On the Other Hand: The Fiscal Drag From the States

Based on a presentation by Lori L. Taylor,
Senior Economist and Policy Advisor, Research Department, Federal Reserve Bank of Dallas

March 2003

The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

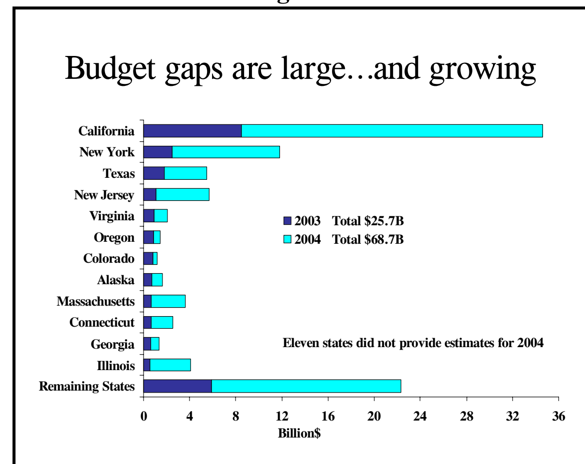
On The Other Hand: The Fiscal Drag From The States

The administration estimates that President Bush's tax plan will provide only $30 billion in economic stimulus for fiscal 2003. On the other hand, the 50 states have a combined budget gap for fiscal 2003 of nearly $26 billion. Because their constitutions require balanced budgets, most states must close that gap immediately by either cutting spending or raising revenues. Such contractionary moves at the state and local level could completely offset the near-term stimulus from the president's tax plan.

The Extent of the Problem

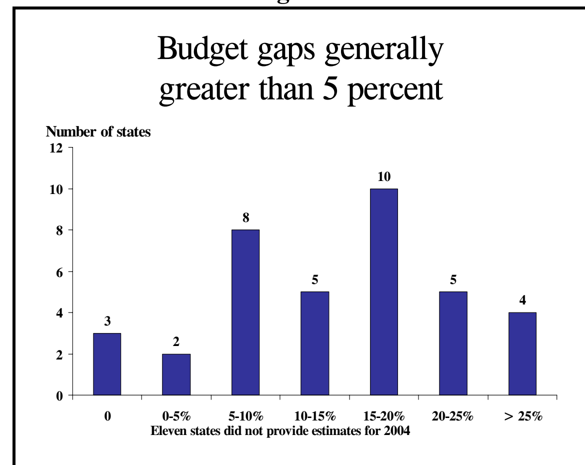
The National Conference of State Legislatures surveyed the states in January regarding their fiscal condition. All but Tennessee responded, and most were very unhappy. Thirty-six states reported significant gaps in their budgets (**Figure 1**). California had an $8.5 billion gap to fill. New York was $2.5 billion short and Texas must come up with $1.8 billion to balance its budget. Across the states, projected expenditures exceed projected revenues by $26 billion.

Figure 1



In most states, the budget for 2003 must be balanced when the fiscal year ends in June. However, fiscal 2003 is only the beginning of their budgetary woes.

Figure 2



The red ink flows even more freely in fiscal 2004. California's projected budget deficit for next year balloons to more than $26 billion all by itself. Together with the $8.5 billion shortfall from 2003, California is looking at trying to fill a $35 billion hole. New York's combined deficit for 2003 and 2004 is almost $12 billion, and Texas' combined deficit is probably $6 billion. It's hard to know for sure about Texas because the state budgets on a two-year cycle. The comptroller's official estimate puts Texas' revenue shortfall close to $10 billion over the 2004-05 biennium, but most analysts believe that the shortfall will be larger in the first of the budget's two years.

With an 18 percent shortfall for 2003 and 2004, Texas has lots of company in its fiscal misery. Nineteen states are facing combined budget gaps in excess of 15 percent (**Figure 2**). The combined gap exceeds 25 percent in Alaska, Arizona, California and New York.

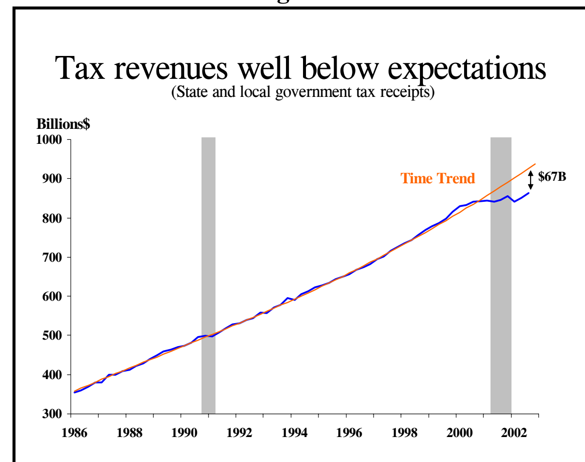
The Causes

The fiscal crisis in the states was precipitated by an unprecedented shortfall in tax revenues.

Figure 3 illustrates the tax revenues of state and local governments and the revenue level implied by a simple time trend. Expressed as a deviation from trend, the revenue shortfall in 2002 was $67 billion. As a percentage of revenues, the shortfall in 2002 was more than six times as great as the shortfall experienced in the wake of the 1990-91 recession.

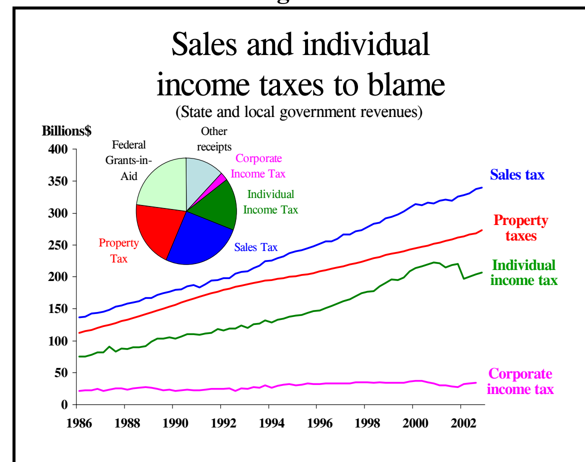
As **Figure 4** shows, there are four major components to state and local government revenues: sales taxes, property taxes, individual income taxes and federal grants in aid. Because federal dollars are generally unavailable for discretionary spending by the states, they really aren't part of any discussion of state budgets. Instead, the focus is on tax revenues.

Figure 3



State and local revenues from property taxes have held up remarkably well during this recession. Such a result is not surprising when you recall how well the housing sector has fared. Also not surprising is the decline in revenues from the corporate income tax. However, since (on average) corporate income taxes make up only six percent of state tax revenues, their budgetary impact has generally been modest. (The major exception is Alaska, which gets 30 percent of its tax revenues from the corporate income tax.)

Figure 4



Sales Taxes

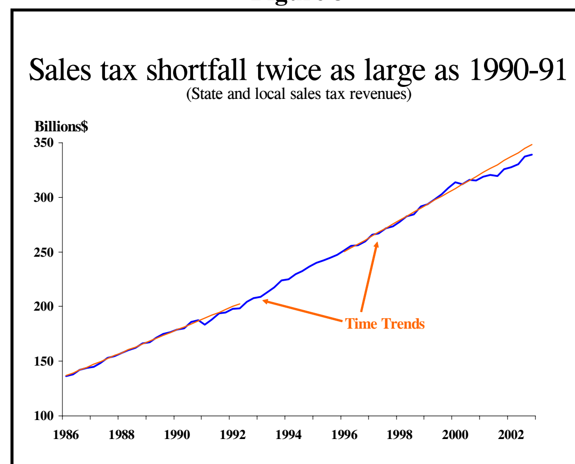
Sales taxes, on the other hand, make up 38 percent of the tax revenues of state and local governments. Therefore, any slowdown in sales tax revenues has a significant impact on the fiscal condition of the states. During this recession, sales tax revenue continued to grow, but the rate of growth dropped by about a percentage point. In contrast, during the 1990-91 recession, sales tax revenue dropped precipitously before bouncing back.

Seven quarters after the start of the 1990-91 recession, cumulative sales tax revenues were only 1.4 percent below trend. Today, cumulative sales tax revenues are 2.6 percent below trend. In other words, despite strong consumer sales during this recession, sales tax revenues have taken nearly twice the hit they did during the 1990-91 recession (**Figure 5**).

There are a number of ways to reconcile weak sales tax revenues with solid growth in consumption expenditures. First, consumers aren't the only ones who pay sales taxes. Taxes on business purchases account for between one-third and one-half of the total revenue from sales taxes. The slump in sales tax revenue could reflect business sector weakness and generally falling prices for producer goods.

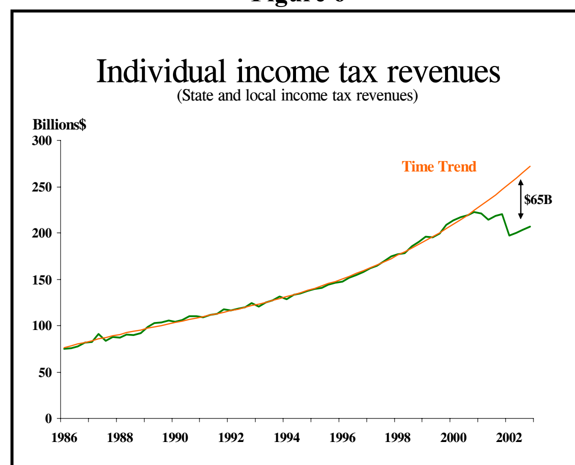
Consumers could be substituting away from taxable goods. With the lowest mortgage rates in a generation, many consumers are buying houses rather than taxable items like cars and clothes.

Figure 5



Consumers could also be avoiding sales tax on their purchases. Over the past seven quarters, I estimate that sales tax revenues were $15 billion lower than one would have reasonably expected, given the prior rate of growth. One frequently-cited estimate puts the tax revenue lost to increased Internet sales at $14 billion for 2001 and 2002 combined. If that's in the ballpark, then much of the shortfall in sales tax revenue could be attributed to the rise in Internet sales.

Figure 6



Whatever the reason for the slow growth in taxable sales, the shortfall in sales tax revenues is a significant factor driving the revenue shortfall in the states. For states like Texas–where more than 80 percent of general revenues come from sales taxes–it is the primary factor. However, it is not the primary factor for state governments in general. Even though the sales tax shortfall is nearly twice as great now as it was after the 1990-91 recession, it can explain only one-ninth of the nationwide shortfall in tax receipts.

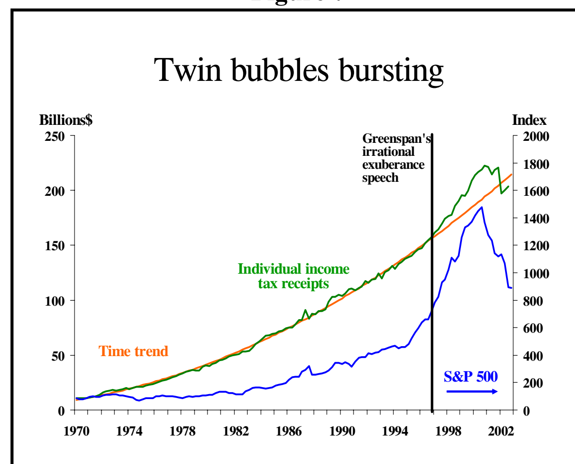
Income Taxes

Most of the shortfall in tax receipts can be attributed to a decline in revenues from the individual income tax. Income tax revenues have fallen seven percent since their peak in the fourth quarter of 2000 (**Figure 6**). More problematic, individual income tax revenues are 20 percent below the level that a simple trend-based forecast would have projected at the start of the recession.

The dramatic shortfall in income tax revenues has at least three causes. The slowdown in economic activity is obviously part of the explanation. Growth in personal income slowed markedly during the recession. Lower income growth easily translates into lower growth in tax revenue.

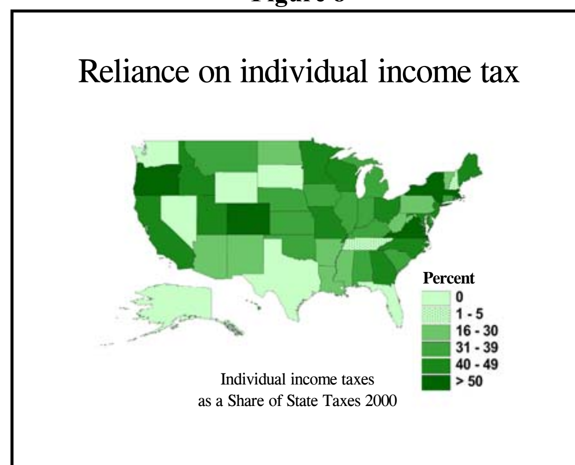
Another contributing factor is the popping of the stock market bubble. All that irrational exuberance in the stock market generated a lot of income tax revenue for the states. In California, revenues from the personal income tax jumped 60 percent between fiscal year 1998 and fiscal year 2001. Based on cumulative deviations from trend, I estimate that the states received at least a $50 billion income tax windfall between 1997 and 2001. Shortly after the stock market bubble burst, so did the tax revenue bubble (**Figure 7**).

Figure 7



Finally, changes in the federal income tax code took a modest toll on state and local income tax revenues. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increased the standard deduction, increased allowable IRA contributions and introduced an above-the-line deduction for higher education expenses. Because many states piggy-back off of the federal code, changes in the federal definitions of adjusted gross income or taxable income affect state tax revenues. The National Conference of State Legislatures estimates that EGTRRA reduced state tax revenues by at least $1.5 billion.

Figure 8



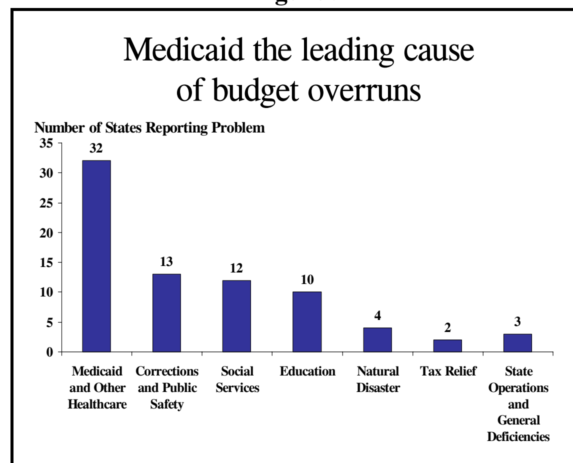
The president's current tax plan–particularly the proposal to eliminate the tax on dividends–could cut state income tax revenues by another $4 to $5 billion per year, starting in 2004. There is also some concern that eliminating the tax on dividends would make tax-free municipal bonds less attractive and increase borrowing costs for state and local governments. On the other hand, the administration has argued that once the additional economic activity is taken into account, the plan's net effect on aggregate state revenues would be positive rather than negative.

Of course, the states were not equally impacted by the income tax declines and would not be equally affected by the President's plan (**Figure 8**). States like Texas, which have no income tax revenue to lose, would be most likely to benefit from federal tax cuts. Oregon, which receives 69 percent of its tax revenue from the income tax, is among the least likely to benefit. Massachusetts, New York, Virginia and Colorado, which get at least half of their tax revenues from the individual income tax, could also wind up with the fuzzy end of the lollipop.

Estate Taxes

In addition to the changes in the income tax code, EGTRRA included a staggered repeal of the federal estate tax credit. Eliminating the credit effectively repeals estate taxes in most states, unless the states changed the way they linked to the federal law. While 17 states have decoupled from the federal estate tax changes, the remaining states will lose the lion's share of their estate tax revenues over the next two years. The Comptroller expects Texas revenues from the inheritance tax to fall by 70 percent over the 2004-05 biennium. As a result, total tax revenues in Texas are expected to fall by a little less than one percent.

Figure 9



Budget Overruns

While the shortfall in tax revenues is the primary source of fiscal distress among the states, budget overruns are also contributing to the pain. Thirty-seven states report that spending has exceeded their projections for 2003. Of those, 32 report that Medicaid or other health care programs are over budget (**Figure 9**). Medicaid is jointly financed by the state and federal governments and serves low-income individuals. It is second only to education spending as a share of state expenditures and has been the fastest growing component of state budgets. Medicaid spending grew 13 percent in fiscal 2002, driven largely by increasing costs for pharmaceuticals and increases in enrollments (**Figure 10**). Medicaid enrollments grew nine percent in fiscal 2002 and were expected to grow six percent in 2003. State appropriations for 2003 called for extensive cost savings and a Medicaid growth rate of less than five percent. Needless to say, those budget predictions were a tad rosy.

Figure 10

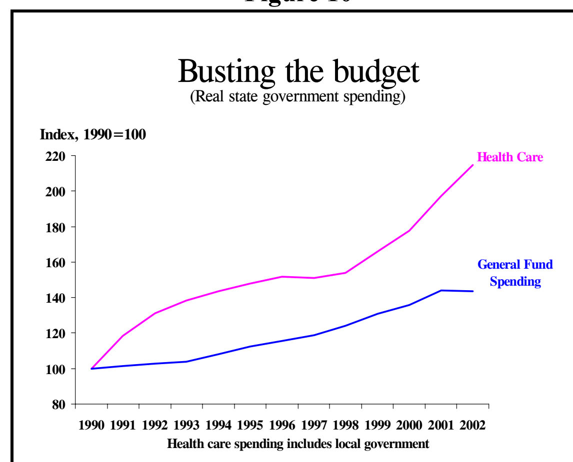
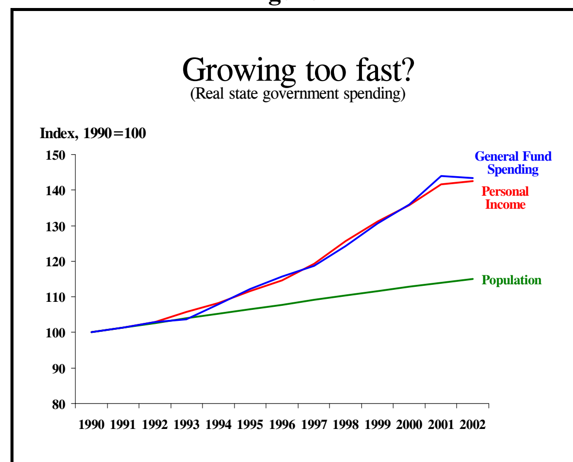


Figure 11



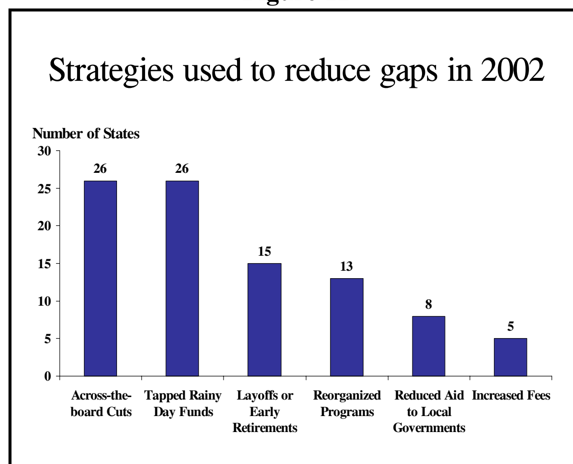
Some analysts argue that the budgets were just plain too big to begin with. Carole Keeton Strayhorn, the Texas comptroller, definitely considers this to be the case in Texas. As **Figure 11** illustrates, even after adjustments for inflation, the general fund expenditures of state governments had been growing much more rapidly than the population. However,

until the recession hit, state government expenditures were growing at almost exactly the same rate as personal income. If the services provided by government are normal goods, then it is not unreasonable for spending to rise as income rises–and fall when income falls.

The Responses

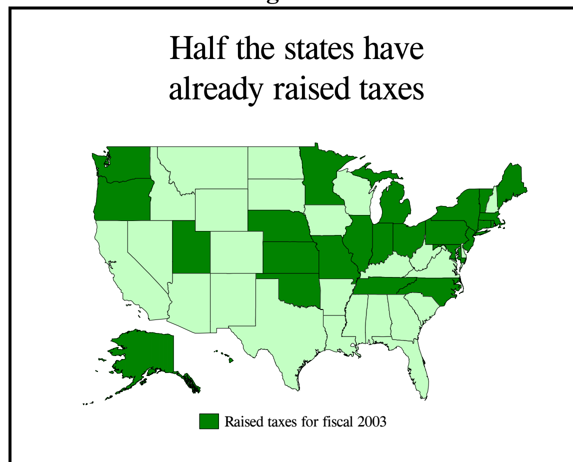
Whatever the source of fiscal distress, the states must still close their budget gaps. Just to make things interesting, the fiscal distress of 2003 and 2004 comes at a time when most of the easy fixes have already been tried. Thirty-seven states were obliged to tighten their belts to balance the budget for fiscal 2002. As **Figure 12** shows, 26 states used across-the-board cuts, 26 tapped rainy day funds, and 15 laid-off employees or offered early retirement programs. The states raided their cookie jars to the tune of $21 billion. The balance in state accounts fell from $38 billion at the start of the fiscal year to $17 billion at the end.

Figure 12



Some states also dipped into the hard stuff. Going into the current fiscal year, 24 states had enacted tax or fee increases (**Figure 13**). Maine increased taxes in a special November session.

Figure 13



As a general rule, the increases were modest. The total expected revenue increase was $8 billion. Cigarette taxes were particularly popular. Nineteen states increased cigarette taxes by a cumulative $3 billion. Most of the remaining $5 billion can be traced to a handful of states. Massachusetts, New Jersey, Tennessee and Indiana raised taxes by roughly $1 billion each. The greatest sticker shock was in Tennessee and Indiana, where tax increases boosted general revenues by 13 percent and 10 percent, respectively. Tennessee raised its sales tax rate by one percentage point, its corporate income tax rate by half a percentage point and its local business taxes by 50 percent. Indiana raised gaming taxes and the sales tax rate. Both raised cigarette taxes.

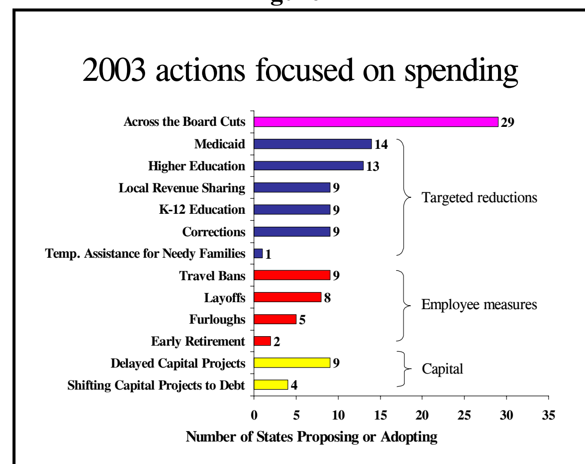
In addition to other user fees, all states increased tuition and fees at public four-year colleges and universities. Sixteen states increased tuition by more than ten percent for the 2002-2003 academic year. Texas, with a 20 percent increase, was second to Massachusetts, which increased tuition and fees by 24 percent.

Current Year Changes

Since the start of the current fiscal year, most actions to close the budget gaps have focused on spending (**Figure 14)**. As of the January 2003 survey, 29 states had proposed across-the-board spending cuts. Texas Governor Rick Perry called for a seven percent cut in all state spending except elementary and secondary education and some health care.

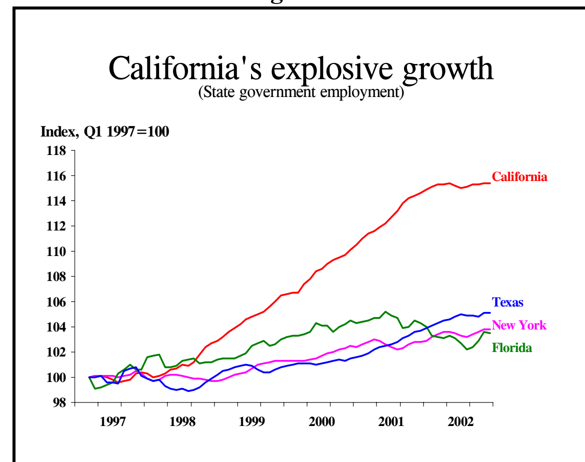
Targeted spending cuts are another popular response. Fourteen states reported plans to cut Medicaid in 2003. The most popular Medicaid cuts are pharmacy controls or limits on provider payments. However, states that are more generous than federal law requires are also exploring cuts in coverage or eligibility. For example, New York's Medicaid program pays for services that few other states provide, such as extensive home health care and personal care aides who administer almost no medical care. The tab for such services approaches $3 billion per year. Partially as a result, New York pays more for Medicaid than California and Texas combined. Governor Pataki has targeted Medicaid for significant cuts.

Figure 14



Given that education spending consumes 48 percent of general fund spending by state governments, it is virtually impossible to avoid cutting education. Nine states have targeted reductions in elementary and secondary education, while 13 have targeted cuts in higher education.

Figure 15



Finally, a number of states report that they have cut personnel and postponed capital projects. Connecticut has laid off 2,800 workers (with another 1,000 likely) and Arizona has eliminated 1,800 positions.

Governor Gray Davis has proposed cutting the equivalent of 7,000 state government jobs in California. However, given the state's hiring binge during the late 1990s (**Figure 15**), there is probably room for further cuts. Had California's state government grown at the same rate as Texas, New York or Florida, state payrolls would be at least 44,000 smaller than they are today.

It is unlikely that the proposed spending cuts will close the budget gaps in most states. Therefore, it is not surprising that 24 states report they have tax increase proposals on the table. At least 15 states are talking about raising cigarette taxes. A handful of states mentioned increases in sales taxes and four propose to raise income taxes for the wealthiest taxpayers. California is trying all of the above. California's Governor Davis has proposed an $8.3 billion dollar tax package that includes an increase in income tax rates, a one percentage point increase in the state sales tax rate, and a $1.12 per pack increase in the cigarette tax.

An Opportunity

One silver lining in all the fiscal distress is that the states have an opportunity to clean up their tax codes. That special tax break or complicated exemption that didn't seem so bad when times were flush can now be removed with a minimum of political fuss. Unfortunately, the tax proposals currently on the table appear to favor rate increases. Such approaches exacerbate existing flaws in tax structure and could make the cure for fiscal distress more painful than the disease.

With lots of exceptions, caveats and special cases, the economics of efficient tax policy for state governments can be boiled down to two basic principles. First, states can't stick it to the rich because the rich can move. If the burdens of government exceed the benefits associated with a particular location, businesses and individuals can and will leave. To prevent erosion of the tax base, state taxes should fall whenever possible on those who benefit from the services governments provide.

The second basic principle is that governments should not play favorites with the tax code. Giving one firm a break because of the products it makes or the way it organizes its business distorts economic decision-making. As a general rule, distorting the allocation of resources away from the market allocation leads to lower economic well-being in the long run.

In practice, these principles imply that states are well advised to match the scope of a tax with the scope of the benefits it finances. Narrow taxes can be appropriate when they are used to finance correspondingly narrow benefits. For example, user fees like gasoline taxes can be efficient if they are used to finance highway maintenance and repair and thus benefit gasoline users.

General revenue taxes, however, should be broadly based. Thus, tax reforms that close loopholes or broaden the tax base can not only raise revenue but can also remove government-induced distortions. New York is much better served by Governor Pataki's plan to remove the sales tax exemption on moderate-priced clothing, than it would be by a proposal to raise the sales tax rate.

A second, less obvious implication is that tax bases can be too broad. Governments can introduce distortions in the guise of broadening the tax base. In particular, intermediate sales (sales to producers rather than consumers) should not be subject to sales taxes. Taxing intermediate sales violates the principle of not playing favorites because it offers preferential treatment to vertically integrated firms at the expense of smaller non-integrated firms. For example, consider accounting services or photocopying. Large corporations have such functions in house and would not pay sales taxes on those services. Small businesses, on the other hand, would need to go to H&R Block or Kinko's, and potentially pay sales taxes. Economically, it is very hard to justify forcing small businesses to pay taxes that big businesses do not pay. Subjecting intermediate sales to sales taxes also deters large firms from taking advantage of efficiency gains from outsourcing.

Conclusions

Rainy day funds and easy fixes are nearly tapped out. The states will be forced to make significant cuts in spending or increases in taxes. While it is too soon to tell how the states will balance their budgets, the economic impact of all this fiscal distress is pretty clear. What the federal government proposes to give, the state governments are preparing to take away. Over the next 18 months, the president's plan could provide $150 billion in economic stimulus. Meanwhile, spending cuts and tax increases at the state and local level will generate close to $100 billion in economic drag. It is possible that contractionary policy at the state and local level will offset most of the president's economic stimulus plan, at least in the near term.

Depending on the mix of tax increases and spending cuts, state governments could come out of this crisis substantially smaller than when they went in. Research conducted at the Dallas Fed and elsewhere suggests that small government is an amenity that attracts labor and capital alike. This pattern hints at an underlying preference for less government. If true, then the fiscal crisis could lead to a right-sizing of the public sector. Timing, however, is everything. As we make the transition to a smaller, hopefully more efficient government, state and local fiscal policy is likely to be a near-term drag on the national economy.

Lori L. Taylor, Senior Economist
and Policy Advisor
Federal Reserve Bank of Dallas
March 2003