Overview for 2007:
State Budgeting at a Crossroad

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As the states budgeted for the 2007-2008 fiscal year, they faced a rapidly changing fiscal environment. One need only look at the titles of reports released in late 2006 to see how in flux that environment was.

In September the Rockefeller Institute Revenue Report was entitled “State Revenue Shows Broad Growth” (Stenson and Kuo). An October Council of State Governments publication trumpeted, “Back in the Black – Expanding Economy Helps States Build Reserves” (Council of State Governments). The Center on Budget and Policy Priorities saw it differently by November with its report “State Budgets on the Edge” (McNichol and Lav). But in December Executive Director Ray Scheppach stated in a National Governors Association/National Association of State Budget Officers report, “It’s a good time to be a Governor” (National Governors Association). The same month the Rockefeller Institute revenue report warned “State Tax Revenue Showing Signs of Slowdown” (Stenson and Kuo, December 2006). Perhaps John Petersen had it right in his article “Seat-Belt Budgeting” (Petersen).

Elements of both optimism and caution can be found within many of the statistics from the previous fiscal year, with more of the latter in some very important trends that were starting to emerge.

SOME GOOD NEWS, SOME TROUBLING TRENDS

From the big picture point of view, FY-2006 was a good one for the states. Aggregate year-end balances were up 25 percent from FY-2005, and stood at 9.9 percent of spending (NASBO). This helped rainy day balances increase 23 percent. Of concern, however, was the fact that final state spending for FY-2006 was up 8.4 percent, significantly more that the 5.85 percent that had been budgeted. A strong predictor of state budget deficits in 1991 was a state’s previous year’s increase in spending (Wallin).

Complicating the situation was the fact that states enacted budgets for FY-2007 that projected general fund revenues to grow 3.15 percent, but general fund spending to increase by 7.5 percent. This failure to live within current year means is reflected by the fact that aggregate year-end balances were projected to decline by 29 percent, a dangerous drop in a time of uncertainty. Fiscal positions varied greatly by region and within regions. Pennsylvania, Michigan, Wisconsin, and Washington State, for example, were all projecting FY-2007 balances under 2 percent, compared to a US average of 6.5 percent.

The area of greatest budgeted growth for the states in FY-2007 was K-12 education at 7.9 percent, as school age populations continued to grow in most states, court-ordered school finance
reform required greater financial support of schools in many, while a greater emphasis on adequacy and performance brought higher costs. Higher Education spending rebounded and was expected to grow 6.3 percent; the same increase budgeted for Medicaid. Corrections accounted for the final above average category of spending growth at 5.7 percent.

By November of 2006, the National Conference of State Legislatures reported that revenue performance was stronger than expected for 23 states, which revised them upward. But noteworthy was the fact that last year at the same time 42 states were in that favorable position. The tax that was under performing the most was the sales tax. Fourteen states had to revise that estimate downwards, compared to seven the year before. Many state officials were starting to worry that the downturn in the housing market, along with the emerging credit tightening, were causing taxpayers to rely less on equity loans to finance purchases at previous levels.

As states began budgeting for FY-2008, their financial positions were mixed, to say the least.

AN UNCERTAIN FUTURE

States had gotten somewhat used to fairly strong economic performances in recent years, but as they began putting their budgets together for FY-2008 they had to be concerned about an emerging slowdown. Indeed, growth in the 3rd quarter of 2006 was the slowest growth in 10 quarters. Federal Reserve Chairman Paul Bernanke identified two areas of specific concern. The first was a decline in housing prices, which was starting to produce some defaults and bankruptcies, and was causing a slowdown in consumer spending. The second area of concern for Bernanke was the rise in energy prices and the negative effect it would have on consumer spending, as well as its potential inflationary impacts. The stock market run-up had also been producing revenue windfalls for states in the form of stock options being cashed in and capital gains taxes, but signs were emerging that the market was losing steam.

In addition to the economy, health care continued to pose a threat to state solvency. Medicaid spending, one of the two largest budget items in almost every state, began to rise more rapidly once again. While it grew only 2.8 percent in FY-2006, it climbed to 5.7 percent in FY-2007, with the upward trend likely to continue for several reasons. First, many states (including notably Massachusetts) have enacted broad health reforms, often to cover the uninsured (Holahan and Blumberg). In Massachusetts, which is being viewed as a model, a substantial part of the funding comes from additional Medicaid spending. Erosion in employer sponsored health care coverage has also had an impact on the growth of Medicaid beneficiaries. Second, inflation in the health care sector continues to outpace the general rate of inflation, as well as the growth in state revenues in many states. Technological advances and most importantly the cost of prescription medications are the main causes. Third, there has been a consistent increase in the amount of Medicaid funds going to nursing homes. This will only worsen as the baby boom population ages. And finally, the inflation in the health care sector has been having a dramatic impact on the amount states have to pay to insure both current employees and retirees. Many states have large unfunded liabilities for the health care of what will soon become a substantial increase in the number of state employees who retire.
States also are under continuing pressure to adequately and equitably fund K-12 education, whether by court mandate or political pressure. Many states have expanded funding on testing and test preparation for fear of impacts from the No Child Left Behind Act. Usually the first or second largest budget category for states continues to grow faster than inflation, and as noted above, had the largest percentage increase in state spending nationwide in FY-2007.

In addition to the No Child Left Behind Act, there are other areas of federal government policy that are a cause for concern for state budget-makers in 2007. With deficits rapidly increasing and a national government focused on the Iraq War and homeland security, states are having to revive their role as laboratories of democracy (and policy), health care reform being only one example. But with that added responsibility come additional costs. More specifically, the federal government has refused to fill in the gap for cost overruns in the SCHIP program, leaving states with a potential shortfall of $13.4 billion over the next five years (Park). The Bush Administration’s budget for FY-2007 proposed shifting $24.7 billion in Medicaid costs to the states over the next five years, and is likely to ask for more. Finally, should the federal government eliminate the estate tax, it would have significant consequences for those states that conform to the federal income tax.

Finally, the fluctuation in the value of properties will have an impact on state budgets. Local governments benefited greatly from the growth in the value of existing properties and new construction during the past five years. So did property owners, who often took out second mortgages with their new equity for a variety of reasons, from college tuition to home remodeling to buying new cars. But over-speculation and over-building, along with the economic slowdown, has burst this bubble. Reassessments, along with foreclosures, will reduce property tax revenues for local governments, who will surely turn to their respective states for relief. There has also been a lot of pressure for states to fund circuit breaker property tax relief for seniors, a very costly proposition, and one likely to grow with the aging of the population.

A review by the Rockefeller Institute of the themes in annual messages of 13 governors in February of 2007 reinforced most of this analysis (Stenson and Grinnell). The top priorities, garnered from governors’ state of the state messages and state legislative staff, were:

- access to health care and Medicaid
- K-12 continued on equity and adequacy, and new early-ed
- Economic development – new economy
- Tax Reform (and property tax relief)

CONCLUSION

President John F. Kennedy once observed that the time to fix the room is when the sun is shining. Thus health care and education reforms should be undertaken when states are in a position of fiscal strength. But this is often politically difficult to do, as taxpayers aware of surpluses usually demand tax cuts. And states will be increasingly pressured by bond rating agencies to reduce their unfunded pension and health care liabilities for retirees, something that also will receive little praise from taxpayers.
Some states put together their budgets for FY-2008 hoping to make some important reforms. But the clouds looming on the horizon make it likely that the survival, rather than innovation, mode is likely to return and dominate.

REFERENCES


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