Unprepared for boom or bust: Understanding the current state fiscal crisis

Leslie McGranahan

In October 2001, the state governors sent a letter to the U.S. Senate concerning the Senate's proposed stimulus package. The governors sought to prevent the passage of a package that would be detrimental to already weak state budgets and to ask for specific assistance from the federal government for state budget items. As a result of the connection between federal and state revenues and spending, state leaders often comment on federal changes. What is remarkable about this letter is that only seven months after the end of the greatest post-war economic boom, the states were already seeking fiscal help from the federal government. In addition to its concerns about mounting defense and intelligence obligations and the flailing macroeconomy, the government now faced the specter of service shutdowns by bankrupt state governments.

The crisis facing the state governments emerged quickly. In August 2000, commentators at the National Conference of State Legislatures (NCSL) were boasting that states were "in their best financial conditions in decades" (NCSL, 2000). In January 2001, the NCSL asserted that the states remained in "excellent fiscal condition" (NCSL, 2001c). But by August 2001, the NCSL was detailing how states were coping with budgetary shortfalls (NCSL, 2001a).

In this article, I ask how the states found themselves in fiscal trouble so quickly. I begin by discussing the excellent revenue news from the states throughout the economic expansion. Tax revenues increased, welfare reform kept block grants at high levels, and the tobacco settlement provided a generous new form of funds. As a result, states faced the pleasant dilemma of what to do with their windfall revenues.

I investigate the ways states decided to use these revenues. They faced four fundamental choices: they could spend the money on high-priority programs; they could return the money to taxpayers in the form of rebates and reductions; they could reduce indebtedness; or they could save the money for a less brilliant future. All states chose a combination of these four.

States increased spending. Much of the spending increase was due to mounting expenditure pressures in health-care related areas. States also aggressively cut taxes, particularly personal income taxes, throughout the expansion. While the states did not move to reduce indebtedness, they did increase their savings. States save money by maintaining balances in their reserve funds. Most states have created budget stabilization or "rainy day" funds as a way to cope with unexpected shortfalls. (The only states without such funds as of October 2001 were Arkansas, Montana, and Oregon). Money transferred into these funds can be withdrawn under specific circumstances. States also maintain reserve balances in their general fund accounts. During the expansion, balance increases in these accounts were substantial but were insufficient to offset even a mild downturn.

When state revenues began to deteriorate in the third quarter of 2000 as the first signs of the pending recession surfaced, state budgets soon ran into deficit. Because nearly all states are required to pass balanced budgets and are limited in their ability to issue debt, they needed to deal with the budget imbalance quickly. State debt limits restrict states' ability to borrow if changes in economic circumstances lead to shortfalls during the fiscal year (National Association of State Budget Officers [NASBO], 2002).[1]

Now, instead of the four pleasant choices outlined earlier, states faced four difficult options to deal with these revenue shortfalls. Because of the restrictions

Leslie McGranahan is a consultant to the Federal Reserve Bank of Chicago and an associate fellow in the Department of Economics at the University of Warwick. *The author would like to thank Bill Testa, David Marshall, and Helen Koshy for comments and guidance.*

on debt, debt issuance was not one of the options. States could increase taxes; they could cut spending; they could reduce the balances available in their reserve funds; or they could rely on the federal government to bail them out. Few states have chosen to increase taxes. Tax increases are both politically very unpopular and slow and difficult to shepherd through legislatures. Most states have used a combination of spending cuts and reserve fund withdrawals to bring their budgets into balance. While the states have asked the federal government for assistance, federal aid has not been particularly forthcoming.

The current fiscal crisis highlights the problems inherent in the states' balanced budget system. States cut taxes and increase expenditure during booms only to be faced with revenue shortfalls during recessions. Then, the states have to cut spending just when the need for government services becomes most pronounced and must raise taxes when taxpayers are at their poorest. To prepare for future downturns, state governments should consider some policy changes. First, states should control spending during both expansions and recessions in order to avoid the need for dramatic cuts during difficult times. Second, states should restructure their rainy day funds, so that they can draw on these more heavily to maintain services during difficult times. In order to do this, reserve fund balances would need to grow much larger than they did in the recent expansion.

I highlight the experience of the five states that make up the Federal Reserve's Seventh District—Illinois, Indiana, Iowa, Michigan, and Wisconsin. This allows me to paint a more precise picture than would come from only generalizing across 50 states. These midwestern states are interesting because they were among the first to be harmed by the economic slowdown. As a result, they were forced to make difficult decisions earlier than other states. At the same time, the behavior of the midwestern states has been fairly typical of that of states nationwide.

The boom: Revenues

The U.S. Census Bureau segregates state funds into four separate categories—the general fund, insurance trust funds, utility funds, and funds for state-operated liquor stores. In this article, I focus on the general fund as it is the source of revenues and expenditures over which the state has the most control and it supports the largest state government expenditures. The other funds are very small, with the exception of the insurance trust fund. This fund supports unemployment insurance, workers' compensation, and programs for state government employees.[2]

States generate revenues from a variety of sources, the two most important being taxes and the federal government. In 1999, the federal government provided just over 25 percent of general fund revenues while taxes provided 55 percent. In 1999, most state taxes came from general and selective sales taxes (48 percent), personal income taxes (35 percent) and corporate income taxes (6 percent).

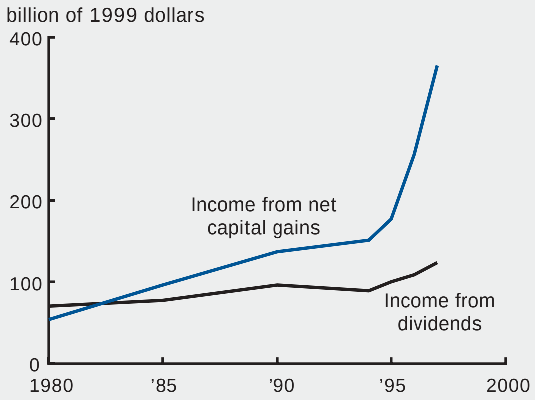
Over time, general state revenues have been increasing along with the rise in national income. Between 1980 and 1992 (the first year of positive economic growth during the recent expansion), real general revenues increased by an average of 4 percent per year in total and 3 percent per year per capita. Throughout the recent expansion, strong national economic conditions translated into continued strong state revenue performance. Between 1992 and 1999, state revenues grew an average of 4 percent per year and 3 percent per capita, despite significant enacted tax reductions (U.S. Department of Commerce, Bureau of the Census, 1981 and 2002a).[3]

The reason for the continued revenue growth was that everything was going right. Robust consumer spending translated into high sales tax revenues. Sales tax revenues are procyclical both because spending is itself procyclical and because states exempt the least cyclically sensitive products from taxes—in particular, food and drugs. Between 1992 and 2000, real total state general sales tax revenues increased by 40 percent, or by an average of 4.2 percent per year. Revenues from the even more procyclical personal income tax also increased dramatically during the expansion, by 59 percent in real terms between 1992 and 2000, or by 6 percent per year (U.S. Department of Commerce, Bureau of the Census, 2002b). One reason for the increase in income tax revenues was the high level of employment and earnings. But likely even more important was the dramatic increase in revenue from taxes on capital gains and dividends.

The exact role of the growth of capital gains and dividends in boosting the revenue performance of the states is difficult to ascertain because data on income tax revenues from different sources are not available for most states.[4] However, two sources point to a significant increase in revenues derived from capital gains taxes. First, state capital gains taxes are closely linked to the federal capital gains tax and readily available data on capital gains and dividends declared on federal individual income tax returns show a dramatic hike over the 1990s, especially post 1994. The growth in capital gains and dividends reported on federal income tax returns is pictured in figure 1. Second, we do have separate data on state personal income tax

FIGURE 1

Income from dividends and capital gains reported on federal returns



Source: U.S. Department of the Treasury, Internal Revenue Service, 2001a and 2001b.

withholding, estimated payments, and final settlements paid when taxes are filed. Trends in estimated payments give some indication of the level of capital gains and dividends received, because these are taxes paid on non-wage income. While estimated payments are highly volatile, they did increase dramatically at times during the expansion. For example, estimated payments for 2000 taxes made between April 2000 and February 2001 were 17.1 percent higher than similar payments made the previous year (Jenny and Boyd, 2001). Again, in parallel with the experience of the federal government, the states' personal income tax revenues exceeded expectations every year during the expansion, probably due to the high level of realized capital gains.

Two less obvious factors also contributed to the impressive state revenue performance of the end of the millennium. First, 46 states and four major tobacco companies signed the Master Settlement Agreement in November 1998. To settle state lawsuits aimed at recovering tobacco-related Medicaid costs, the tobacco companies promised the states $206 billion over a 25-year period. The states began receiving money in late November 1999 following the approval of the agreement by the required number of states. During 1998, 2000, and 2001, states received $2.4 billion, $6.4 billion, and $6.9 billion, respectively, from the tobacco settlement.[5] Some states received even greater revenues than indicated by the settlement, because they used financial intermediaries to trade the 25-year stream of benefits for a single lump sum. Wisconsin, for example, arranged for a single payment. These tobacco monies are large, even in the context of multibillion-dollar state budgets. The $8.3 billion due to the states in 2002 is equivalent to 1.8 percent of state general fund revenues in 2002 recommended budgets. For 2000, without funds from the tobacco settlement, revenue growth would have equaled 3.7 percent; including the settlement raised the growth rate to 4.5 percent (Wilson, 1999; NCSL, 1999a).

While anti-smoking groups anticipated that these funds would be spent on state smoking cessation initiatives and other health causes, the funds entered state coffers with no strings attached. While some of these funds have been spent to curb smoking, most have simply served to increase revenues and have not been earmarked for specific causes.

The second factor, aside from taxes, contributing to state revenues during the expansion was the change in the welfare program. When Aid to Families with Dependent Children (AFDC) changed to Temporary Assistance to Needy Families (TANF) in 1996 (discussed in more detail below), welfare funding changed from a federal matching program to a fixed federal block grant. Under the AFDC program, the declines in caseloads that accompanied the programmatic change and economic expansion would have led to a decline in spending and, therefore, a decline in the federal match. By contrast, under the new program, block grants stayed fixed in the face of declines in the recipient population. As a result, states could both cut their own spending down to the levels required by the legislation and use their funds to increase benefits and restructure programs to support a wide array of social services for their welfare populations.

Spending

Like revenues, state government spending has generally been increasing over time. Between 1980 and 1992, real general government expenditure increased by 4.4 percent overall per year and by 3.4 percent per capita. During the expansion, between 1992 and 1999, real expenditure growth slowed to 3.5 percent per year, or 2.5 percent per capita. Census data on state government spending are only available until 1999 (U.S. Department of Commerce, Bureau of the Census, 2002a). More recent data from NASBO show that real total state expenditure increased by 5 percent between 1999 and 2000 and 5 percent between 2000 and 2001 (NASBO, 2001c).[6] Even in the presence of impressive revenue growth, by 1999 appropriations growth was expected to outpace revenue growth. In the light of the fiscal problems emerging in fiscal 2002, governors recommended that appropriations growth slow substantially.

State government spending is less cyclical than revenue, because many of the major state services are not particularly cyclically sensitive. For example, enrollment in elementary and secondary education is a function of past fertility decisions and is not very responsive to the condition of the economy.

However, spending in some programmatic areas is sensitive to economic conditions. The most obviously cyclically sensitive area is need-based services. Demand for these services declines as the economy improves and employment rates increase. Then, demand grows in a downturn. States partially fund three crucial need-based programs: unemployment insurance, Medicaid (the health insurance program for the low-income population), and welfare (TANF, formerly AFDC). Among these, unemployment insurance is covered by funds not considered as general expenditure in the Census Bureau definitions.

That said, some expenditure pressures are even slightly procyclical. This minor procyclicality derives from the fact that states are major employers and compete for their employees in the labor market. Labor market tightness should lead to increased wage demand among teachers, highway workers, police officers, and others employed by the state. Looking at teachers, for example, we see that real salaries rose during the expansion. Between the 1991–92 and 1999–2000 academic years, average nominal teacher salaries rose by 23 percent and starting teacher salaries by 28 percent (American Federation of Teachers, 2002). This second number is a better indication of labor market tightness because education systems compete against other employers for new college graduates. Between 1992 and 2000, total inflation was about 17 percent (this is the increase in prices as measured by the gross national product price index) (Executive Office of the President, Council of Economic Advisers, 2002). In their role as employers, states were faced with increased spending pressures during the expansion, while in their role as providers of services to the needy, they faced declining pressures. On balance, the expansion probably cut expenditure pressures somewhat, but by no means dramatically.

To further investigate increases in expenditures, I look at increases by spending category. Table 1 shows the real dollar and percentage change in expenditure in four major state spending categories between 1992 and 1999. Spending increased between 22 percent and 32 percent in all of these categories over the entire period or from just under 3 percent to just over 4 percent per year. The table also shows spending growth in current and capital spending. Current expenditures grew more quickly than capital outlays.

While funding increases during the expansion were pretty universal, two areas deserve special attention: education and Medicaid, which is classified by the Census Bureau as part of public welfare.

Trends in Medicaid spending

The almost universally acknowledged source of the states' most significant spending woes is the Medicaid program. Medicaid is the health insurance program for low-income people. The program covered over 40 million recipients in 1998. The states and federal government split Medicaid expenditures, with the federal government picking up between 50 percent and 76.8 percent of the program's costs. The federal share decreases as state per capita income increases. Between fiscal 1992 and fiscal 2001, real total Medicaid program costs are estimated to have increased from $135 billion to $209 billion 1999 dollars or by 56 percent in total and 5.1 percent per year (which actually represents a decline from the average annual rate of growth between 1980 and 1992 of 9.1 percent per year). Over the same period, state Medicaid program costs are estimated to have grown by a similar percentage (U.S. Congress, House Committee on Ways and Means, 2002).

TABLE 1

Changes in expenditure, 1992–99

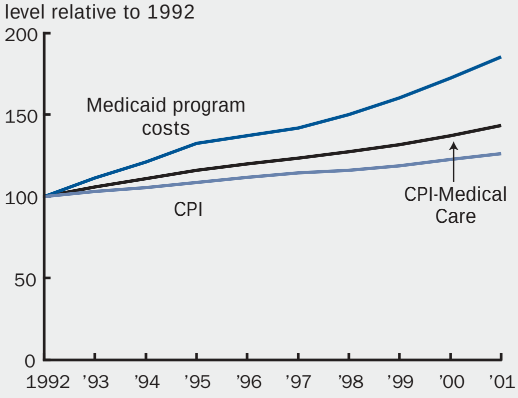
	1992 expenditure	1999 expenditure	Percent change
	(1999 dollars, 000s)	*(000s)*	
Education	240,790,734	318,601,796	32
Public welfare	177,170,480	221,166,721	25
Highways	55,787,475	68,317,477	22
All other	224,402,866	281,389,231	25
All categories, current operations	368,391,413	476,968,246	29
All categories, capital outlays	57,117,136	68,508,917	20

Source: U.S. Department of Commerce, Bureau of the Census, 2002a.

Figure 2 depicts the growth in total nominal Medicaid program costs from 1992 to 2001 (costs for 1999–2001 are estimates), compared with the overall growth in the Consumer Price Index (CPI) and the growth in the Consumer Price Index for Medical Care. The figure shows that medical care expenses were growing much more rapidly than the overall price

FIGURE 2

Growth in Medicaid costs vs. inflation



Sources: CPI data from the Executive Office of the President, Council of Economic Advisers, 2002. Medicaid data from U.S. Congress, House Committee on Ways and Means, 2002.

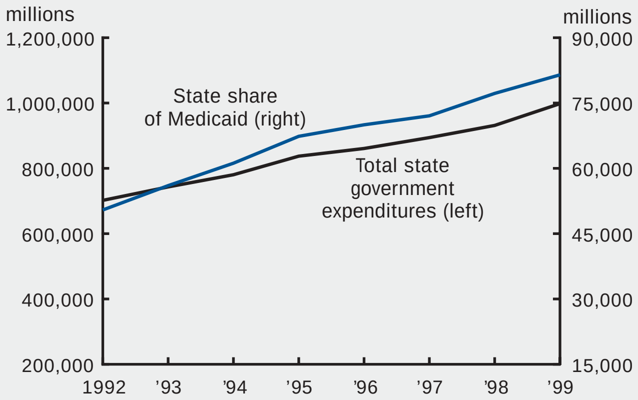
level as reflected in the CPI, and Medicaid expenditures were growing dramatically more rapidly than medical care expenses. In other words, while some of the increase in Medicaid expenditures can be attributed to an overall increase in health care costs, most of the increase needs to be explained by other factors. Medicaid expenditures have also been increasing rapidly relative to state government expenditures more generally, as illustrated in figure 3, which depicts the growth in total state Medicaid program costs relative to the growth in total state expenditure from 1992 to 1999.

We can break down the increase in costs into two component parts—first, the increase in the number of program recipients and, second, the increase in the cost per recipient. Figure 4 shows three comparisons between 1992 and 1998: the growth in number of recipients by eligibility category (panel A), the growth in per capita Medicaid costs by eligibility category (panel B), and the growth in total expenditures by eligibility category (panel C).[7] Spending increases by eligibility category have been fairly similar—between 1992 and 1998, the percentage of expenditures represented by each eligibility category has been nearly constant. But the reasons underlying these similar growth rates in spending have differed somewhat. For aged recipients, an increase in costs combined with a relatively flat recipient population led to increased total spending. For disabled recipients, both costs and the recipient population grew. For children and adults, a dramatic increase in the recipient population and nearly constant costs per recipient underlie the growth in total spending. The increase in the number of recipient children and adults derives from legislated extensions of coverage to children and parents of poor families not receiving public assistance.[8]

As this discussion shows, it is difficult to attribute the increase in Medicaid spending to one single force as both eligibility and costs have increased. That said, much of the debate on Medicaid program costs has naturally focused on the aged and disabled groups. Although these groups represent less than 30 percent of all recipients, they account for over 70 percent of program costs. Two particular areas of spending have received special attention: nursing facilities and prescription drugs. Nursing facilities accounted for 22.4 percent of total Medicaid payments in 1998 and 62.9 percent of the costs for aged recipients. It is the single largest programmatic spending category. In fact, Medicaid pays 46 percent of all U.S. nursing home expenditures (U.S. Department of Health and Human Services, Health Care Financing Administration, 2000). Prescription drugs represented 9.5 percent of all Medicaid program costs in 1998 and spending for drugs has been increasing rapidly. In 1992, drugs were only 7.4 percent of program costs. These increases in drug expenditures are attributed to a nationwide increase in drug prices and the advent of a number of new (hence, expensive) drugs. Medicaid drug expenditure increased by an additional 17.9 percent in 1999, 22.2 percent in 2000, and is estimated to increase by

FIGURE 3

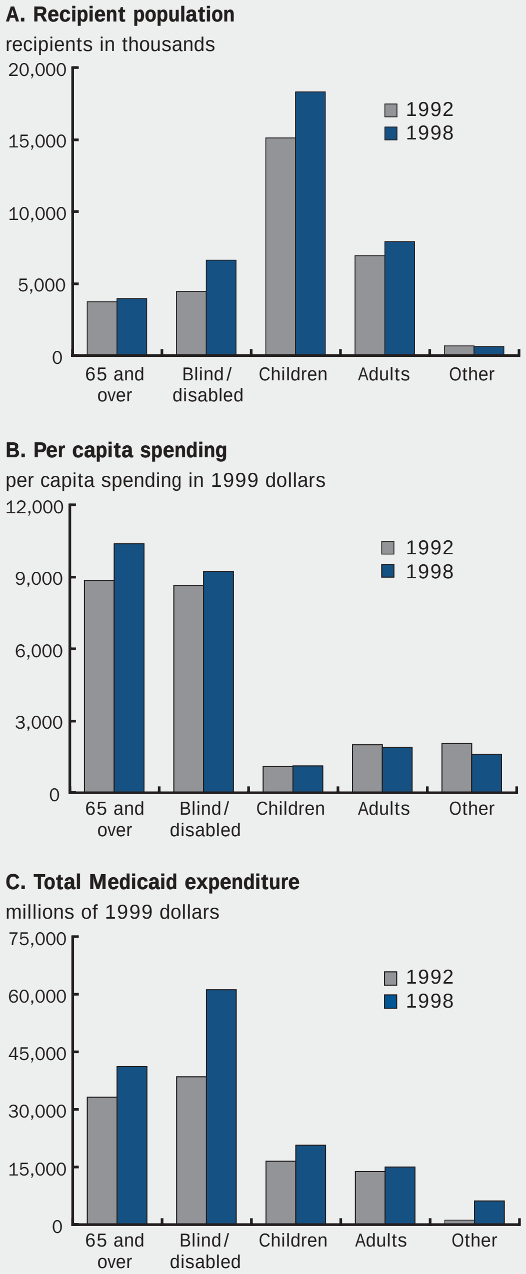
State government expenditure vs. state share of Medicaid



Sources: State government expenditures are from U.S. Department of Commerce, Bureau of the Census, 2002a. Medicaid data from U.S. Congress, House Committee on Ways and Means, 2002.

FIGURE 4

Medicaid recipients and costs by eligibility category



Sources: U.S. Congress, House Committee on Ways and Means, 1996 and 2002.

an additional 19.7 percent and 14.9 percent in 2001 and 2002, respectively (NASBO, 2001a).

In addition to this general upward trend, Medicaid spending does have a cyclical component as well, because the loss of jobs and health insurance increases the size of the medically dependent population. However, this relationship should not be overstated. When I performed simple regressions of the recipient population between 1972 and 1998 on the civilian unemployment rate, a time trend, and dummies controlling for legislated changes in eligibility in 1990 and 1996, I only found a statistically significant relationship between the number of adult recipients and the unemployment rate. For all other recipient categories, there is no discernible relationship between the unemployment rate and the size of the recipient population. Because spending on adults is such a small part of total Medicaid expenditure, this cyclical factor is not a huge part of the Medicaid spending story.

Even though Medicaid spending is not very cyclical, worries about costs tend to be most common when the economy is weakest. This is because state budgetary problems become more acute during downturns and Medicaid is such a significant spending area. This is no exception during the current economic climate. I discuss potential cost saving measures for Medicaid in a later section.

Trends in education spending

Education spending, specifically spending for elementary and secondary education, represents the single greatest expenditure category for state governments. About $0.36 out of every $1.00 in general expenditure is spent on education. Between 1992 and 1999, state education spending increased by 32 percent. States cover just under half of total education expenditure, with local governments funding 40 percent to 45 percent and the federal government paying the remainder (U.S. Department of Commerce, Bureau of the Census, 2002c; U.S. Department of Education, National Center for Education Statistics, 2001).

The growth in school expenditure results from a number of sources. First, there was an increase in the number of pupils in elementary and secondary schools. Between 1992 and 1999, the number of pupils increased by 9.4 percent. However, as this percentage increase is less than one-third of the percentage increase in expenditure, other forces are needed to explain the total increase in costs. Second, over the same period, the number of teachers increased by 18.2 percent. The resultant increase in the teacher–pupil ratio represents the continuation of a long-standing trend in education. Costs for instruction (teachers and textbooks) represent 53 percent of total education expenditure, so the growth in teachers, combined with the increase in teacher salaries discussed earlier, goes a long way toward explaining the increase in total expenditures.[9] Third, during the boom, states increased spending on school-related capital projects. Capital expenditure jumped from 7.6 percent of school expenditures in 1990 to 9.9 percent in both 1999 and 2000 (U.S. Department of Commerce, Bureau of the Census, 2002c). This increase in capital spending was needed to help shore up deteriorating school buildings and assure compliance with federal mandates regarding accessibility and health hazards (U.S. Congress, General Accounting Office, 1995). Despite this increase in capital spending, school buildings continue to be in poor shape, with 50 percent reporting at least one inadequate building feature as of 1999 (U.S. Department of Commerce, Bureau of the Census, 2002c). Finally, although precise national statistics on special education spending are not available, there is a general consensus that increases in the number of students with diagnosed disabilities have challenged the resources of school districts. Between the 1992–93 and 1998–99 school years, the percentage of students with a disability increased from 11.8 percent to 13.0 percent. In 1976–77, only 8.3 percent of students were diagnosed with a disability.

School expenditure holds a privileged position in the debate over state expenditure. While it is the largest single expenditure area, it is also very politically popular and somewhat sacred. Discussions of school spending on the state level often take place outside the general budget debate and it is the area most frequently exempted from across-the-board budget cuts.

Overall spending growth is driven by a number of factors, but the two largest programmatic areas—Medicaid and education—go a long way toward explaining the overall condition of state budgets. Spending in both of these areas increased throughout the expansion. And as budgets tighten, much of the debate inevitably focuses on these two areas.

One other feature of state expenditure deserves attention. During an expansion, when state expenditure rises, increases for programs are debated and specifically funded. However, during budget crises, cuts tend to be across the board. (I discuss this issue in greater detail below). In other words, budget cuts are neither specific nor particularly debated. As a result, state agencies have an added incentive to maximize their budget by adding items that will be easy to cut in time of crisis. So, if individual agencies are concerned about the economic cycle, it is in their best interest not to save now for later, but to spend more.

Tax cutting

Throughout the economic boom, states reduced the tax obligations of businesses and individuals within their borders. The federal program that sent tax rebate checks to households in 2001 disbursed a total of $38 billion. Combined, the 50 states reduced taxes between 1995 and 2000 by a similar amount, $36 billion in 2001 dollars (NCSL, 2001c).[10] Some of the state reductions are permanent, such as legislated reductions in income tax rates. Other reductions were one-time events, such as tax rebates and refunds. States also reduced tax burdens further by providing funding to localities to reduce property tax burdens. These tax reductions served to bolster the already robust macroeconomy by returning funds to individuals at the same time as other forces were serving to increase personal income. The tax reductions were widespread, occurring every year between 1995 and 2001 and occurring in some manner in all 50 states.

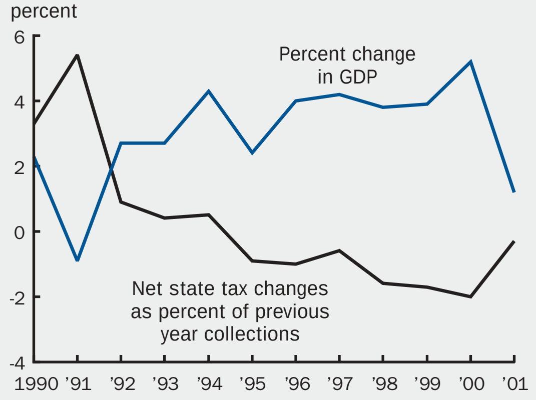
Figure 5 graphs net yearly state tax changes as a percent of the previous year's tax collections against the year-over-year percentage change in second quarter gross domestic product (GDP is seasonally adjusted at annual rates). I use second-quarter GDP because most state fiscal years end at the end of the second quarter. Therefore, the two lines correspond to similar periods. Most tax reductions take effect in the year after the year of passage. The figure shows that as the percentage change in GDP turned positive in 1992, enacted tax increases began to fall, finally turning negative (into a net tax decrease) in 1995. The correlation between the two sets of numbers is a striking –0.8, showing the close connection between GDP growth and tax cuts. The figure also shows that the tax cutting continued in earnest until 2000. The preliminary 2001 number shows a continued decline in taxes during the 2001 legislative session as well.

These data do not distinguish between one-time tax rebates and permanent changes in taxes. Therefore, this figure only accurately depicts the change from one year to the next and does not show aggregate changes over a number of years. Many of the enacted changes represented permanent changes and, therefore, the total tax reductions over time are greater than the simple sum of the numbers presented in the figure.

As the figure shows, extensive tax cutting began in 1995—the first year since 1985 that states engaged in a net tax reduction (Mackey, 1999). In the 1995 legislative session, states reduced the taxes to be collected in fiscal 1996 by $3.3 billion—0.9 percent of the previous year's tax collections. Most reductions occurred in the traditionally unpopular personal income tax. Personal income tax reductions represented $1.1 billion of the decline. Reflecting on the 1995 tax reduction, Scott Mackey of the National Conference of State Legislators wrote: "There are several reasons to think that state tax cutting activity may have

FIGURE 5

Net tax changes vs. changes in GDP



Note: 2001 data are preliminary.
Sources: GDP data from the U.S. Department of Commerce, Bureau of Economic Analysis, 2002a; tax data from NCSL, 2001c and 2000.

peaked during 1995. First, federal budget cuts that affect state budgets are a virtual certainty in 1995 and beyond, making states cautious about reducing revenues. Second, the strong revenue growth that states enjoyed in fiscal year (FY) 1994 and FY1995 appears to be returning to more modest levels. Finally, local property tax relief may be a higher priority than reducing state taxes" (Mackey, 1999). Mr. Mackey's prediction proved wide of the mark. In 1996, states reduced taxes again. It was the first time that states had cut taxes in two consecutive years since FY1979–80. Further tax reductions occurred in the next five years.

Figure 6 shows the reduction in taxes by year for the major tax categories—personal income tax, corporate income tax, sales and use taxes, and others. Other taxes include health care, motor fuel, cigarette, alcohol, and miscellaneous taxes. As the figure demonstrates, the tax cuts throughout the period tended to follow a general pattern. Every year, the main focus of cuts was personal income tax. Personal income tax was cut across numerous dimensions—rates were reduced in some cases, in others the base was narrowed, while other states chose to increase standard deductions or exemptions, or issue refunds. Corporate income taxes were also reduced, but not to as great an extent as personal income taxes. Sales and use taxes were largely stable, with some increases in exemptions for food, drugs, and other necessities. Figure 6 shows that other taxes were also cut throughout the period. Most of these declines in other taxes represent changes in state-specific tax programs such as Florida's 1997 enactment of a $411 million freeze in the special assessment for the special disability trust fund. As a result, these other tax changes are difficult to generalize. One exception to this general pattern, not shown in the figure, is that throughout the decade, "sin" taxes on alcohol and tobacco were stable or increasing. In fact, tobacco taxes increased every year between 1995 and 2001, except 1998 when they remained unchanged.

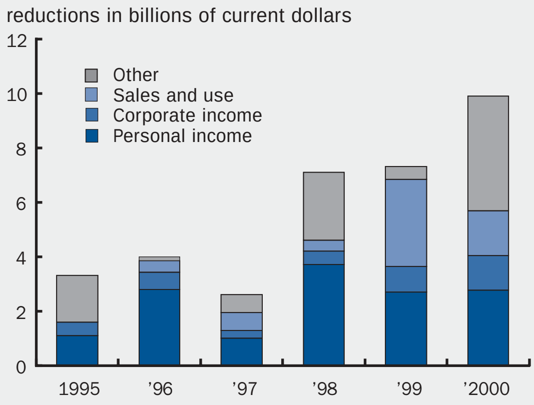
Tax cutting in the Midwest

Tax cutting was persistent, across the board, and widespread throughout the second half of the decade. The behavior of the midwestern states was representative of this overall pattern. Faced with unexpectedly high revenues, state governors and legislators chose to return some monies to state residents and resident corporations. In this section, I briefly detail the major revenue actions undertaken in Indiana, Illinois, Iowa, Michigan, and Wisconsin during this period.

Michigan was one of the most aggressive tax cutters, legislating significant tax reductions on numerous occasions during the second half of the 1990s. As was the case with the overall pattern of tax cuts, the major source of cuts was the personal income tax. In 1995, Michigan increased personal exemptions and standard deductions. This was followed by a tax cut passed in 1999 that cut income tax rates and expanded personal exemptions even further. This second cut reduced taxes by $218 million dollars. Prior to the start of the expansion, businesses in Michigan were heavily taxed, relative to corporations in other states. As of 1992, corporate income taxes represented 7.8 percent of Michigan's general revenues, compared with 3.6 percent across all states. In order to increase state competitiveness, the Michigan legislature significantly reduced business taxes in 1995 and 1999.

FIGURE 6

Tax reductions by type of tax



Source: NCSL, 2001a, 2001c, 2000, 1999a, and 1999b.

The reductions in personal and corporate income taxes continued to be phased in through 2002. Michigan was also typical in that any taxes that were increased were excise taxes. In 1997, motor fuel taxes were increased, and in 1999 there was a major increase in cigarette taxation, bringing in an additional $95.2 million in revenues.

Illinois's tax reductions were similar in direction to those in Michigan, but smaller in magnitude. The main tax cut was a three-year doubling of the personal income tax exemption passed in 1998. This was viewed as a welcome change in Illinois's historically regressive income tax policies. Illinois also slightly reduced corporate income taxes, but the change was not as significant as in Michigan. In 1999, Illinois engaged in a significant excise tax hike. In order to fund a major state public works program, state leaders increased motor vehicle and liquor taxes. The program, termed "Illinois FIRST," was passed as a five-year, $12 billion program. Two other tax reductions were a 2000 property tax rebate program and an increase in the state earned income tax program.

Wisconsin's most notable tax reductions were enacted in 1999. The state rebated $700 million in excess sales tax revenues to taxpayers who had filed income tax returns in 1998. The state also reformed the personal income tax by increasing standard deductions, reducing rates, and raising credits for married couples. These changes saved taxpayers $655 million.

Indiana's major tax reduction was passed during the 1999 legislative session when a major property tax decrease was coupled with an increase in the dependent child exemption to $1,000 per child. The state also changed excise taxes, reducing the unpopular automobile excise tax in 1996, while increasing motor vehicle license fees in 1998.

Although Iowa is the least populous midwestern state, it was one of the most aggressive tax cutters. The major tax changes in Iowa were almost exclusively in the personal income tax. In 1995, personal exemptions and standard deductions were increased, while in 1997 personal income tax rates were reduced.

Overall, tax changes in the midwestern states were fairly representative of those taking place across the nation. The major source of cuts was personal income tax. States both increased exemptions and deductions and lowered tax rates. Some states also decreased corporate income taxes, but not to nearly as large an extent. The states only engaged in minor changes in excise taxes. Some states also acted to reduce or rebate some of the perennially unpopular property tax.

We have seen how during the expansion, states used some of their windfall revenues to engage in the very popular activity of cutting taxes. However, they also used some of these excess funds to prepare for future economic contingencies by shoring up their reserve funds. In the next section, I explore the condition of state rainy day funds and other reserves and the extent to which states prepared for a downturn in the economic cycle.

Reserve funds

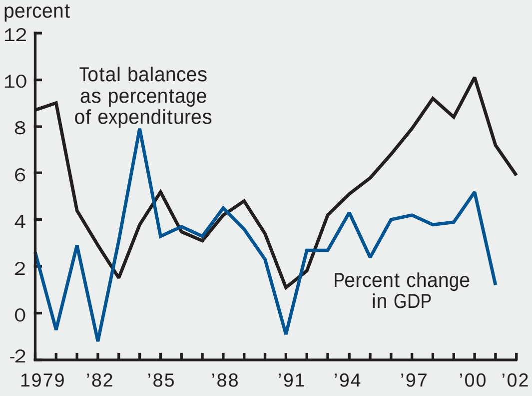
In order to confront unexpected shortfalls and economic downturns, states maintain reserves. These reserves may be in the form of ending balances in the general fund, monies in a budget stabilization fund, or monies in a diverse array of other emergency funds. Specific rules govern when states may access the monies in budget stabilization or "rainy day" funds. By contrast, access to general fund ending balances is controlled by the same type of legislation that regulates other general fund appropriations. As a result, it is politically more complicated for states to access rainy day balances in the absence of an obvious need. As in the case of withdrawals, deposits for rainy day funds are controlled by specific provisions.

All but three states have budget stabilization funds, which may be budget reserve funds, revenue shortfall accounts, or cash flow accounts. Those states without rainy day funds maintain all reserves as ending balances in their general fund accounts. In 2000, just under half of all reserves were maintained in rainy day funds, the other half remaining as general fund ending balances. Three-fifths of states limit the size of rainy day fund balances to between 3 percent and 10 percent of appropriations. Funds above those permitted in the budget stabilization fund remain in the state's ending balance (NASBO, 2001a).

Reserves, whether in rainy day funds or as general fund ending balances, offer states an important source of funds when unexpected contingencies threaten to disrupt fiscal functions. It is frequently cited that Wall Street views any total level of reserves in excess of 5 percent of expenditures as adequate. Figure 7 depicts total state reserves as a percent of total state expenditures from FY1979 to FY2002. The figure also depicts the year over year percentage change in U.S. real GDP as of the second quarter (the end point for most state fiscal years). The data demonstrate a number of important patterns concerning reserves. First, reserves have been quite strong. According to the data displayed in the figure, by 1998, state reserve fund balances exceeded the heights they had attained in 1980. Fiscal year 2002 is projected to be the ninth consecutive year with total state reserves above 5 percent of expenditures. As of June 2001, 2002 reserves were anticipated

FIGURE 7

Total reserve fund balances vs. changes in GDP



Note: Total balances include both ending balances in the general fund and amounts in budget stabilization funds.
Sources: GDP data from U.S. Department of Commerce, Bureau of Economic Analysis, 2002a; balances from National Association of State Budget Officers, 2001a.

to be 5.9 percent of expenditures. However, while reserves remain high relative to their historical patterns, they fell between 2000 and 2001 and are expected to continue falling in fiscal 2002. Total reserve fund balances reached a high of 10.1 percent of expenditures in 2000 and were expected to decline to 5.9 percent by the end of FY2002. This projection for 2002, based on governors' recommended budgets, is probably optimistic, because these estimates were published in June 2001 when the economic outlook was better. Even these optimistic forecasts predict that fiscal 2002 reserve balances as a percentage of expenditures will be lower than they have been in the past seven years. These averages mask significant variety across states. While 22 states anticipated total reserve balances below 5 percent of expenditures for 2002, four predicted balances would exceed 10 percent. The decline since 2000 is widespread. In 2000, 21 states had reserve fund balances above 10 percent and 11 had reserve fund balances below 5 percent. Reserve fund balances have declined over the past two years due to additional tax cuts, increases in spending especially in the areas of health care and education, and the slowing of the economy.

The data also show how quickly reserves can fall in responses to economic difficulties. Between 1989 and 1991, reserves fell from 4.8 percent of expenditures to 1.1 percent of expenditures. So, while reserves were nearly adequate according to the oft-cited Wall Street rule of thumb prior to the early 1990s downturn, they nearly evaporated in just two difficult years.

This begs the question whether the reserves that states built up during the booming 1990s are sufficient to help them weather the current economic storm. The news reports from state governments suggest (discussed in detail below) that these reserves are not sufficient to allow states to endure the current economic situation without cutting spending or raising taxes.

The inadequacy of state reserves to maintain services in the event of a downturn was addressed in an article by the Center on Budget and Policy Priorities (CBPP) in March 1999 and updated in May 2000 (Lav and Berube, 1999, and Zahradnik and Lav, 2000). The authors calculate the amount of reserves each state would need to endure a recession without cutting programs dramatically or enacting significant tax increases. They then compare this level of needed reserves to the level available. In their calculations, the authors assume that states would face a fall in the growth rate of revenues between FY2000 and FY2003 similar to the decline experienced between FY1989 and FY1992 that corresponded to the 1990 recession. This methodology leads them to assume that the growth rate of revenues would be 43 percent of the growth rate from FY1993 and FY1998. At the same time, they assume that state expenditures would grow at the same pace as they did between 1989 and 1998. The authors calculate the needed reserves as the gap between expenditures and revenues over the three-year period.[11] These calculations yield a conservative estimate of necessary reserves, because the 1990 recession was relative short-lived and mild. In addition, as mentioned above, the demand for government services tends to increase slightly more rapidly during a recession, suggesting the growth rate in expenditures (absent government action) would be greater than experienced between 1989 and 1998. The authors conclude that only eight states (Delaware, Indiana, Iowa, Maine, Massachusetts, Michigan, Minnesota, and North Dakota) had adequate reserves on hand to combat a relatively mild recession. Other states had reserves that were lower than needed. In fact, they find that in most states reserves on hand were more than 10 percent of expenditure below what was required to maintain services. In their follow-up report, the authors noted that five of those original eight states (Delaware, Indiana, Massachusetts, Michigan, and Minnesota) had enacted tax cuts since the previous publication that left them without sufficient reserves. The CBPP report also argues that the statistic that 5 percent of expenditures is sufficient, while frequently cited, is "of uncertain origin and even more questionable validity." They argue that reserves equal to 5 percent of expenditures are insufficient for managing recessions in all but a couple of states. The report correctly points out that needed reserves vary from state to state. States that depend heavily on cyclical sources of revenue, especially income taxes, need a greater level of reserves. The 5 percent statistic better represents the level needed on hand for unpredictable emergencies, perhaps an event like September 11, than the level required to counteract revenue losses caused by the business cycle.

This leads one to question why states did not take advantage of the strong economy and move to build adequate reserves, and why those few states with sufficient reserves had spent them. The simple answer to both of these questions would be that it is far easier to spend money than to save it. One might say state leaders are either myopic and do not worry about future economic difficulties or are overly optimistic and, thus, did not believe another recession was likely. However, such thinking misses the important point that states do not view reserve funds as designed to allow them to maintain services in a downturn. Rather they view these funds as allowing a window during which they can adjust their budgets and cut services or raise taxes in an orderly fashion. In other words, reserve funds are designed to allow states time to build the ark; they are not designed to carry them through the deluge.

The evidence for this distinction is widespread. First, most states cap the amount of money allowed in the reserve fund. Thirty-three of the 46 states with rainy day funds cap the amount allowed in the fund. Most of the caps are at or below 5 percent of expenditures. If states wanted these funds to counteract the fiscal effects of recession, they would not cap them at such a low level. Second, the language used by states when discussing their reserves tends to be based on concern for unexpected or short-term disruptions, not prolonged economic problems.

For example, Illinois passed Rainy Day Fund legislation in April 2000. The state controller made the first deposit into the new fund on July 1, 2001. The Illinois fund is capped at $600 million (2.6 percent of 2000 state general fund expenditure). Previously, the entire ending balance had been left in the general fund. In a press release praising the legislature's action, Governor George Ryan stated that the fund was "for use at the discretion of the governor and General Assembly in the event of an *unseen* economic downturn that threatens state services (State of Illinois, 2000)." The language used by NASBO in explaining reserve funds is similar. They write, "[T]otal balances reflect the funds states may use to respond to *unforeseen* circumstances after budget obligations have been met" (NASBO, 2001a).

State balanced budget requirements and debt restrictions limit the ability of states to borrow to meet short-term needs. In lieu of access to short-term credit markets, states maintain reserves, permitting them to dip into savings rather than borrow. These reserve funds buy states time, giving them the opportunity and flexibility to adjust their budgets in a deliberate, sensible manner. These funds help states avoid fiscal gimmickry to affect budget balances. However, the reserve funds do not allow states to emerge unscathed from recessions. For better or worse, state governments cling firmly to their balanced budget requirements and believe that they ought to spend in one year what they receive in that year (or over two years in states with biennial budget cycles). That said, overall state fiscal health would improve if reserve funds were adequate to allow states to maintain, or even increase, spending without increasing taxes during economic downturns. Preserving balances for this purpose would require a change in thinking about state budgeting.

Midwestern states' reserves

Table 2 shows the level of reserves as a percent of general fund expenditures in the midwestern states and for the nation as a whole from FY1998 to FY2002. The data show that reserves among this group of states have been fairly typical of the U.S. averages—reaching high levels over the past five years, though falling more recently. With the exception of Wisconsin in 2001–02, all midwestern states have maintained reserves above the 5 percent threshold. The final column of the table also displays the level of reserves needed to survive a mild recession, according to the CBPP report. These numbers tend to vary quite dramatically across states.

Wisconsin's reserves are the weakest of the group. They declined dramatically between 2000 and 2001, principally due to tax rebates passed in 1999. At the same time, Wisconsin's required recession reserves are the highest of the Midwest states and the eighth highest among the 50 states.

Illinois's reserves have been quite stable over the past five years, hovering close to the 5 percent mark. By contrast, required reserves are quite high, suggesting that Illinois will face fiscal difficulties.

Both Iowa and Indiana have reserves that have been declining over time but are slightly above the national average. Their required reserves are lower than the national average, but still double the level of reserves on hand.

Michigan's reserves have proven the strongest among this group of states, exceeding 10 percent in all five years presented in the table. As of 1999, Michigan exceeded the reserves required to withstand a recession by 10 percent. However, significant tax

TABLE 2

Reserve balances as percent of expenditures

	1998	1999	2000	2001	2002	Required reserves (as of 1999)
Illinois	6.10	6.30	6.60	5.70	5.60	22.90
Indiana	23.00	20.60	18.30	9.80	8.30	14.90
Iowa	19.60	16.00	13.40	9.80	8.20	16.30
Michigan	12.20	15.40	15.10	12.90	12.90	5.10
Wisconsin	5.70	7.00	7.40	2.70	2.00	27.00
5 state total	10.90	11.00	10.50	7.30	6.70	
50 state total	11.00	8.90	11.90	9.10	6.30	18.60

Note: Data for 2001 are estimated and data for 2002 are from recommended budgets.
Sources: Required reserves from Lav and Berube, 1999; reserves from National Association of State Budget Officers, 1999 and 2001a.

cuts enacted during the last years of the expansion have increased the state's required reserves from the 5.1 percent reported in the table to 25.0 percent. Therefore, after aggressive tax-cutting, Michigan's reserves were quite low relative to required levels.

The experience of the midwestern states has been fairly typical. Reserves are high relative to historical levels, but low relative to cyclical requirements. The only states with low reserves as a group are a number of southern states—Alabama, Arkansas, Kentucky, Louisiana, North Carolina, and Tennessee—that did not benefit as much from the economic expansion as states in other regions.

Indebtedness

In addition to lowering taxes, increasing spending, and bolstering reserves, states also had the option of using their new-found revenues in the 1990s to reduce their indebtedness. States are not major debtors. Total outstanding state debt at the end of FY1999 of $510 billion represented just 51 percent of total annual state expenditure (U.S. Department of Commerce, Bureau of the Census, 2002a). By comparison, the federal government's indebtedness is over three times its annual expenditures (U.S. Department of Commerce, Bureau of the Census, 2002c). On balance, real state indebtedness actually increased by 20 percent between 1992 and 1999, but this was less than the percentage increase in expenditure. Because most debt is long term and funds specific capital projects, it is not surprising that debt increased at a time that capital spending was also increasing. While states could have used their surplus funds to pay down their debt or fund more capital projects out of current funds, they did not do so. The only kind of debt that declined during the expansion was short-term debt, which was 21 percent lower at the end of 1999 than at the end of 1992. This type of debt that matures in one year or less comprises bond and tax anticipation notes and is a barometer of the health of state finances.

The bust: Revenues

The first real signs of the deterioration in state budgets were seen in the third quarter of 2000. These signs could be seen in the revenue numbers being reported by state governments. Figure 8 shows year-over-year changes in quarterly tax revenues both in total and for sales taxes. As the figure shows, between the third quarter of 1999 and the third quarter of 2000, state tax revenues, adjusting for tax changes and inflation, had grown by only 4.1 percent. These data for total tax revenues are estimates of what state revenues would have been had legislated tax changes not occurred. State revenue growth had slowed for the first time in a year and was only half the growth rate reported in the previous quarter. The changes in actual sales tax revenues were even more dramatic relative to their historical trend. Sales tax revenues grew by 4.7 percent that quarter, the lowest growth rate reported since the first half of 1997. These sales tax revenue numbers, unadjusted for inflation or tax changes, are probably the most reliable indication of the revenue situation. Major legislated changes in the sales tax are rare and, as a result, these numbers do not rely upon predictions of the effects of legislated changes.

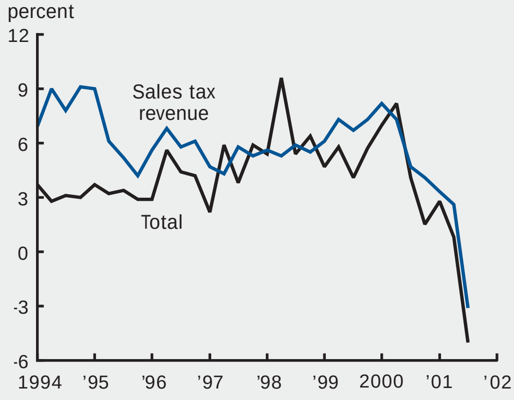
At this juncture, there was a great deal of variation in the financial situation confronting different states and regions. Figure 9 displays changes in year-over-year sales tax revenues, by quarter, for the various regions. The figure shows that, as of the second quarter of 2000, some regions were doing far better and others far worse than the national averages. In particular, sales tax revenues in the Far West were growing well above the national average, while revenues in the Mid-Atlantic, Great Lakes, and Southeast were lagging the national average. Between the second and third quarter, growth rates dropped off in all areas, with the exception of the Mid-Atlantic and Rocky Mountain states, where they were flat. Revenues in these two regions fell the following quarter. Some states were still well entrenched in the impressive expansion, while others were falling quickly into revenue troubles.

The decline in the growth rate of tax revenues first hinted at in the third quarter of 2000 accelerated in all the subsequent quarters for which data are available except one. In the third quarter of 2001, overall tax revenues and sales tax revenues fell. Between the third quarter of 2000 and the third quarter of 2001, revenues had fallen in nearly every region, exceptions being the Southeast and Southeast where revenues were close to flat. We see a similar picture when we look at the revenue growth rates for the second quarter of 2001. Although still positive, revenue growth rates were weak in all regions. The state revenue situation was rapidly deteriorating in advance of the September 11, 2001, terrorist attacks. Although it is difficult to distinguish the effects of the attacks from the effects of a continuing secular decline in revenues, there is little doubt that state finances were in trouble before September 2001.

Next, I look at personal income tax revenues. Because of the frequency of legislated changes in this tax, I present numbers that are unadjusted for legislated tax changes, as well as adjusted numbers. Unadjusted revenues are the revenues actually received by the state government. Adjusted numbers display estimates of what receipts would have been had the legislature not changed the tax code. While income tax revenues, adjusting for legislated tax changes, held up through the end of 2000, the income tax situation was also poor by mid-2001. Figure 10 depicts the quarterly change in personal income tax revenues by quarter, both adjusted for legislated tax changes and unadjusted. Because nearly all income tax changes lowered taxes, the unadjusted line (revenues actually received) lies almost entirely below the adjusted line. Income tax revenue changes are more difficult to interpret than changes in sales tax revenues for two principal reasons. First, the income tax is frequently changed and even thorough estimates of the effects of legislated tax changes are bound to be imprecise. Second, because taxes must be filed prior to April 15, there is a high level of seasonality in income tax revenues and, as a result, comparisons across quarters are quite difficult. The fall in income tax revenues is more easily understood by looking at the changes in year-over-year revenues by quarter as show in figure 11. This figure shows that in every quarter since 2000:Q4, revenue growth rates have fallen below their level from a year earlier. The fact that income tax revenues fell slightly later than sales tax revenues suggests that the more sales-tax-dependent states were likely confronted with revenue issues earlier than more income-tax-dependent states.

FIGURE 8

Year-over-year changes in tax revenues, by quarter



Note: Total tax revenues are adjusted for tax changes and inflation. Sales tax revenues are actual nominal receipts.
Sources: Jenny, 2001, and Jenny and Boyd, 2001.

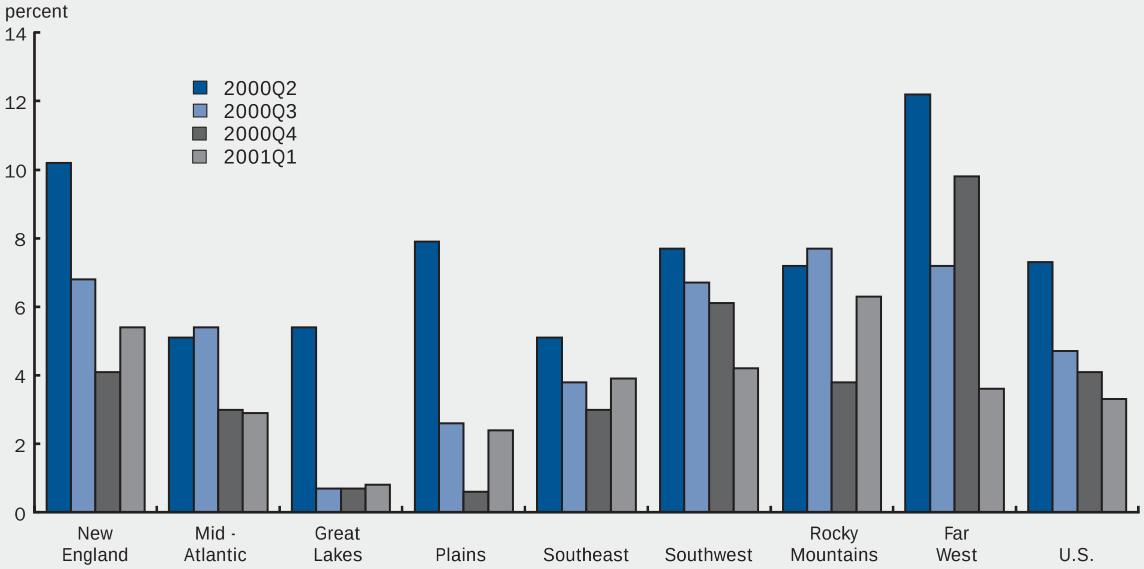
When looked at from numerous angles, the state revenue situation appears poor. Revenue growth rates slowed early relative to the slowdown in GDP and have continued to decline. Revenue numbers also continued to fall below already reduced expectations and, by November 2001, 43 states were reporting that revenues had come in below what they had anticipated for FY2002. By April 2002, this number had risen to 48 states. (NCSL, 2001b; NCSL 2002)

Expenditures

Unsurprisingly, this decline in revenues has not coincided with a decline in the demand for state services. On the contrary, among the 43 states reporting revenue shortfalls for FY2002 in November 2001 (NCSL, 2001b), 20 were also reporting that spending was exceeding levels anticipated when fiscal 2002 budgets were passed. By April 2002, 33 states were reporting spending overruns (NCSL, 2002). Predictably enough, the main source of spending overruns and concerns involved the Medicaid program. Nearly every state that reported spending problems, along with some that reported that spending remained on target, highlighted Medicaid spending as problematic.

FIGURE 9

Year-over-year changes in sales tax revenues, by region and quarter



Sources: Jenny, 2001, and Jenny and Boyd, 2001.

Next, I look at how states might respond to this budget predicament. To do so, I examine how the states reacted to previous downturns, how the states hit earliest by the current recession have reacted so far, and the projections and pronouncements coming from state capitols.

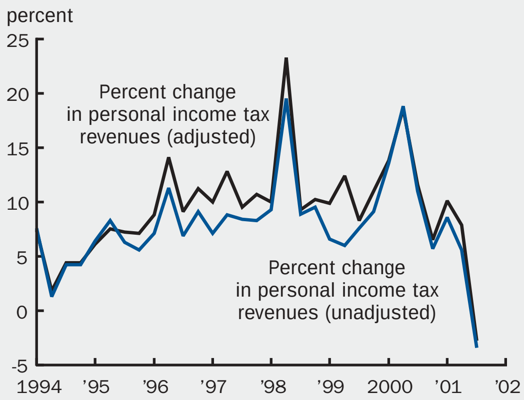
State reactions: The 1991 recession

The 1991 recession was mild and relatively short compared with previous downturns, but it hit the states very hard. States dramatically cut services and enacted large tax hikes (see figure 5). Many of these changes occurred in the middle of the fiscal year. In many cases, states were compelled to change their enacted budget mid-year to avoid running foul of their balanced budget provisions. Reducing enacted budgets is a sign that the economy is worse than was anticipated when the original budget was passed. Thirty-five states faced a potential budget deficit at one point from 1990 to 1992, and 20 or more states acted to reduce enacted budgets during each year from fiscal 1990 to fiscal 1993. The worst year was 1991, when 30 states faced a mid-fiscal-year deficit of nearly $15 billion (2.7 percent of general expenditures). In 1991, states drew down their reserve balances. Balances at the start of the downturn were reasonably healthy, totaling 4.8 percent of expenditures in 1989. However, by 1991 balances had fallen to 1.1 percent of expenditures. A similar pattern existed during the 1980s recession. For example, balances declined from 9 percent to 4.4 percent in the one-year period from fiscal 1980 to fiscal 1981 (shown in figure 7). In 1991, states were also forced to cut their budgets by $7.6 billion.

Because balances had been used to deal with the 1991 fiscal situation, these excess funds were no longer available in FY1992 and FY1993. With little available reserves, states were forced to reduce current

FIGURE 10

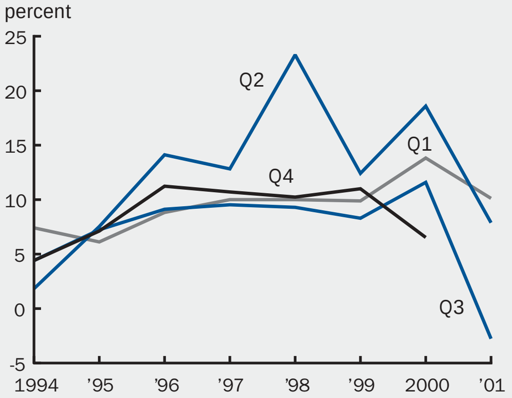
Year-over-year percent changes in personal income tax revenues, by quarter



Sources: Jenny, 2001, and Jenny and Boyd, 2001.

FIGURE 11

Percent change in quarterly income tax revenues



Sources: Jenny, 2001, and Jenny and Boyd, 2001.

year budgets further and raise taxes. In 1992 and 1993, 35 states and 23 states, respectively, reduced current-year budgets, and states raised taxes by a total of $25 billion. If spending cuts and tax increases were insufficient, states resorted to fiscal gimmickry to affect budget balances. The most popular form of gimmickry is for states to postpone payments to vendors, employees, and other recipients of state funds. Illinois was one of the main practitioners, increasing the time between the receipt and payment of bills. States could also speed up the collection of revenues by forcing vendors to remit payments to the states more quickly.

Enacted budget reductions are very disruptive to service provision, because budget changes need to go into effect almost immediately (and sometimes even retroactively) leaving state agencies and their clients little time to anticipate and adapt to the changes. While declines in service provision can take effect almost immediately, tax increases take longer. Most tax increases go into effect in the fiscal year following the year of passage.

States can only cut spending mid-year for a select range of programs. Many programs are nearly impossible to cut mid-year. The largest item in state budgets, elementary and secondary education, is hard to reduce once teacher contracts have been signed. Also, schooling involves significant start-up costs that occur in the beginning of the school year, which is fairly early in the fiscal year in most states. By mid-fiscal year, school expenditure is fairly inflexible. In the early 1990s, therefore, states cut spending on those programs where cuts were possible mid-year, which tended to be programs that serve the poor (Lav and Berube, 1999).

The largest of these programs—then AFDC, now TANF—has undergone a series of changes that will greatly limit the states' ability to cut funds in the future. In 1996, the program changed from an entitlement program where the states and federal government split payments to a discretionary program where specific amounts were block granted to each state. States were given more control over the structure of their programs, with the exception that they needed to maintain spending at or above 75 percent of their 1994 spending level if they met work requirement provisions, and at or above 80 percent of their 1994 spending level if these work requirements were not met. These "maintenance of effort" provisions prohibit states from reducing their expenditure below a certain level.

Throughout the recent economic boom, caseloads have dramatically dropped and the maintenance of effort provisions has proved to be binding in a number of cases. In federal fiscal year 2000, only 11 states spent more than 80 percent of their 1994 baseline, with 15 states spending exactly 75 percent of their 1994 level and five states spending exactly 80 percent. The combination of relative fixed funding levels and smaller case loads has meant that states have been able to support their dependent populations with a wide array of benefits and services in addition to cash grants. Such additional programs include work transportation, childcare, and housing assistance. In the face of significant fiscal pressures, states will not be able to decrease funding levels below their maintenance of effort requirements. However, they may well keep funding at, or lower funding to, the maintenance of effort levels.

A number of states will actually be able to increase total TANF funding during an economic downturn without harm to their budget situation, because these states have not spent their entire block grants, leaving excess amounts on account with the federal government. The TANF legislation explicitly allows states to reserve part of their block grant for future spending. Funds reserved with the federal government can be spent in subsequent years on "assistance." While states will not be able to spend these monies on the wide array of "non-assistance" purposes that TANF has funded, these funds will allow greater expenditure on cash benefits.

Unspent TANF funds are categorized in one of two ways for federal reporting purposes—as either unobligated funds or as unliquidated obligations. Unobligated funds are monies neither committed nor expended; these funds would be available for additional cash assistance spending during a period of economy hardship. Unliquidated obligations are payments that have been committed by state governments, but not yet spent.

Additionally, in some states portions of unliquidated obligations are not truly committed and would also be available during a downturn.[12] The true measurement of available funds lies somewhere between the level of unobligated funds and the sum of both types of unspent funds.

As of the end of federal FY2000, the 50 states had $2.7 billion in unobligated funds on account at the federal government and $8 billion in total unspent funds. This represents 9.7 percent and 28.6 percent, respectively, of total required state and federal TANF spending in federal FY2001, where required state and federal spending is defined as the sum of the 2001 TANF grant and the 80 percent maintenance of effort provision. There is a great deal of variation in the amounts available to different states. While 11 states have less than 10 percent of one year's funding unspent, nine states have more than 50 percent of a year's funding unspent (Lazere, 2001).

These unused block grants are an additional form of rainy day reserves, providing states with an added cushion as the economy declines. Therefore, TANF spending changes will be more complicated in the coming days. On the one hand, the saved block grants will make it easier for states with saved amounts to increase spending, and the maintenance of effort provisions will not allow states to cut spending below a certain threshold. On the other hand, states have added flexibility to cut expenditure to the level of their maintenance of effort requirement, because the program is no longer an entitlement program.

If the dependent population increases, as occurs with a deteriorating economy, and funding levels stay relatively fixed or increase only slightly, benefits and services will inevitably be cut. The most likely targets for cutting will be those same creative new benefits in transportation and childcare that have characterized the very successful first years of TANF.[13]

If state behavior during the current downturn parallels that taken during the 1991 recession, we will see states begin by drawing down their balances and cutting budgets and then progress to cutting spending more dramatically and increasing taxes.

The 2001 recession: Action thus far

The combination of lower revenues and high or stable spending has meant that state budgets are coming increasingly under pressure. State governments have taken various actions to confront these budget issues and bring their FY2002 budgets into balance. State governors have also begun to put forward their FY2003 budgets. As of November 2001, 36 states had cut their budgets for fiscal 2002, 24 had decided to use some of their reserves, and 22 had turned to other measures, explained by the NCSL (2001b) as including "hiring freezes, capital project cancellations, and travel restrictions." By April 2002, 40 states had reduced or were planning to reduce their budgets, 26 had turned to their rainy day funds, and 17 were eyeing tobacco settlement dollars (NCSL, 2002).

Mid-year budget cuts are often across the board, with nearly all departments faced with funds a few percentage points below previously budgeted levels. In many states some sacrosanct departments, particularly K–12 education, are spared from these cuts. Across the board spending cuts are common perhaps because they are the easiest to implement quickly. Because states need to bring their budgets back into balance quickly, they lack the ability to carefully determine areas where budget reductions would be least damaging. It then falls to the individual state agencies to choose the exact programs where the reductions will be implemented. More specific budgetary debate has accompanied the early discussions concerning 2003 budgets.

As states have debated spending cuts, attention has inevitably turned to the Medicaid program. Throughout the 1990s expansion, there was little broad discussion of the problems with Medicaid spending. Although health care expenditure specialists did debate the issue, debate was not widespread. As the economic situation has deteriorated, Medicaid spending has once again come to the fore. This is not surprising, given that it is a quickly growing program that already accounts for nearly 20 percent of all state expenditures. To reduce costs, states have both restricted eligibility further and tried to cut costs per eligible recipient. Cost cutting can take many forms. States have limited access to services and drugs by increasing the need for pre-approval and by reducing optional benefits. States have also contemplated increases in co-payments, shifting more of the costs onto recipient families. In addition, states have reduced payments to service providers. This strategy is successful in reducing costs, but may lead more providers to refuse to serve Medicaid patients. For example, state proposals for reductions in prescription payments have led drugstores to threaten to stop filling Medicaid prescriptions (Associated Press, 2002). States have also turned to drug companies and asked for larger volume discounts on Medicaid drug purchases. Finally, states have asked the federal government for an increase in the matching rate. One justification for this request is that some of the increase in Medicaid costs derives from federally legislated increases in the eligible population.

In addition to cutting spending, states have also drawn down their reserve fund balances. As shown in figure 7 and discussed earlier, balances were expected to fall from 10.1 percent of expenditure in 2000 to 5.9 percent by the end of fiscal 2002. As of November 2001, seven states indicated that they would definitely be using reserves to balance their budgets, and 17 additional states were contemplating using reserves to balance their 2002 budgets (NCSL, 2001b).

Thus far, there has been little movement, especially among state governors, to raise taxes. In 2001, only six states passed substantial increases in taxes. And only in North Carolina was the increase viewed as a response to revenue problems caused by the recession (Jenny, 2002) One lesson that was reinforced during the early 1990s recession was the political unpopularity of raising taxes. Governors who had enacted significant tax increases were almost universally voted out of office in favor of politicians promising to lower taxes. In many cases, these changes in leadership coincided with the improving economy and new governors were able to keep their campaign promises. A number of the governors and legislatures that came to power in the early 1990s will soon face a similar dilemma to that confronted by their unfortunate predecessors.

So far, the limited discussion of tax increases has revolved around the cigarette and alcohol taxes. Oregon's governor proposed increasing these two taxes in order to balance the budget. Similarly, Indiana's governor has proposed hiking taxes on cigarettes and gambling. These taxes are politically the easiest to hike, although they are not the most lucrative revenue sources. However, for the most part, governors have chosen to speak out vociferously against tax increases. For example, New Jersey Governor McGreevey stated that he was "ruling out a tax increase" as a way to solve budget problems (Herszenhorn, 2001). This sentiment has been echoed by numerous other governors and legislative leaders across the country. That said, judging from the experience of the 1990s, tax hikes tend to occur late in a decline after other, easier avenues of budget balance have been exploited.

The debate over 2003 budgets is quite similar to the debate over 2002 budgets. While this discussion is occurring in a less panicked environment, the policy decisions closely parallel the decisions made concerning FY2002 budgets. In particular, states are relying on spending cuts and reserve funds rather than on tax increases.

If revenue estimates for FY2003 prove too optimistic, more states will likely turn to discussion of tax hikes. Tax increases during FY2003 may prove particularly politically challenging. If the trend in positive national economic news continues, state leaders will need to justify tax increases at the same time that voters are hearing more about the overall health of the macroeconomy.

Actions in the midwestern states

Midwestern states were among the first hit by the downturn. Returning to figure 9, we see that the Great Lakes states had either the weakest or close to the weakest tax growth in all the quarters pictured. The midwestern (and southeastern) states had tax collections significantly below projections in 2001. Most other states did not begin experiencing revenue problems until FY2002 (see NASBO, 2001a).

The midwestern states were among those hit earliest by falling revenues. One principal reason for this was that a downturn in manufacturing production preceded the downturn in overall GDP growth. Figure 12 shows the trend in manufacturing relative to the trend in GDP, while table 3 details the percentage of state employment in manufacturing both overall and for the midwestern states.

Illinois

As of November 2001, Illinois was facing a $500 billion deficit in the FY2002 budget. This deficit was principally caused by lower-than-expected state revenues. As of October 2001, FY2002 revenues were $262 million below the level collected over the same period the previous year. In order to confront the deficit, the government called on state agencies to reduce their spending by 2 percent and instituted travel restrictions, a hiring freeze, and a one-day furlough program for state workers. (In the end, the furlough program was prevented by the state employees' union.) The governor also cut Medicaid payments to some hospitals, although some of the original cuts were subsequently restored.

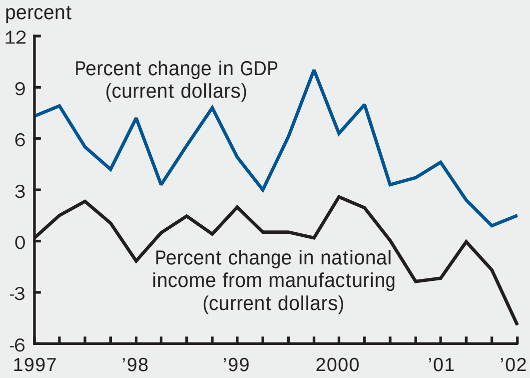
The 2003 budget proposed by the governor in late February 2002 appropriated $22.7 billion from the state general fund, representing a decline in $700 million from the previous year's appropriations. The proposed budget included no tax increases, but further across the board agency cuts of 3 percent. Additionally, the governor proposed a cut in the state work force of 3,800 workers, principally through an early retirement program. Furthermore, some state penal mental health facilities were to be closed or have their opening delayed (State of Illinois, 2002).

Indiana

As of November, Indiana's revenues were anticipated to be $540 million below the original forecast for FY2002. By April, the state was facing a deficit of $1.3 billion in the fiscal 2002–03 biennial budget.

FIGURE 12

National income from manufacturing vs. GDP growth, by quarter



Source: Data from U.S. Department of Commerce, Bureau of Economic Analysis, 2002a and 2002b.

The governor dealt with this shortfall by freezing a series of state capital projects, instituting a hiring freeze (both in September), and calling on agencies to reduce expenditures by 7 percent. He also proposed increases in a number of different taxes, including taxes on cigarettes and casinos and further cuts in agency budgets. The legislature failed to enact tax increases before adjourning in March, and the governor put spending cuts directly into effect and recalled the legislature for May. School funding was among the areas cut. Indiana is the only one of the midwestern states that is seriously considering tax increases. However, the discussion concerning tax increases is taking part in the context of a general tax restructuring caused by a court-ordered change in the property tax.

Iowa

Through the end of December 2001, Iowa's revenues were $200 million below original projections. In order to confront the resulting deficit, the governor implemented a 4.3 percent across-the-board spending cut. Subsequently, funding was restored for a selection of programs, including elementary and secondary education. Further bad news in February was met by an additional 1 percent cut in the 2002 budget, use of state emergency and tobacco settlement funds, and a furlough program for state workers.

The governor's proposed (revised) 2003 budget continues to avoid tax increases but proposes to balance the budget using a further 3 percent cut to agency budgets and funds from a number of state reserves. Education would continue to be shielded from cuts. Included in the reserves the governor proposes to use is $48 million that had been slated for the state rainy day fund and an additional $42 million from the existing rainy day fund balance. Competing budget plans from senate Republicans (the governor is a Democrat) propose reducing spending more dramatically, including spending on education, and relying less on emergency funds (Okamoto, 2002).

Michigan

As of November, Michigan's general fund revenues were projected to be $462 million below original estimates and overall revenues 2.5 percent below fiscal 2001 collections. The state made up for this shortfall by canceling a series of capital projects, enacting spending cuts, and using money from outside the general fund, including tobacco settlement money and money from the contingency fund. Spending cuts focused on health, welfare, and corrections, but K–12 education spending was not cut. The state considered delaying or canceling previously enacted income and business tax cuts, but chose not to do so.

The governor's proposed 2003 budget plans to make up for a $1 billion shortfall using additional spending cuts, in particular a freeze in the state–local revenue sharing program and significant withdrawals from the rainy day fund and other state reserves. He does not recommend tax increases, aside from a small increase in diesel taxes. The budget shields schools from cuts, in part by moving the timing of school tax payments (Cain et al., 2002).

Wisconsin

Wisconsin was facing a $1.1 billion deficit in its biennial budget covering FY2002 and FY2003. The deficit is primarily a result of lower than anticipated income tax collections. Because of the biennial budget cycle, the state needed to confront 2002 and 2003 issues together. The governor's proposed budget plan includes 3.5 percent and 5 percent reductions in

TABLE 3

Percent of employment in manufacturing by state, 2000

	Manufacturing %	50 state ranking
Illinois	16.1	17
Indiana	23.2	1
Iowa	17.8	12
Michigan	21.6	4
Wisconsin	22.2	2
U.S.	14.3	

Source: U.S. Department of Commerce, Bureau of the Census, 2002c.

agency spending in 2002 and 2003, respectively, modest cuts in university spending, and a phase out of the provision of discretionary moneys or “shared revenues” to local governments. Education and state programs serving the needy were for the most part shielded from cuts. The governor also proposes to borrow $794 million from the state tobacco settlement fund to fund the shared revenue program while it is being phased out (McCallum, 2002).

Each of the midwestern states has chosen a different package of changes to address budget deficits for the current fiscal year. These states have also begun debating how to ensure that the budgets for FY2003 will be balanced. While the choices made have been different, a general pattern emerges with the states enacting the least painful changes first and evolving to harder decisions as the budget situation has continued to deteriorate. Hiring freezes and travel restrictions have been followed by across the board spending cuts and a drawing down of reserve funds. States have relied on reserves not only in their rainy day fund, but also funds from the tobacco settlement, and other more obscure places. While tax increases have largely been avoided, if state revenues continue to disappoint, further agency cuts may prove too painful, reserves will be largely spent, and the states may have to resort to tax hikes to balance their FY2003 budgets.

Conclusion: Lessons learned

After the 1991 recession, many observers hoped that states had learned about the dangers inherent in their budget situations and would react in subsequent booms in ways that would prevent a recurrence of fiscal crisis. The current fiscal situation indicates that many of these lessons were inadequately learned.

The biggest problem states face is the combination of cyclical revenues with acyclical or even countercyclical obligations and institutions that are not permitted to use financial markets to deal with this disjoint. States have acted in ways that exacerbate this mismatch. For example, while the reduced sales tax rates on food and prescription drugs are motivated by understandable, even admirable, policy objectives, these serve to increase the sensitivity of revenues to the business cycle.

How can states deal with this problem?

Rainy day funds

While states’ balanced budget requirements prohibit them from borrowing, they are permitted to save money. The principal ways this is done is through rainy day funds and cash balances in the general account. States should increase the levels of these funds during booms to prepare for the inevitable decline in revenues when the economy sours. As mentioned earlier, rainy day balances have been rising over recent decades. States should continue this trend.

In fact, if states are successful in managing the current downturn without resorting to significant tax hikes, research may ultimately attribute this success to the health of reserves at the start of the recession.

One issue regarding rainy day funds is that they are perceived as funds to cover short-term adjustment needs rather than longer-term revenue shortfalls. They are preparing states to manage for a rainy day rather than for the rainy season, or several seasons, that an economic downturn represents. State leaders would need to change their perception of these funds in order to allow them to grow to the levels needed to maintain services in the face of widespread economic difficulties.

In keeping with the increased role of reserves, state legislatures would need to increase the permitted size of reserve funds. As mentioned above, many states limit the level of reserves.

Tax cuts

The current situation, where taxes are cut during a boom and increased during a recession, both exacerbates the economic cycle and means that considerable energy is being expended in debating changes that are soon reversed. Given the political popularity of tax cuts, it would be idealistic to suggest that states should not cut taxes when the economy is booming and instead maintain all excess funds as reserves. At the same time, the political unpopularity of tax increases means that needed tax increases occur late in the economic cycle after considerable damage has been done in terms of interruptions to state-provided services. In order to deal with this problem, states should consider enacting tax cuts that do not require offsetting legislation to be reversed in subsequent years. In particular, they might consider tax rebates and refunds rather than legislated reductions in rates. In this way, states could return money to taxpayers without jeopardizing the finances of the government during economic difficulties any more than is done by the contingencies of the economic cycle itself. Many of the tax cuts enacted during the expansion were rebates. More states should consider these during future surplus years.

Expenditure patterns

One reason some observers argue against higher reserve balances is that they believe that governments will see these balances and find wasteful ways to spend them. By returning money to taxpayers instead, government leaders are relieved of this temptation. In other words, these commentators believe that taxpayers are better stewards of resources than legislators.

The long-term spending trends in the states justify this worry. State spending has been on an upward trajectory relative to personal income for quite some time. Governors and legislators should work to confront the spending demons by carefully reexamining spending priorities. Spending appears only to be carefully controlled during fiscal crisis and not during calmer times. States should look closely at how agencies confront across-the-board spending cuts to determine where excess fat may be in the system. Additionally, when the economy improves, the states should continue the scrutiny of the Medicaid program that is occurring during budget discussions. Medicaid spending is particularly problematic because its rate of growth shows no sign of abating. Also, major adjustments in the program are likely to be slow to develop because they would require the cooperation of state and federal authorities.

Additionally, states should consider public relations programs that educate the public about the valuable services they provide. For example, do taxpayers know that states are the largest providers of school funding or do they believe that this service is principally funded locally?

Leaning on the federal government

States should not expect the federal government to bail them out when the economy sours. While the states need to act quickly to affect budget balances during recessions, the federal government makes policy in a slow and considered fashion. The recent experience with Medicaid spending demonstrates the problems of relying on the federal government. While the states have been requesting additional funds for over six months, stimulus packages containing Medicaid relief for states have consistently stalled in Congress. While states may well get their additional Medicaid support eventually, it will not come quickly enough to ameliorate the last-minute budget crises. The problems underlying the requests for added Medicaid funds are part of long-standing trends. The federal government may have been more receptive to these requests during more robust economic times.

Reversing balanced budget restrictions

One additional option for the states would be to reverse their long-standing balanced budget restrictions and debt limits. This would allow states to borrow from financial markets when the economy deteriorates and (presumably) to pay the money back as the economy improves. There are two principal arguments against such a suggestion. First of all, such a recommendation is impractical. Governors and legislators are very proud of their balanced budgets. Even the suggestion that these rules be reversed would be political suicide. Second, and more importantly, without these restrictions, states would be less compelled to make difficult spending decisions. As a result, state spending would likely get even more out of hand. Balanced budget restrictions mean that budgets are balanced both from year to year and (as a result) on average. While yearly balanced budgets are troubling because of the business cycle, the fact that states are not major debtors is an important strength of the state fiscal process.

The current fiscal condition of the states and the difficult budget negotiations states are engaged in have come alarmingly soon after a long period of windfall revenues. While state leaders used these revenues to cut taxes and increase spending, they did not use them to plan adequately for a weak economy. After two similar fiscal crises only a decade apart, one might hope that states will understand the need to plan for future recessions. States could better prepare for recession by relying more completely on their reserve funds. This would allow them to escape their historical pattern of increasing taxes when citizens are poorest and cutting services when they are most needed.

NOTES

[1]The majority of state budgets pertain to a fiscal year that starts on July 1 and ends on June 30. A small number of states use a different fiscal year. While most states operate annual budgets, 21 have biennial budget cycles. In some smaller states, this is in conjunction with a legislature that meets every other year. In states with biennial budgets, full-blown budgets are only authorized every other year, but supplemental budget bills are often passed in off years to cope with unplanned contingencies.

[2]States themselves rely on different fund definitions than the Census Bureau. I use Census Bureau definitions because these guarantee comparability across states.

[3]Throughout this article, I use 1992 as a dividing point for data comparisons because it was the first year of positive economic growth during the recent expansion. The last year of data used depends on data availability. I use the most recent year for which historically comparable data is available. All real numbers are calculated using the gross domestic product implicit price deflator from the Executive Office of the President, Council of Economic Advisers, 2002. Average yearly growth rates are based on compounding.

[4]California does collect these data. Income from options and capital gains in the state grew from $25 billion in 1994 to $200 billion in 2000 then fell to $70 billion in 2001 (Sterngold, 2002).

[5]Due to the particulars of the settlement, no monies were due for 1999. However, states received the 1998 funds in 1999.

[6]The levels of expenditure from the NASBO and Census data sets are quite different; however, historical comparisons find that the rates of expenditure growth tend to be very similar (Merrimam, 2000).

[7]Administrative costs are not included in any of these categories. The underlying numbers include only Medicaid payments on behalf of recipients.

[8]There have been numerous changes relating to the eligibility of children since 1986. For a full discussion, see U.S. Congress, House Committee on Ways and Means, 2002.

[9]Instruction represents 61.7 percent of current education expenditure, and current expenditure represents 85 percent of total expenditure. The 61.7 percent number is frequently cited as the percentage of spending on teachers, but this excludes non-current spending.

[10]This figure actually underestimates the net effects of the decline in state taxes because it treats each reduction as only reducing one year's taxes. Many reductions were permanent and therefore reduced taxes in all subsequent years.

[11]This is a reasonably quick way to get an approximate calculation. One problem with this measure is that it leads to the prediction that those states with the fastest growth rates of revenues from FY1993 to FY1998 would continue to face the fastest growth rates in the future. However, if revenues grew more quickly because some states rely on more cyclical forms of revenue, one would expect revenues to be slowest in those states that grew most quickly during the expansion. A more precise estimate of necessary reserves would be based on the cyclicality of the specific revenue sources relied on by each state. In a paper in 1998, Dye and McGuire provide estimates of revenue cyclicality by state, but do not estimate required reserves. The correlation between the estimates of needed reserves and the cyclicality of revenues is –0.26. In other words, those states that CBPP calculate as needing the most reserves (as a percent of their budget) to withstand a recession are the states that Dye and McGuire find rely on least sensitive revenue sources.

[12]For further information on the distinction between reported unliquidated obligations and unobligated funds, see Lazere, 2001.

[13]TANF will need to be reauthorized in 2002. Significant changes are not anticipated because the program has been widely perceived as being successful.

American Federation of Teachers, 2002, "Survey and analysis of teacher salary trends 2000," February 28, available on the Internet at www.aft.org/research/survey00/salarysurvey00.pdf/.

Associated Press, 2002, "Drugstores threaten to end Medicaid service," New York, wire service, March 12.

Cain, Charlie, Mark Hornbeck, and Gary Heinlein, 2002, "Critics argue Engler takes from future to fix budget," *Detroit News*, available on the Internet at http://detnews.com/2002/politics/0202/08/a01-411373.htm, February 8.

Dye, Richard F., and Therese J. McGuire, 1998, "Block grants and the sensitivity of state revenues to recession," in *National Tax Association Proceedings of the Annual Conference on Taxation,* Washington, DC, pp. 15–23.

Executive Office of the President, The, Council of Economic Advisers, 2002, *Economic Report of the President*, Washington, DC: United States Government Printing Office, available on the Internet at http://w3.access.gpo.gov/eop/, February.

Executive Office of the President, The, Office of Management and Budget, 2002, *Historical Tables, Budget of the United States Government, Fiscal Year 2003,* Washington, DC: U.S. Government Printing Office, available on the Internet at www.whitehouse.gov/omb/budget/fy2003/pdf/hist.pdf/.

Herszenhorn, David M., 2001, "McGreevey warns of tough fiscal future in New Jersey," *New York Times*, November 8.

Jenny, Nicholas W., 2002, "2001 tax and budget summary," *State Fiscal Briefs*, Albany, NY: The Nelson A. Rockefeller Institute of Government, Fiscal Studies Program, No. 63, available on the Internet at www.rockinst.org/publications/fiscal_studies/FB_63.pdf, January.

__________, 2001, "Severe decline in state tax revenue," *State Revenue Report*, Albany, NY: The Nelson A. Rockefeller Institute of Government, Fiscal Studies Program, No. 46, available on the Internet at www.rockinst.org/publications/fiscal_studies/RR_46.pdf, tax data from 1995–2001, December.

Jenny, Nicholas W., and Donald J. Boyd, 2001, "A second quarter of slow tax revenue growth," *State Revenue Report,* Albany, NY: The Nelson A. Rockefeller Institute of Government, Fiscal Studies Program, No. 44, available on the Internet at www.rockinst.org/publications/fiscal_studies/RR_44.pdf, data for 1994, June.

Lav, Iris J., and Alan Berube, 1999, *When it Rains it Pours: A Look at the Adequacy of State Rainy Day Funds and Budget Reserves,* Washington, DC: Center on Budget and Policy Priorities.

Lazere, Ed, 2001, "Unspent TANF funds at the end of federal fiscal year 2000," Washington, DC: Center on Budget and Policy Priorities, available on the Internet at www.cbpp.org/1-22-01sfp00surplus.htm, February 23.

Lex, Leo, 1998, "States' use of surplus funds," Congressional Budget Office, report, available on the Internet at www.cbo.gov/showdoc.cfm?index=1044&sequence=0&from=1, November.

Mackey, Scott, 1999, "State tax actions 1995," National Conference of State Legislatures, report, available on the Internet at www.ncsl.org/programs/fiscal/STA95P1.HTM/.

McCallum, Scott, 2002, "State of Wisconsin budget reform bill summary," Department of Administration, Division of Executive Budget and Finance, Madison, WI, available on the Internet at www.doa.state.wi.us/debf/sbo/state_budget/0103_exec_budget/pdf_files/budgetreformbill.pdf, January.

McGranahan, Leslie, 1999, "State budgets and the business cycle: Implications for the federal balanced budget amendment debate," *Economic Perspectives,* Federal Reserve Bank of Chicago, Vol. 23, No. 3, pp. 2–17.

Merrimam, David, 2000, "Sources of data about state government revenues and expenditures," The Urban Institute, report, available on the Internet at www.urban.org/UploadedPDF/discussion00-04.PDF/.

National Association of State Budget Officers, 2002, *Budget Processes in the States*, Washington, DC, January.

__________, 2001a, *Fiscal Survey of the States: June 2001*, Washington, DC: National Governors Association and National Association of State Budget Officers.

__________, 2001b, *Fiscal Survey of the States: December 2001*, Washington, DC: National Governors Association and National Association of State Budget Officers.

__________, 2001c, *State Expenditure Report 2000*, Washington, DC, available on the Internet at www.nasbo.org/Publications/PDFs/00exprpt.pdf/.

__________, 1999, *The Fiscal Survey of the States: December 1999*, Washington, DC.

National Conference of State Legislatures, 2002, "State fiscal update: April 2002", Washington, DC, available on the Internet to members at www.ncsl.org/programs/fiscal/sfo2002.htm, April 16.

__________, 2001a, "State budget and tax actions 2001: Preliminary report," Washington, DC, available on the Internet at www.ncsl.org/programs/fiscal/presbta01.htm/.

__________, 2001b, "State fiscal outlook for FY 2002: November update," Washington, DC, available on the Internet at www.ncsl.org/programs/fiscal/sfo2002b.htm, December 3.

__________, 2001c, "State tax actions 2000: Executive summary," Washington, DC, available on the Internet at www.ncsl.org/programs/fiscal/sta00sum.htm, January 31.

__________, 2000, "State budget and tax actions 2000: Preliminary report: Executive summary," report, Washington, DC, available on the Internet at www.ncsl.org/programs/fiscal/presbta00.htm.

__________, 1999a, "State budget and tax actions 1999: Preliminary report," Washington, DC, available on the Internet at www.ncsl.org/programs/fiscal/presbta99.htm/.

__________, 1999b, "State tax actions 1996: Executive summary," available on the Internet at www.ncsl.org/programs/fiscal/sta96sum.htm/.

Okamoto, Lynn, 2002, "Revised budget lists cuts for some agencies," *Des Moines Register*, available on the Internet at www.dmregister.com/news/stories/c4780934/17540924.html, March 7.

State of Illinois, 2002, "Governor Ryan proposes balanced $52.8 billion 2003 budget," Springfield, IL, press release, available on the Internet at www200.state.il.us/PressReleases/ShowPressRelease.cfm?SubjectID=10&RecNum=1684, February 20.

__________, 2000, "Ryan commends legislators for advancing education, human services, VentureTECH, tax relief, and public safety, Springfield, IL, press release, available on the Internet at www.state.il.us/gov/press/00/Apr/endssn.htm, April 15.

Sterngold, James, 2002, "California officials face unprecedented budget gap," *New York Times*, May 12.

U.S. Congress, General Accounting Office, 1995, "School facilities: Condition of America's schools," letter report, No. GAO/HEHS-95-61, February 1.

U.S. Congress, House Committee on Ways and Means, 2002, *2000 Green Book*, Washington DC: U.S. Government Printing Office, No. 106-14, available on the Internet at www.access.gpo.gov/congress/wm001.html/.

__________, 1996, *1996 Green Book*, Washington, DC: U.S. Government Printing Office, No. 104-14.

U.S. Department of Commerce, Bureau of the Census, 2002a, "State government finances," Washington, DC, report, available on the Internet at www.census.gov/govs/www/state.html, data for 1992–99, February 27.

__________, 2002b, "State government tax collections," Washington, DC, report, available on the Internet at www.census.gov/govs/www/statetax.html, data for 1992–2000.

__________, 2002c, *Statistical Abstract of the United States: 2001, 121st Edition*, Washington, DC: Government Printing Office, available on the Internet at www.census.gov/statab/www/.

__________, 1981, "State government finances in 1980," Washington, DC, report, series GF80, No. 3.

U.S. Department of Commerce, Bureau of Economic Analysis, 2002a, "Current and 'Real' gross domestic product," report, Washington, DC, available on the Internet at www.bea.doc.gov/bea/dn/gdplev.xls.

__________, 2002b, *National Income and Product Account*, Washington, DC, table 6.1C.

U.S. Department of Education, National Center for Education Statistics, 2001, "Public school student, staff, and graduate counts by state, school year 1999–2000," Washington, DC, available on the Internet at http://nces.ed.gov/pubsearch/pubsinfor.asp?pubid=2001326R, May 18.

U.S. Department of Health and Human Services, Health Care Financing Administration, 2000, *A Profile of Medicaid: Chart Book 2000*, Washington, DC, available on the Internet at www.hcfa.gov/stats/2Tchartbk.pdf/.

U.S. Department of the Treasury, Internal Revenue Service, 2001a, *Individual Income Tax Returns: Selected Income and Tax Items for Selected Years, 1994–1998, in Current and Constant 1990 Dollars*, IRS Publication 1304, Revised 4-2001, available on the Internet at www.irs.gov/pub/irs-soi/98intba.xls, federal capital gains data for 1994–98.

__________, 2001b, *Individual Income Tax Returns: Selected Income and Tax Items for Specified Tax Years, 1980–1999*, SOI Bulletin, Spring, available on the Internet at www.irs.gov/pub/irs-soi/99in01si.xls, federal capital gains data for 1980–99.

Wilson, Joy Johnson, 1999, "Summary of the Attorneys General master tobacco settlement agreement," National Conference of State Legislatures, Washington, DC, report, available on the Internet at www.ncsl.org/statefed/tmsasumm.htm, March.

Zahradnik, Bob, and Iris J. Lav, 2000, "When it rains it pours—One year later," Center on Budget and Policy Priorities, report, available on the Internet at www.cbpp.org/5-22-00sfp.htm, May 22.