Special Report

Washington Research Council

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Closing the Budget Gap is Now a Major Competitiveness Challenge

BRIEFLY

Lawmakers returning to Olympia in January will again face serious budget difficulties. Solving the problem without harming the state's economic competitiveness poses a severe challenge. Legislators should:

- **Implement long-term expenditure controls.**
- **Restore an effective tax and expenditure limit.**
- **Pursue effective cash management strategies while avoiding recovery-killing tax increases.**
- **Restore the integrity of the general fund by reducing the effects of ballot initiatives.**

Note: As this report went to press, the budget outlook further deteriorated. The state Forecast Council reduced its general fund revenue forecast by $34 million for the 2001-03 biennium and $265 million for the 2003-05 biennium.

Introduction

Having finessed the 2002 supplemental budget shortfall, using a combination of one-time fiscal stratagems and substantive program reductions, those lawmakers returning to Olympia in January will again face serious budget difficulties. Estimates of the shortfall range from a low of $900 million up to $2.3 billion. At the high end of the range, the shortfall represents just about nine percent of projected biennial spending in the general fund and health services account.

Solving the problem without harming the state's economic competitiveness poses a severe challenge for the state legislature.

In facing stark fiscal realities, this state is not alone.

State economies, tax structures and budget obligations vary considerably, yet the budget picture across the nation is remarkably monochromatic. After a decade of spectacular growth, which allowed lawmakers across the nation to indulge the twin joys of increasing spending and cutting taxes, the end of the cycle arrived with a vengeance.

Nearly every state confronts similar budget problems. On July 24, with several states still developing their budgets, the National Conference of State Legislatures (NCSL) reported that state fiscal problems were "widespread and often severe." As with our state, the problems that began in 2002 will worsen in 2003.

- Forty-three states reported FY 2002 budget gaps; in twelve states, the gap exceeded ten percent.
- Of the 40 states providing FY 2003 data (i.e., the current fiscal year), thirteen states report anticipated budget gaps of more than ten percent. Twenty states expect cash balances to drop below current levels.

The National Governors Association (NGA) and the National Association of State Budget Officers (NASBO) in May released *The Fiscal Survey of States*. In addressing the FY 2002 shortfalls, they found, "states have utilized an assortment of short-term solutions to bring their budgets back into balance."[1] The "short-term" nature of the solutions contributed to the escalating problems experienced in fiscal 2003 and anticipated for 2004 and beyond.

The Fiscal Survey reports that next year's budget challenges will be substantial: "Revenue growth is anemic, spending pressures continue to rise, and states are facing massive budget shortfalls. … Because state revenue growth

generally lags the end of a recession by as much as 12 to 18 months, state fiscal woes are expected to continue in fiscal 2003."

Each state will attempt to preserve essential services, minimize recovery-killing tax increases, and recalibrate budgets to provide for ongoing stability.

Over the past three years, our state leaders have begun to confront the serious challenges threatening the competitiveness of businesses here. Among the issues identified by the Washington Alliance for a Competitive Economy and the Washington Competitiveness Council are taxation, regulation, workforce preparation, and education. How the 2003 legislature addresses the budget shortfall will affect virtually every effort to improve the state's long-term economic vitality.

The 2003-2005 biennial budget, consequently, becomes not just a fiscal issue but a dominant business climate issue as well.

Washington's Budget Crunch

When the legislature adjourned March 12, 2002, lawmakers celebrated an on-time departure and a supplemental budget that bridged the deficit without drastic spending reductions (although there were some tough cuts) or substantial tax increases. The ramshackle bridge, however, would not carry the weight of state spending for more than a few months without further repair.

Even before legislators left Olympia, preliminary indications suggested a $1.5 billion budget shortfall in the 2003-2005 legislative session. As the Washington Research Council wrote in its session wrap-up, there will be a difference this January: "… the reserve funds will be tapped out, a quarter of the tobacco settlement funds will be gone, and the easy spending cuts will already have been made."

In the months since, the budget picture has become more clear. An analysis by the Senate Ways and Means Committee staff produced in July identified a 2003-2005 budget problem of from $900 million to $2.3 billion. The staff analysis recognizes the growing deficit in the Health Services Account (HSA), which they identify as facing a deficit of about $500 million. Resolution of the HSA problem will have a direct impact on the general fund.

A similar analysis by the Office of Financial Management (OFM) shows a gap of $1.8 billion in 2003-2005. The OFM projection compares the June state revenue forecast of just under $23 billion with more than $24.7 billion of potential state spending. The expenditure estimate represents the likely costs of extending current services into the coming biennium based on forecast growth in caseloads and enrollments in state-funded human service programs and schools and inflation increases, including a 12 percent per case per year increase in health care costs. Not strictly a "maintenance-level" projection, the OFM estimates assume some policy additions, e.g., cost-of-live increases for state employees based on the Seattle CPI as prescribed by Initiative 732 for most school employees and increases in enrollments at state colleges and universities to maintain current participation rates.

(While the OFM forecast does not include the HSA, analysts there agree that the HSA deficit represents a major problem of the magnitude estimated by Ways and Means staff.)

In early September, the federal government rejected the state's claim to nearly $1 billion in Medicaid reimbursements, offering $70 million. Only about $150 million in reimbursement had been included in the legislature's 2001-2003 budget. The revenue loss, while relatively small, further jeopardizes the current budget and increases the stress for 2003-2005. An appeal of the decision is unlikely.

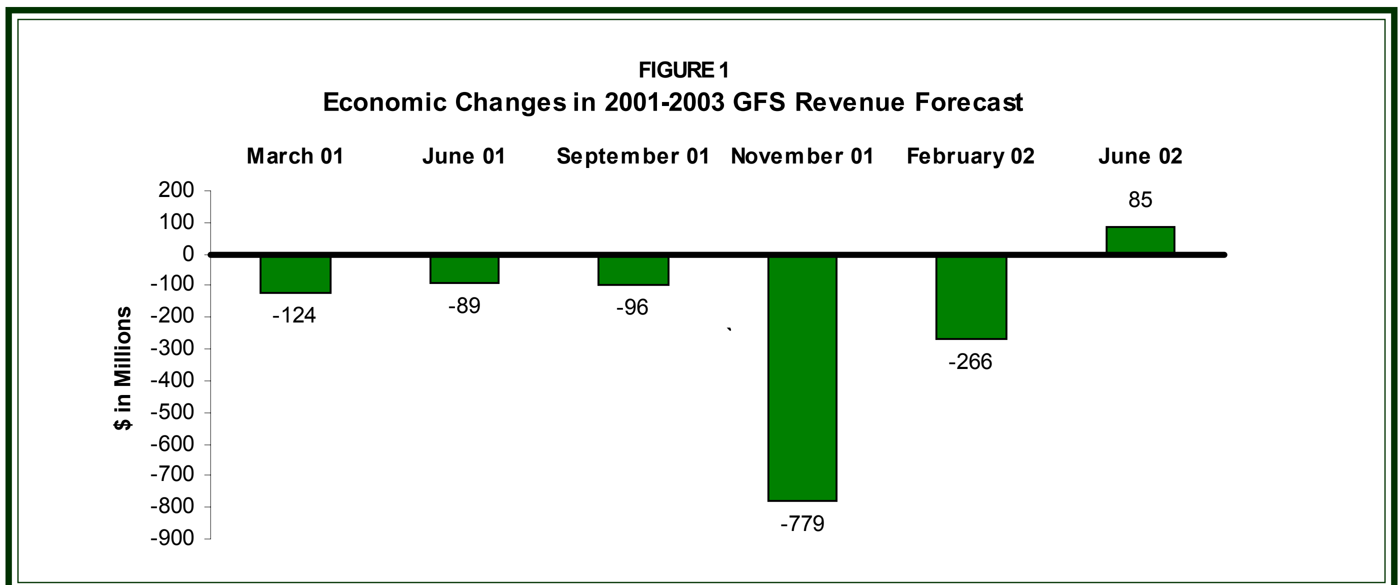
A Little History

The budget signed by the governor June 26, 2001 appropriated $22.8 billion, about $667 million more than forecast revenues. It also left rather thin reserves: $161 million in the general fund and $446 million in the emergency reserve fund. In total, reserves projected for the end of the biennium amounted to only 2.7 percent of biennial spending.

General fund appropriations increased 8.3 percent to $22.8 billion, up $1.7 billion from the 1999-2001 level. Lawmakers made extensive use of budget maneuvers permitted by revisions to the Initiative 601 expenditure limit made during the 2000 legislative session. In particular, by transferring funds into the general fund from other accounts, lawmakers were able to lift the spending cap by the amount of the transfer.

The availability of reserves and transferred revenue, augmented by apparent faith in continued economic growth, allowed lawmakers to make excessive use of one-time revenues to support long-term expenditure commitments. The budget adopted by lawmakers in 2001 was clearly unsustainable well before the tragedy of September 11 accelerated the national recession.

Ultimately, Initiative 601 ceased to be a constraint on general fund spending. In a matter of months, a new constraint would appear: the simple lack of money.



The Positive Legacy of Initiative 601

In 1993, the legislature and governor addressed a budget shortfall of about a billion dollars by cutting spending by $535 million, and boosting taxes by $649 million. Most of the taxes fell on service businesses, whose Business and Occupation Tax rate increased from 1.5 percent to 2.5 percent, although virtually every business in the state bore a share of the tax hike.

Voters responded by passing Initiative 601, which limited growth in general fund state expenditures to a three-year moving average of the rates of population growth and inflation and required a two-thirds supermajority of the each house of the legislature to raise taxes and fees.

While it is difficult to isolate the effect of the tax and expenditure limit from economic and political factors (e.g., the lower inflation rate or a more conservative legislative majority), clearly the initiative played a role in controlling budget growth.

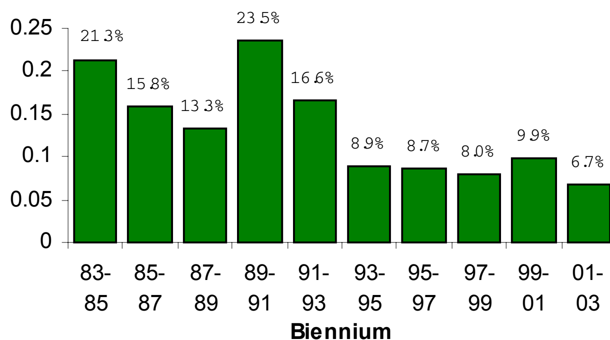
With slower growth in spending, reserves grew and taxes were reduced. Most of the business tax hikes imposed in 1993 came off within five years, property tax limitations were imposed, and the motor vehicle excise tax was repealed by the legislature following passage of Initiative 695.

As shown in Figure 2, biennial general fund state (GFS) spending rose at a considerably slower pace in the years immediately following passage of the initiative.

In 2000, as mentioned above, the legislature amended the initiative substantially. And in 2002, the legislature suspended key provisions of the initiative, including the requirement of a legislative supermajority for tax increases.

FIGURE 2

General Fund-State Expenditures
Biennial Percent Change



Revenue Declines

In March 2001, the Office of the Forecast Council made the first of what would be five consecutive negative adjustments to the 2001-2003 biennial revenue forecast (see Figure 1 for the economic changes, i.e., not revisions resulting from policy actions). The March change was a relatively modest cut of $124 million, followed in June by another $89 million reduction, and a third downward adjustment of $96 million in September. By the end of the third quarter of 2001, then, the revenue forecast had dropped $309 million.

With the November 2001 forecast, the first official estimate after September 11, the bottom dropped out. The precariously balanced budget could not withstand the projected loss of an additional $779 million. The further insult of a $266 million slice to the forecast in February 2002 brought the total estimated revenue loss to $1.354 billion, down more than five percent from original expectations.

Even before the recession, two voter initiatives had narrowed the state's revenue base, increasing the state's fiscal vulnerability. Initiative 695 led to legislative repeal of the Motor Vehicle Excise Tax (MVET), and Initiative 728 redirected property tax revenues to an off-budget dedicated account. The MVET and property tax are more stable than sales or business taxes, and would have provided a cushion during the downturn.

The revenue losses seriously exacerbated existing stresses in the state budget. Although a swifter and bolder response to signals that the economy had soured would have mitigated the damage, even a considerably more conservative state budget would have foundered.

Expenditure Growth

Under the I-601 limit, state spending has grown steadily, in part reflecting demographic changes. State government here, as in most states, spends most of its money on the public schools (our state government funds a higher share of public school costs than do most states), higher education, and human services.

In the 2001-2003 budget originally adopted in 2001, the public schools received 44 percent of the $22.8 billion; higher education, 12 percent; and the Department of Social and Human Services (DSHS) and other human services (mainly corrections), 33 percent. That's 89 percent of it all; the remaining 11 percent covers the legislature, debt service, the judiciary and a host of executive branch agencies.

With a growing college-age population, demand for post-secondary education will increase at least through the next decade. Public school

enrollments, after increasing steadily from 1985 on, should level off as the age 5-17 cohort stabilizes.

As OFM points out, policy decisions influence the degree to which demographics drive spending. For example, welfare caseloads sharply declined with the shift from Aid to Families with Dependent Children (AFDC) to Temporary Assistance for Needy Families (TANF). When expectations changed and the program emphasized work, more people found jobs, reducing welfare rolls.

Similarly, prison populations and costs rose in response to changing attitudes toward crime and punishment, including tougher drug laws, determinate sentencing, "Three Strikes and You're Out, " and "Hard Time for Armed Crime." Public school spending continues to climb as enrollment stabilizes, accelerated by voter-approved initiatives directing funds to class size reduction (among other uses) and mandating specific compensation increases.

Health care costs again on the upswing. According to OFM, the growth stems both from rising caseloads (due to the combined effect of public policy expanding eligibility and a decline in private sector coverage) and from increased costs per case. Senate Ways and Means analysts point out that costs per person are growing at two and a half times the average rate of inflation and caseloads have increased nearly three times faster than population growth.

The combination of influences has stark implications for the coming biennium.

Looking Ahead

- ❑ In assessing 2003-2005 budget prospects, analysts in state government focus on several things:
- ❑ Slow economic recovery with state revenues lagging personal income growth
- ❑ Rising health care costs and increasing caseloads
- ❑ Continued diversion of property tax revenue to the Student Achievement Fund created by Initiative 728
- ❑ Annual, Seattle CPI-based salary increases for all state-funded K-12 employees and some higher education employees as required by Initiative 732
- ❑ Reduced federal Medicaid reimbursements

A continuation of the policy *status quo* virtually assures ongoing deficits. Assuming normal policy additions, such as salary increases, the deficits quickly reach the upper end of the range estimated, up to $2.3 billion. This budget deficit, considered a structural problem (i.e., representing a fundamental imbalance between revenues and expenses) by Senate Ways and Means analysts, is projected to extend for several years. On an annual basis, they show shortfalls exceeding a half billion for each year from 2002 to 2007.

OFM says that savings of about $685 million from permanent long-term expenditure reductions in the supplemental budget produce more than $1 billion in savings in the 2003-2005 biennium.

It's not enough.

In developing the budget for the coming biennium, OFM will be looking for additional long-term savings. The budget agency has asked departments and agencies to examine their "activity inventories", evaluate expenditures, and identify one-third of them as having the lowest priority. While landing in the bottom third does not mean that an activity will be targeted for elimination or reduction, it will assure an additional measure of budget scrutiny.

Agency staff members are also working to identify core governmental activities, and concentrate on the results to be achieved within each area. In focusing on activities, the process will not be bound by the "org chart" as analysts work to get a better understanding of total state spending in various activity areas. The effort should result in improved allocation of organizational responsibilities, creating opportunities for increased efficiency and lower costs.

Recognizing that funding challenges exist beyond the GFS, OFM is conducting the exercise on the "all funds" budget. The goal of the sharpened focus: to establish the "price of government" and associate the price with achievable outcomes.

A long-term focus on spending control is necessary, because Washington's budget problem is both structural and cyclical.

The collapse in revenues that caused the immediate shortfall is temporary. The state economy will recover, albeit slowly. While Washington is unlikely to see a return to the booming 1990s anytime soon, it is also unlikely to remain mired in recession for long.

Consequently, budget writers should continue to identify low priority programs and services and make permanent spending reductions wherever possible. Economic recovery alone will not result in a sustainable state budget without policy changes.

A growing economy, however, will reduce the pressure on the state budget. And policy makers should concentrate on fiscal adjustments that will improve the business climate, enhancing the prospects of a rapid return to economic vitality.

Across the nation, the situation is much the same.

The State of the States

Even as the national economy begins a slow, fragile recovery, forty-five states swim in red ink and anticipate another year of budget shortfalls.

For perspective, analysts look back to the early 1990's, the nation's last recession. In 1991, according to the National Association of State Budget Officers (NASBO), "state budget shortfalls were 6.2 percent of total state general fund revenues, forcing 28 states to make cuts to enacted budgets." As NASBO analysts point out, the recession ended in 1991, but the shortfalls in 1992 were even greater than in the prior year, 6.5 percent of revenue, forcing

budget cuts in 35 states. Such was the case in Washington, where budget cuts in 1992 preceded the tough 1993 budget session.

Few states have weathered the recession without confronting substantial budget shortfalls. While dollars are short, theories abound as lawmakers endeavor to explain the situation. The recession, of course, comes in for most of the blame, but also mentioned are issues familiar in our state: tax cuts, rising health care costs, increased school enrollments, and labor contracts. Some states face the additional complication faced by Washington lawmakers: ballot-box budgeting by initiative.

When problems are so widespread, some argue that the mess is unavoidable and no one is accountable.

The executive director of the Federation of Tax Administrators, Harley Duncan, says, "Everyone's in the same boat."[2]

In an address to the Midwestern Association of Tax Administrators August 26, Duncan observed that "self-inflicted wounds exacerbated states' revenue difficulties," singling out reliance on one-time money and increased spending accompanied by tax cuts.

NASBO estimates that fiscal year 2002 shortfalls will approach 7.8 percent of estimated total general fund revenue. Based on the prior decades experience, NASBO similar expects the budget problems to extend into 2003.

In late July, NCSL reported on techniques 42 states (not all had concluded budget deliberations) had taken to address the budget gaps for fiscal years 2002 and 2003.

In closing the gaps for 2002 (with only months remaining in the budget year when most legislatures convened), states had to react swiftly. "Twenty-six states collected less revenue in FY2002 than they did the previous year."[3] The 42 states reported a total gap of $37.2 billion. According to NCSL, 29 states cut spending, 20 tapped other state funds, and nineteen dipped into reserves. Higher education took cuts in 19 states, corrections in 18, and twelve states cut Medicaid, usually by eliminating optional programs.

"While many may be breathing a sigh of relief that fiscal 2002 is over," says William Pound, NCSL executive director, "our data suggests there isn't much time to catch their breath."[4]

In developing their 2003 budgets, lawmakers confronted an aggregate shortfall of $58 billion, about forty percent of which can be attributed to California's $23.7 billion gap. NCSL reports thirteen states foresee gaps exceeding ten percent. Again, most states handled the shortfall by cutting spending, raiding other accounts, and draining reserves. Sixteen states, including Washington, securitized tobacco settlement funds.

Even K-12 education, often held harmless in tough times, came in for reductions with 23 states making downward adjustments in either their 2002 or 2003 budgets. These cuts came after a decade of steady growth in public school spending. Nicholas Jenny reports that inflation-adjusted per pupil expenditures, all sources, increased by nearly 15 percent from the 1991-92 school year to 2001-2002.[5] In our state, real per pupil spending increased by 19.7 percent, ranking Washington 18th in the nation.

There were also tax increases in 2002, according to NCSL, "the first time since 1994 that there as been a net state tax increase. Sixteen of the 47

states reporting data raised taxes by more than 1 percent over 2001 collections. Tobacco taxes accounted for the bulk of the tax hikes, $2.9 billion. Sales taxes went up $1.1 billion; corporate income taxes, $1.0 billion; personal income taxes, $706 million; and health care taxes, $71 million.

Fee increases and other non-tax revenues accounted for $1.7 billion, with thirteen states boosting motor vehicle fees.

While some Washingtonians blame the lack of a state personal income tax for our current problems, the national evidence shows that states with such taxes were particularly hard hit. From January through April 2002, reports NCSL,[6] "total individual income tax collections … were 14 percent or about $14.7 billion below the level of a year ago. In April alone, when many states receive the bulk of their balance due or final payments, collections fell by 21.3 percent, or $8.6 billion. Income tax receipts in the first four months of 2002 were greater than receipts in 2001 in only six states."

Part of the problem, say analysts, is the decline in income not subject to withholding, including capital gains, interest and dividends. Loss of stock options and the decline in bonus compensation also play a role.

In Oregon, lawmakers approached mid-September in their fifth special session, still struggling to balance the state budget. The state, hard-hit by the recession, has seen revenues fall by about $1.7 billion since lawmakers adopted the biennial budget in July 2001. A patchwork of spending cuts of $550 million, $170 million in new taxes, and borrowing has succeeded in only partially plugging the hole.[7]

Looking to the budget for 2003-2005, the shortfall approaches $1.5 billion. Lawmakers wrangled over how much (if at all) income taxes should be increased, whether an increase should be referred to the voters, the size of required spending cuts, and the degree to which borrowing and cash management could buy time until the economy recovered.

Lacking either a sales tax or state property tax, Oregon relies on personal and corporate income taxes for nearly 90 percent of general revenues, says Matt Evans, president of Oregon Tax Research. The volatility of the income tax made the state particularly vulnerable to the downturn.

A March 2002 report by the Rockefeller Institute remains pertinent. Analysts conclude, "Although a recovering economy is helpful to states, their budgets will continue to be buffeted by forces not reflected in simple measures of the economy. These forces, which include stock values that remain well below their peak (and) a drastic decline in taxable wages related to stock options … will restrain direct state spending and state aid to local governments in the year ahead. The net effect yields a seeming paradox: states with income taxes may revise revenue forecasts down at the same time that they raise their economic forecasts."[8]

Common Spending Drivers

Most states report the same sources of expenditure growth: rising human services caseloads (particularly in Medicaid), health care cost inflation, and public school spending buoyed by increases in both enrollment and per pupil spending.

In June, Nicholas Jenny of the Rockefeller Institute assessed caseload trends. "Median state Medicaid caseloads grew by five percent in 2001. States projected that this will increase slightly to 5.2 percent in 2002, and then slow to

3.4 percent in 2003. State TANF caseloads have declined for several years now and the estimated median decline in 2001 was 2.3 percent. States projected that TANF caseloads will increase by 1.4 percent in 2002, and by 0.8 percent in 2003."[9] (Caseloads here appear to have flattened, they are expected to remain relatively stable at about 55,000 for the next two years.) Jenny also noted that prison population growth is also likely to slow in the next two years.

While expenditure growth in the 1990s undoubtedly contributed substantially to the current problem, the sharp revenue drops hit virtually every state hard, including states that did not show substantial spending growth in the last decade.

The Taxpayer Bill of Rights (TABOR), a constitutional amendment passed by a citizen initiative in 1992, for example, has controlled state spending in Colorado more most of the last ten years. Washington's I-601, adopted in 1993, takes the TABOR approach of tying expenditure and revenue growth to population and inflation and requiring a public vote on tax increases.

Yet, Colorado has not avoided serious budget problems. Tom Dunn, the state's chief economist with the Legislative Council, says that for 2001-2002 the state faced a $1.1 billion shortfall, as revenues of $5.6 billion failed to cover $6.7 billion in general fund obligations. (Revenues were down from $6.6 billion in 2000-2001). Like most states, Colorado sought to bridge the gap with temporary measures – borrowing, inter-fund transfers – and spending reductions, including a five percent across the board cut. The Legislative Council reports that the state general fund has a structural deficit: "Given the assumed revenue and expenditure growth, a potential deficit situation appears to persist each year. Significant amounts of money are not available for borrowing from other funds after this year."

Even with the tight spending cap, then, Colorado could not avoid the fate of most states.

Rather than focus on the decade, a more short-term perspective seems appropriate in assessing the states' budget plight. States facing the toughest times now are those that failed to act swiftly to control spending as the economy slowed, particularly states with volatile revenue streams (e.g., highly progressive personal income taxes or extraordinary reliance on corporate income taxes) and thin reserves.

Emphasis on growing expenditure demands, without corresponding attention to the policy choices that have accelerated spending, risks creating undue pressure to solve the short-term spending problem with permanent tax and fee increases. In many states, the recession in the early 1990s was accompanied by tax hikes that permanently raised the spending base once the recession had passed, adding to the current difficulties.

How Other States are Handling It

As the national picture demonstrates, there are no silver bullets, no quick fixes to budget deficits of this size. Most states have pushed problems into the next fiscal cycle. The degree to which the strategy is successful will largely depend on whether the budget shortfalls represent brief responses to a cyclical economic downturn or are, instead, the beginnings of long-term structural imbalances in state fiscal systems.

For three contrasting approaches to the budget challenges, we look to Texas, Massachusetts and Wisconsin.

Texas

In Texas, budget writers dodged a bullet in 2002. Last July, NCSL showed Texas as one of the states with no budget gap in either FY 2002 or FY 2003. John Kennedy, an analyst with the Texas Taxpayers and Research Association (TTARA), a respected business-supported group, says the state has been "real lucky," but goes on to note a couple of items that contributed to its good fortune. First, the state's elected comptroller, Carole Keeton Rylander, who is responsible for revenue forecasting, held to a conservative estimate of revenues for FY 2002, making it difficult for lawmakers to increase spending to unsustainable levels. Also, Texas, like Washington, budgets on a biennial basis, which gave legislators some room to adjust spending. Finally, they responded quickly when the economy showed signs of cooling.

Next year, however, Texas lawmakers face a significant budget shortfall. September 3, the comptroller issued a press release confirming a $5 billion shortfall – "not deficit," she emphasized – for the 2004-2005 biennium. She said estimates of a larger shortfall are "based on 'wish lists' of various agencies and … manufactured from faulty fabric that ignores natural revenue growth." Rylander called on lawmakers to build the balance in the Rainy Day, counseling "conservative fiscal policies have served our state well in the past, and are the best bet for the future."

TTARA points out that the 2002-03 budget was financed with a $2.9 billion budget surplus as well as other one-time fiscal tactics that will not be available next year. Texas, like Washington, does not have an income tax, and there is no sentiment for adopting one anytime soon. State analysts say revenues have been growing with the economy.

In Texas, the state share of public school funding in the 1990s declined from about 50 percent to roughly 42 percent. Property taxes provide more than 50 percent of local school support.

Although the state has a tax and expenditure limit, Kennedy describes it as "a sheep in wolf's clothing" that has done nothing to restrain state spending.

With the prospects for economic recovery in the state good, business groups favor "effective cash management techniques." ("We don't call it smoke-and-mirrors anymore," Kennedy says.) They would prefer to see the state close the gap with one-time measures, including use of reserves, believing that a return to steady revenue growth will allow the current tax structure to fund a sustainable budget in the future.

A cyclical budget downturn, they believe, does not warrant a major long-term fiscal response.

Massachusetts

Confronting a $3 billion shortfall in a $23 billion budget, the Commonwealth faced one of the nation's most severe budget problems. Having used nearly $1.8 billion in reserves and one-time revenues to cover the FY 2002 deficit, the options for 2003 were few.

Massachusetts saw tax receipts drop nearly 15 percent in FY 2002, including a 26 percent plunge in the fourth quarter of the fiscal year, according to the Massachusetts Taxpayers Foundation (MTF).[10] Home to many high technology firms, the state had benefited from substantial revenue growth as the tech sector soared in the 1990s; when it soured in the last two years, the state treasury suffered. The Foundation singles out the collapse in capital gains receipts as a major cause of the state's budget woes.

In a prescient analysis in early 2001, MTF identified the "convergence of three major trends" that portended major changes in the state's fiscal condition: the approaching recession; voter approval of a $1.2 billion tax cut, accompanying other tax reductions; and "rapidly escalating and largely uncontrollable health care costs," amounting to 25 percent of the state budget.

Mike Widmer, MTF president, believes the state faces a long-term, structural budget problem, requiring policy changes. In considering the "structural" character of the Massachusetts budget shortfall, he points out that the state substantially expanded Medicaid in the late 1990s. From 1997 to 2001, caseloads grew from 700,000 to one million (one-sixth of the state population). The budget consequences were substantial, with Medicaid currently representing about one-fourth of the state budget.

MTF, Associated Industries of Massachusetts, the Greater Boston Chamber of Commerce, and the Massachusetts Business Roundtable in April endorsed a three-part plan for addressing the budget gap. The plan called for $700 million in spending cuts, $700 million in additional revenues, and $500 million from reserves.

"We got some flak for it," Widmer says, but there was no credible alternative to a solution involving a combination of spending cuts and new revenues.

When the legislature adopted its budget shortly after midnight July 31, the package included a combination that Widmer found "largely balanced." Taxes increased $1.1 billion (including $215 million from not implementing a scheduled tax cut), spending was cut by about $725 million (plus $129 million in pension funding cuts), reserves and other one-time revenues were tapped for $844 million and $150 million in tobacco dollars were pulled in. Among the tax increases: elimination of the charitable deduction, lowering personal exemptions, and boosting capital gains and tobacco taxes.

And, as the Boston Globe reported, "The Legislature created an off-budget account by moving $357 million in Medicaid expenses into a separate fund [and] moved $42 million off the budget that will cover a shortfall that has developed in the fund for hospital care for the uninsured…"[11] The shift was criticized by MTF.

Notably, total spending for fiscal 2003 increased $1.1 billion, about 5 percent, from 2001 – up $700 million in 2002 and nearly $400 million in 2003. Most of the spending growth is in health care programs, including Medicaid and employee health benefits, in the public schools, and in caseload-driven human service programs, according to MTF.

Still, after raising taxes by a billion dollars and cutting spending by a billion dollars, Widmer says, the state will go into 2004 facing another $1 billion shortfall.

Given the extent of the remaining problems, Massachusetts's lawmakers will again wrestle with budget issues next year. MTF counsels them to "protect jobs by preserving the long-term competitiveness of the Massachusetts economy." Specifically, the state must work to control business costs, maintain a good tax climate, protect essential public investments, and avoid one-time revenue gimmicks and cost deferrals.

Wisconsin

As mentioned earlier, "let's just get through the year" might have been the overarching theme of state budget writers across the country this year. Perhaps no state exemplified the theme more than Wisconsin.

Wisconsin securitized all of its tobacco settlement funds: $450 million in 2001 and the rest, more than $800 million, in 2002.

"We blew all the money," says Todd Berry, president of the Wisconsin Taxpayers Alliance.

But he goes on to point out that the one-time solutions may make sense. Wisconsin's problem, he says, seems to be a short-term revenue downturn, not a long-term mismatch between revenues and expenditures.

Andrew Reschovsky disagrees. In an article in State Tax Notes, Reschovsky, a University of Wisconsin public affairs professor, contends, "the state has faced a structural deficit at least since the mid-1990s," attributable to the state's assumption of a larger share of public school funding and a growing prison population as a result of tougher sentencing policies. Only extraordinary economic growth covered the gap until the recent recession.

Berry, formerly Assistant Secretary of the Wisconsin Department of Revenue and Executive Director of the Governor's Tax Reform Commission, agrees that stepped-up public school funding requirements have contributed to the problem, and acknowledges that economic recovery will not close the possibly $1 billion gap in the next budget. Nonetheless, he contends the problem results primarily from the recession, exacerbated by higher spending commitments.

"If you're going to generate new revenues," he says, "they should be one-time, not ongoing."

It makes little sense to solve a short-term problem with a long-term tax hike. That mistake, he says, was made in the early 1980s when permanent revenue increases were adopted, filling the short-term budget shortfall and raising the base for future years, exacerbating later fiscal problems.

A Bit of Perspective from the Plains in the Early 1990s

Finally, in wrapping up a look at various states' efforts to deal with fiscal challenges, it's useful to consider how one executive handled the problem in the recent past.

Former North Dakota Governor Ed Schafer took office in 1992. The state's two key industries, agriculture and energy, were "in the tank" and 50,000 people had left the state. The previous administration had proposed budget balancing tax increases. The tax hikes were referred to the voters, who rejected them in 1989.

Schafer promised to "bring business principles" to government, with a goal of reducing spending and taxes. The budget proposal left by the outgo-

ing governor included $120 million in new taxes and spending. Schafer and his team developed a budget without the revenue hikes. He calls his first legislative session a "band-aid" session, after which they went to work implementing his set of business principles for government.

Among the steps he took:

- Implementing a hiring freeze, with oversight by a hiring council chaired by the lieutenant governor.
- Adopted a modified form of zero-based budgeting to get away from the incremental increases of the past.
- Involved state employees in establishing program and activity priorities in all executive branch departments (a process similar to the exercise OFM is currently undertaking).
- Emphasized economic diversification and growth, eliminating redundant and unnecessary regulations, streamlining regulatory processes, and cutting workers' compensation rates and unemployment insurance taxes.

He counts as an early accomplishment the reduction in the cost of government and state employment. At the same time, the Schafer administration was able to direct more spending to public education. Eventually, the trend of outmigration was reversed; technology and new energy industries expanded; and the state began to grow.

A retrospective on the Schafer years in the Bismarck Tribune confirms Schafer's evaluation of his gubernatorial successes: "Schafer deserves the credit he claims" for job creation and changing the mindset of the state.[12]

As Schafer says, the small size and scope of government in North Dakota makes it easier to accomplish such objectives. Regardless of size, however, the governor of any state has a powerful platform from which to exercise fiscal discipline and compel a long-term focus on economic prosperity.

Findings

1. The budget solution will be dictated by the definition of the problem. Most budget shortfalls reflect both cyclical and structural dimensions.

Among the states, circumstances vary, reflecting different demographic and economic conditions. While the recession created severe hardships in virtually every state, the response to the downturn will be driven by each state's particular condition. Cash management strategies, including use of reserves and one-time revenues, can bridge temporary budget gaps resulting from extraordinary revenue losses or expenditure hikes. More extensive restructuring of revenue and expenditure bases will be required to address structural problems.

Structural deficits, representing a long-term mismatch between expenditures and revenue streams, reflect policy choices, not simply demographic inevitability. While all states have experienced increased fiscal stress as a

result of rising health care costs, for example, the budget consequences they experience reflect choices policy makers have made regarding eligibility and cost sharing and the services provided or covered.

2. Properly constructed tax and expenditure limits can help maintain fiscal stability, but provide only limited protection against sharp and deep revenue losses.

There may be no “normal” growth rate for state revenues in a dynamic economy. Revenues fluctuate within the business cycle. The national experience shows that in this recession all states suffered rapid revenue loss – states with “balanced” tax systems as well as states lacking sales or income taxes. The art of state budgeting requires controlling spending during periods of rapid growth and building adequate reserves in order to lessen the impact of the inevitable downturn.

The boom-and-bust cycle afflicting state budgets can be moderated by expenditure limits that tie state spending to an indicator of demand (e.g., population plus inflation) or ability to pay (e.g., personal income). An effective limit will also establish a solid rainy day account. Supermajority requirements for tax increases also can impose a reasonable check on lawmakers, forcing them to examine expenditure reforms or cash management strategies before raising taxes.

Recent experience has shown that large budget reserves create almost insuperable temptations to voters and lawmakers. Either they lead to demands for increased spending or for tax cuts. Citizen initiatives in this state have used the surplus both to justify property tax diversions to public schools and to repeal the MVET. While it is unlikely that any responsible reserve level would have allowed the legislature to address the 2002 budget challenge without other extraordinary measures, the thin reserve available increased the difficulties for lawmakers.

3. Successful state strategies maintain a long-term focus on economic growth.

During the 1990s, state governments were able to expand programs and services and cut taxes as a result of economic prosperity. In addressing the current fiscal crisis, successful political leaders and lawmakers will concentrate on budget strategies that enhance the long-term economic competitiveness of their states.

4. Washington’s budget problem is both cyclical and structural.

The magnitude of the state’s budget shortfall reflects the intensity of the national recession, compounded by the effects of September 11 on the state’s aerospace industry. In that respect, the state’s budget problem is primarily a revenue problem. Had the recession been milder, the shortfall would have been more manageable. When the economy revives, revenue growth will ease some of the fiscal stress.

Nonetheless, growth alone will not solve the state’s budget problem, as expenditure levels were unsustainable as far back as March 2001, well before the precipitous revenue drop. The public policies underlying the spending growth in education, human services and corrections contribute to an enduring structural deficit.

Recommendations

In addressing a $2 billion budget shortfall, state leaders should adopt a balanced approach. While many of the state's businesses remain globally competitive, many others – including leaders in key sectors of our economy – are vulnerable. Improving the state's business climate remains the best strategy for achieving the economic recovery that will generate the revenues required to fund adequately essential public services.

1. Implement long-term expenditure controls.

The governor's budget office has begun a productive examination of expenditure policy, seeking to identify core activities of government and focus on results. This effort should produce useful information to guide the development of the 2003-2005 budget. Although the revenue loss associated with the recession may properly be treated as a temporary set back, the current scale of state programs and services (including those mandated by initiative) cannot be sustained in the near future, even with full economic recovery.

Consequently, state officials must make some politically difficult decisions, such as elimination of low-priority programs, increased cost sharing and benefit reduction in health care programs for state employees and enrollees in state programs, program consolidations, and outsourcing. Identification of efficiencies (including use of the private sector to deliver some services), however, will not solve the near-term problem. Productivity increases typically are obtained over time, particularly in the public sector.

2. Restore an effective tax and expenditure limitation.

For most of the last decade Initiative 601 effectively controlled state spending. It was not perfect, but it worked. In the past few years, changes in the limit, culminating in its suspension by legislators in the 2002 session, rendered it ineffective. Lawmakers should propose a successor limitation early in the 2003 session. The current "price of government" exercise being undertaken by the Office of Financial Management demonstrates the utility of an external benchmark in guiding budget decisions; an effective limitation reinforces the benchmark.

3. Continue to pursue effective cash management strategies. Avoid recovery-killing tax increases.

Businesses investment in a competitive economy involves complex and long-term decisions. In making those decisions, business leaders look for stability and predictability in tax policy. For Washington to maintain and enhance its attractiveness for economic development, lawmakers should avoid calls to retreat from existing tax policies adopted to increase investment and job creation in the state.

Business taxpayers go into 2003 already facing substantial state-imposed cost increases. Employers must contend with automatic statutory increases averaging more than 15 percent for unemployment insurance taxes. In addition, the Department of Labor and Industries has proposed average increases of 40.5 percent in workers' compensation premiums for State Fund employers.

Washington already imposes one of the nation's highest tax burdens on business. Any further increase will jeopardize economic recovery and damage our state's competitiveness.

4. Restore the integrity of the general fund by reducing the effects of ballot initiatives.

Three initiatives passed in the past few years have reduced the ability of the legislature to manage the state budget effectively and eroded the general fund tax base. In response to the current fiscal crisis, lawmakers should reclaim control of the budget by amending these initiatives to reflect current economic conditions.

Initiative 728 created the Student Achievement Fund with a diversion of property taxes from the state general fund. The initiative will deprive the general fund of more than $2 billion through 2005-2007, money initiative sponsors said would come from budget surpluses. Initiative 773 raised the cigarette tax by sixty cents a pack, dedicating the funds to the Health Services Account, but requiring that it may only be used for program expansion. These funds should properly be used to cover the budget shortfall, including deficits in health care programs. Finally, the mandated salary increase for selected school employees imposed by Initiative 732 has become the *de facto* standard for all state employees and is based on a flawed and artificial measure of inflation. It also takes control of compensation policy, a major budget driver, out of the hands of the state legislature.

Endnotes

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