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BUDGETING BEYOND THE BELTWAY

How the federal budget imperils state and local finances

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How bad could the finances of state and local governments be? Well, if current trends continue, state and local governments as a whole will be forced by law to close an aggregate budget gap of nearly $100 billion by July 2003.[1] There is presently no indication that the Bush Administration or the Congress appreciate this dilemma, leaving little hope that adequate remedies will be forthcoming.

Table 1 shows total receipts and expenditures in March 2001, the peak of the previous business cycle. It also shows a spending estimate based on the trend of the 1990s, alongside the implied level of receipts over the next 18 months if the downward trend of the past year is allowed to continue.

State and local governments will be forced to close this gap, and so actual receipts and expenditures will converge. In other words, these governments will cut spending, raise taxes, and tap further into their reserves in a weak economy. Moreover, new security-related expenditures will displace some basic services provided by these governments. The question is whether this is the best possible outcome, and, if not, what the federal government might do about it.

The cost of the largest state program—Medicaid—increased by 12% in FY 2002 and will total $160 billion in 2003. Recession-induced unemployment is certain to increase the need for Medicaid, since it is an income-tested program. Although some relief was considered in the Senate, negotiations in Congress over any sort of stimulus bill have broken off. No resumption is presently anticipated.

For all their problems, state and local governments as a whole have run in the black since the third quarter of 1993. At one point in 1998, the surplus was as high as $58 billion; current it stands at around $1.9 billion. Although the surplus remains positive for state and local governments as a whole, there are some governments in relatively good shape and others that have foundered.

TABLE 1
Projected state-local budget gap, FY2003 (billions)

	March 2001	Projected July 2003
Current receipts	$1,273.4	$1,333.9
Current expenditures	1,251.1	1,431.2
Surplus/(deficit)	22.3	(97.1)

Note: Expenditures are projected through July 2003 according to their average rate of growth in the 1990s. Receipts are projected according to their trend since March 2001.

Source: National Income and Product Accounts.

After the recession bottoms out, state and local revenues should eventually rebound and match the growth of the previous business cycle. Some states even had the foresight to build up "rainy day funds" in the boom years, enabling them to continue to fund services adequately while revenue growth is slow. But reserves in 15 states (including New York, California, Illinois, and Wisconsin) have fallen below what is widely viewed as a prudent level (Zahradnik and Johnson 2002). Even if the recession were over today, this would be a problem. Take, for example, the last recession, in which the economy began to recover in the second quarter of 1991 but state and local governments still registered deficits as late as 1993. Even after GDP growth turns positive for the economy as a whole, many state and local governments will still be in recession.

To complicate matters, local governments typically do not have the fiscal flexibility to establish reserves in the first place. Their ability to borrow is also more limited than that of state governments. They will be forced to make cuts in basic services, particularly in elementary and secondary education.

Lost revenue for state and local governments

Rather than providing aid to states, the federal government has been reverting to the bad habits of the 1980s by adding to the fiscal burdens of state and local governments (Kenyon 1995). The Bush Administration's budget continues the practice of shifting costs to the states, a practice sometimes described as "negative aid" or "reverse revenue sharing." This negative aid can take several forms:

Reductions in grants-in-aid. In 2001, state and local governments financed over 20% of their expenditures with federal grants-in-aid. Setting aside the Medicaid grant, the budget proposed by President Bush provides for an increase of less than $15 billion. Many areas come in for explicit cuts, including transportation, agriculture, social services, and physical capital (infrastructure). Programs with proposed cuts include the Low Income Home Energy Assistance Program, Community Services Block Grant, Economic Development Assistance, and Dislocated Workers (FFIS 2002). (See the appendix for more details on the effects of the cuts proposed in the Bush budget.)

When examining the proposed Bush budget, it is important to distinguish aid for routine expenditures from security-related costs stemming from the terrorist attacks of this past September. Security expenditures are not a substitute for basic public services. Of the $15 billion increase, about $5.6 billion is for spending related to combating terrorism, or for anticipated increases in welfare spending. In other words, little is left over for states to close the budget gaps in basic services.

For FY2001, nine states reduced spending, four deferred capital projects, and three increased their borrowing. In California, agencies have been asked to reduce their projected budgets by 15%. Washington state has deferred the financing of new capital projects (Eckl and Perez 2001).

Taxes. The tax cuts enacted last year, as well as new ones being proposed in the President's budget, will cause further leakage in state budgets. In particular, the stimulus proposal passed in the House of Representatives will cost state and local governments $5 billion annually (Lav and Carey 2001). The reason is that state income taxes on individuals and corporations often "piggy-back" off the federal system (e.g., states may rely on the federal definition of taxable income). If the federal government narrows the tax base by enacting new deductions, revenues to state and local governments may fall.

The second source of lost revenue via taxes stems from the imminent repeal of the federal estate and gift tax. When this law takes full effect, it will reduce state government revenue by an estimated $9 billion (McNichol, Lav, and Tenney 2001). Elimination of the federal tax will force states to reinvent their own estate tax, and construct new bureaucracies to administer such taxes.

The third tax drain on state revenue stems from the impending reductions in marginal income tax rates. Presently state and local income and property taxes are deductible in determining taxable income. The value of such deductions is directly affected by a change in marginal tax rates. A decrease in such rates makes all deductions less valuable, since it reduces tax liability by a smaller amount. Reducing the value of the deductions adds to pressure on state and local tax systems from the minority of taxpayers who itemize their deductions (about 30% of filers). The majority of the public is unaffected as taxpayers, but they could end up with less access to public services from their state or local governments.

Solutions

Increase federal aid to states. A temporary supplement to grants-in-aid is affordable in the federal budget and would help stimulate the recessionary economy. Adding enough funds to non-Medicaid grants to ensure that the total keeps pace with inflation and population growth would only add about $20 billion to the Bush budget deficit, which is arguably too small already to provide much of an economic stimulus (Sawicky 2002; Scott and Weller 2001). This aid could take the form of an anti-recession general assistance program (Sawicky 2001). Alternatively, the Medicaid formula could be altered to further leverage states' funding of their biggest budget responsibility.

Reform federal tax policy. Impending federal tax cuts reduce state and local tax revenues, so rescinding or freezing these cuts will have the opposite effect. Freezing the tax cuts will also improve the long-term budget outlook and have the potential to reduce long-term interest rates and increase investment. More generally, the

best way to facilitate state and local tax collection is comprehensive reform of the federal income tax by broadening the tax base (i.e., reducing the number of deductions and exclusions of income from taxation). Another important problem that needs to be addressed is the federal ban on state taxation of electronic commerce.

Conclusion

The federal government cannot afford to neglect the fiscal condition of state and local governments during a recession. Problems in state and local budgets will persist well beyond the point when GDP begins to grow. The result will be untimely state tax increases and service cuts that will place a drag on economic growth and create needless disruptions in services. We have to hope that the national government's concern over internal security doesn't make it difficult or impossible for states to provide basic services. That would be defeat of another kind.

Technical notes

The rates underlying the table's projections are based on the average change in quarterly data from the Bureau of Economic Analysis of the U.S. Department of Commerce, National Income and Product Accounts. These data are expressed in terms of annualized levels. For the business cycle that ran from the third quarter of 1990 to the first quarter of 2001, the average compound quarterly rate of growth of state and local government current receipts (annualized basis) was 1.53%. After March of 2001, that rate dropped to 0.52%. The revenue rate is biased upward in two ways: it does not reflect the fourth quarter of 2001, when revenues continued to erode; and it does reflect some efforts by the states to shore up revenues with tax increases.

The average rate of growth of current expenditures in the 1990s was 1.50%. We define the average rate of growth of expenditures in the previous business cycle as reflective of a current services concept. The contrast between the continuance of such a trend and the more recent trends of revenue stagnation reflects a budget gap that state and local governments will be obliged to close.

Appendix

The Bush Administration's recently released budget proposes significant changes to 38 of the largest federal grants-in-aid programs. Under the Bush proposal, total federal spending on these programs would decline by 3% in real terms and by 0.8% in nominal dollars. In addition, aid to all but two states would decrease, after adjusting for inflation.

These 38 programs represent a total cost of $122 billion in FY2002, and they comprise about 35% of total federal grants-in-aid or roughly 10% of total spending by state and local governments. The largest grant program, Medicaid, is excluded from these totals because it is an entitlement whose funds increase automatically. Medicaid alone accounts for about 40% of total federal grants.

Appendix Table 1 shows total grant allocations for FY2002 for each state as provided for in the appropriations bills passed by Congress. The second column shows proposed allocations in the Bush budget. The third column presents the percent change in each state's total aid, followed by a column in which these numbers are shown with a uniform inflation adjustment of 2.2%. This adjustment is derived from the Bush Administration's forecast of the change in the consumer price index for FY2003. The bottom row of the table shows that the total funds for these programs decrease in the Bush budget in both current and inflation-adjusted dollars.

Appendix Table 2 shows the same data sorted from the highest to lowest real percent change. The variation among states is significant—from a cut of 8.1% in New York to a slight gain of less than 1% in Nevada. After adjusting for inflation, all states but two sustain a decrease in aid. Note that, in light of population growth, each state's average per capita increase is a percentage point or so less still. Some states, such as Texas, use the amount of money required to maintain a program's real per capita spending as an index of a program's so-called "current service" level. In this sense, nearly every states' ability to maintain current services in these programs is reduced in the Bush budget proposal.

The source for these data is Federal Funds Information for States (www.ffis.org).

APPENDIX TABLE 1
Proposed changes in selected grants-in-aid, Bush Administration budget, FY2003

States	Enacted, FY2002	Proposed in Bush budget, FY2003	Percent change, current dollars	Percent change, constant dollars*
Alabama	1,681,698	1,691,847	0.6%	-1.6%
Alaska	677,073	641,709	-5.2	-7.4
Arizona	1,908,962	1,898,165	-0.6	-2.8
Arkansas	1,139,827	1,142,008	0.2	-2.0
California	17,307,651	17,267,255	-0.2	-2.4
Colorado	1,322,543	1,332,276	0.7	-1.5
Connecticut	1,536,209	1,534,367	-0.1	-2.3
District of Columbia	547,193	544,324	-0.5	-2.7
Delaware	389,011	382,701	-1.6	-3.8
Florida	5,330,796	5,442,759	2.1	-0.1
Georgia	3,187,691	3,228,450	1.3	-0.9
Hawaii	565,007	568,316	0.6	-1.6
Idaho	561,459	561,079	-0.1	-2.3
Illinois	5,028,765	5,074,933	0.9	-1.3
Indiana	2,245,840	2,142,218	-4.6	-6.8
Iowa	1,149,053	1,135,425	-1.2	-3.4
Kansas	1,031,464	1,038,208	0.7	-1.5
Kentucky	1,795,189	1,698,426	-5.4	-7.6
Louisiana	1,916,520	1,967,109	2.6	0.4
Maine	634,570	617,326	-2.7	-4.9
Maryland	2,042,873	1,925,697	-5.7	-7.9
Massachusetts	2,744,258	2,646,431	-3.6	-5.8
Michigan	4,429,742	4,473,217	1.0	-1.2
Minnesota	1,850,890	1,854,946	0.2	-2.0
Mississippi	1,338,332	1,344,756	0.5	-1.7
Missouri	2,325,780	2,263,981	-2.7	-4.9
Montana	567,925	560,991	-1.2	-3.4
Nebraska	721,910	711,458	-1.4	-3.6
Nevada	612,643	631,257	3.0	0.8
New Hampshire	450,889	452,337	0.3	-1.9
New Jersey	3,095,739	3,000,921	-3.1	-5.3
New Mexico	977,242	986,683	1.0	-1.2
New York	11,030,631	10,381,146	-5.9	-8.1
North Carolina	2,935,643	2,899,753	-1.2	-3.4
North Dakota	394,930	385,716	-2.3	-4.5
Ohio	4,685,401	4,720,656	0.8	-1.4
Oklahoma	1,469,675	1,467,409	-0.2	-2.4
Oregon	1,403,171	1,411,907	0.6	-1.6
Pennsylvania	5,159,827	5,162,893	0.1	-2.1
Puerto Rico	1,805,252	1,816,769	0.6	-1.6
Rhode Island	590,722	568,881	-3.7	-5.9
South Carolina	1,613,625	1,544,981	-4.3	-6.5
South Dakota	403,545	397,147	-1.6	-3.8
Tennessee	2,016,628	2,031,934	0.8	-1.4
Territories	263,384	266,719	1.3	-0.9
Texas	7,864,629	7,937,697	0.9	-1.3
Utah	807,843	819,826	1.5	-0.7
Vermont	381,918	382,672	0.2	-2.0
Virgin Islands	65,620	66,065	0.7	-1.5
Virginia	2,219,206	2,225,532	0.3	-1.9
Washington	2,462,481	2,487,144	1.0	-1.2
West Virginia	914,661	903,881	-1.2	-3.4
Wisconsin	2,258,850	2,216,986	-1.9	-4.1
Wyoming	371,057	365,074	-1.6	-3.8
Total	**122,233,444**	**121,222,362**	**-0.8**	**-3.0**

* Assumes inflation adjustment of 2.2%.

Source: Federal Funds Information for States (www.ffis.org). Totals reflect 38 largest federal grants-in-aid programs.

APPENDIX TABLE 2
States most affected by grant allocations in Bush Administration budget, FY2003

States	Enacted, FY2002	Proposed in Bush budget, FY2003	Percent change, current dollars	Percent change, constant dollars*
New York	11,030,631	10,381,146	-5.9%	-8.1%
Maryland	2,042,873	1,925,697	-5.7%	-7.9%
Kentucky	1,795,189	1,698,426	-5.4%	-7.6%
Alaska	677,073	641,709	-5.2%	-7.4%
Indiana	2,245,840	2,142,218	-4.6%	-6.8%
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New Jersey	3,095,739	3,000,921	-3.1%	-5.3%
Maine	634,570	617,326	-2.7%	-4.9%
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Delaware	389,011	382,701	-1.6%	-3.8%
Wyoming	371,057	365,074	-1.6%	-3.8%
South Dakota	403,545	397,147	-1.6%	-3.8%
Nebraska	721,910	711,458	-1.4%	-3.6%
North Carolina	2,935,643	2,899,753	-1.2%	-3.4%
Montana	567,925	560,991	-1.2%	-3.4%
Iowa	1,149,053	1,135,425	-1.2%	-3.4%
West Virginia	914,661	903,881	-1.2%	-3.4%
Arizona	1,908,962	1,898,165	-0.6%	-2.8%
District of Columbia	547,193	544,324	-0.5%	-2.7%
California	17,307,651	17,267,255	-0.2%	-2.4%
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Arkansas	1,139,827	1,142,008	0.2%	-2.0%
Vermont	381,918	382,672	0.2%	-2.0%
Minnesota	1,850,890	1,854,946	0.2%	-2.0%
Virginia	2,219,206	2,225,532	0.3%	-1.9%
New Hampshire	450,889	452,337	0.3%	-1.9%
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Alabama	1,681,698	1,691,847	0.6%	-1.6%
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Kansas	1,031,464	1,038,208	0.7%	-1.5%
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Nevada	612,643	631,257	3.0%	0.8%
Total	**122,233,444**	**121,222,362**	**-0.8%**	**-3.0%**

* Assumes inflation adjustment of 2.2%.

Source: Federal Funds Information for States (www.ffis.org). Totals reflect 38 largest federal grants-in-aid programs.

Endnote

1. This figure should not be confused with recent estimates of a $50 billion shortfall pertaining solely to state governments (NGA 2001, 2002).

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