

## Trends in Federalism: Is Fiscal Federalism Fizzling?

By John Kincaid

*The states' current fiscal crisis is due not only to the country's economic downturn but also to changes in fiscal federalism that have exposed state fiscal systems to the impacts of federal policy-making, economic developments and demographic changes to greater degrees than in the past. Essentially, the states face growing long-term contradictions between escalating spending pressures and eroding tax bases over which states have only limited control. Short-term crisis-management actions, such as cutting spending, increasing taxes, accelerating tax collections, delaying bill payments, expanding gambling and using up reserves, are damaging, stopgap tactics. Long-term solutions will require more fundamental remedial fiscal reform by both the federal government and the states.*

The states' current fiscal crisis, which began in 2000 and will continue into 2004 (and beyond, for some states), is cyclical. State revenues and budgets will grow again, following improvements in the nation's economy. However, the severity of the crisis raises concerns about fiscal federalism today. The National Governors Association reported that the states' fiscal crisis is their worst such crisis since the 1941-1945 World War II era.<sup>1</sup> Yet the economic downturn that produced the crisis was the least severe since that era, and the boom that preceded the crisis was the greatest of the postwar era.

The current crisis, then, is somewhat different from past crises. A key difference is that state budgets are more deeply affected by federally induced costs during today's era of coercive or regulatory federalism. In turn, the related shift of federal policy-making from places to persons<sup>2</sup> has pushed state budgets away from programs tied to a particular place, such as economic development and transportation programs, toward programs aimed at persons, such as Medicaid. These "person" programs have significant nondiscretionary cost pressures built into them by federal policy-making, demographic developments and economic cycles. Additionally, they are extraordinarily difficult and painful to cut.

### The Fiscal Crisis

The fiscal crisis arrived quickly and unexpectedly for most state officials. In January 2001, the National Conference of State Legislatures reported that the states enjoyed "excellent" fiscal health,<sup>3</sup> even though state revenues had begun to decline in the third quarter of CY 2000. Eight months later, the NCSL announced that most states faced budget shortfalls. The organization reported an expected \$49.1 billion shortfall for FY 2002 and anticipated shortfalls of \$58

billion for FY 2003 and \$50 billion for FY 2004 unless states adjusted their FY 2003 and FY 2004 budgets. In California, for example, state revenues plunged from a 23 percent increase in FY 2000 to a 14 percent decline in FY 2002. Gov. Gray Davis forecasted a \$34.8 billion budget gap for FY 2003 — a gap larger than the budget of every other state except New York (which faced a \$10 billion shortfall in 2002). It is "a hole so deep," said California's Assembly Speaker Herb J. Wesson, "that even if we fired every single person on the state payroll ... we would still be more than \$6 billion short."<sup>4</sup> Nationwide, state revenue collections were 6.3 percent lower in FY 2002 than in FY 2001, although spending grew by 1.3 percent.

Local governments also face crises. In FY 2002, Boston and Pittsburgh, for example, each faced "budget gaps of more than \$60 million."<sup>5</sup> New York City faced a \$6 billion gap. Most counties, municipalities, townships and school districts across the country faced shortfalls induced by falling revenues and/or declining state aid.

To close the gaps, many states increased taxes by a combined \$9.1 billion in CY 2002, thus ending eight years of tax-cutting that began in 1994. They enacted about \$2 billion in other revenue enhancements (e.g., tuition increases for state universities), while also reducing spending and expending reserves. Nineteen states increased tobacco taxes in 2002 (ranging from a 7-cents-per-pack increase in Tennessee to a 70-cents-per-pack increase in New Jersey). This most prevalent type of increase was expected to generate about \$2.9 billion in new revenue for FY 2003. Many state and local governments have also increased taxes on land and wireless telephone services; such taxes account for 19.6 percent of the average monthly bill in California, 17.8 percent in Florida, and 17.1 per-

cent in Virginia.<sup>6</sup>

About 13 states raised fees, mostly for motor vehicles; six enacted tax-amnesties; and some accelerated tax collections. States also used tobacco-settlement money to close budget gaps, and about a dozen states in 2002 sold billions in future tobacco payments to bondholders at below face value in order to obtain cash. Wisconsin, for instance, sold \$6 billion in future tobacco revenues for \$1.3 billion. Proposals to expand gambling and introduce new gambling, especially lotteries and slot machines, were also floated in many states.

Overall, states reduced spending growth from 8.3 percent in FY 2001 to 1.3 percent in FY 2002, but reserves were expected to decline to \$13.2 billion in FY 2003, compared to \$31.5 billion in FY 2001. The political impact of the crisis was evident in the 2000 elections. The incumbent party was ousted in 16 of the 20 open-seat gubernatorial contests, and newcomers captured 24 percent of the 6,214 state legislative seats up for election, the biggest legislative turnover in 40 years.<sup>7</sup>

The crisis had roared into the states after nearly a decade of fiscal plenty following the 1990-1991 recession. States saw seemingly ever-increasing revenues from capital-gains, dividend, earned-income and other taxes boosted by a stock-market boom, low unemployment, high overtime pay and robust consumer spending. Welfare reform in 1996 kept federal funding high for Temporary Assistance for Needy Families, and the tobacco settlement provided extra revenue. As a result, states cut taxes and funded more programs.

### The Federal Role in the Crisis

In December 2002, President George Bush invited the country's two dozen new governors to the White House for discussions. Many declined the invitation because they were busy preparing to face their upcoming fiscal challenges. Yet, most state officials saw the federal government as being partly, even substantially, responsible for the states' crisis, for several reasons.

First, they viewed unfunded federal promises and mandates in health (especially Medicaid), education, welfare, homeland security and election reform as significant strains on state budgets. For example, the federal government had not provided the \$3.5 billion promised to help train and equip state and local police, firefighters and rescue personnel for terrorism. The U.S. Conference of Mayors reported that cities were spending \$2.6 billion of their own money on homeland security. Similarly, the No Child Left Behind Act of 2001 imposes costs on the states for

student testing, data collection, and higher teacher and curriculum standards for public schools; yet, none of the promised \$28 billion for student testing and teacher training came through from the federal government. The Help America Vote Act of 2002 requires states, among other things, to supply voting equipment guaranteeing minimum errors, maintain voter-registration rolls, establish voter-identification rules, assure voting access for persons with disabilities, and create procedures to resolve voter complaints; however, Congress did not appropriate the promised money.

In addition to the budgetary strain from unfunded mandates, some state officials argue that federal tax reductions are reducing income- and estate-tax revenues for the many states whose tax codes are coupled to the federal code. Moreover, they claim, federal curtailments of state tax bases, especially the Internet Tax Freedom Act of 2001, are also to blame.

The governors have sought aid from the federal government, especially to help fund Medicaid, but few state officials have called for comprehensive fiscal relief. Governors requested, but did not receive in 2002 a one-shot subsidy of about \$12 billion for Medicaid and social services, although the U.S. Senate approved such aid in July 2002.

Economist Felix Rohatyn proposed federal revenue-sharing<sup>8</sup> to help the states, as did Alice Rivlin and others. However, R. Glenn Hubbard, chairman of the President's Council of Economic Advisers, said, "As to ... whether federal taxpayers should be on the hook for states' budget problems, I'm skeptical."<sup>9</sup> Even U.S. Sen. George Voinovich (R-Ohio), ordinarily sympathetic to the states, said, "Every time something goes wrong, everybody comes to Washington. Nobody likes to increase taxes, so they want us to borrow the money."<sup>10</sup> Already, the federal government provides about 25 percent of the states' general-fund revenues through its approximately 608 categorical grants and 17 block grants.

### The States' Role in the Crisis

An immediate factor in the states' crisis is the balanced budget requirements present in 49 of the 50 states (Vermont being the exception). Unlike the federal government, the states cannot engage in deficit spending; consequently, spending reductions and tax increases enacted to balance state budgets will create fiscal and service pain for citizens and also counteract federal stimulus policies. State recessionary and deflationary actions could "shave as much as a half-point from the economy's growth so that 'overall fiscal policy will be no more than neutral'" in 2003.<sup>11</sup>

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These responses to the crisis indicate, as well, that many state officials regarded the increased revenues of the boom years as permanent rather than cyclical. Additionally, many new governors discovered after their election that their state's fiscal crisis was much worse than announced by the outgoing administration. For example, Gov. Mark Warner said he took office in 2001 believing that Virginia's budget shortfall was \$750 million; actually, it was \$3 billion more.<sup>12</sup>

Many commentators blamed the crisis on excessive state spending. Cait Murphy, senior editor of *Fortune* magazine, opined, "it's a rare politician who doesn't adore spending other people's money — and governors in both parties spent like drunken sailors during the late '90s."<sup>13</sup> The number of state employees in California, for instance, grew from 282,000 in 1999 to 326,000 by 2001, with most of this growth being in prisons and state universities.<sup>14</sup> Between 1994 and 2001, moreover, some 43 states enacted tax cuts amounting to about \$40 billion in foregone revenue.<sup>15</sup> The states, therefore, precipitate fiscal crises by overspending and undertaxing during booms and underspending and overtaxing during busts. The only solution, editorialized the *Wall Street Journal*, "is to straightjacket the politicians before they can spend again."<sup>16</sup> The solution, however, is neither so easy nor so draconian.

### Underlying Causes of the States' Fiscal Crisis

Although states increased spending and decreased taxes during the 1990s, their spending was not necessarily profligate. According to U.S. Bureau of the Census data, real general-government spending during most of the boom years (1992-1999) actually slowed to 3.4 percent per year, compared to 4.4 percent per year between 1980 and 1992. Only near the end of the boom, between 1999 and 2001, did spending increase to about 5 percent per year.<sup>17</sup> States also cut taxes, but revenues still grew at an average annual rate of 4 percent between 1992 and 1999. State own-source spending increased from 8 percent of personal income to 8.4 percent between 1989 and 1999, "the lowest level of growth in any of the last five decades since 1949."<sup>18</sup> Local own-source spending increased from 6.5 percent to 6.6 percent between 1989 and 1999. Total federal-state-local spending dropped from 30.3 percent of Gross Domestic Product to 28.1 percent by 1999, although the state and local share of GDP increased from 9.1 percent in 1989 to 9.4 percent in 1999.

To the extent that states increased spending during the boom, their key expenditure objects were

health care (mainly Medicaid) and primary and secondary (K-12) education.

Medicaid, enacted in 1965 to provide public health insurance for low-income people, covers more than 40 million recipients, or about one in seven Americans. The federal government funds states for 50 percent to 76.8 percent of Medicaid's costs, depending on each state's per capita income. Total, real Medicaid costs increased from \$135 billion to \$209 billion between FYs 1992 and 2001, about 5.1 percent per year, totaling 56 percent. Nominal Medicaid spending rose by about 11 percent in 2001 and by 13.4 percent in 2002. Today, Medicaid is, on average, the second largest component of state budgets (after K-12 education), accounting for about 20 percent of state budgets, compared to 10 percent 20 years ago and an expected 25 percent by 2005. Since the early 1990s, Medicaid costs have been growing faster than the Consumer Price Index, the CPI's medical care index, and general state expenditures.

Costs are being driven up by health-care inflation, rising caseloads, increasing prescription-drug costs, and higher premiums for private health insurance (which have increased the number of uninsured Americans). The number of children and adults covered by Medicaid increased significantly, due largely to federal and state expansions of eligibility, especially for pregnant women and children and for families otherwise not receiving public welfare. Although the number of elderly recipients did not increase significantly, their costs did so, especially for nursing homes and prescription drugs. The number of disabled recipients and their costs both increased during the 1990s. The elderly and disabled constitute less than 30 percent of Medicaid recipients, but more than 70 percent of Medicaid spending. Indeed, Medicaid pays for about 46 percent of all nursing-home care.<sup>19</sup> Medicaid was the largest category of increased state spending during the 1990s. Increases occurred mostly in the early 1990s, but costs picked up again by 2000. Consequently, facing fiscal crises, 45 states acted to constrain growth in Medicaid spending in FY 2002.

K-12 education accounted for the second largest increase in state spending. Expenditures grew by about 32 percent between 1992 and 1999. Even so, state spending for K-12 education increased from only 2.1 percent of personal income in 1989 to 2.3 percent in 2000.<sup>20</sup> K-12 spending increased for the following reasons:

- School enrollment rose by 9.4 percent between 1992 and 1999;
- The number of teachers grew by 18.2 percent (due to increased enrollments, demands for smaller class

sizes, and needs for more special education), and the employment cost index for schools increased by 45.5 percent between 1989 and 1999 (due partly to increased teacher salaries);

- The number of special-education students increased by about 1.5 million from 11.8 percent of all students in 1993 to 13 percent by 1999;
- States hiked capital spending for school construction and reconstruction.

All other spending categories grew modestly (e.g., corrections), remained flat, or declined during the roaring 1990s.

Whatever fat accumulated in state budgets during the boom was lean compared to expenditure increases for human services subject to only limited state control. This is a salient characteristic of the current fiscal crisis. State budgets are tied tightly to federal policy-making, especially through the intergovernmental Medicaid program, which accounts for more than 42 percent of all federal aid to states and localities. The shift in federal policy-making from places to persons since the mid-1970s, which is reflected in the fact that 64 percent of all federal aid is now dedicated for payments to individuals, has driven state budgets in the same direction. Overall, the states' human-services programs are affected only marginally by state policy-making; they are affected more substantially by federal policy-making (and national interest-groups behind that policy-making), demographics and economics. Morally and politically, moreover, they are difficult to cut, especially during economic downturns when human-services demands increase. Cutting spending for highways inconveniences drivers, but cutting spending for nursing-home care hurts people.

### The Federal Remedial Responsibility

The federal government, therefore, has some remedial responsibility for the states' fiscal crisis insofar as it has loaded costs onto states via policy changes and conditions of aid for programs such as Medicaid, failed to fund mandates, declined to appropriate fair shares of funds for new policy initiatives, and preempted or curtailed states' authority to adjust their tax systems to contemporary economic realities.

A revival of 1970s-style revenue sharing or enactment of federal counter-cyclical aid is unlikely and perhaps unwise, even though it would counteract the state's anti-stimulus tax increases and spending reductions. The former General Revenue Sharing program of 1972-1980 (for the states) failed to achieve

its objectives. GRS funds often replaced state own-source revenues or went into operating costs rather than capital investments. Counter-cyclical aid triggered by rising unemployment or other economic indicators would create a moral hazard that could weaken incentives for state fiscal reform.

The states did obtain \$6.4 billion more over 10 years for Food Stamps; 13 additional weeks of federally funded unemployment insurance payments; up to \$8 billion in accelerated Reed Act payments; a \$1.1 billion block grant to help state and local governments respond to bioterrorism; and \$100 million to enhance emergency-management plans.<sup>21</sup> State and local officials also obtained restoration of half of a scheduled \$8.5 billion reduction in Transportation Equity Act for the 21st Century funding for surface transportation.

Targeted aid and specific expense reimbursements are more efficient than general aid; however, the federal government's willingness to share costs commensurate with the fiscal consequences of its policy-making is exceeded by its eagerness to shift costs onto the states. Hence, the governors have not yet achieved their major objective of full, or fuller, federal funding of long-term care under Medicaid — a cost slated to grow with the country's aging population.

At the same time, federal policies — such as the Internet Tax Freedom Act (extended in 2001 to November 1, 2003) and the U.S. Supreme Court's *Bellas Hess* and *Quill* rulings — have constrained states' authority to bring their tax systems in sync with today's economy. The inability to collect sales and use taxes on out-of-state mail-order and Internet sales costs state and local governments about \$16.4 billion a year.

The Bush administration's new tax-cut proposals will, if enacted, further depress revenues for states coupled to the federal tax code, but more problematic is the administration's consideration of shifting federal taxation from income to consumption — perhaps a value added tax or national sales tax. Although there is virtue in hiking taxes on consumption, and the United States is the only Organization for Economic Cooperation and Development (OECD) country lacking a value added tax,<sup>22</sup> to produce revenue equivalent to current federal revenue, a national sales tax would have to be about 25 percent. Politically, this could compel states to repeal income taxes, too, and increase sales-tax rates. A key problem, though, is that unlike some other federal countries, the U.S. government is neither obligated nor motivated to consider, relieve or coordinate with state tax systems when it alters its own tax code.

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Ultimately, repairing the nation's fiscal federalism is a political, perhaps even constitutional, issue. So long as federal officials can enjoy public acclaim for reducing taxes and seeming not to be spending tax money on popular programs — while quietly passing the pain of extracting the money from taxpayers on to state and local officials — they will do so.

### The States' Remedial Responsibility

However, states also have been timid about reforming their own fiscal households. Although state revenue systems are not in immediate danger of becoming obsolete,<sup>23</sup> obsolescence is on the horizon. State sales taxes, for instance, are stuck in the rotary-dialing era when Americans purchased more consumer goods than services; yet states are extending the sales tax to services at a snail-mail pace. Completing the Streamlined Sales and Use Tax Interstate Agreement (approved by representatives of 31 states in November 2002) and obtaining congressional approval of it would be another important step.

The 41 states that levy a broad-based personal income tax need to consider such roller-coaster distortions as excessive reliance on upper-income filers and on capital-gains and dividend income. In California, for example, the top 10 percent of filers pay 75 percent of the personal income tax. In FY 2000, California received \$17 billion from capital-gains taxes; in FY 2002, it received less than \$5 billion. These states also need to re-think their couplings to the federal income-tax code. Likewise, states should stem the erosion of the corporate-tax base by reforming their corporate taxes individually or, preferably, in concert with each other, perhaps even adopting a common tax for interstate corporations.

States should increase their rainy-day funds and other reserves beyond the conventional level of 5 percent of expenditures, and also reconceptualize their rainy-day funds as long-term fiscal insurance rather than as short-term stopgaps for fiscal trouble. In turn, states should de-emphasize tax cuts during booms in favor of tax refunds, so that tax rates remain in place for bust years. States also should moderate their appetite for levying more fees, raising "sin taxes" and expanding gambling during lean years. These policies have their place, but excessive reliance on them has regressive impacts. State fiscal reform should foster both equity and efficiency.

Stricter accounting and transparency rules should ensure that no new governor or legislator is surprised by an unexpectedly large budget shortfall on inauguration day, and states should rein in "creative" borrowing, especially to close budget gaps, such as

underselling future tobacco-settlement payouts. The credibility of state fiscal policy-making is severely weakened by bait-and-switch tactics, such as diverting tobacco-settlement monies that were to be used to reduce tobacco use and help pay associated health care costs.

More generally and ominously, though, the states face long-term contradictions between unavoidable spending pressures and eroding tax bases due to federal policy-making, the changing economy, demographic developments and the larger role played by the states in funding social services and education, and now homeland security, than was true 20 or 30 years ago. The nation's aging population, for example, will put tremendous upward pressure on spending and downward pressure on taxes and also pose morally anguishing policy dilemmas. Consequently, the states need to look forward more fundamentally than superficially, as well as more intergovernmentally, in order to pull up from their slippery fiscal slope.

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## Notes

<sup>1</sup> Robert Pear, "States Are Facing Big Fiscal Crises, Governors Report," *The New York Times*, November 26, 2002, A1-A22.

<sup>2</sup> See John Kincaid, "State-Federal Relations: Continuing Regulatory Federalism," *The Book of the States 2002* (Lexington, KY: The Council of State Governments, 2002), 25-32.

<sup>3</sup> National Conference of State Legislatures, "State Tax Actions 2000: Executive Summary," (Washington, D.C.: National Conference of State Legislatures, 2001).

<sup>4</sup> John M. Broder, "Loss of Boom's Billions Sinks California," *The New York Times*, December 9, 2002, A21.

<sup>5</sup> Michael Powell, "A Fiscal Hangover," *Washington Post National Weekly Edition*, December 2-8, 2002, 13-14.

<sup>6</sup> Yochi J. Dreazen, "New Taxes, Fees Hit Telephone Bills," *Wall Street Journal*, September 18, 2002, D1-D2.

<sup>7</sup> Gene Rose and Ginger Sampson, "Putting the Squeeze On," *State Legislatures* 29 (January 2003): 12-16.

<sup>8</sup> Bob Herbert, "For Struggling States, All Solutions Point to Washington," *The New York Times*, December 12, 2002, A21.

<sup>9</sup> Jonathan Weisman, "Blame Washington," *Washington Post National Weekly Edition*, December 16-22, 2002, 29-30.

<sup>10</sup> Jackie Calmes, "States Confront Fiscal Crisis," *Wall Street Journal*, December 18, 2002, A4.

<sup>11</sup> Calmes.

<sup>12</sup> Calmes.

<sup>13</sup> Cait Murphy, "In a Bad State," *Fortune* 146 (December 9, 2002): 34-35.

<sup>14</sup> Broder.

<sup>15</sup> Weisman, 30.

<sup>16</sup> "California's Gray Hole," *Wall Street Journal*, December 20, 2002, A14.

<sup>17</sup> National Association of State Budget Officers, *State Expenditure Report 2000* (Washington, D.C.: National Association of State Budget Officers, 2001).

<sup>18</sup> Elizabeth McNichol and Kevin Carey, "Did States Overspend During the 1990s?" (Washington, D.C.: Center on Budget and Policy Priorities, October 15, 2002), 2.

<sup>19</sup> U.S. Health Care Financing Administration, U.S. Department of Health and Human Services, *A Profile of Medicaid: Chart Book 2000* (Washington, D.C.: U.S. Government Printing Office, 2001).

<sup>20</sup> McNichol and Carey, 10.

<sup>21</sup> Carl Tubbesing, "What States Want from the Feds," *State Legislatures* 28 (October/November 2002): 17.

<sup>22</sup> Michael Keen, "States' Rights and the Value Added Tax: How a VIVAT Would Work in the United States," *Proceedings of the Annual Conference on Taxation of the Na-*

*tional Tax Association* (Washington, D.C.: National Tax Association, November 8-10, 2001), 195-199.

<sup>23</sup> Robert Tannenwald, "Are State and Local Revenue Systems becoming Obsolete?" *National Tax Journal* 55 (September 2002): 467-489.

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