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

- **Sales**
- **Ind. Inc**
- **Corp Inc**
- **Gas Tax**
- **Other**

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales</th>
<th>Ind. Inc</th>
<th>Corp Inc</th>
<th>Gas Tax</th>
<th>Other</th>
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<tbody>
<tr>
<td>1950</td>
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<td>1960</td>
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<td>2000</td>
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<td>2004</td>
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</tbody>
</table>
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

State Tax Increases in early 1980s

State Tax Increases in the late 1980s and early 1990s

State Tax Increases after 2002

Tax Cuts of mid-1990s to early 2000s 1990s

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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

State Revenues

Economic Activity

Tax Systems Become More Sensitive to Changes in Economy
Volatile State Tax Revenues


- 1997-2000
- 2000-2003
- 2003-2006

billions of dollars

- total
- personal inc
- corp inc
- sales
- other
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

1/ Other includes public safety, natural resources, general administration.
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
- 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)

<table>
<thead>
<tr>
<th>Income - Employment Statistics</th>
<th>Virginia</th>
<th>U.S.</th>
<th>Va Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per Capita Personal Income (2005)</td>
<td>$38,390</td>
<td>$34,586</td>
<td>7</td>
</tr>
<tr>
<td>Unemployment Rate (March 2006)</td>
<td>3.6</td>
<td>4.7</td>
<td>49</td>
</tr>
<tr>
<td>% Change in Employment (2001-06)</td>
<td>5.2</td>
<td>1.8</td>
<td>13</td>
</tr>
<tr>
<td>% Change in Personal Income (2002-05)</td>
<td>20.8</td>
<td>15.5</td>
<td>5</td>
</tr>
</tbody>
</table>

### Revenues as a Percent of Per Capita Income

<table>
<thead>
<tr>
<th>Revenues as a Percent of Per Capita Income</th>
<th>Virginia</th>
<th>U.S.</th>
<th>Va Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total State-Local Revenues (FY 2004)</td>
<td>18.6</td>
<td>23.8</td>
<td>48</td>
</tr>
<tr>
<td>Federal Aid</td>
<td>2.4</td>
<td>4.2</td>
<td>49</td>
</tr>
<tr>
<td>Personal Income Tax</td>
<td>2.6</td>
<td>2.1</td>
<td>15*</td>
</tr>
<tr>
<td>Sales Tax</td>
<td>2.5</td>
<td>3.5</td>
<td>43</td>
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<tr>
<td>Corporate Income Tax</td>
<td>0.1</td>
<td>0.3</td>
<td>41**</td>
</tr>
<tr>
<td>Property Tax</td>
<td>2.7</td>
<td>3.1</td>
<td>32</td>
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<tr>
<td>Fees, Charges</td>
<td>4.1</td>
<td>4.4</td>
<td>36</td>
</tr>
</tbody>
</table>

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

Federal Defense Spending in Virginia is 4.5 times US per capita average. In Northern Virginia, it is 9.2 times US average.
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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