

State Finances: Looking Backward and Forward

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Stanton Virginia

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Past and Future ...

- ◆ Looking at all states ... where they have been and seem to be heading.
- ◆ State spending has changed greatly in last half-century(!), but the basic revenue sources have stayed much the same (except many bases of tax have been constricted).
- ◆ Looking at changes in the past, I muse on the challenges of the next few years.

The Setting: Roaring 1990s

- The states, as did the U.S. economy, had an amazing run in the 1990s
- What a deal!: Tax *rate cuts* with spending *increases ... it worked!*
- A new philosophy takes hold and drives the state fiscal agendas: Smaller state government that cuts taxes and gets out of the way of private sector
- Faith in “market-driven” growth

Early 2000's: Sharp Reversal in State Fiscal Fortunes

- In 2000, stock markets dropped, then economy slumped, and revenues fell
- Legacy of the 90's was a high "elasticity in" tax revenues
 - Personal income taxes ... capital gains
 - Sales tax ... narrowing the base
 - Estate Tax ... a key target
 - Corporate income tax ... no growth
 - Fees & charges ... fair game

State Stresses in early 2000s

- By FY 2002, states had sharp revenue declines, but many continued spending. *Estimated* state budget shortfalls reached \$50 billion.
- Early steps to close budget deficits had many “one-shots” and cosmetic cures.
- By FY 2003, serious spending cuts started: Higher education, welfare, transportation, and public schools took spending cuts.

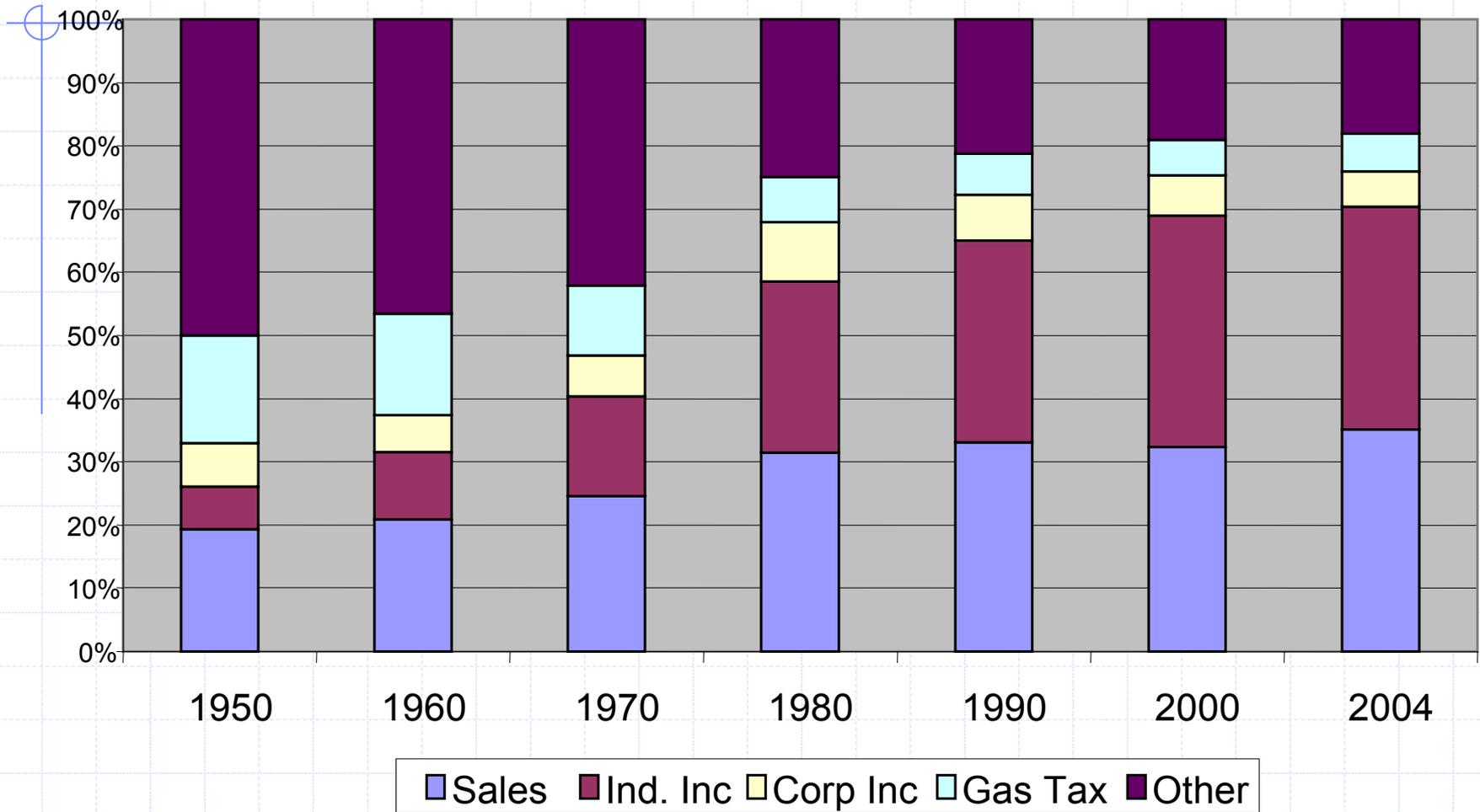
Post 2003: Relief ... Recovery?

- ◆ Since the depths of 2003, state revenues have climbed strongly.
- ◆ But, recovery more due to economic rebound than tax *rate* raising or tax *base* expansion.
- ◆ State tax collections up by about 10% for last two fiscal years.
- ◆ Spending has been growing at a bit slower rate. States have built reserves.

Some History: How States Have Financed Themselves

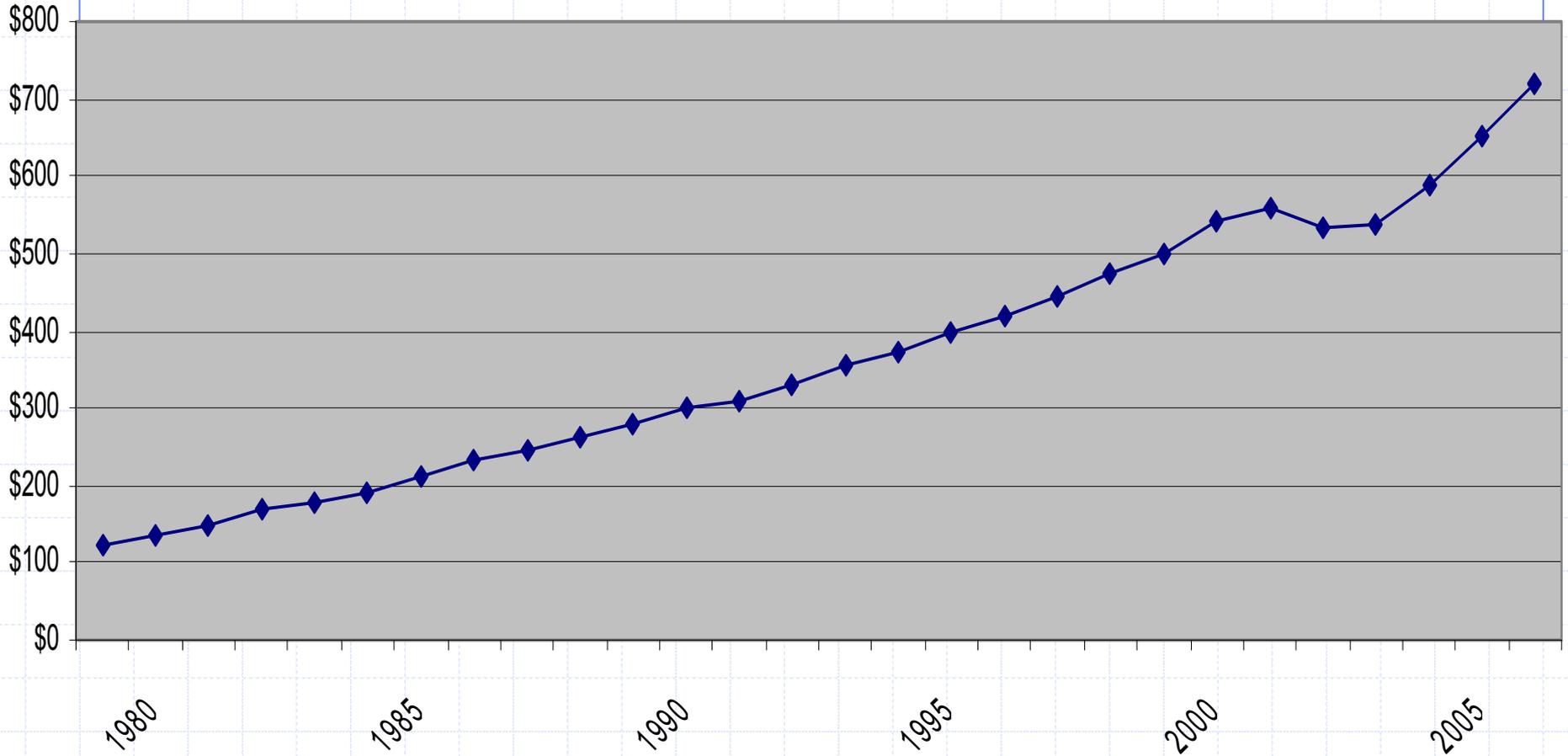
- ◆ Next few charts review changing state revenues structures
- ◆ The big revenue dip of the early 2000s
- ◆ How states have legislated tax changes over the past 20 years (changing base or rates)
- ◆ Role of federal aid

Composition of State Own Source Revenues: 1950-2004



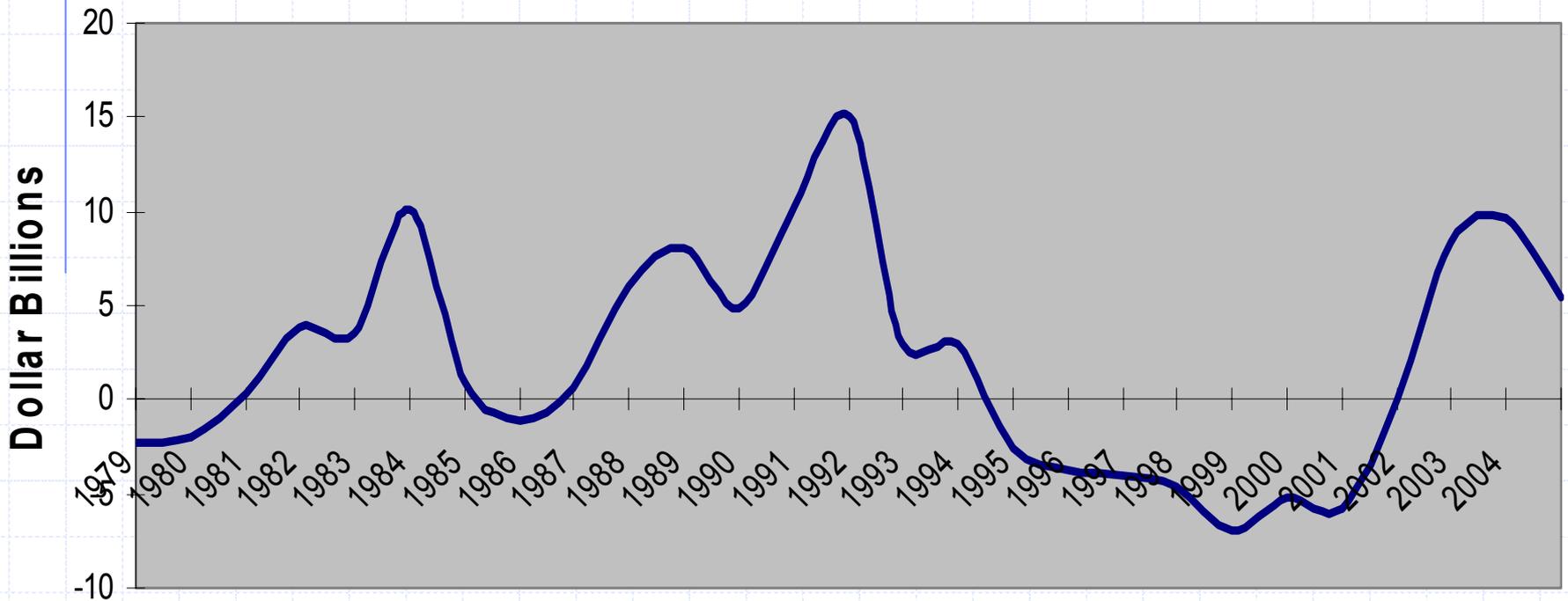
State Tax Collections: 1979 - 2006

Billions of Dollars

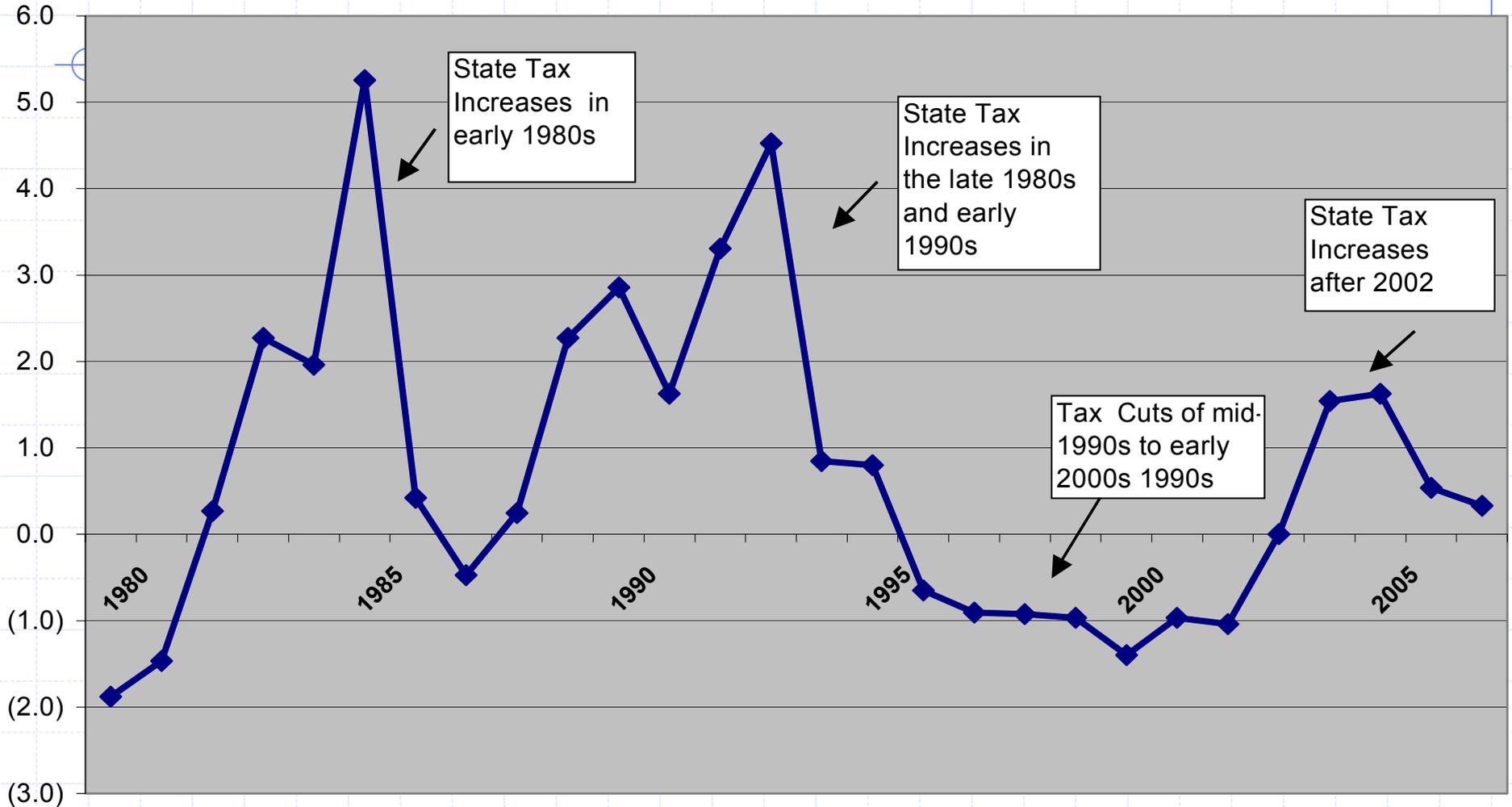


Legislated State Tax Revenue Changes: 1979 to 2005

Billions of Dollars

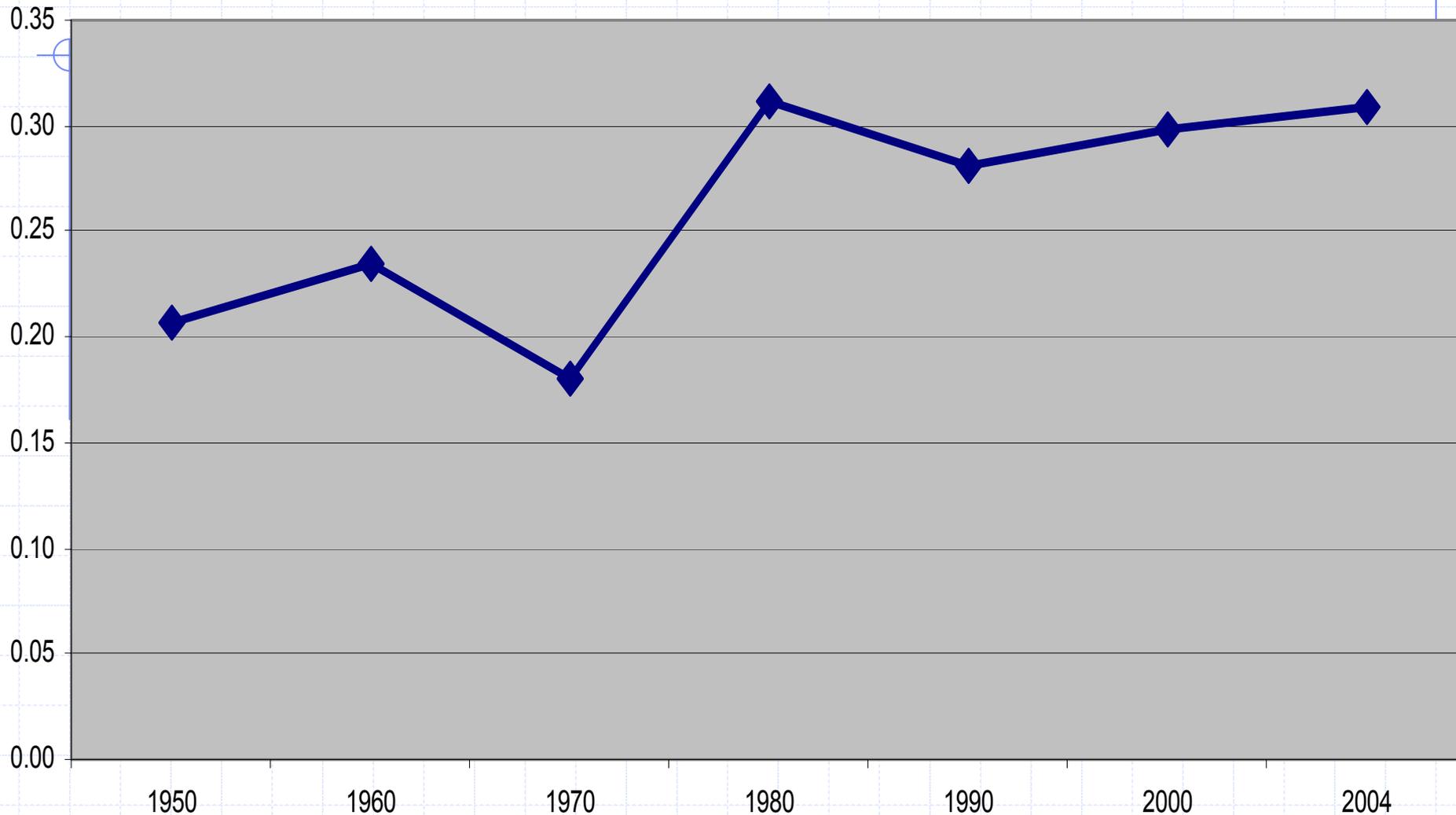


Legislated Tax Changes as Percent of Tax Revenues



◆ Legislated tax changes as % of Rev.

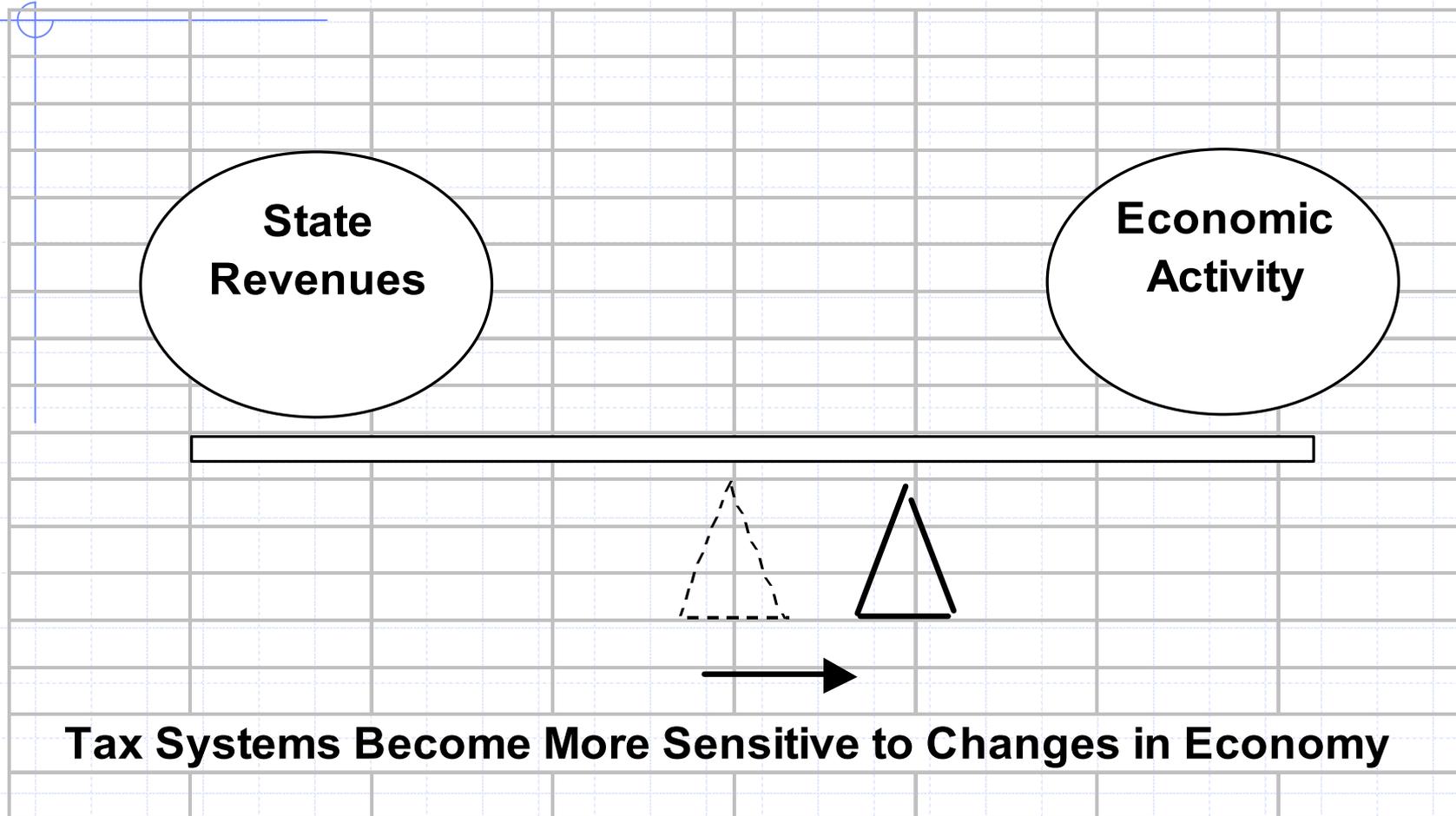
Federal Aid as Percent of Total General Revenues: 1950-2004



Volatility of State Taxes

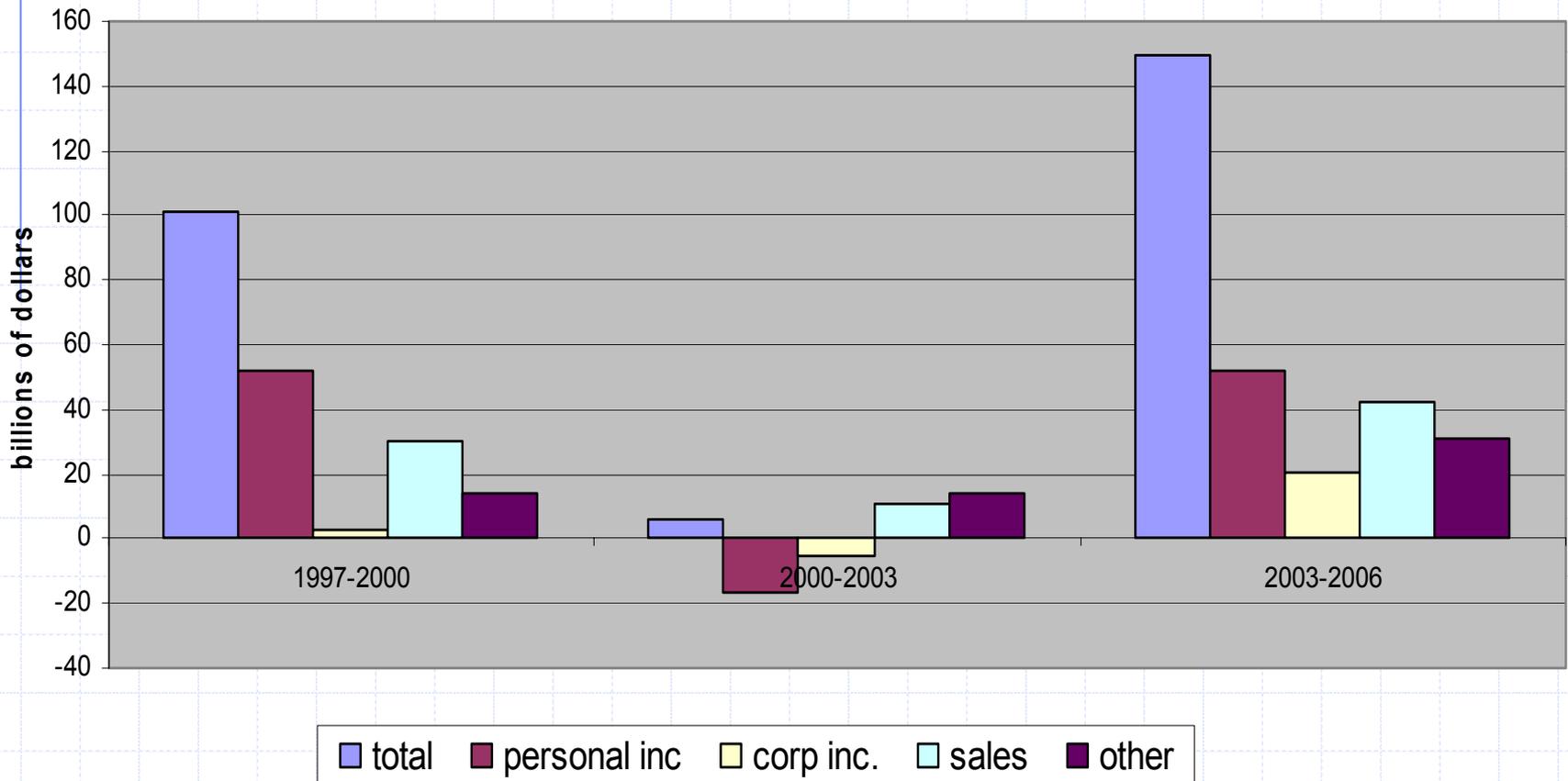
- ◆ Over time, states have squeezed tax bases and increased the rates on those restricted bases. Greater use of fees.
- ◆ Reliance on fewer taxpayers and transactions to pay most taxes. This has shifted systems to “teeter-totter” effect where small changes in economy have greater impact on revenues.

Tax Systems Made Volatile



Volatile State Tax Revenues

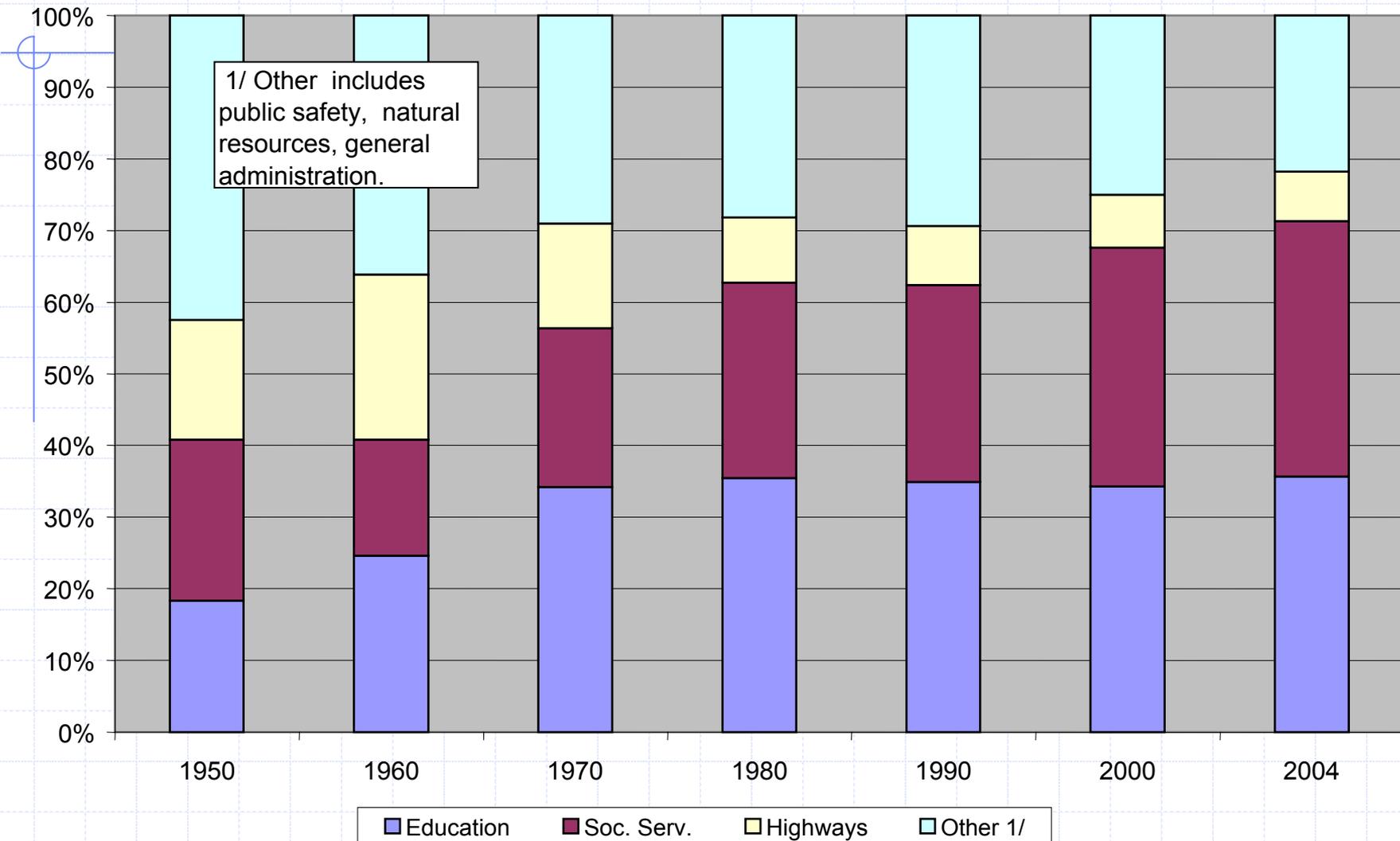
Changes in State Tax Revenues: Intervals for 1997-2006



Changes in State Spending

- Health care costs now dominate state budgets
- Education struggles for position
 - Public support wanes
 - Costs keep going up
 - Higher education moves to a fee basis
- Transportation slides to “back of bus”
- Pressure of “costly” public employees

State Spending By Purpose: Percentage Composition: 1950-2004



Health Care ... Medicaid

- ◆ A rapidly growing, persistent cost issue.
- ◆ High-cost Medicaid users are the disabled and elderly. Eats up about 25 percent of state general fund budgets.
- ◆ Rate of increase in Medicaid cost has been around 10%@yr and is projected to rise at 8%@yr over the next 5 years.
- ◆ Rising employee and post retirement health benefits ... GASB 45.

Education ... Higher and Lower

- ◆ States are major financiers of public education. Big increase in state effort in the 1970s-1980s.
- ◆ Subsequently, other expenditures have pressed into education's share.
- ◆ Higher education took large hits in state budget cuts of early 2000's ... move to user fee basis.
- ◆ Public schools under pressure with NCLB. Federal government *de facto* standards setter.

Transportation ...

- ◆ A strong traditional state function, Highway spending has declined and state trust funds are waning.
- ◆ Federal Highway trust fund running down as maintenance takes most of funds. States borrowing against future.
- ◆ Opposition to gas tax increases.
- ◆ Privatization/tolling of roads appears to be coming fast. Passing off needed increases.

Employee Pensions ...

- ◆ Funding public pensions is a continuing “hangover” from better times.
- ◆ Stock market downturn of 2000 greatly reduced values of investments: funds are recovering some six years later.
- ◆ Net result is “unfunded” liabilities, which will lead to tax increases to pay.
- ◆ Most employee pension benefits are legally protected ... can't be cut.

Fiscal Meltdowns to Come?

- Built-in state deficits?
- States are stuck in the middle of the governmental system, with expensive programs ... health, education
- Federal government in very poor long-term condition. International exposures.
- Over time, unavoidable large cuts in spending ... unless there is high growth.

Remedies? No Easy Ones

- Private versus public consumption has moved to favor the former over time.
- Federal Government represents about 32% of all state revenues and is now budgeted at only 1%@yr growth in domestic spending over next decade.
- Volatile revenues and future decline in federal assistance spell continue shrinkage in spending for most states.

“Check Your Seatbelts” ...

- ◆ Net sum: aside from a few states, most should worry about their fiscal futures.
- ◆ States finances are now highly reliant on continuing “good times.”
- ◆ State Legislators may see more benefit in thinking hard about the fiscal future (saving tax surpluses, keeping tax bases broad and simple).
- ◆ Who knows? Will the voters listen?

And Where is Virginia?

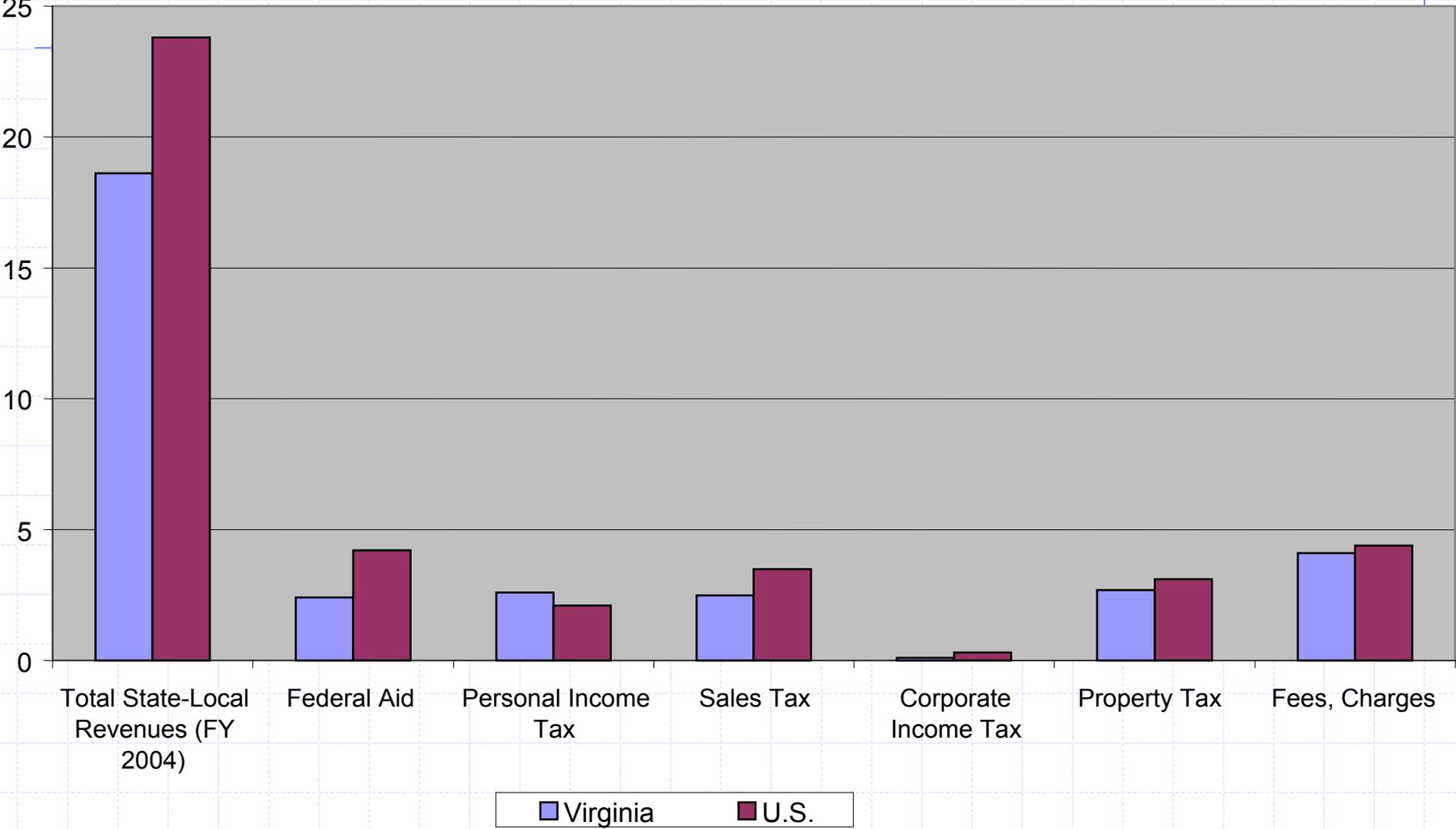
- ◆ *Great Advantage*: State economy is lightly burdened by taxes compared to the rest of the nation. Virginia ranks 48th in taxes as % of personal income.
- ◆ The tax system is “balanced” among income, sales, charges, property taxes.
- ◆ Low reliance on Federal Aid ... but
- ◆ Virginia has avoided damaging constitutional restrictions on taxes and spending. Flexibility remains.

Virginia, U.S. Averages, Virginia Rank: Personal Income and Employment Statistics State and Local Revenues as a Percent of Personal Income (FY 2004)

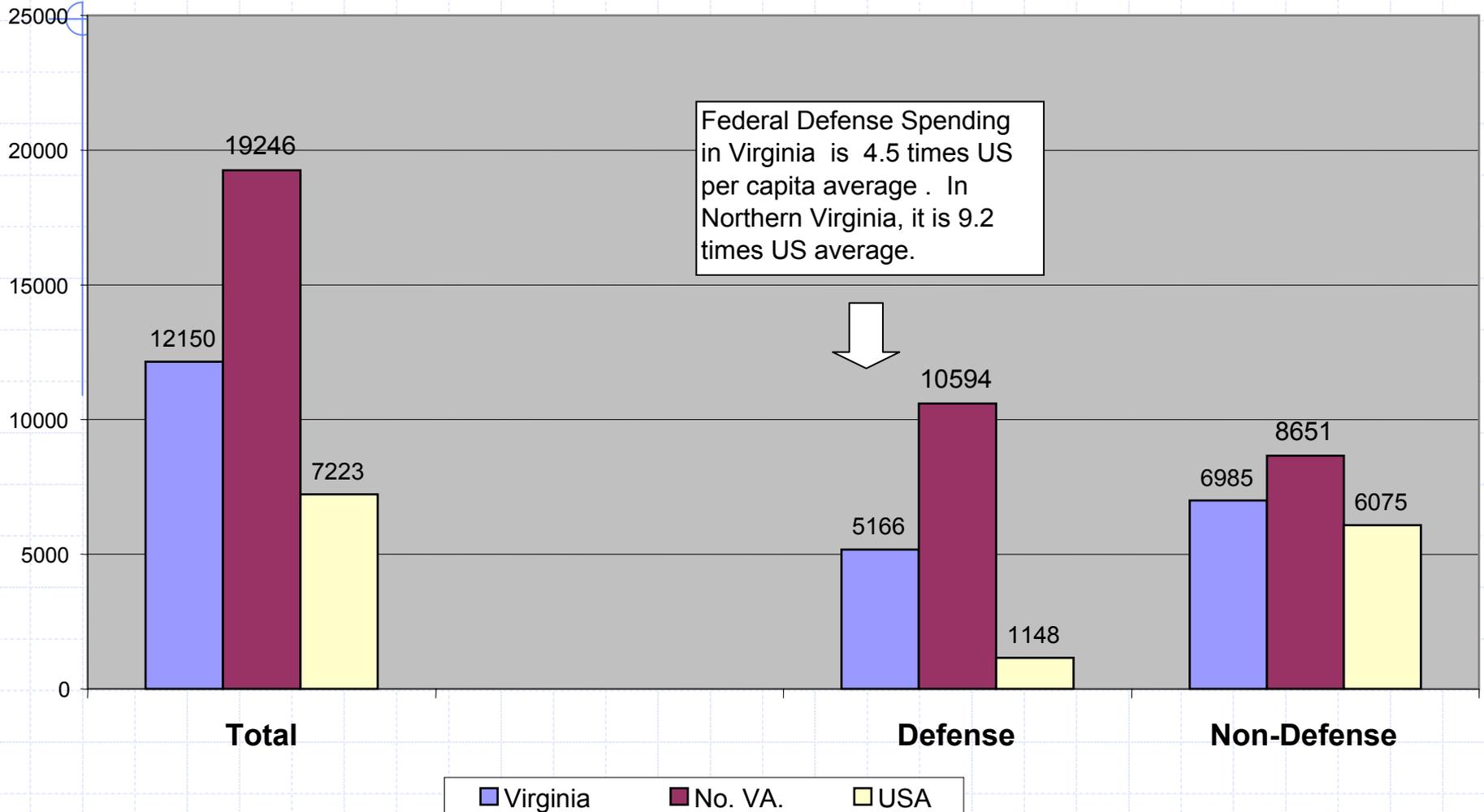
<i>Income - Employment Statistics</i>	Virginia	U.S.	<i>Va Rank</i>
Per Capita Personal Income (2005)	\$38,390	\$34,586	7
Unemployment Rate (March 2006)	3.6	4.7	49
% Change in Employment (2001-06)	5.2	1.8	13
% Change in Personal Income (2002-05)	20.8	15.5	5
 <i>Revenues as a Per cent of Per Capita Income</i>			
Total State-Local Revenues (FY 2004)	18.6	23.8	48
Federal Aid	2.4	4.2	49
Personal Income Tax	2.6	2.1	15*
Sales Tax	2.5	3.5	43
Corporate Income Tax	0.1	0.3	41**
Property Tax	2.7	3.1	32
Fees, Charges	4.1	4.4	36

Notes: */ out of 43 states. **/ out of 47 states

State and Local Revenues By Category as a Percentage of Personal Income: Virginia and US State Average



Federal Spending in Virginia, Northern Virginia and US Average (FY 2004): Dollars Per Capita



Virginia's Economic Challenge: Diversify..Integrate

- ◆ State's economy is a challenge ... The overriding impact of Federal spending.
- ◆ Huge dependence on Defense spending, especially Northern Virginia.
- ◆ Problems of fast growing suburbs and the older small cities.
- ◆ Extending new growth along the state's corridors. The "Necessary Dream" to be realized.

End of Presentation

Thanks for your interest

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