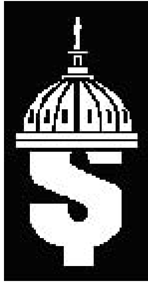

Fiscal Crisis in State Governments:

A Focus on 13 Western States

WRDC Public Policy Information Brief

No. 1, July 2003

About This Document

This report is the first paper published by the WRDC on the topic of fiscal crisis in the West. A companion document is titled *Fiscal Crisis in State Budgets: Are Taxes in Western States "Wobbly"?* (WRDC Public Policy Information Brief, No. 2, July 2003). These reports reflect the efforts of a multi-state team of land grant university faculty. The team was organized under the leadership of Steven Daniels (Western Rural Development Center) and Lou Swanson (Colorado State University), with Jim Christenson (University of Arizona) serving as the administrative advisor. The research team held a planning session in April, 2003 to refine project scope and objectives. Participants in that meeting were:

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This project was supported by the tireless research efforts of Dr. Brian Eisenhauer, under contract to the Western Rural Development Center. The report was written by Dr. Steven Daniels, who is responsible for all errors and omissions. Reviews of the manuscript were provided by Dr. Andrew Seidl (Colorado State University) and Dr. William Jaeger (Oregon State University). Thanks to Carey Dufner for editorial assistance and document layout.

Data Sources

The data used to create this report were drawn predominantly from public sources (U.S. Census, BEA, etc.) or from national associations (National Association of State Budget Officers, National Governors' Association, etc.). Information on university tuition and financial aid came from the Center for Higher Education and Policy, bond data came from Thomson Financial, and information on TANF changes came from reports prepared by the Center on Budget and Policy Priorities and the Center for Law and Social Policy. Structural deficit information came from a report prepared for the National Center for Higher Education Management Systems. Every reasonable attempt was made to provide the most contemporary and accurate data, but the fiscal situation in state budgets changes constantly. The datasets used to create the figures are available on CD-ROM for $10, shipping and handling included. Contact the Western Rural Development Center, wrdc@ext.usu.edu or 435/797-9732.

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Executive Summary

This report examines the fiscal situation for 13 western states, focusing on the causes and consequences of the current budget difficulties. Causes have been grouped into three sets: background, long-term and short-term. Background factors are balanced budget requirements, citizen-enacted initiatives, and unbalanced "wobbly" tax structures. The long term causes (past 3 decades) include devolution, tax and expenditure limitations, term limits, and the under-taxation of the service sector of the economy. Short-term events include the 9/11-induced economic disruption and the collapse of the dot-com speculative bubble. Taken together, these factors explain how a mild recession (less than a 1% contraction in economic activity) was magnified into 10, 15, or 20% state budget imbalances.

Structural deficit calculations indicate that the states' underlying tax systems may not be sufficient to generate revenues sufficient to fund their on-going obligations. All of the western states have structural deficits, ranging from 0.4% (Montana) to 9.2% (Nevada).

The states have developed coping strategies that address both the expenditure and revenue sides of the budget. On the expenditure side there have been layoffs, early retirements, hiring freezes and furloughs. States have used strategies ranging from program elimination to restricted access to programs. Prisoners have been released early, and some criminal cases have not been tried. On the revenue side, many kinds of charges, fees, and minor taxes have been increased. University tuitions have experienced double-digit increases, while financial aid has been cut. The various rainy day funds in the region have largely been exhausted. Public debt issuance has increased significantly. No state has raised one of the major taxes (income, sales or property), although the Governor of Idaho proposed a sales tax increase.

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Introduction

By some measures, state budgets are in their worst shape in 60 years. States across the country are making cuts that virtually no one could have imagined five years ago. School programs are being eliminated, critical medical and public safety needs are going unmet, and early retirements are depleting the ranks of the most experienced personnel. The fiscal impact of the recent recession has been concentrated at the state and local government levels because states—unlike the federal government—have balanced budget requirements.

There is a paradox in these recent events. The recent recession was quite mild by historical standards; it was about a 1% contraction in economic activity and lasted roughly nine months. But now state budgets are 10, 15, or 20% out of balance, with projections that the next two to four years will be much the same. *How can a brief 1% recession cause a protracted 10+% budget shortfall?* This report is one of the preliminary products of a multi-state university-based research project on public finance that examines that question. Project objectives are to

- Create a 10-year database of state revenue and expenditure data that permit comparison and analysis across states;
- Describe the events and trends that contributed to the budget shortfalls; and
- Describe the various coping strategies that states are using to balance their finances.

These objectives were identified as a means to accomplish the broader goal of improving and informing public discussion of budget issues. State and local budgets are so complicated that few of us take the time to understand them. As a result, only the most devoted legislators, policy wonks, and lobbyists have a meaningful role in the budget process. The rest of us pay what we pay, and get what we get, with little understanding of the link between the two. This project is intended to de-fog the complexity of public finance. The focus is on 13 western states (Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, and Wyoming). This region was selected to make the project size manageable, to match the Bureau of Labor Statistics' Western Region, and to mirror the organizational system of the land grant universities undertaking the project.

Part I: The Causes

Specific information that supports this discussion can be found in Appendix Table 1: *Antecedent Conditions*.

I.1 Background Factors

I.1a Balanced Budget Requirements

Each western state has some form of balanced budget requirement. Some are constitutional, and others are legislatively established. California has perhaps the least stringent requirement; the Governor must submit a balanced budget proposal but the legislature is not required to enact one.

The significance of the balanced budget requirement is that states do not have the flexibility to even out spending by running surpluses or deficits as tax revenues vary across the business cycle.

> Historically state government finances have followed patterns closely associated with business cycles. In times of prosperity, revenues from sales, income and other taxes grow rapidly. At the same time, some spending needs, such as those for safety net programs, are reduced because of lower unemployment . . . Recession typically causes such substantial shortfalls in revenues and increase in spending that states cannot sustain their budget patterns and meet their balanced budget requirements. As a result, recessions typically see both cutbacks in spending and increases in taxes to restore states to solvency. (Hovey 1999a, p. 36-37)

I.1b Citizen-Enacted Initiatives

As is true across the country, western states have a political tradition the draws heavily on citizen engagement. When the states were formed out of sparsely populated territories, citizen governance was essential—there was no experienced cadre of policy professionals to serve in state legislatures or lead agencies. This emphasis on citizen governance continues in the form of citizen initiatives; in most western states there are mechanisms through which citizens can bypass their legislators and directly enact legislation or constitutional amendments through popular vote. Three states in particular—California, Colorado, and Oregon—have had their fiscal structures re-designed through initiatives. California's property tax-limiting Proposition 13 was enacted in 1978, and helped establish its reputation as a bellwether of change that subsequently played out across the nation. Colorado citizens enacted the Taxpayers' Bill of Rights in 1992, which linked the rate of tax growth to a formula based on population and economic growth. Oregon experienced both a series of tax limiting and cost increasing initiatives in the 1990s that fundamentally altered the ability to fund schools and state services.

I.1c Unbalanced Tax Structures

(This topic is discussed more fully in a companion report, *Fiscal Crisis in State Budgets: Are Taxes in Western States "Wobbly"?* (WRDC Public Policy Information Brief, No. 2, July 2003)

Public finance economists have recognized that diversifying a state's tax structure across several taxes makes total revenues more stable. How well diversified are tax structures in the western states? Table 1 shows state and local tax structures, while Table 2 shows only the state level tax structures.

PROPORTIONS OF STATE AND LOCAL TAX REVENUE FROM SPECIFIC TAXES

STATE	Personal Income Tax (%)	Sales Tax (%)	Property Tax (%)	State Corporate Tax (%)	Other Tax (%)	Total Tax (%)
Alaska	0	12	33	19	36	100
Arizona	17	46	29	4	4	100
California	33	33	22	6	6	100
Colorado	28	37	28	3	4	100
Hawaii	26	52	15	2	5	100
Idaho	29	32	26	4	9	100
Montana	24	16	43	5	12	100
Nevada	0	62	25	0	13	100
New Mexico	18	51	13	3	15	100
Oregon	44	10	30	4	12	100
Utah	29	41	22	3	5	100
Washington	0	61	29	0	10	100
Wyoming	0	39	34	0	27	100

Table 1. Proportions of State and Local Tax Revenue from Specific Taxes. (Percentages rounded to nearest 1%, may not equal 100%) Source: State and Local Government Finances by Level of Government and by State 1999-2000 (US Census)

PROPORTION OF STATE ONLY TAX REVENUE FROM SPECIFIC TAXES, 2000						
STATE	Personal Income Tax (%)	Sales Tax (%)	Property Tax (%)	State Corporate Tax (%)	Other Tax (%)	Total Tax (%)
Alaska	0	10	3	32	56	100
Arizona	28	57	4	6	4	100
California	47	35	4	8	6	100
Colorado	51	38	0	5	6	100
Hawaii	32	62	0	2	4	100
Idaho	41	44	0	5	10	100
Montana	37	24	16	7	16	100
Nevada	0	85	2	0	13	100
New Mexico	24	54	1	4	18	100
Oregon	69	12	0	7	12	100
Utah	42	48	0	4	6	100
Washington	0	77	14	0	9	100
Wyoming	0	49	11	0	40	100

Table 2. Proportions of State Only Total Tax Revenue from Specific Taxes, 2000 (Percentages rounded to nearest 1%, may not equal 100%) Source: State Government Tax Collections 2000 (US Census)

Key observations that emerge from the data summarized in these tables are:

- Four states (Alaska, Nevada, Washington, and Wyoming) do not assess personal income tax.
- Three states (Alaska, Oregon, and Montana) do not assess general sales tax at the state level, although they all tax specific items (gasoline, cigarettes, alcohol, etc.). Alaska does allow local jurisdictions to levy sales taxes.
- All western states assess property taxes, with Montana depending the most significantly upon them, and New Mexico the least.
- Two western states (Alaska and Wyoming) depend significantly upon energy revenues to fund state government. Two other states (Montana and New Mexico) depend upon energy to a lesser, but still sizable, extent.
- Nevada has a tax system that is highly dependent upon the gaming and tourism industries, as well as the value of mines.
- Oregon has a higher dependence on personal income tax than any other state in the region.
- Four states (Hawaii, Nevada, New Mexico, and Washington) receive more than 50% of their revenues from sales taxes.
- Three states (California, Colorado, and Idaho) have the most balanced tax structures in terms of equal percentages of tax types.

Western state and local tax structures vary more widely than elsewhere in the country. On a national level there are eleven “wobbly” state and local tax systems (i.e., lacking one of the three major tax types). Of these eleven, six are in the West. Other states include Delaware (does not have a sales tax); Florida, South Dakota, Texas (do not have income taxes); and New Hampshire (has no sales or significant income tax). So while only 22% of all states lack one of the major tax types, almost half of the western states do. In addition, the only non-western state with a significant tax reliance on energy is Kentucky, although it does not depend on energy tax revenues to nearly the extent that either Alaska or Wyoming do.

The relatively high frequency of "wobbly" tax systems in western states may expose them to more fluctuation in revenues than would otherwise be the case (Seyfried and Pantuosco, 2003). Stability can also be enhanced through rainy day funds.

I.2 Long-Term Trends

This section discusses events that occurred over roughly the past 30 years, and their role in creating the current budget situation.

I.2a Devolution

The question of the appropriate balance between federal and state governments is as old as our country. Even the framers of the Constitution sent mixed signals with the Supremacy Clause (pro-federal) and the Tenth Amendment (pro-states). Devolution refers to relocating authority/obligation for programs away from the federal government to state and local governments. Depending on which historian you rely upon, devolution has been a recent phenomenon (past 10-15 years) or a longer trend (past 40 years). But there is little doubt that since the "Great Society" federal program boom of the 1960s a huge number of programs that were federal have been transferred to the states. Under President Reagan, for instance, over 500 categorical programs were combined into nine block grants (Hovey 1999, viii). In part, this is why the federal budget deficit shrank in recent decades as both the authority and the financial burdens for major programs were shifted to the states. This shift gave rise to complaints among the states about "unfunded mandates;" Congress required states to provide services without providing the funds to do so. It also partially explains why state budgets became increasingly vulnerable over the same period.

Two of the major devolved programs are Temporary Assistance to Needy Families (TANF) and Medicaid. Each of these deserves its own discussion, although a complete treatment of them is beyond the scope of this project. TANF is the program that replaced Aid to Families with Dependent Children (AFDC) in the welfare reform of 1996. TANF is significant because it is clearly intended to be a counter-cyclical program with expenses low when the economy thrives, but increased expenses when a weak economy leaves families without adequate income. Federal funding for TANF, however, is a block grant payment that is fixed at 1994 expenditure levels and can not vary with economic conditions. Medicaid is significant because it represents an increasing proportion of state expenditures; the rate of spending for Medicaid is expected to grow significantly faster than the rest of state expenditures. This rapid cost increase is due to aging populations and the escalation of health care costs.

I.2b Tax and Expenditure Limitations (TELs)

New Jersey became the first state in the nation to have a TEL, and 26 states now have some form of tax and/or expenditure limitation. TELs are quite popular in the West, where 11 of 13 states have them. TELs are intended to constrain the rate of growth of government spending and are variously based on 1) a fixed percentage of personal income of the state's residents, 2) population growth, 3) inflation, or 4) past spending plus an annual rate of growth. Aside from the population growth-based systems, there is little flexibility in these limitations to allow for change in demand for programs. In addition, states that use a fixed percentage of personal income (e.g., Arizona and Idaho) may have limited ability to respond to new demands in recessionary times; expenses for certain social programs may go up when personal incomes go down. States with high numbers of retirees may face more additional expenses than revenues. Some TELs, such as Washington's Initiative 601 (enacted 1993), limit per capita expenditure

growth to the rate of inflation. Various states, including Oregon and Colorado, require taxpayer rebates if certain tax receipt thresholds are exceeded. In Colorado these rebates totaled more than $3.2 billion between 1997 and 2002 (New, 2002). Further, in order to raise taxes a number of western states have supermajority voting requirements in their legislatures.

I.2c Term Limits

Term limits have become a popular political mechanism in the West. The requirement that an individual can only occupy a political office for a only a few terms is certainly consistent with the region's political ideology; it presumably prevents a relatively small number of career politicians from becoming entrenched in the legislature or the Governor's mansion. Six western states have term limits for legislators, and 10 have term limits for the Governor.

The longest term allowed by any western state is 12 years, although exceptions are possible for legislators who serve in both the House and Senate. Ironically, the latest economic boom lasted 10 years, making it the longest sustained economic expansion since WWII. This means that virtually all western state legislators who were in office during the 1991-92 recession by law no longer hold office. The long expansion of the 1990s lasted longer than a political generation, and there is virtually no institutional memory of how to best weather recessionary budget times. In those states with term limits shorter than 10 years, there is virtually no one in elective office who can offer wisdom and experience in dealing with recession.

Term limits may also shift power to lobbyists, staffers, and consultants—none of whom are directly answerable to the voters. Interestingly, the people with the most direct experience with term limits—the legislators themselves—do not like them.

> Term limits are widely unpopular among those who serve in state legislatures. Overall, 79% of state legislators reject the argument that term limits promote healthy change in the legislature, believing that they don't work as intended. Those serving in states that have term limits in place are about as likely to view them negatively as those in non-term limited states (77% vs. 80). (Pew Center on States 2003, p.2)

I.2d Under-Taxation of the Increasingly Important Service Sector

The composition of the nation's economy has gradually shifted since the 1950s. Manufacturing and agriculture have become smaller portions of the economy, while the service sector became an increasingly larger share. But the states' tax codes have not kept pace; the service sector is not taxed as heavily as more traditional or tangible industries.

The most thorough examinations of the taxation of services have been conducted by the Federation of Tax Administrators, which has identified 164 different services that could be taxed. Nationally, the states tax on average 53 services, slightly less than a third of the total. The average in the West (57 services taxed) mirrors the national average. But the rate of taxation is hugely variable in this region, with the nation's three highest service taxing states: Hawaii (157), New Mexico (152), and Washington (164), and some of the lowest: Alaska (1), California (13), Nevada (11), and Oregon (0).

> Under-taxation of the service sector leads to several problems for the general sales tax. It creates inequities and distorts the otherwise efficient economic choices when purchase of tangible property is taxed and a closely related service is untaxed. For example, most states tax purchases of tuxedos, but tuxedo rental (the related service) is frequently not taxed. The under-taxation of services, in light of

growth of the service sector, also causes the sales tax base to shrink over time. This shrinking tax base must have played an important role in the rise of general sales tax rates over the past twenty years. (Kenyon 1999, p. 89-90)

I.3 Recent Events

I.3a Aftermath of 9/11

The terrorist attacks of September 11, 2001 had more impacts on our country than we can list. The timing of the attacks coincided with the end of the long economic boom of the 1990s to create an economic "double whammy" (Figure 1). Two outcomes that directly affected state tax revenues were the stock market decline and the reduction in rate of capital expenditures by business. Stock market impacts were felt primarily through capital gains provisions of the personal income tax, while the slowdown in business activity was reflected in sales tax receipts. Two western industries hard hit by post -9/11 concerns were tourism and aerospace, both of which were hurt by reduced desire to fly.

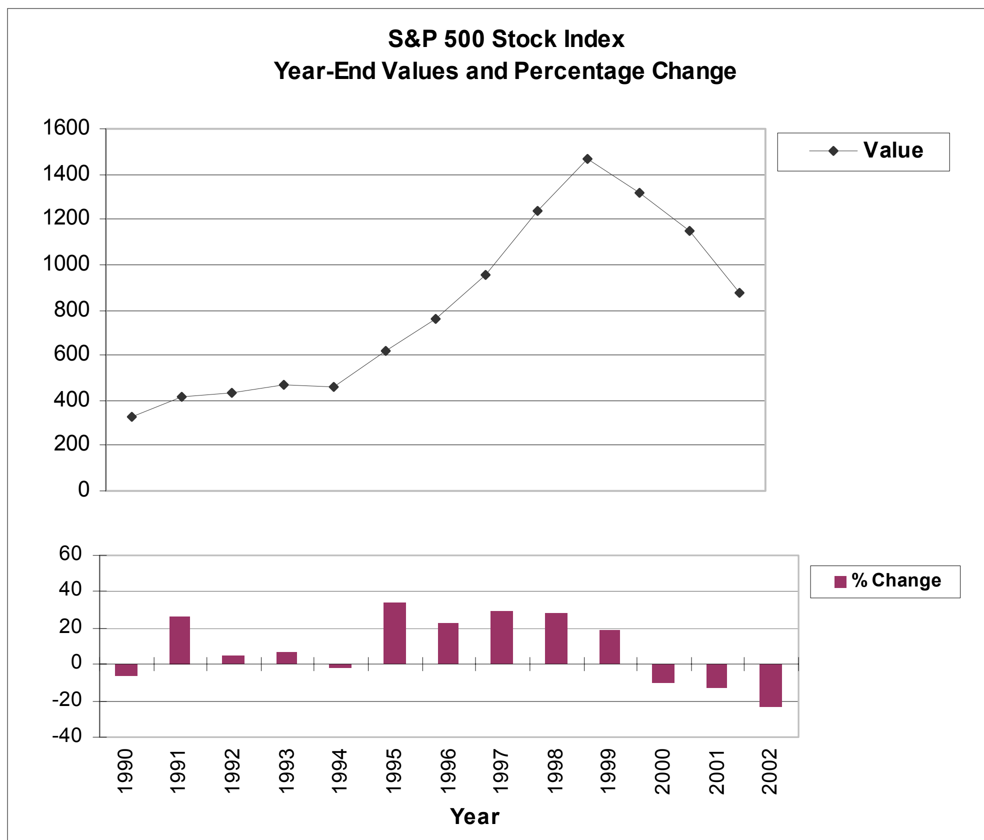

Figure 1. S&P 500 Stock Index Values and Percentage Change. Source: Standard and Poors.

I.3b Recession

The recent recession was both mild and brief. Based on Bureau of Economic Analysis data, the economy stalled for much of 2001, as measured by gross domestic product (Figure 2). Economic activity fell by 0.6% (annual rate, seasonally adjusted) in the first quarter of 2001, by 1.6% in the second quarter, and by 0.3% in the third quarter before resuming its growth.

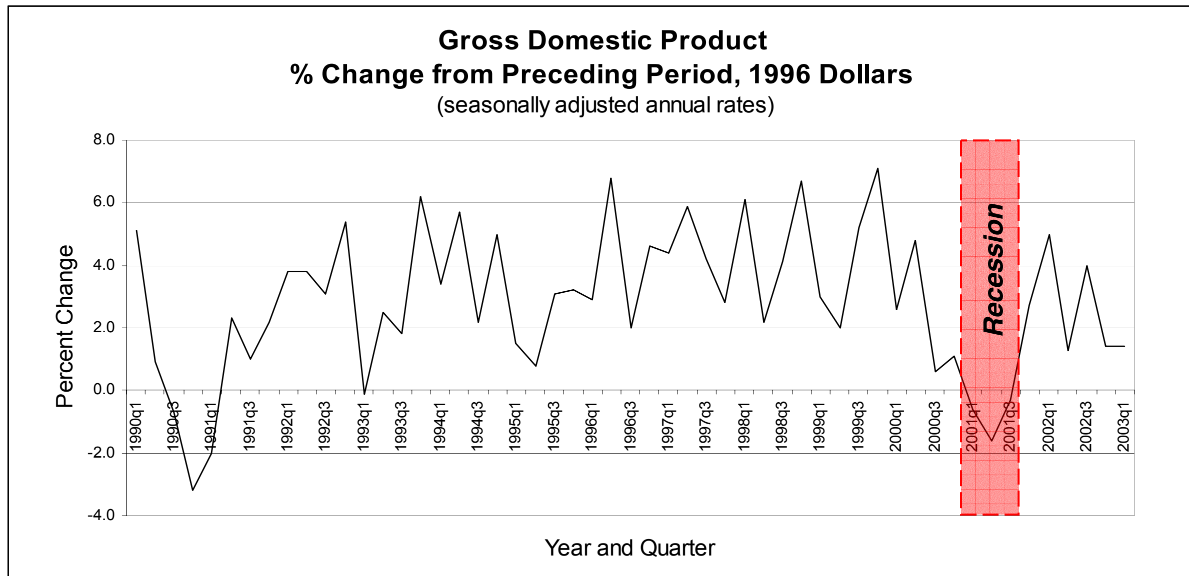

Figure 2. Gross Domestic Product % Change from Preceding Period, 1996 dollars. (Shaded area indicates Quarters 1-3 of 2001.) Source: U.S. Bureau of Economic Affairs

I.4 Revenue & Expenditure Trends

In the last 10 years there have been consistent trends in state budgets that have both led up to the fiscal crisis but also allow us to see how quickly things began to change in 2000-01. A review of western data shows that while these trends do represent consistent patterns across all western states, the data available on the CD-ROM released by the WRDC as part of this project adds another level of state-specific detail.

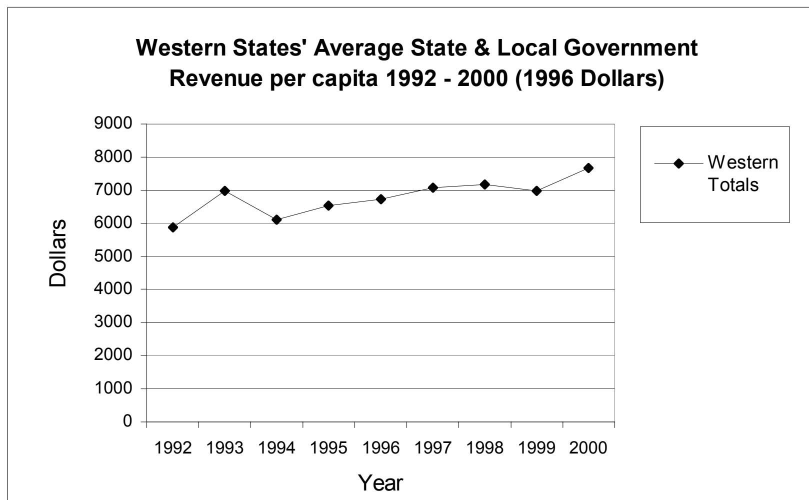

Figure 3. Western States' Average State and Local Government Revenue per capita 1992-2000 (1996 Dollars). Source: U.S. Census Bureau

As noted elsewhere in this report, the 1990s were a time of fiscal prosperity for states, and revenue trends reflect it. Revenues (Figure 3) and expenditures (Figure 4) for state and local governments rose steadily during these years. The expenditure increase is particularly noteworthy, because while prosperity of this period reduced demand on social services and other need-based pro-

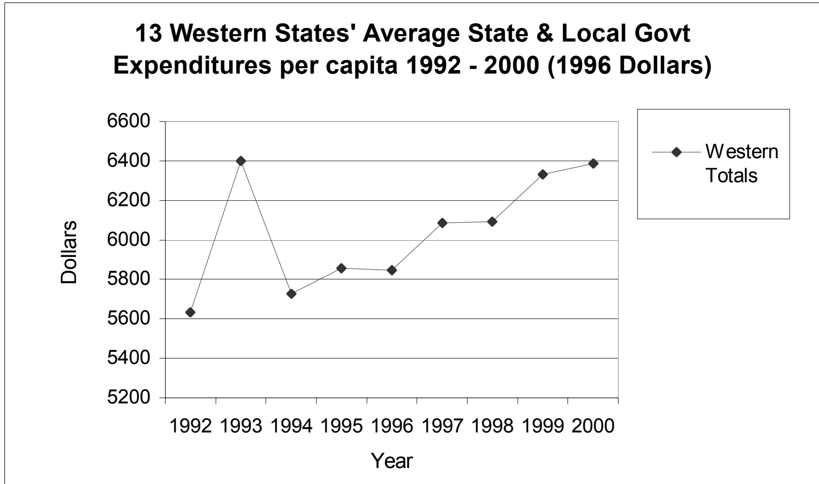

Figure 4. Western States' Average State & Local Government Expenditures per capita 1992-2000 (1996 Dollars). Source: U.S. Census Bureau

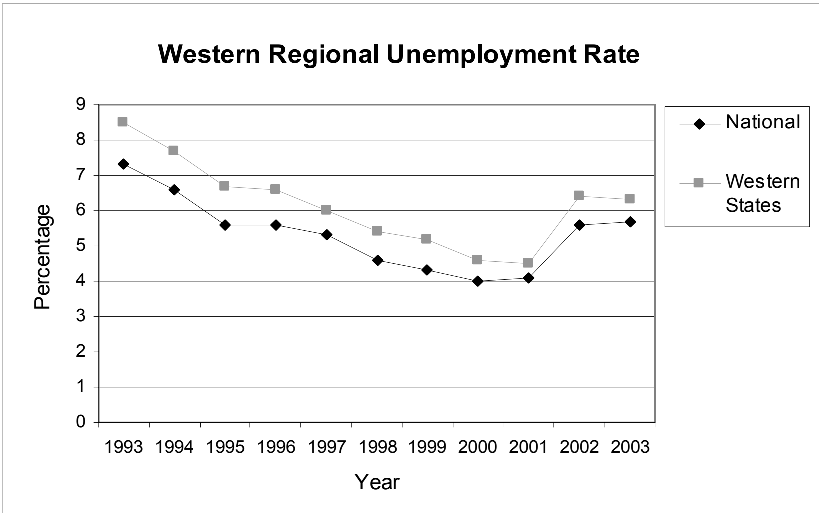

Figure 5. Percentage of labor Force Unemployed 1992-2002. Source: U.S. Bureau of Labor Statistics.

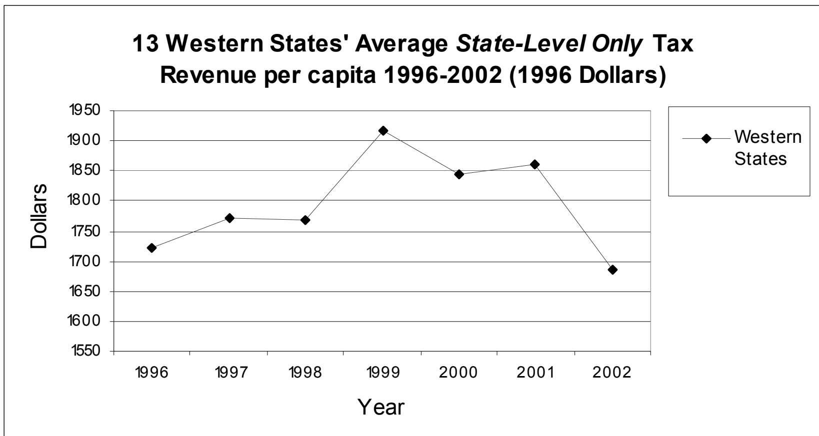

Figure 6. 13 Western States' Average State-Level Only Tax Revenue per capita 1996-2002 (1996 dollars) Source: U.S. Census Bureau

grams, devolution of these programs to the states still resulted in a net increase in expenditures. In addition, fiscal prosperity allowed states to reduce (or at least not increase) tax rates while still expanding programs.

Unemployment data charted in Figure 5 shows that the economy began to turn in 2000. Unfortunately the best available data for a full picture of the economy, namely data sets that include both state-level and local-level revenues and expenditures, are only available through 2000.

Figures 6 and 7 use state-level only expenditure and revenue data, but do cover the periods before and after the beginning of the fiscal crisis. The tax revenue chart (Figure 6) uses per capita data, which adjusts for the rapid population growth that states such as Nevada were experiencing.

These charts tell an interesting story—but they mask important changes that occurred in response to budget woes. Tax collections decreased as a direct result of economic events, as would be expected in most states where income tax and other revenue streams responded to the economic downturn.

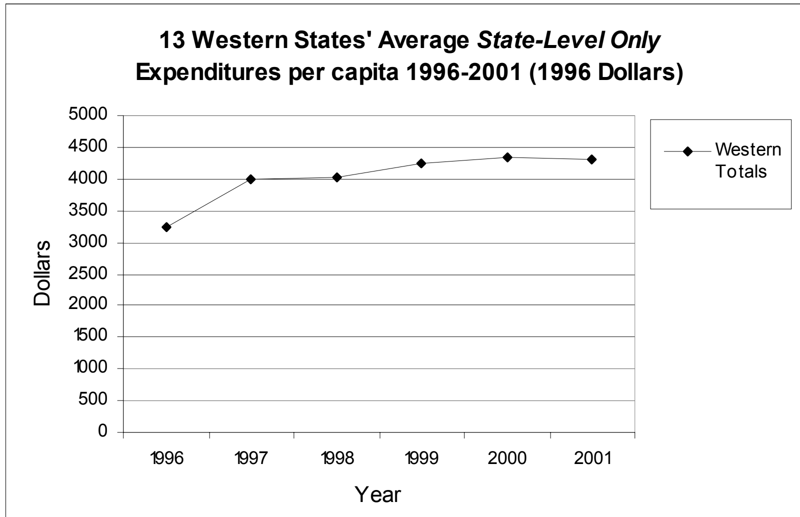

Figure 7. 13 Western States' Average State-Level Only Expenditures per capita 1996-2001 (1996 Dollars). Source: U.S. Census Bureau

Expenditures continued an upward trend, and herein is the core of the crisis: revenues going down and expenditures going up. The fiscal crisis placed a higher demand on social services, and expenditures for these programs increased. This increase is not readily apparent in the chart because at the same time that these programs demanded more resources, large cuts in areas such as higher education were taking place (see Part II, The Coping Strategies).

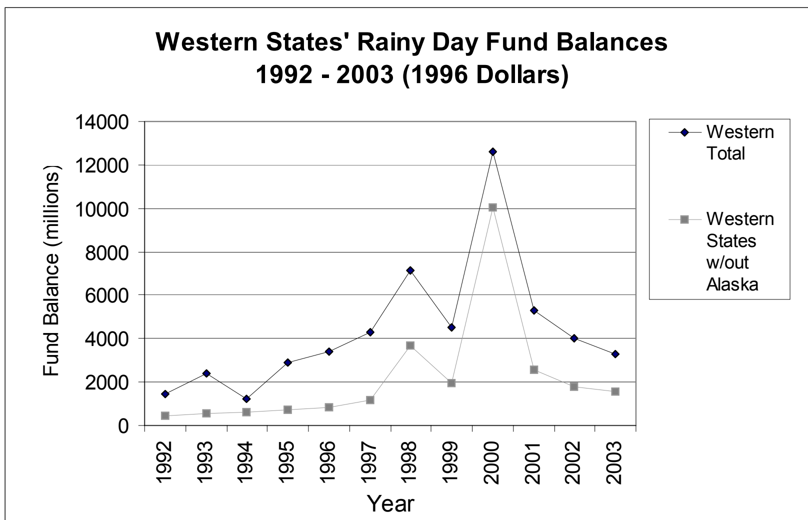

Figure 8. Western States' Rainy Day Fund Balances 1992-2003 (1996 dollars). Source: National Association of State Budget Officers

The last piece of the puzzle for understanding these trends clarifies how states were able to continue the upward expenditure trend despite the loss of revenue–they relied heavily on rainy day funds to make up the difference. Figure 8 shows the western state's rainy day fund balances, and reveals that states relied heavily on them to balance their budgets when revenues began to fall. The energy-based endowment in Alaska represents roughly half of the region's total reserves. Most states had less than $100 million in reserves in FY2002. While California's $1.4 billion reserve might seem large, their deficit is over $30 billion.

I.5 Structural Deficits

There is evidence that many state budgets have developed "structural deficits;" their projected revenues are less than their projected expenditure needs, based on current commitments and full employment economic assumptions. It is very similar to a family whose monthly take-home pay is less than their ongoing expenses (rent, car payments, utilities, food, insurance, etc.). Through the late 1990s, states were able to balance their budgets in spite of these structural deficits through various one-time or unsustainable revenue sources (capital gains receipts generated by the stock market bubble, lottery proceeds, tobacco settlement funds, etc.).

But accounting tricks and short term fixes work no better for state governments than they do for families. Oregon offers a case in point (Figure 9). A detailed examination of Oregon's 1997 budget situation revealed that it had a persistent structural deficit (Weber and Fisher, 1997). While the 1995-97 biennial current law expenditure estimate was $8.2 billion, the available budget resources were $7.3 billion, leaving a $0.9 billion gap. Oregon balanced its budget through gambling revenues (lottery and video poker) and programmatic cuts.

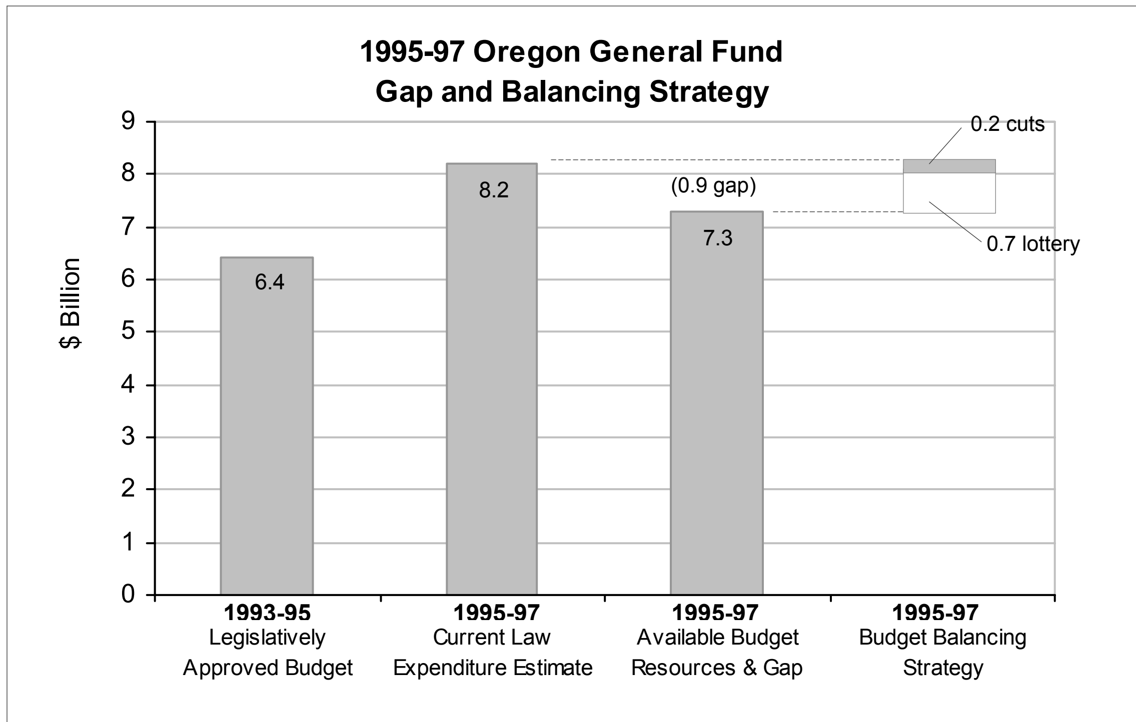

Figure 9. 1995-97 Oregon General Fund Gap and Balancing Strategy. Source: Weber and Fisher, 1997.

Structural deficit analyses of all 50 states conducted in the late 1990s (Hovey 1998, 1999b) estimated that states were going to experience a 3.8% average budget shortfall over an 8-year projection period. Seven of the 10 worst deficits were expected to be among western states, which in general were projected to experience substantial failures of their tax systems to keep pace with their spending needs. A subsequent analysis (Boyd 2002) estimated that deficits would be slightly smaller (3.4 % average, nationwide), and that the western states would no longer be the worst off. Table 3 shows a comparison of the data from Hovey and Boyd.

STRUCTURAL DEFICIT ESTIMATES				
STATE	Hovey (1998, 1999b)		Boyd (2002)	
	Deficit*	National Rank**	Deficit*	National Rank**
Alaska	16.4	2	2.4	28
Arizona	10.5	7	0.7	38
California	2.8	28	2.5	27
Colorado	7.0	13	2.3	29
Hawaii	15.1	3	3.6	19
Idaho	13.2	4	5.0	12
Montana	5.7	17	0.4	39
Nevada	18.3	1	9.2	2
New Mexico	12.0	5	3.6	18
Oregon	0.1	40	1.3	37
Utah	4.0	23	0.8	37
Washington	6.7	15	4.9	13
Wyoming	10.6	6	7.8	6
**Deficit =*	*Percentage state and local revenue gap over an 8 year projection*			
***National Rank =*	*1 indicates largest deficit, 50 indicates largest surplus*			

Table 3. Structural Deficit Estimates. Comparison of data from Hovey (1998, 1999b) and Boyd (2002)

A subsequent analysis (Boyd 2002) estimated that deficits would be slightly smaller (3.4 % average, nationwide), and that the western states would no longer be the worst off (Table 4). Structural deficit estimates depend heavily upon expenditure and revenue estimates, which in turn depend on a framework of demographic and economic assumptions. Recognizing the degree to which these assumptions affect results, Boyd conducted a number of additional estimates based on different assumptions. None of the different assumptions resulted in an average surplus for the states, nor did they significantly alter the number of states with deficits.

EFFECT OF ASSUMPTIONS OF STRUCTURAL DEFICIT ESTIMATES		
Scenario	Average Deficit	# States with Deficit
Increase spending per K-12 student by 1.5%	6.2	49
Increase spending per K-12 and higher education student by 1%	6.0	49
Stem sales tax losses due to Internet sales	2.4	39
Slow rate of growth of Medicaid spending by 1%	2.1	37

Table 4. Effect of Assumptions of Structural Deficit Estimates (Boyd, 2002)

The difference between the Hovey and Boyd results is largely because Boyd assumed personal incomes would grow more rapidly than Hovey did. Alaska, Nevada, Arizona, Hawaii, and New Mexico are the five states with the largest difference between the Hovey and Boyd estimates.

Sidebar

A budget scenario developed by a widely published public finance professor in 1999 comes eerily close to describing the history of state budgets in recent years:

> *The long awaited recession occurs and is more protracted than expected. Welfare caseloads mushroom, and states feel the pinch of the block grant aid from the federal government instituted under TANF (Temporary Assistance for Needy Families. At the same time, the baby boomlet fuels taxpayer demands for school expenditures, rates. States find their tax revenues to be insufficient, and becoming more so, particularly due to the shrinking bases of the general sales and corporate income tax. Political resistance to enactment of new taxes or higher tax rates remains strong. State Government revenue systems are thrown into disarray and revenues fall drastically short of expenditure needs. States enact massive service cuts and reach into their grab bag of "gimmicks." The state-local fiscal crisis at the turn of the century makes the fiscal crisis of the early 1990s pale in comparison. (Kenyon, 1999, 90-91)*

Part II: The Coping Strategies

So how are the western states balancing their books? Much of what is discussed in this section is drawn from Appendix Table 2: *Coping Strategies*. The focus is on state government responses to revenue shortfalls from 2001-2003.

II.1 Expenditure Strategies

States have pursued a tremendous variety of strategies to reduce expenses in order to balance their budgets.

II.1a Personnel Expenses

It takes people to run programs, and personnel costs are the predominant expense for state and local governments. State governments have employed a wide range of hiring and salary freezes, benefits reductions, furloughs, and direct layoffs. Not surprisingly, the states with more extensive budget woes (California, Oregon, and Colorado among them) are responding with more sweeping changes.

II.1b Access to Services

States are restricting access to programs as well as limiting the services that programs offer. Reduced services have been experienced in virtually every category of state service: law enforcement and corrections, health services, school programs and school closures, etc.

TANF-related programs have experienced widespread cuts, in part because the unspent TANF funds from the late 1990s have been exhausted but also because caseloads in many states began

to increase in 2001-02 (Richer, Rahmanou and Greenberg 2003). States have reduced access by lowering the eligibility limit (New Mexico), reducing cash assistance payments (Montana and Oregon), and reducing transportation assistance (Arizona and Montana). Several states have reduced their support for welfare-to-work programs (Arizona, California, Montana, and Oregon), and others have modified their child care programs (Alaska, Arizona, California, Idaho, Montana, New Mexico, Oregon, and Washington). In Colorado, counties have the discretion to determine child care policies, and many of these same cuts have been playing out on a county-by-county basis (Parrott and Wu, 2003).

II.2 Revenue Strategies

II.2a Rainy-Day Funds and One Time Money

As would seem appropriate, the various emergency and budget stabilization funds were among the first places legislatures turned for budgetary relief. Nationally, these funds had grown from roughly $0.7 billion in the 1992 recession to a peak of $10.5 billion in early 2000, only to fall to $5.0 billion by mid 2002. The pattern in the West is much the same, with only the Arizona budget stabilization fund and Alaska's energy-based trust fund remaining significant.

II.2b Minor Taxes and Fees

Legislators have relied on increasing specific taxes and fees to address budget issues.

> In general, state legislators are only willing to consider the least painful kinds of tax increases to balance their state budget. The most popular options are raising "sin" taxes on alcohol and tobacco (71%) and increasing tolls or user fees (66%). (Pew Center on the States, 2003, p.2)

II.2c Major Taxes

Few politicians in western states have been willing to propose raising the major taxes (income, property or sales). An exception is Idaho, where the Governor proposed a 0.125% increase in the sales tax rate. This reluctance mirrors national sentiment among legislators whose opinions were recently surveyed.

> Various broad based tax hikes are found acceptable by less than half of state legislators, including raising state taxes on gasoline (43%) higher state income taxes (40%) and increasing state sales taxes (39%). (Pew Center, 2003, p.2)

II.2d Fees

Fees are charges for specific services, and the list of fees charged by state and local governments in the West runs the gamut from port fees to document recording fees to inspection fees. One of the most significant fees, or charges as they are known in some states, is tuition for higher education. Support for higher education in western states dropped through much of the 1990s, to the extent that some university presidents now prefer to call their institutions "state assisted." There was a significant tuition increase in the early 1990s, and that pattern has been repeated in recent years.

> Higher education has been the "cash cow" of state budgets, with its share of the budget falling from 13.9 % in 1990 to 11.7% in 1998. Appropriations of tax dollars for higher education operating expenses were virtually unchanged during the state fiscal crises of 1990 to 1993, while tuition rose sharply. (Gold and Wallin 1999, p. 65)

Since 1990, many states have seen double-digit increases in tuition at the 4-year colleges and universities. While this might normally be offset by financial aid, those funds have undergone double-digit decreases, jeopardizing affordability, according to some analysts (Trombley, 2003). In addition, tuition at 2-year schools is rising as fast—or faster—than at 4-year schools, reducing their ability to serve as entry-level portals into higher education.

II.2e Expanded Borrowing

State and local governments have done what many families do to meet expenses—they borrow money. Total state and local bond offerings have gone up substantially in recent years, from $165 billion in 1994 to $360 billion in 2002 (nationally). Comparing the first six months of 2003 to the same period in 2002, debt offerings in the West are up 22% overall, led by New Mexico (up 83%), Oregon (up 74%) and California (up 62%). (Thomson Financial, 2003)

This increase in state and local debt may not be solely due to financial stress; it may also be a response to the gradually decreasing interest rates in recent year. State and local governments are taking advantage of low interest rates just as many families are doing to refinance their mortgages.

Editorial by Steven Daniels

(These opinions are his alone.)

This report began by posing the question "How can a brief 1% recession cause a protracted 10+% budget shortfall?" An answer to that question becomes apparent when we put together a number of policy puzzle pieces.

First, this budget crisis resulted from forces that had been building up for decades; the various balanced budget requirements, term limits, and unbalanced tax structures set the stage. Since all western states have balanced budget requirements, their state budgets are closely linked to economic fluctuations. Term limits, also popular in the West, mean that very few legislators were in office during the last recession (1990-91). Finally, about half of the western states have tax structures that lack at least one of the major taxes (income, property or sales taxes). This makes their revenues more variable than they would be with more diversification.

Second, over the past three decades a number of trends have made western state budgets precarious. These include devolution/unfunded mandates, tax and expenditure limitations, rapid population growth, and an erosion of the tax base due to an economic shift to service and Internet-based businesses. Finally, the 9/11 terrorist attacks and the collapse of the dot-com speculative economic bubble led to a recession that began in early 2001. This convergence of long-term trends and short-term events is why some analysts have referred to the past few years as "The Perfect Deficit," which likens it to a "Perfect Storm."

Third, the recent downturn showed how complacent we had become. The states had enjoyed the best of times through much of the 1990s—a stable economy combined with increasing asset values kept tax receipts growing. This meant that legislators could cut tax rates and increase spending at the same time. It doesn't get much better than that for elected officials. But over that period, the underlying structures of state budgets were weakening. Various citizen-enacted initiatives locked state budgets into formulas that implicitly assumed the good times would never end. State budgets became increasingly dependent on non-core taxes. Support for higher education eroded as tuition rose and financial aid fell, but demographics kept classrooms full. The ability of state fiscal systems to weather bad times eroded without our noticing. Much of this gradual erosion is captured in the concept of structural deficits. It appears that like states elsewhere in the country, western states do not have basic tax systems sufficient to meet their on-going obligations.

Finally, western state legislatures appear to be doing everything they can to balance budgets without raising the major taxes. Rainy day funds have been drained and minor taxes and charges of all stripes have been increased. But trying to balance a state budget by raising park entrance fees and beer taxes, or pre-spending tobacco settlement payments, does little to address the fundamental fiscal situation. This approach is as questionable as trying to manage family debt by switching credit card companies.

What can be done about this situation? Analysis of the finances of western states reveals that perhaps nothing less than a fundamental re-founding of the public sector role can bring budgets back in line. The expectation we have of government in terms of program provision does not seem to be well linked to a willingness to be taxed at a level sufficient to pay it. Such a fundamental re-founding does not necessarily mean that taxes will go up; it may well mean that

taxes remain much the same, but services would need to be significantly restructured. Either way, the kinds of "Band-Aid" fiscal fixes that seem to predominate in the West do not go nearly far enough.

A thorough examination of the roles of state and local governments in the West would test our collective capacity for civic discourse. Few politicians are willing to broach the topic of broad-based tax increases. In recent years, such a statement would be tantamount to saying "I retire." The spate of tax and expenditure limitation initiatives in the region has no doubt had a chilling effect on the desire of politicians to be even the slightest bit pro-tax. This would seem to force our discussion to the expenditure side of the situation. But each program exists because it has constituents, and constituents rally at the State House if cuts appear likely. Political scientists have long recognized that programs are far more difficult to eliminate than create. So the options before our elected officials are tremendously constrained; politicians face a political lynching if they touch either side of the budget.

We are simultaneously recipients of programs and the taxpayer-funders of them. A fundamental reconsideration of what we expect from government, and how we intend to pay for it, would be a discussion so important that we could not dare leave it solely to the policy elite. In a recent Pew Center survey of state legislators, 99% said that voters in their districts were the most important influence on their decisions. But if those voters are silent on an issue, whose voice takes their place? In the same survey, the second and third most commonly cited influences were party leaders (79%) and lobbyists (77%). Left to their own devices, lobbyists, legislators, and their political leaders could no doubt craft budgets that conform to the peculiar logic of statehouse politics. But it is unclear if it would also meet the broader needs in the state.

In order to have a voice in the process, the citizenry would need to invest the time and energy needed to become adequately versed in these issues. It may also be the case that the traditional initiative process is not nearly deliberative enough to suffice. Certainly there is evidence among western states that citizens are willing to pass tax limitations and initiatives that raise expenditures in the same election. That is a move in the wrong direction. Progress on this issue will require a citizenry capable of informed judgments, not merely opinions. The region will also need elected leaders who can truly lead. Leadership sometimes demands that one take unpopular stands. It may well be that structural deficits are an unintended consequence of political systems that penalize courage. If you can't say no to the tax opponents, and you can't say no to the program proponents, eventually the taxes don't cover the commitments.

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Appendices

	Table Title	File Name	File Size	Page Format
Appendix Table 1	Antecedent Conditions	AntecedentConditions.pdf	41 KB	Legal Size
Appendix Table 2	Coping Strategies (Full Sheet)*	CopingStrategiesFull.pdf	14 KB	Legal Size
Supplemental Table A	Coping Strategies (Part 1 of 2)	CopingStrategiesA.pdf	11 KB	Letter Size
Supplemental Table B	Coping Strategies (Part 2 of 2)	CopingStrategiesB.pdf	11 KB	Letter SIze
Data Files**	Fiscal Crisis in the West	(Excel files)	-	CD-ROM

* Appendix Table 2, *Coping Strategies*, is a table that does not print conveniently. If printed on a single sheet of legal sized paper, the font size becomes illegibly small. The most useful format we have found is to print and join Supplemental Tables A and B. (Both are formatted to be printed on letter sized paper.)

** The data files used to create the charts and figures in this document are available on CD-ROM for $10, shipping and handling included. Contact the Western Rural Development Center, wrdc@ext.usu.edu or 435/797-9732.

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