Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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STATE BUDGET TROUBLES WORSEN

By Elizabeth McNichol and Iris J. Lav

States are facing a great fiscal crisis. At least 41 states faced or are facing shortfalls in their budgets for this and/or next year. Over half the states had already cut spending, used reserves, or raised revenues in order to adopt a balanced budget for the current fiscal year — which started July 1 in most states. Now, their budgets have fallen out of balance again. New gaps have opened up in the budgets of at least 31 states plus the District of Columbia just four months after they struggled to close the largest budget shortfalls seen since the recession of 2001. And these problems are expected to continue into next year.

Current estimates are that mid-year gaps total $24.3 billion — 6.6 percent of the budgets of the 29 states that have estimated the size of the gap — but they will almost certainly widen as the continuing economic turmoil causes revenues to come in below estimates in more states.

STATE FISCAL STRESS DEEPENS

- In total, 41 states are facing fiscal stress in their FY2009 and/or FY2010 budgets. Because economic conditions remain unsettled, it is highly likely that budget gaps will grow.
- New mid-year shortfalls have opened up in the budgets of at least 31 states and the District of Columbia. Initial estimates of these mid-year gaps total $24.3 billion.
- This new round of shortfalls is in addition to the budget gaps of $48 billion that had to be closed in 29 states in their FY2009 budgets, adopted a few months ago.

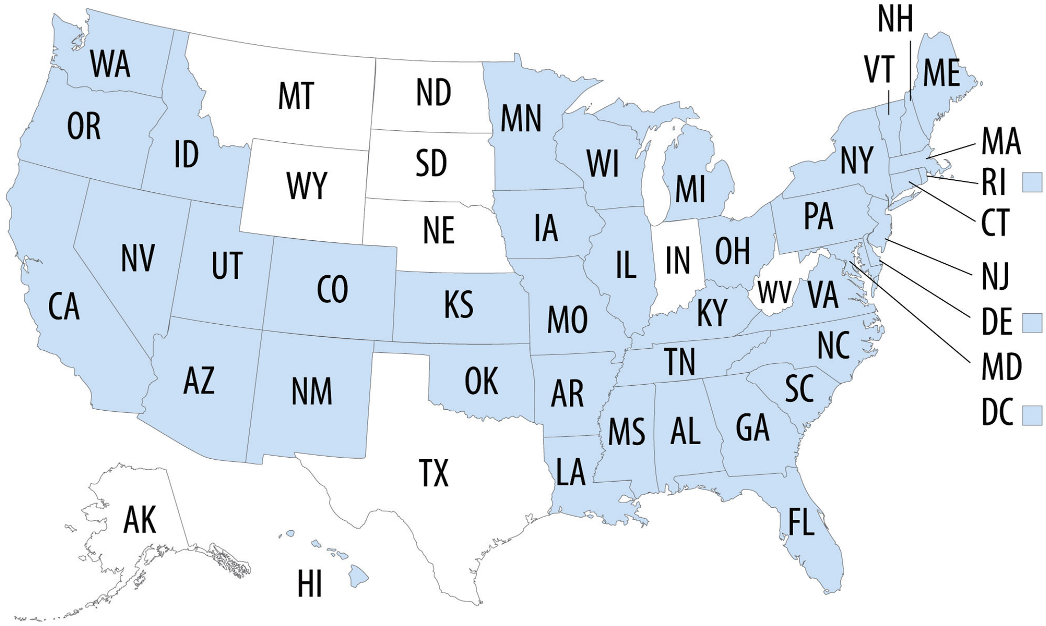
The 31 states facing mid-year shortfalls are **Alabama, Arizona, California, Colorado, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Kansas, Kentucky, Maine, Maryland, Massachusetts, Mississippi, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Vermont, Virginia, and Wisconsin.** In addition, the **District of Columbia** faces a budget shortfall. These budget gaps are in addition to the shortfalls that these and other states faced as they adopted their budgets for the current fiscal year.[1] At that time, 29 states faced a total of more than $48 billion in combined shortfalls.[2]

[1] Of these states Colorado, Hawaii, Idaho, New Mexico, Pennsylvania and Utah did not also face shortfalls before adopting FY2009 budgets.

[2] For more detail see the Appendix of this paper and 29 States Faced Total Budget Shortfall of At Least $48 billion in 2009 available at http://www.cbpp.org/1-15-08sfp.htm.

FIGURE 1

41 States Face Budget Shortfalls



Note: Includes states with shortfalls in fiscal 2009 or projected shortfalls for fiscal 2010.

In general, states closed these budget gaps through some combination of spending cuts, use of reserves, or revenue increases when they adopted a fiscal year 2009 budget.

Recent data on state tax collections confirm the mounting fiscal problems of the states. In the first half of 2008, most states experienced flat or declining revenues relative to the previous year. The most recent indications are that revenues are continuing to weaken significantly.

The states' fiscal problems are likely to continue for some time. At least 21 states have looked further ahead and prepared projections of revenues and/or spending for fiscal year 2010 and beyond that foresee continued fiscal distress. These 21 states include fifteen of the states projecting mid-year gaps for the current fiscal year — Alabama, Arizona, California, Connecticut, Florida, Hawaii, Kansas, Maine, Maryland, Nevada, New York, North Carolina, Vermont, Virginia, and Wisconsin — as well as Louisiana, Minnesota, Missouri, Oregon, Rhode Island and Washington.[3] It may be particularly difficult for states to recover from the current fiscal situation, suggesting that there will be multi-year fiscal distress. Housing markets may be slow to fully recover; the decline in housing markets has already depressed consumption and sales taxes as people refrain from buying furniture, appliances, construction materials, and the like. Property tax revenues are also beginning to be affected, and local governments will be looking to states to help address the squeeze on local and

[3] The list of states at risk for budget problems in fiscal year 2010 is very likely larger than these 21 states. Most states do not regularly prepare projections of the amount of spending that would be needed to maintain existing services — current services spending — so it is difficult to determine whether projected revenues are sufficient to cover the future cost of existing programs.

TABLE 1: STATES WITH MID-YEAR FY2009 BUDGET GAPS		
	Size of Gap	Percent of FY2009 General Fund
Alabama	$458 million	5.5%
Arizona	$700 million	7.0%
California	$9.5 billion	9.4%
Colorado	$99 million	1.3%
Connecticut	$300 million	1.7%
District of Columbia	$131 million	2.1%
Florida	$1.7 billion	6.6%
Georgia	$1.6 billion	7.5%
Hawaii	$162 million	2.8%
Idaho	$174 million	5.9%
Illinois	DK	
Kansas	$137 million	2.1%
Kentucky	$294 million	3.2%
Maine	$150 million	4.9%
Maryland	$248 million	1.7%
Massachusetts	$1.4 billion	5.0%
Mississippi	$24 million	0.5%
Nevada	$575 million	7.8%
New Hampshire	$50 million	1.6%
New Jersey	$400 million	1.2%
New Mexico	$253 million	4.2%
New York	$1.5 billion	2.7%
North Carolina	$800 million	3.7%
Ohio	$540 million	1.9%
Pennsylvania	$565 million	2.0%
Rhode Island	$372 million	11.4%
South Carolina	$554 million	8.1%
Tennessee	$300 million	2.7%
Utah	$354 million	5.9%
Vermont	$24 million	2.0%
Virginia	$974 million	5.7%
Wisconsin	DK	
TOTAL	$24.3 billion	6.6%

Note: An entry of "DK" in Size of Gap means that an estimate of the size of the projected gap in that state is not yet available.

education budgets. And if the employment situation continues to deteriorate, income tax revenues will weaken and there will be further downward pressure on sales tax revenues as consumers become reluctant or unable to spend.

Although fiscal year 2010 does not start until next year, the effects of these upcoming problems are likely to be felt sooner. For example, the governor of New York called legislators into a special session in August to make budget cuts designed to reduce projected fiscal year 2010 budget gaps and Maryland has cut spending this year in part to address projected gaps for the next year.

The vast majority of states cannot run a deficit or borrow to cover their operating expenditures. As a result, states have three primary actions they can take during a fiscal crisis: they can draw down available reserves, they can cut expenditures, or they can raise taxes. States already have begun drawing down reserves; the remaining reserves are not sufficient to allow states to weather a significant downturn or recession. The other alternatives — spending cuts and tax increases — can further slow a state's economy during a downturn and contribute to the further slowing of the national economy, as well.

Some states have not been affected by the economic downturn but the number is dwindling. There are a number of reasons why. Some mineral-rich states — such as New Mexico, Alaska, and Montana — saw revenue growth as a result of high oil prices. However, the recent decline in oil prices has begun to affect revenues in some of these states. The economies of a handful of other states have so far been less affected by the national economic problems.

In states facing budget gaps, the consequences sometimes are severe — for residents as well as the economy. Unlike the federal government, states cannot run deficits when the economy turns down; they must cut expenditures, raise taxes, or draw down reserve funds to balance their budgets. As a new fiscal year begins in most states, budget difficulties are leading some 25 states to reduce services to their residents, including some of their most vulnerable families and individuals.[4]

For example, at least 17 states have implemented or are considering cuts that will affect low-income children's or families' eligibility for health insurance or reduce their access to health care services. Programs for the elderly and disabled are also being cut. At least 15 states are cutting medical, rehabilitative, home care, or other services needed by low-income people who are elderly or have disabilities, or significantly increasing the cost of these services.

At least 16 states are cutting or proposing to cut K-12 and early education; several of them are also reducing access to child care and early education, and at least 21 states have implemented or proposed cuts to public colleges and universities.

In addition, at least 10 states have proposed or implemented reductions to their state workforce. Workforce reductions often result in reduced access to services residents need. They also add to states' woes by contracting the state economy.

If revenue declines persist as expected in many states, additional budget cuts are likely. Budget cuts often are more severe in the second year of a state fiscal crisis, after reserves have been largely depleted and thus are no longer an option for closing deficits. The experience of the last recession is instructive as to what kinds of actions states may take. Between 2002 and 2004 states reduced services significantly. For example, in the last recession, some 34 states cut eligibility for public health programs, causing well over 1 million people to lose health coverage, and at least 23 states cut eligibility for child care subsidies or otherwise limited access to child care. In addition, 34 states cut real per-pupil aid to school districts for K-12 education between 2002 and 2004, resulting in higher fees for textbooks and courses, shorter school days, fewer personnel, and reduced transportation.

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[4] For more detailed information see *Facing Deficits, Many States are Imposing Cuts that Hurt Vulnerable Residents* http://www.cbpp.org/3-13-08sfp.htm.

Expenditure cuts and tax increases are problematic policies during an economic downturn because they reduce overall demand and can make the downturn deeper. When states cut spending, they lay off employees, cancel contracts with vendors, eliminate or lower payments to businesses and nonprofit organizations that provide direct services, and cut benefit payments to individuals. In all of these circumstances, the companies and organizations that would have received government payments have less money to spend on salaries and supplies, and individuals who would have received salaries or benefits have less money for consumption. This directly removes demand from the economy. Tax increases also remove demand from the economy by reducing the amount of money people have to spend.

The federal government — which can run deficits — can provide assistance to states and localities to avert these "pro-cyclical" actions.

States Have Restrained Spending and Accumulated Rainy Day Funds

Many states have never fully recovered from the fiscal crisis in the early part of the decade. This fact heightens the potential impact on public services of the deficits states are now projecting.

State expenditures fell sharply relative to the economy during the 2001 recession, and for all states combined they remain below the FY2001 level. In 18 states, general fund spending for FY2008 — six years into the economic recovery — remained below pre-recession levels as a share of the gross domestic product.

In a number of states the reductions made during the downturn in education, higher education, health coverage, and child care remain in effect. These important public services were suffering even as states turned to budget cuts to close the new budget gaps. Spending as a share of the economy declined in FY2008 and is projected to decline further in FY2009.

One way states can avoid making deep reductions in services during a recession is to build up rainy day funds and other reserves. At the end of FY2006, state reserves — general fund balances and rainy day funds — totaled 11.5 percent of annual state spending. Reserves can be particularly important to help states adjust in the early months of a fiscal crisis, but generally are not sufficient to avert the need for substantial budget cuts or tax increases.

Federal Assistance Needed

Federal assistance can lessen the extent to which states take pro-cyclical actions that can further harm the economy. In the recession in the early part of this decade, the federal government provided $20 billion in fiscal relief in a package enacted in 2003. There were two types of assistance to states: 1) a temporary increase in the federal share of the Medicaid program; and 2) general grants to states, based on population. Each part was for $10 billion. The increased Medicaid match averted even deeper cuts in public health insurance than actually occurred, while the general grants helped prevent cuts in a wide variety of other critical services. The major problem with that assistance was that it was enacted many months after the beginning of the recession, so it was less effective than it could have been in preventing state actions that deepened the economic downturn.

The federal government should consider aiding states earlier, rather than waiting until the downturn is nearly over.

Moreover, it seems increasingly likely that this recession will be more severe than the last recession, and thus state fiscal problems may be worse. For instance, unemployment, which peaked after the last recession at 6.3 percent, has already hit 6.4 percent, and many economists expect it to rise much further, which will reduce state income taxes and increase demand for Medicaid and other services. And with consumers' reduced access to home equity loans and other sources of credit, sales taxes are also likely to fall more steeply than they did in the last recession. These factors suggest that a new round of fiscal relief should be s larger than was enacted in 2003.

TABLE 2: SIZE OF FY2009 BUDGET GAPS				
	Gap before budget was adopted	Additional mid-year gap	Total	Total Gap as Percent of FY2009 General Fund
Alabama	$784 million	$458 million	$1.2 billion	15.0%
Arizona[1]	$1.9 billion	$700 million	$2.6 billion	25.9%
Arkansas	$107 million		$107 million	2.4%
California	$22.2 billion	$9.5 billion	$31.7 billion	31.4%
Colorado		$99 million	$99 million	1.3%
Connecticut	$150 million	$300 million	$450 million	2.6%
Delaware	$217 million		$217 million	6.0%
District of Columbia	$96 million	$131 million	$227 million	3.6%
Florida	$3.4 billion	$1.7 billion	$5.1 billion	19.9%
Georgia[1]	$245 million	$1.6 billion	$1.8 billion	8.7%
Hawaii		$162 million	$162 million	2.8%
Idaho		$174 million	$174 million	5.9%
Illinois	$1.8 billion	Yes, DK size	$1.8 billion	6.3%
Iowa	$350 million		$350 million	5.5%
Kansas		$137 million	$137 million	2.1%
Kentucky	$266 million	$294 million	$560 million	6.0%
Maine	$124 million	$150 million	$274 million	9.0%
Maryland	$808 million	$248 million	$1.1 billion	7.0%
Massachusetts	$1.2 billion	$1.4 billion	$2.6 billion	9.2%
Michigan	$472 million		$472 million	4.8%
Minnesota	$935 million		$935 million	5.4%
Mississippi[1]	$90 million	$24 million	$114 million	2.2%
Nevada	$898 million	$575 million	$1.5 billion	20.1%
New Hampshire	$200 million	$50 million	$250 million	8.0%
New Jersey[1]	$2.5 billion	$400 million	$2.9 billion	8.9%
New Mexico		$253 million	$253 million	4.2%
New York	$4.9 billion	$1.5 billion	$6.4 billion	11.4%
North Carolina		$800 million	$800 million	3.7%
Ohio[1]	$733 million	$540 million	$1.3 billion	4.5%
Oklahoma	$114 million		$114 million	1.7%
Pennsylvania		$565 million	$565 million	2.0%
Rhode Island	$430 million	$372 million	$802 million	24.5%
South Carolina	$250 million	$554 million	$804 million	11.7%
Tennessee[1]	$468 million	$300 million	$768 million	6.8%
Utah		$354 million	$354 million	5.9%
Vermont	$59 million	$24 million	$83 million	6.8%
Virginia	$1.2 billion	$974 million	$2.2 billion	12.8%
Wisconsin	$652 million	Yes, DK size	$652 million	4.6%
TOTAL	$47.6 billion	$24.3 billion	$71.9 billion	12.2%

[1]Only the low end of the estimated FY09 gap for these states — ones that provided a range of estimates — is shown in this table. For more detail see *29 States Faced Total Budget Shortfall of At Least $48 billion in 2009* available at http://www.cbpp.org/1-15-08sfp.htm.

TABLE 3 – SOURCE OF MID-YEAR GAP ESTIMATES	
State	Source
Alabama	Executive budget office, press reports of education fund shortfall
Arizona	Joint Legislative Budget Committee
California	Press reports
Colorado	Governor's office
Connecticut	Office of Fiscal Analysis
District of Columbia	Chief Financial Officer
Florida	Revised revenue projections
Georgia	Press reports of Governor's presentation
Hawaii	Press reports of Treasurer's presentation to the state legislature
Idaho	Revised revenue projections
Illinois	Press reports
Kansas	Legislative Research Department
Kentucky	State budget director
Maine	Press reports of Maine Revenue Service presentation
Maryland	Revised revenue projections
Massachusetts	Governor's office
Mississippi	Governor's office
Nevada	State Economic Forum lowered revenue projections
New Hampshire	Budget Director
New Jersey	Governor's office
New Mexico	Revised revenue projections
New York	Division of Budget
North Carolina	Press reports
Ohio	Press reports of governor's statements
Pennsylvania	Governor's office
Rhode Island	Press reports of House Finance Committee presentation
South Carolina	State Budget and Control Board
Tennessee	Comptroller's office
Utah	Governor's special session call
Vermont	Revised revenue projections
Virginia	Governor's office
Wisconsin	Governor's office

For source information for the original shortfall estimates, see *29 States Faced Total Budget Shortfall of At Least $48 billion in 2009* available at http://www.cbpp.org/1-15-08sfp.htm.