

## State Finances Entering FY06 ... Regaining Ground But Path Still Uphill

### Summary

Similar to Washington, state governments have benefitted from stronger-than-expected revenues in fiscal 2005 (FY05)<sup>1</sup>, but Medicaid and other program demands plus proposed curbs on federal domestic spending will slow their full recovery.

### A broad revenue pick-up ...

State tax receipts are up an estimated 9½% for the first three quarters of FY05, building on a 7½% gain in FY04. This news is welcome, given that State tax revenues have been slow to recover from the 10% decline from FY00 to FY03 on a real per capita basis after legislated tax changes. In FY05, revenues across all States are expected to exceed *Budget* forecasts by just over 2.0%, with 42 States reporting gains and only three States experiencing shortfalls. Only five States were compelled to make mid-year program spending cuts in FY05, and the reductions amounted to just 0.1% of total State outlays. In contrast, 18 States trimmed expenditures during FY04 and 37 States during FY03. State personal income taxes (PIT) were up 9½% for the first nine months of FY05, and similar to federal taxes, solid withholding amounts were supplemented by a surge in estimated payments as capital gains and bonuses expanded. Sales tax revenues, that account for more than 40% of States' total tax receipts, were up 5.9%. Corporate income tax (CIT) revenues were ahead a whopping 38%, though the strength from January to March was partly due to California's tax amnesty. The gains for the first three quarters of FY05 were greatest in the Western States, and Alaska, Oklahoma and Wyoming are benefitting from elevated petroleum prices, but even the Great Lakes and Plains regions reported advances in the 4½%-6% range.

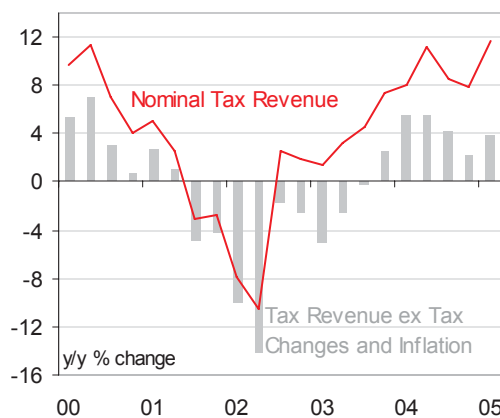
### ... permits a further slowing in tax and fee increases for FY06 ...

Governors' recommended FY06 *Budgets* indicate a further 5.2% revenue advance. The FY06 boost from tax and fee changes is expected to total only \$2.4 billion, sharply lower than the \$9.6 billion hike in FY04. After \$33 billion of legislated tax and fee reductions from FY95 to FY01, State governments were reluctant to raise taxes during the recent revenue downturn, relying instead on a healthy build-up of reserves, one-time resources, higher fees and deferred capital spending. In FY06, higher tobacco and alcohol taxes and fees account for more than three-quarters of the proposed tax increase, with a net \$366 million PIT cut and modest CIT and sales tax increases.

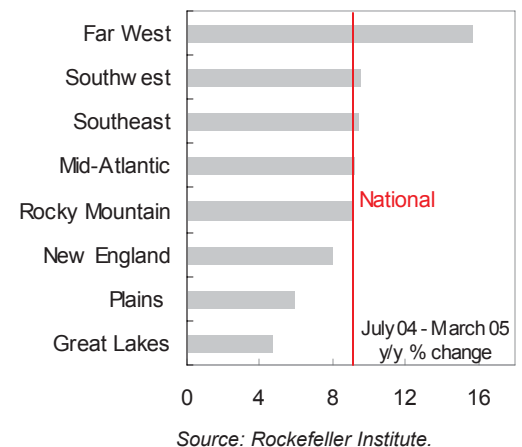
### ... but considerable spending pressures ...

State expenditures, as estimated by the National Association of State Budget Officers (NASBO)<sup>2</sup> climbed 6.6% in FY05, reflecting a one-time upswing in federal fiscal assistance and some catch-up on spending priorities after cutbacks earlier in the decade. Medicaid, the health care program for low-income residents funded by the federal and state governments, continues to squeeze State budgets, with overall increases of close to 9% in both FY04 and FY05. In FY04, Medicaid surpassed elementary and secondary education as the largest State spending category.

State revenues revive ...



... with strongest gains in the West



Last year, 24 States experienced Medicaid shortfalls and Washington's share of Medicaid financing is slated to edge lower under the 2003 Federal Medical Assistance Percentage formula. Funding increases of 6.9% for States and 3.7% for Washington in FY06 are expected to cover the forecast 4.9% advance in Medicaid outlays. With Medicaid enrollments expected to climb 3.9% this year, this spending forecast could well prove conservative. A future complication is the eventual State impact of the new Medicare prescription drug benefit. The outcome is clouded because a clawback mechanism will leave States funding most of the drug costs for residents eligible for both programs. States also face the expense of higher education standards, larger postsecondary enrollments and rising pension plan contributions. The gap in federal funds to pay for federal mandates widened to almost \$32 billion in FY05 from \$26.6 billion in FY04.

**... will continue to limit the States' fiscal flexibility ...**

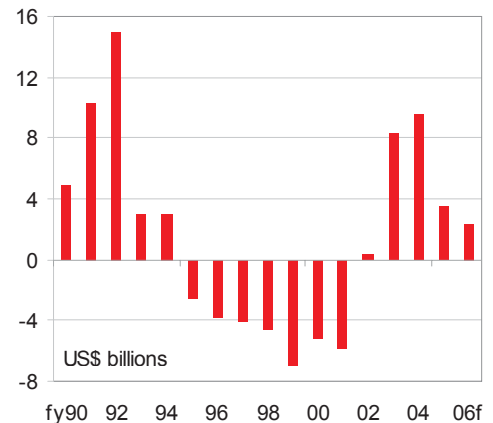
Though revenues are finally regaining traction, State governments' ending balances plus their budget stabilization funds are expected to trend lower again in FY06, both in absolute terms and relative to total expenditures. A number of jurisdictions face structural imbalances with Washington's plans for spending restraint exacerbating the gap between anticipated revenues and spending requirements. In response to the most obvious pressure, Medicaid, State Governors and Legislators suggest a number of options including greater flexibility to impose larger deductibles and payments from higher-income recipients and multi-State purchasing pools to lower drug and other expenses. An emerging concern is the escalating cost of longer-term care, prompting proposals for expanding private insurance to cover this expense as well as expanded avenues for States to recover Medicaid costs from estates.

State governments are concerned about how Washington will wring \$10 billion of savings from Medicaid over the next five years and the possibility of further federal caps for the program. Federal spending restraint will also affect other State responsibilities, such as transportation, spurring suggestions for significant change such as toll lanes. Municipal concern over federal cuts to community-development block grants partly reflects reduced financial support from a number of State governments. A further risk to both State and local governments is the President's tax reform initiative. Potential options such as expanding federal consumption taxes or scaling back the deductibility of state and local income and property taxes could have far reaching consequences for junior governments' fiscal situation.

**... suggesting ongoing restraint**

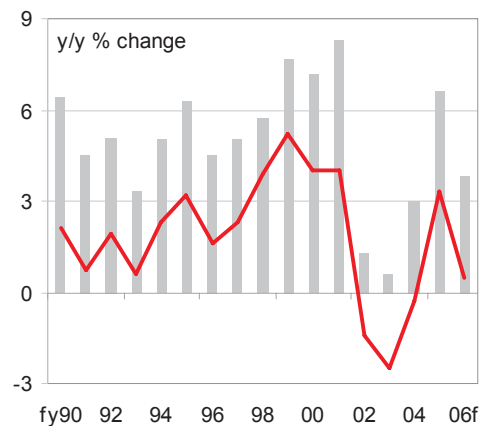
The Governors' 2006 Budget proposals suggest slowing this year's expenditure growth to 3.8% from 6.6% in FY05. Ten States plan reduced expenditures in FY06, double the number that cut outlays last year. Near-term pressures on State governments have eased, but their ability to offer significant stimulus for now is constrained, especially if Washington stays the course on spending restraint. In Canada, the Provinces' multiple challenges in putting health and other social services on a sustainable footing have a number of similar features to the States' situation. The conservative overtones to many State fiscal plans reflect both the big-ticket nature of their responsibilities and the proven worth, for 47 States, of building up budget stabilization funds as a cushion against unexpected events.

**States limit tax and fee increases\* for FY06 ...**



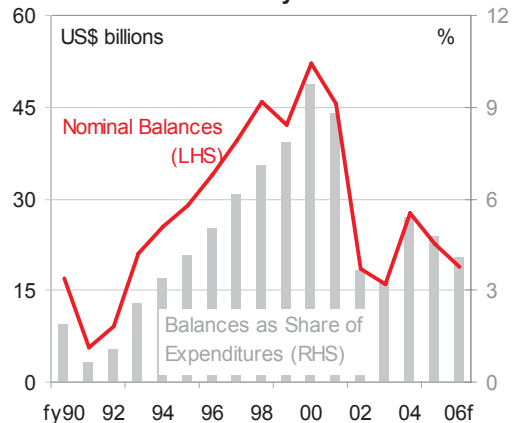
\* Negative amounts represent tax and fee reductions.

**... alongside constrained spending\* growth ...**



\*Includes outlays from surplus funds, transfers into budget stabilization funds and other reserves and payments to local governments to trim property taxes.

**... and reduced State year-end balances**



Source for charts on page 2: National Association of State Budget Officers.

1 The fiscal yearend is June 30th for 46 States. All dollar amounts in the report are expressed in US dollars.

2 Early data on State expenditures from the National Association of State Budget Officers (NASBO), followed by more comprehensive and consistent Census Bureau data approximately two years later.