to reach $450 in 2007-08, saving $237 million in the 2003-05 biennium.
- **COLAs.** In 2000, voters approved Initiative 732 by a 63 percent margin, providing automatic annual COLAs for K-12 employees beginning with the 2001-02 school year. The 2003 Legislature suspended I-732 until the 2005-07 biennium, saving $191 million.
- **Health benefits.** The Legislature added $116 million for health benefits, but school employees are still expected to pay more out of pocket.
- **Other K-12 cuts.** These cuts totaled $170 million, including reductions of $72.6 million in flexible grants and levy equalization to districts, and savings of $61.4 million resulting from adopting a new actuarial method in the pension program.

Higher education traditionally has been underfunded, and received additional cuts, although the Legislature did pay some attention to the most pressing needs. Legislators budgeted for just over 212,000 full-time equivalent (FTE) higher education students in each year of the biennium, well short of the demand. In 2002-03, the state's colleges and universities enrolled 229,000 FTE students, although the Legislature budgeted for only 213,512. The 2003-05 higher ed budget includes a $131 million general reduction to higher education institutions, partially offset by authorization to increase tuition by 7 percent; $29 million in additional funds for financial aid to needy students; no general salary increase, but $10 million approved for recruitment and retention; and $5 million for two-year college faculty salary increases, including part-time faculty; as with all state employees, higher out-of-pocket for healthcare; and

$50.6 million additional funding for high demand fields, job training and assorted other programs.

The Legislature also saved money by implementing “efficiencies” to reduce staffing throughout the government, and by reducing social spending. Lawmakers set aside I-773 and cut the Basic Health Plan, approved a much smaller raise for homecare workers than that negotiated under the terms of I-775 and reduced a number of other social programs.

The Legislature also refused to restore cuts to child care and prekindergarten that the governor had made to offset shortfalls in the Temporary Assistance for Needy Families (TANF) budget. Those cuts included: eliminating on June 30, 2003, the Career and Wage Ladder Pilot Project (a program that provided wage increases and education incentives to approximately 1,000 teachers); eliminating recruitment and training programs for child care teachers; reducing the TEACH scholarship program; eliminating supplemental child care programs administered by the State Board for Community and Technical Colleges for TANF recipients and others enrolled in training classes as of March 31, 2003; and increasing co-pays for families over 82.5 percent of the federal poverty line (FPL) by $25.

On the positive side, the Legislature did take advantage of low interest rates and attempted to inject some stimulus into the economy by expanding the state's bonding capacity and approving $2.6 billion in new capital spending, in addition to $1.8 billion in re-appropriations. Legislators expanded bonding capacity by changing the statutory definition of general state revenue to include the entire state property tax, thereby increasing the base on which the 7 percent debt service limit is calculated. The new capital appropriations include $405 million for K-12 construction and $760 million for higher education construction.

Appendix IV: Summary of Wisconsin's 2003-05 Budget

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As they began budget deliberations in spring 2003, Wisconsin's governor and legislators faced a projected deficit for the 2003-05 biennium of $3.2 billion. Not only did this shortfall represent one of the largest state deficits in the country, as a percentage of general purpose revenues, but it came at a time when Wisconsin was also struggling—as were most other states—with a slow recovery from the recent recession. Democratic Gov. Jim Doyle and many rank-and-file legislators had limited their options for dealing with the deficit by making campaign promises just months before that they would not raise taxes or cut spending on K-12 education (which represents more than 40 percent of total state spending each year). As a result, the budget (Act 33) was balanced using a combination of one-time sources of revenue (including some from the federal government), significant cuts to some programs, increased fees and optimistic revenue projections.

Using one-time sources of revenue allowed lawmakers to avoid deeper program cuts and tax increases, and in effect pushed off the remaining structural imbalance (between revenue collections and expenditures) to be dealt with at a later date. About $1 billion in one-timers were used to close the budget gap. Some of the more significant include:

- A one-time transfer of $175 million from the Transportation Fund to the General Fund;
- Use of an additional $400 million from the Transportation Fund in this biennium for Shared Revenue;
- Reliance on $284 million in increased federal Medicaid funding that, if it materializes, is likely to be one-time funding;
- Transferring $46 million from the utility Public Benefits Fund, mostly on a one-time basis;
- A short-term savings of more than $140 million by using bonding to finance pension and sick-leave obligations; and
- A reduction in the required statutory balance (from $235 million to $45 million), freeing up $190 million that will have to be restored in the 2005-07 budget.

Even with these—and many other—short-term fixes, significant agency and program cuts were necessary to balance the budget because lawmakers were so adamant about avoiding tax increases. In the end, agency and program-specific cuts totaled more than $400 million. The biggest single cut was a $250 million reduction in state support for the university system. Approximately $150 million of that can be made up by the university through higher resident tuition (for example, if fully utilized by the University of Wisconsin System, resident undergraduate tuition at the university's Madison campus would increase by 18.2 percent in 2003-04 and 15.4 percent in 2004-05).

State jobs also were targeted, with 2,003 positions to be shed over the biennium. The cuts will be most severe in the following agencies: Agriculture, Trade, and Consumer Protection; Commerce; Corrections; Electronic Government (completely abolished); Health and Family Services; Natural Resources; Transportation; and Workforce Development. Though nearly every agency must deal with fewer positions, these eight account for 80 percent of the job cuts included in the 2003-05 budget.

The effects of specific program cuts will no doubt be felt by those utilizing various state services delivered at the local level. This is particularly true of cuts in human services programs being made by county boards. County-level services are being squeezed from many different directions, including a $20 million cut in shared revenue in 2004 and the property tax freezes being adopted by many local governments. Other budget factors that put downward pressure on county funding for human services include:

- **Community Aids.** The state funding for community aids is maintained at the 2002-03 level, but federal funding is reduced by a little over $1 million per year. Although this cuts community aids by only 0.4 percent, it comes on top of a long erosion of this crucial source of support for county human services programs. Community aids is the program to support county human services programs such as foster care and support for the disabled.
- **County Intergovernmental Transfer (IGT) funds.** The budget eliminates the $40 million per year in federal Medicaid funding that many counties were receiving from IGTs. Although that funding was intended for county-operated nursing homes, the large hole created by the cut drains money from other parts of counties' budgets.
- **Income maintenance administration.** Funding for county administration of income maintenance programs has been cut by almost $3.5 million, or 6 percent, in 2003-04, at a time when caseloads are rising.

- **Reduced W-2 funding.** The counties that administer the Wisconsin Works (W-2) program are affected by a 5 percent cut in funding for W-2 local administration and a cut of almost 28 percent for W-2 ancillary services. These services, such as transportation assistance, are designed to help the working poor be able to stay on the job.

In addition to the increase in University of Wisconsin resident tuition mentioned above, several other state fees were increased (or continued when set to expire). These include: the land record fee, court support services fees, various filing fees and the motor vehicle registration fee. Also raised were several healthcare-related fees such as the SeniorCare enrollment fee and BadgerCare premiums. In all, more than $22 million in general purpose revenue, $200 million in program revenue and $190 million in segregated revenue will be raised over the biennium from increased fees.

A contentious revenue-raising issue during budget deliberations was the governor's plan to renegotiate the state's gaming compacts with the Indian Tribes. While legal battles are still being waged as to the governor's authority to renegotiate the compacts as he did, one result of the longer compacts is that Wisconsin will receive an additional $157 million over the 2003-05 biennium.

The lion's share of the $3.2 billion deficit was handled through what some criticize as smoke and mirrors and others call standard budget operating procedure: a reliance on significant economic growth and the resulting increased revenue collections stemming from that growth. The Legislative Fiscal Bureau estimated annual growth for the two years at 5.1 percent and 5.6 percent, respectively. If achieved, such growth would increase revenues by approximately $1.7 billion. If that growth level, which is significant, is not achieved, other cuts or revenue increases will be required to bring the budget into balance by the end of the biennium, as required by the Wisconsin constitution.

What the state will face in the next budget cycle is truly a mixed bag. Because the Legislature and governor relied on many one-time revenue sources to balance the current budget, the state will face another structural deficit in 2005-07. The shortfall is currently estimated at $700 million. While this is a significant amount, it is less than one-fourth of the shortfall faced at the beginning of the 2003-05 budget deliberations. The 2005-07 estimate is a conservative one, however, in that it does not account for likely pressure to increase spending in numerous areas—including Medicaid, school funding, prisons and pension costs.

It's important to remember a couple of other aspects of Wisconsin's 2003-05 budget that offer some hope for future deliberations. It was the first state budget in a long time to be completed on time, and the first in even longer to be devoid of nonfiscal policy items. Whether it represents a new era of budgeting in Wisconsin or simply another "one-timer," however, remains to be seen.

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