

# THE FISCAL CRUNCH CONFRONTING THE SOUTH

Presentation to the 2002 Alabama Legislative Orientation  
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The Council of State Governments' Southern Office  
Southern Legislative Conference

Alabama Law Institute  
December 3, 2002  
Tuscaloosa, Alabama



It is a great honor to be here this afternoon at the 2002 Alabama Legislative Orientation. I would like to thank the Honorable Speaker of the Alabama House of Representatives and Mr. Bob McCurley, Director, Alabama Law Institute, for extending this invitation to me and to The Council of State Governments' Southern Office, the Southern Legislative Conference (SLC), to be a part of your Legislative Orientation.

My remarks this afternoon deal with the dire fiscal circumstances affecting almost every state in the country. In particular, it will concentrate on the fiscal situations in the 16 SLC states. Broadly, my presentation will consist of five inter-connected parts. Part I reviews some aspects of the longest economic expansion in the history of the country that extended between March 1991 and March 2001. Part II focuses on our current predicament, both at the federal and state levels, and provides some detail on the extent of these difficulties. Part III delves into some of the specifics of the tightening fiscal conditions in state government finances. Part IV presents some of the measures adopted by states in recent times to help alleviate their financial dilemmas. Finally, in an effort to not dwell exclusively on the doom and gloom scenarios, Part V, explores several positive aspects of the current state of the economy.

## **Part I of this presentation looks at the longest economic expansion in the Nation's history**

After a decade of sustained economic growth, unsurpassed in the economic history of the country, March 1991 to March 2001, the U.S. economy is currently recovering from the negative effects of the recession that swept the country last year. While technically the economy has emerged from the recession, the pace of economic growth and, in particular, the pace at which the economy has been generating jobs, has been extremely sluggish. During the decade of expansion,

an unparalleled level of prosperity facilitated soaring personal incomes and corporate profits; dwindling unemployment and inflation numbers amidst rapid economic growth rates; rising revenue flows leading to budget surpluses at the federal, state and local levels; and a booming stock market that elevated the investment portfolios of a number of American households to remarkable levels.

National and state economies grew considerably faster than most forecasters predicted which resulted in a bountiful fiscal environment for every level of government. In general, tax revenues tend to be significantly more volatile than GDP growth and revenues flew into state coffers from growing capital-gain taxes, income and other taxes boosted by taxpayers' healthy stock-market gains, base salaries and overtime checks. State sales tax inflows grew steadily too, as consumers slashed back on savings and consumed more and more. Furthermore, state spending pressures were mild too; for instance, Medicaid enrollments declined while the federal decision to switch welfare funding from an entitlement to a block grant generated cash inflows for states, too. The \$246 billion state tobacco settlement was another factor in pushing state budgets towards healthy surpluses. Consequently, states were able to cut taxes, raise spending in such areas as education and boost reserve funds.

Three measures of this impressive economic performance involve GDP growth, unemployment levels and stock market gains. The following sections highlight these areas.

A review of gross domestic product (GDP) data for both the United States and the 16 SLC states during this period of economic expansion helps illustrate this point. Reviewing the output of goods and services produced by the labor and property located in the United States in the last decade or so is a sound way of getting acclimatized with the Nation's economic potential and output. The following table contains information on real GDP percent changes from the preceding year between 1991 and 2000.

1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
-0.5	3.0	2.7	4.0	2.7	3.6	4.4	4.3	4.1	3.8

Source: U.S. Department of Commerce

As evident, during this decade, there were several years, particularly in the late 1990s, when GDP growth rates were very impressive. An annual growth rate of 4.4 percent in 1997, 4.3 percent in 1998 and 4.1 percent in 1999 and the slower, but certainly noteworthy, rate of 3.8 percent in 2000. More importantly, this stellar economic growth levels were achieved without an accompanying rise inflation, a development that defied conventional economic wisdom.

For the 16 SLC states, a review of federal data on state gross domestic product, or gross state product (GSP), for this period indicates some noteworthy gains. The following table presents information showing percentage growth in GSP for the period between 1980 and 2000. (Statistics from 2000 are the latest federal GSP data available).

State	1980 to 1990	1990 to 1996	1996 to 1997	1997 to 1998	1998 to 1999	1999 to 2000	2000 Amount (Millions of Current \$)
Alabama	98.3%	38.7%	5.0%	5.2%	5.2%	4.0%	\$119,921
Arkansas	91.0%	48.1%	4.1%	3.6%	6.1%	4.1%	\$67,724
Florida	154.7%	41.8%	6.3%	6.7%	6.1%	7.0%	\$472,105
Georgia	148.3%	55.2%	7.4%	8.1%	8.5%	7.1%	\$296,142
Kentucky	85.2%	40.7%	6.3%	6.0%	4.4%	5.5%	\$118,508
Louisiana	48.4%	23.1%	5.7%	-0.8%	4.4%	7.6%	\$137,700
Maryland	143.2%	26.1%	6.6%	6.1%	6.1%	6.9%	\$186,108
Mississippi	81.9%	44.4%	3.8%	5.0%	5.0%	3.9%	\$67,315
Missouri	95.3%	39.8%	6.3%	4.9%	3.8%	5.4%	\$178,845
North Carolina	136.1%	44.9%	8.5%	8.8%	8.0%	8.1%	\$281,741
Oklahoma	53.4%	29.6%	6.1%	3.5%	4.4%	6.9%	\$91,773
South Carolina	134.7%	36.0%	6.2%	6.2%	5.8%	5.7%	\$113,377
Tennessee	109.5%	49.5%	6.8%	6.9%	5.0%	4.7%	\$178,362
Texas	87.1%	42.5%	10.0%	5.4%	6.8%	8.4%	\$742,274
Virginia	145.0%	34.9%	6.1%	7.5%	5.5%	8.6%	\$261,355
West Virginia	48.4%	31.5%	2.9%	1.9%	4.1%	4.0%	\$42,271
SLC Avg.	6.7%	39.2%	6.1%	5.3%	5.6%	6.1%	

Source: U.S. Department of Commerce

As demonstrated, a number of SLC states were high-fliers in terms of GSP growth during this boom period. Between 1999 and 2000, GSP growth in Virginia, Texas and North Carolina were the leaders here and their growth rates, and the SLC state averages, were significantly higher than the U.S. average of 3.8 percent.

Another key measure of the success during the decade of the national economy and the individual SLC states was the stellar performance of the employment situation. As indicated in the following table, the unemployment rates at the national, regional and individual SLC state levels were at historic lows. A number of the SLC states were among the fastest growing in the country during this period and this is reflected in the low unemployment rates in these states. The following table presents information for the boom years (1995 to 2000) in the month of September.

## Unemployment Rates (Percent) in the SLC States, September 1995 to September 2000

SLC State	1995	1996	1997	1998	1999	2000
Alabama	6.3	4.8	5.1	4.1	4.9	4.6
Arkansas	4.5	5.2	5.2	5.6	3.9	3.7
Florida	5.8	5.4	4.7	4.2	4.0	3.6
Georgia	5.1	4.8	4.4	4.1	4.1	3.6
Kentucky	5.3	5.4	5.2	4.5	4.1	4.1
Louisiana	6.4	6.6	5.9	5.7	4.9	5.6
Maryland	5.2	4.8	5.2	4.3	3.3	4.0
Mississippi	6.6	5.7	6.0	5.3	5.1	5.3
Missouri	4.4	4.2	4.2	3.9	2.9	3.7
North Carolina	4.0	3.9	3.6	3.4	2.9	3.8
Oklahoma	4.4	3.8	4.1	4.6	3.1	3.0
South Carolina	5.2	6.3	4.1	3.8	4.7	3.6
Tennessee	5.2	4.8	5.4	4.1	3.7	4.1
Texas	6.0	5.4	5.3	4.9	4.6	4.1
Virginia	4.5	4.5	3.8	2.9	3.0	2.2
West Virginia	7.2	6.7	6.7	6.6	5.9	5.5
SLC Average	5.4	5.1	4.9	4.5	4.1	4.0
U.S. Average	5.6	5.2	4.9	4.5	4.2	4.0

Source: U.S. Department of Labor

This table clearly demonstrates the steady decline in the nation's unemployment rate between September 1995 and September 2000 (from 5.6 percent in 1995 to 4 percent in 2000). This trend accurately tracks the growth path taken by the American economy which grew steadily during this time period before first contracting in 2001, and then expanding at a much slower pace subsequently. Even in terms of the SLC state average for the same period, it appears that the average unemployment rate reflected the trends depicted by the national rate. After reaching 5.4 percent in 1995, the average unemployment rate in the SLC states began declining steadily in the next five years to 4 percent in 2000. Of note, given that a number of states in the region included some of the fastest growing states in the country, there were several years during the 1995 to 2000 period when the SLC state average was lower than the national average. In fact, the SLC state unemployment rate average was never higher than the national average and was lower in 1995 (5.4 percent versus 5.6 percent), 1996 (5.1 percent versus 5.2 percent) and 1999 (4.1 percent versus 4.2 percent).

Given that an increasingly large number of Americans began investing in the stock market, either through 401-K retirement plans, compensation based on stock options or individual investments, the stellar performance of the stock market was another hallmark of the decade of growth. As alluded to earlier, the astounding gains demonstrated in the stock market enabled every level of government to rake in better than expected amounts in tax revenue. Details on total returns for the Standard & Poor's 500 Stock Index for the five-year period 1995 to 1999 are presented below.

1995	1996	1997	1998	1999
37.6%	23.0%	33.4%	28.6%	21.0%

Source: Standard & Poor's

The average growth rate during this time period was a whopping 29 percent.

## Part II focuses on our current predicament, both at the federal and state levels

Unfortunately, the economic boom years of the 1990s are over and federal, state and local governments continue to grapple with the lingering effects of the 2001 recession. Across a number of criteria, the grim economic news percolating across the country continues to befuddle both astute students of public policy and casual observers of the economy alike.

For instance, after running budget surpluses four years in a row (federal fiscal years 1998 through 2001), the most dramatic drop in tax revenue since 1946, alongside several other contributory factors such as the 2001 tax cuts, will propel the federal government into a deficit for the next three years. This year's \$131 billion plunge in tax revenue was considerably steeper than the economy's own fall. Just last year, the Congressional Budget Office (CBO) projected a \$5.6 trillion surplus between fiscal years 2002 and 2011, a projection that permitted the Bush Administration to push through its 10-year, \$1.35 trillion tax cut while leaving room for a prescription drug plan for seniors and a significant allocation toward paying off the federal debt. Yet, a combination of factors—drop in revenues, increased military spending, the 2001 tax cut—has resulted in shriveling up these projected surpluses with the CBO now forecasting that the federal government surplus amount to only about \$1 trillion between fiscal years 2003 and 2012.

The following table presents some details on the federal budget situation (in billions of dollars) in the past decade or so.

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
-221.2	-269.4	-290.4	-255.1	-203.3	-164	-107.5	-22	69.2	125.5	236.4	127.1	-159

Source: Congressional Budget Office

As evident, after reaching a high of \$(290.4) billion in fiscal year 1992, the highest level in 40 years, the federal budget deficit began declining steadily thereafter. The surplus began in federal fiscal year 1998, peaked at \$237 billion in fiscal year 2000 and slipped to \$127 billion in fiscal year 2001. For the just concluded federal fiscal year, 2002, the Bush administration announced a budget deficit of \$159 billion, confirming that the federal government officially returned to the red for the first time since federal fiscal year 1997. As noted earlier, the 2002 deficit was the largest since the \$164 billion deficit reached in fiscal year 1995.

At the state level, the scenario is equally dire. At least 46 states struggled to close a cumulative budget gap of \$37 billion in their most recent fiscal year, most often ending June 30, 2002. For the current fiscal year (fiscal year 2003), the estimated state budget gaps are even higher, with a combined \$58 billion deficit expected. Unlike the federal government, most states are constitutionally required to balance their books at the end of their one- or two-year budget cycles, so they will be forced to slash spending, raise taxes or utilize reserve funds. A few examples from around the South helps reinforce the dismal choices confronting states. Virginia currently faces a budget shortfall of up to \$2 billion, and the governor will have to make substantial program and personnel cuts. In Texas, the state's budget shortfall may reach an unmanageable \$12 billion by early next year. Maryland's new governor and General Assembly will face a budget shortfall of as much as \$1.9 billion when they arrive in Annapolis in January 2003, a scenario that portends severe cutbacks in state services. In Kentucky, analysts estimate a revenue shortfall of between \$150 million and \$200 million for the current fiscal year. Mississippi's Medicaid program faces a \$75 million shortfall this current fiscal year while the state anticipates a budget shortfall exceeding \$400 million for the fiscal year (2004) that begins July 1, 2003. In October 2002, Georgia experienced another month of negative revenue inflows, confirming that 15 of the last 16 months had brought on declining tax revenues and fee collections for the state. In North Carolina, while budget writers used more than \$800 million in non-recurring revenue to fund ongoing expenses in the fiscal year 2003 budget, a deficit that could exceed \$1.5 billion is a real possibility next year. Missouri's governor announced in late November that five months into fiscal year 2003 the state's budget shortfall had grown to \$100 million and estimated that this gap could triple by the end of the fiscal year.

In terms of national GDP growth, given the recession that swept the country last year, it has been much more subdued. The following table lists the percent changes in real GDP by quarter, from one year ago, for the last seven quarters.

2001				2002		
Quarter I	Quarter II	Quarter III	Quarter IV	Quarter I	Quarter II	Quarter III
1.5	-0.1	-0.4	0.1	1.4	2.2	3.2

Source: U.S. Department of Commerce

As noted, growth in two consecutive quarters in 2001 were in negative territory, a scenario that met the technical standards for an economic recession. Even though the increase in this past quarter was the fourth in a row for the economy, the gains were somewhat less than experts had predicted; drawing on reports from other economic data strongly suggests that whatever growth momentum was present during the summer was waning and growth in the final quarter of 2002 will very likely be lower than what it was in the third quarter. The decision of the Federal Reserve Bank to cut interest rates by the hefty 50 basis points at its November 6 meeting was an attempt to stave off the likelihood of the economy recoiling into negative growth territory.

The late October 2002 report from The Conference Board indicated that consumer confidence plunged to a nine-year low in October this year. The Board's consumer confidence index, which gauges the present and future expectations of consumers, fell to 79.4 this month from 93.7 in September, the steepest one-month drop since the decline registered from September to October 1990. Furthermore, it is also the lowest reading on consumer confidence since November 1993, when the index stood at 71.9 and was climbing as the economy recovered from the 1990-91 recession. This decline remains particularly unsettling because consumer spending accounts for about two-thirds of the Nation's gross domestic product.

Another indication of the severity of economy's free fall involves the fact that the number of people employed as a proportion of the working-age population has fallen more steeply in this recession than the average of the last nine recessions. For the month of October 2002, the U.S. Department of Labor reported that the number of unemployed persons (8.2 million) and the unemployment rate was 5.7 percent, slightly higher than the rate reported in the prior month. In terms of regional and state unemployment rates, the South posted a rate of 5.3 percent, with the Midwest and Northeast regions posing 5.2 percent and the West posting the highest regional rate of 6.1 percent in September 2002. Compared with September 2001, jobless rates were higher in 36 states, lower in 12 and unchanged in the remaining two states. Manufacturing remained the weakest industry division, with 49 states posting employment decreases between September 2001 and September 2002. Two SLC states (Georgia and Texas) occupied the second and third of the top four spots in terms of states with the largest decreases in employment during this one year period with drops of 76,800 and 76,600, respectively. The large number of unemployed workers scattered across the country has resuscitated proposals to extend unemployment benefits to those eligible beyond the customary period. It is estimated that unless the economy improves rapidly, two million workers will exhaust their unemployment insurance coverage by the end of the year in addition to the couple of hundred thousand workers who will lose coverage every month thereafter.

Yet another indication of the economy's depressing composition is the bludgeoning of the stock market. As previously mentioned, inflows into states coffers from stock market transactions in the 1990s, given the widespread participation in the stock market and the growing use of stock options to compensate workers, had been especially plentiful. Alongside the economy's contraction, a trend further accelerated by the September 11 terrorist attacks, the spate of corporate scandals have resulted in the stock markets taking a major beating. In fact, the 2000-2002 bear market ranks among the worst in history, only surpassed by the shelackings administered in 1929-32 and 1937-38. The following table, based on S & P 500 Stock Indexes, helps illustrate this point and the recovery times in the post World War II era.

<b>Date of Market Peak</b>	<b>Date of Market Trough</b>	<b>Peak to Trough Decline</b>	<b>Time to Break Even</b>
March 24, 2000	October 9, 2002	-49%	?
July 17, 1998	August 31, 1998	-19%	4 Months
July 16, 1990	October 1990	-20%	9 Months
August 25, 1987	December 24, 1987	-34%	1 Year, 9 Months
November 28, 1980	August 12, 1982	-27	1 Year, 11 Months
September 21, 1976	March 6, 1978	-20	4 Months
January 11, 1973	October 3, 1974	-48	3 Years, 9 Months
November 29, 1968	May 26, 1970	-36	2 Years, 3 Months
February 9, 1966	October 7, 1966	-22	1 Year, 3 Months
December 12, 1961	June 26m 1962	-28	1 Year, 5 Months
August 2, 1956	October 22, 1957	-22	2 Years
Average		-32	1 Year, 7 Months

Source: T. Rowe Price Report

As indicated, the current bear market remains the worst on record in the post World War II period. For the Nasdaq Composite Index, comprising mostly of technology stocks, the 76 percent decline in the 2000-2002 bear market was the worst ever, far exceeding the index's decline of 60 percent in 1973-74. Given that the markets have yet to "break even," the current slide could continue for an even more extended period.

### Part III looks at some of the specific implications on state finances of the current economic slowdown

All these seemingly disparate pieces of economic news act in concert to apply pressure on different sectors of the economy. As expected, the most vulnerable sectors of the economy experience the most pressure, and the weak performance of the economy, exemplified in some of the items listed above, has resulted in squeezing state finances. Consequently, almost all states, have to contend with such developments as dwindling revenue flows, rising unemployment numbers and increasing Medicaid caseloads.

#### ◆ Anemic State Revenues

Anemic state revenue inflows remain one of the most persistent problems of the current economic downturn. Alongside the economic contraction, the September 11 terrorist attacks dealt a sledgehammer blow to confidence levels in an already faltering economy. In the aftermath of the attacks, a range of industries (such as tourism, travel, entertainment, service etc.) experienced serious setbacks with state revenues immediately feeling the pinch. In fiscal year 2002, the SLC states—on average—were almost 4.5 percent under their revenue estimates. A glimpse into some recent revenue trends from selected SLC states help reinforce this point.

SLC State	Dir.	Status
Alabama	↗	Total Revenues increased by 1.56% between October 2001 and October 2002
Arkansas	↗	Net General Revenues increased by 4.3% between the first four months of fiscal year 2002 and the first four months of fiscal year 2003 (July-October 2001 vs. July-October 2002)
Florida	↗	Net Revenue increased by 4.6% between first quarter of fiscal year 2002 and the first quarter of fiscal year 2003 (July-September 2001 vs. July-September 2002)
Georgia	↘	Net Revenue decreased by 6.8% between the first quarter of fiscal year 2002 and the first quarter of fiscal year 2003 (July-September 2001 vs. July-September 2002)
Kentucky	↗	Tax Receipts increased by 7.2% between the first four months of fiscal year 2002 and the first four months of fiscal year 2003 (July-October 2001 vs. July-October 2002)
Maryland	↘	Between October 2001 and October 2002, Corporate Income Taxes decreased 6.2%; Personal Income Taxes decreased 2.3%; Sales and Use Taxes increased 4.9%; Inheritance Taxes decreased 19.3%; and Estate Taxes decreased by 55.4%
Mississippi	↗	Total General Fund Revenue Transfers increased by 4% between the first quarter of fiscal year 2002 and the first quarter of fiscal year 2003 (July-September 2001 vs. July-September 2002)
Missouri	↗	State general revenue collections net of refunds for October 2002 barely increased (by 0.2 percent) over those of October 2001. For the first four months of the fiscal year, collections net of refunds decreased by 2 percent over the same period last year.
North Carolina	↗	State tax revenue collections for October 2002 increased significantly by 21 percent over those of October 2001. For the first four months of the fiscal year, tax revenue collections increased by 15 percent over the same period last year.
Oklahoma	↘	Total General Revenues decreased by 9.5% between the first four months of fiscal year 2002 and the first four months of fiscal year 2003 (July-October 2001 vs. July-October 2002)
Tennessee	↗	Total Revenues increased by 10.39% between the first quarter of fiscal year 2002 and the first quarter of fiscal year 2003 (July-September 2001 vs. July-September 2002).
Texas	↘	State Sales Tax Net Collections decreased by 0.7% between October 2001 and October 2002. (Texas has no Income Tax and Sales Taxes are the state's major source of revenue)



Virginia	↗	Total General Fund Revenues increased by 1.1% between the first quarter of fiscal year 2002 and the first quarter of fiscal year 2003 (July-September 2001 vs. July-September 2002)
West Virginia	↘	Revenues for October 2002 were \$15.4 million under estimate.

For the periods reviewed in the 14 SLC states, revenues declined in five states and increased in nine states. Yet, except for North Carolina and Tennessee, which saw increases in several of its tax rates that went into effect July 1, 2002, the increases in the remaining seven states were quite lackluster.

### ◆ Rising Unemployment Levels

As alluded to earlier, tens of thousands of Americans currently find themselves unemployed. The following table includes information on unemployment rates in the SLC states in the past two years when the economy's contraction had a distinct impact on unemployment levels. (September 2002 is the most current state-based unemployment numbers).

#### Unemployment Rates (Percent) in the SLC States, September 2001 and September 2002

SLC State	2001	2002
Alabama	5.5	5.7
Arkansas	5.2	5.0
Florida	5.0	5.1
Georgia	4.0	4.7
Kentucky	5.6	5.2
Louisiana	6.0	5.9
Maryland	4.2	4.0
Mississippi	5.8	5.9
Missouri	4.8	4.8
North Carolina	5.8	6.1
Oklahoma	4.0	4.2
South Carolina	5.7	5.3
Tennessee	4.6	4.8
Texas	5.1	6.1
Virginia	3.9	3.9
West Virginia	4.7	6.1
SLC Average	5.0	5.2
U.S. Average	5.0	5.6

Source: U.S. Department of Labor

During 2001 and 2002, when the economy began its contraction, unemployment rates in the Southern region began rising too. For instance, after increasing to 5 percent in 2001, the rate increased further to 5.2 percent in 2002. In September 2001, while Louisiana had the highest unemployment rate among the SLC states (6 percent), Virginia's 3.9 percent was the lowest. Yet, a number of states continued to perform better than the national average in terms of their unemployment rates in September 2001, with only seven states posting an unemployment rate higher than the national average during this time period. In September 2002, the situation was even better and only six states posted unemployment rates higher than the national average. The SLC states most hard hit on the unemployment front in September 2002 were North Carolina, Texas and West Virginia, whose unemployment rates all stood at 6.1 percent during this period. Once again, Virginia's 3.9 percent, closely followed by Maryland's 4 percent, represented the opposite side of the spectrum. As noted by the U.S. Department of Labor, given that between September 2001 and September 2002, 39 states reported employment gains in government and that a significant portion of federal government employees live in the states of Maryland and Virginia, the strong showing of these two states on the employment front may be explained.

The current employment malaise brought on by last year's recession has highlighted two important features of the contemporary American economy. One, the spate of layoffs that occurred over the last year and a half and that continue even today have been unusually democratic. Perhaps because the collapse of the technology bubble of the late 1990s has hurt white-collar workers even more than their blue-collar counterparts, the unemployment rate for college graduates has risen as much since early last year as it has for high school dropouts. Two, certain fundamental changes in the American economy have bubbled to the surface in the last decade or so. During this time span, American companies have used new technologies and strategies to become more efficient compared to performance levels in the 1970s and 1980s. While these changes blossomed during the boom years of the 1990s and benefitted the country, they will continue to do so in the long term, allowing both incomes and corporate profits to rise. However, during the current employment slump, the productivity increases have enfeebled the job market as companies were able to enhance their output without hiring new workers.

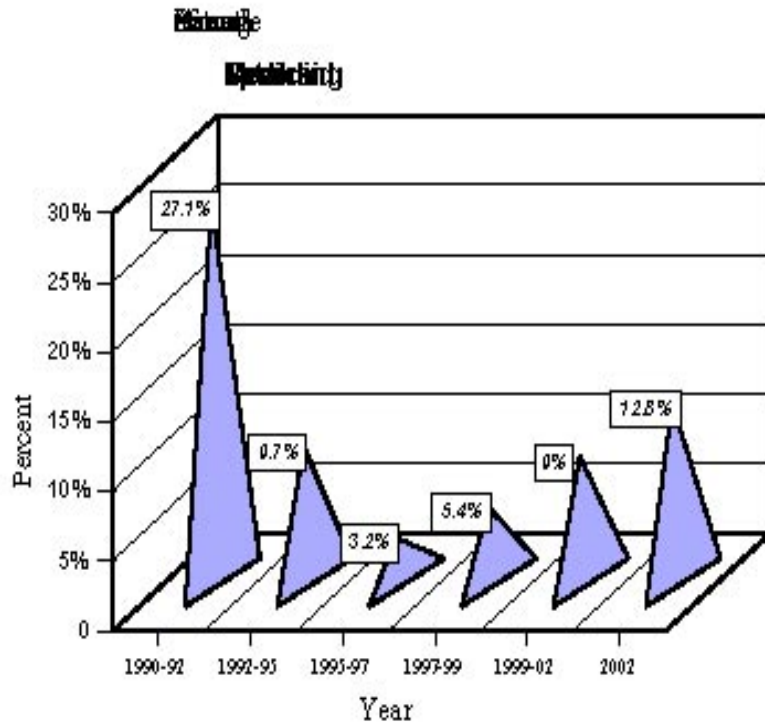
### ◆ **Exploding Medicaid Expenditures**

Because Medicaid represents such a large proportion of most state budgets and because Medicaid costs continue to increase at a much faster pace than most of the other expenditure items, a number of states have been forced to pare down their Medicaid expenditures in an effort to balance their budgets. Unfortunately, since Medicaid, the joint federal-state program that is expected to cover more than 47 million people this year, plays such a critical role in the lives of low-income people, the cutbacks end up affecting the more vulnerable segments of the population. According to the CBO, of the 47 million people expected to be served by Medicaid this year, 24 million are children, 11 million are adults and more than 13 million are elderly and disabled individuals.

The federal government and the states share responsibility for financing Medicaid even though Medicaid is the largest source of federal funds to the states, accounting for 43 percent of all federal grants-in-aid. While the federal government matches state spending for Medicaid services under a federal matching rate, formerly known as the federal medical assistance percentage (FMAP), there is a great deal of variation between states. On average, the federal government pays for at least 57 percent of states' Medicaid expenditures (the range is 50 percent to 77 percent) on a formula based on state per capita incomes. Because of the matching formula, state spending on Medicaid attracts increased federal dollars to the state. Consequently, state cutbacks on Medicaid spending has the unintended consequences of further reducing Medicaid spending with the drop-off in federal funds to the state.

With some states experiencing three consecutive years of budget shortfalls, state Medicaid budgets have come under increasing pressure. Responsible for compounding this bleak fiscal situation are the significant increases in caseload or enrollment numbers and steep increases in the prices of prescription drugs. These twin forces have acted as pincers to squeeze state Medicaid budgets, a trend that eventually affects overall budgets. According to a recent survey, 44 states listed that spending on prescription drugs as one of the three most important reasons for their Medicaid costs to increase while 25 of those states cited prescription drugs as the most significant factor for the higher Medicaid costs. In addition, 39 states noted that increased enrollment was one of the three greatest sources of Medicaid spending growth. Inevitably, the economic contraction sweeping the country caused more people to be eligible for Medicaid coverage, though the aggressive expansion in eligibility and outreach with such programs as the State Children's Health Insurance Program (SCHIP) enacted previously contributed to the growth in enrollment numbers.

Consequently, for the second year in a row in fiscal year 2002, Medicaid spending rose by more than 10 percent. Specifically, while total Medicaid spending in fiscal year 2002 increased by 13 percent (federal, state and local funds), the state share of Medicaid spending expanded by 11 percent (non-federal). In fact, state Medicaid budgets have grown at increasing levels each year since the mid-1990s even though the level it reached in fiscal year 2002 was the highest it has been in almost a decade. The figure demonstrates some of these trends.



Source: For 1990-1999, Urban Institute estimates prepared for the Kaiser Commission on Medicaid and the Uninsured, 2000. For 2000-2002, Health Management Associate surveys for the Kaiser Commission on Medicaid and the Uninsured, 2002.

As documented in the figure, there has been a steady increase in the average annual growth rate of total Medicaid spending since the mid-1990s. After dropping from 27.1 percent in 1990-92, to 9.7 percent in 1992-95, and then 3.2 percent in 1995-97, the average annual growth rate has begun a steady upward growth path. From 5.4 percent in 1997-99 to 9 percent in 1999-2001 and finally, to 12.8 percent in 2002, the rising cost of a number of component items has resulted in the rise of overall Medicaid spending.

The table below provides information on Medicaid enrollment in 14 of the 16 SLC states for June 1997 and December 2001. (Data for Tennessee and West Virginia were not included in this October 2002 Kaiser Commission on Medicaid and the Uninsured survey and consequently are not included in the table.) Given the souring economies in the states, it is fair to expect that at the end of 2002, these enrollment numbers would have increased even further.

**Medicaid Composition in 14 SLC States, June 1997 and December 2001(Enrollment in Thousands)**

SLC State	June 1997			December 2001			Percentage Difference in Total Enrollment (June 1997 to December 2001)
	Total Enrollment	Aged & Disabled	Families, Children, Pregnant Women	Total Enrollment	Aged & Disabled	Families, Children, Pregnant Women	
Alabama	497.4	215.4	282.0	598.4	244.6	353.8	20.3%
Arkansas	273.3	134.6	138.7	399.1	138.0	261.0	46.0%
Florida	1,454.9	527.7	927.3	1,831.7	629.2	1,202.6	25.9%
Georgia	946.6	277.6	669.0	1,063.1	294.2	769.0	12.3%
Kentucky	526.8	225.0	301.8	632.8	250.0	382.7	20.1%
Louisiana	541.7	230.4	311.2	768.2	240.6	527.5	41.8%
Maryland	438.9	138.3	300.5	541.9	142.7	399.2	23.5%
Mississippi*	409.3	185.0	224.0	566.9	204.7	361.6	38.5%
Missouri	569.7	165.7	404.0	847.1	193.6	653.5	48.7%
North Carolina	828.5	305.5	523.0	991.5	348.2	643.2	19.7%
Oklahoma**	282.5	102.9	176.3	465.4	117.5	346.2	64.7%
South Carolina	393.6	161.9	231.6	652.1	174.3	477.8	65.7%
Texas	1,944.1	497.0	1,447.1	1,972.9	501.2	1,471.7	1.5%
Virginia	522.1	185.5	336.6	492.5	193.8	298.7	-5.7%

Source: Medical Enrollment in 50 States: December 2001 Data Update, Kaiser Commission on Medicaid and the Uninsured, October 2002

As demonstrated in the table, a number of SLC states saw a sharp upsurge in their total Medicaid enrollment numbers. In fact, except for Virginia, where there was actually a decline, and Texas, which saw a very nominal increase between the two review periods, all the other Southern states experienced significant double-digit increases. South Carolina and Oklahoma depicted the highest increases in their Medicaid enrollment numbers, with expansions of 65 percent and 66 percent respectively, between June 1997 and December 2001. Furthermore, except for Georgia and North Carolina, which saw increases of 12 percent and just under 20 percent, respectively, all the remaining states experienced growth levels exceeding 20 percent. Given that the severity of the economic contraction has lingered through 2002, it is fair to predict that the current enrollment numbers would reflect a continuation of this trend of steadily increasing Medicaid rolls.

**Part IV deals with what states are doing to overcome the serious economic setbacks**

While the previous sections dealt with where we were and where we are now, this section will delve into some of the actions adopted by states to deal with the ongoing economic slowdown. Policymakers continue to be extremely wary of raising taxes though a number of states had to pursue this course of action; yet, it continues to be the measure of last resort. Some of the measures adopted by states include the following:

■ **Slashing Spending**

A number of SLC states face the unenviable choice of slashing essential programs on account of serious revenue shortfalls plaguing almost all state governments. The governor in Louisiana, for instance, ordered cutting \$75 million in budget cuts at 19 state agencies; the state's Department of Health and Hospitals faces the largest cut, almost \$49 million, a trend that would negatively affect the largest areas of Medicaid spending (hospitals, nursing homes and prescription drugs). Unfortunately, since the state uses state spending to secure matching funds from the federal funds, total losses to health care will surpass \$160 million. In mid-October, the governor was forced to order an additional round of \$82 million in cuts on account of revenue shortfalls.

Given the budget shortfalls in Texas, the governor's attempts to secure input from state agency heads on facing 3 percent to 5 percent reductions in their 2004-2005 budget requests, resulted in a flood of alarming scenarios that

the state would probably have to contend with. Some of the possible scenarios forwarded include the state Health Department slashing aid to 26 counties for indigent health care; the University of Texas closing buildings, losing faculty, offering fewer courses, larger class sizes and reducing freshman enrollment; the Teacher's Retirement System raising premiums by between 11 percent and 17 percent or reducing health care benefits; the Department of Public Safety estimating that 104 more drunk driving deaths could result; and, the Forest Service warning of larger fires, more property losses and slower responses times. Given that Texas ranks 50<sup>th</sup> in the country in overall spending per capita and last in state employment pay, opportunities for trimming fat from the state budget remain very limited.

Virginia is another state dealing with a serious budget shortfall and in mid-October, the governor announced \$858 million in emergency spending cuts, including laying off 1,837 state government workers, shutting down all Department of Motor Vehicles offices one day a week, forcing colleges to raise tuition or lay off staff members, reducing many community services by 10 percent and shortening hours at state-run liquor stores. Given that these drastic steps, budget reductions between 11 percent and 15 percent (the legal maximum) for each of the state's 91 agencies, eliminates less than half of the state's estimated \$2 billion budget shortfall, further cuts remain almost a certainty.

Due to serious revenue shortfalls in its current fiscal year (2003), Oklahoma's State Office of Finance announced across-the-board budget cuts; after making cuts of 2.85 percent in September this year, the Office announced cuts of 6.02 percent for the rest of the fiscal year (October 2002 through June 2003) and then, additional cuts totaling 9.02 percent from December 2002 through June 2003. The state's budget problems will result in the Department of Corrections, for example, furloughing its 4,850 employees for 23 days each this fiscal year; the state Department of Human Services reducing \$22.2 million for the current fiscal year with even bigger losses surfacing with federal matching fund reductions. In Georgia, an SLC state that has pursued very conservative revenue estimates for over a decade now, the governor ordered state agencies to cut spending by 3 percent in July this year; then, in mid-November, the governor ordered another 2 percent reduction in state spending. It is expected that the latest cuts would include cuts in state funding to the 180 local school systems. In Maryland, legislative analysts recently laid out a grim set of options for how the state might deal with its almost \$2 billion budget shortfall, including cutting all employee pay by 1 percent, withholding aid to local governments, scaling back scholarships, raising income taxes on the wealthy, hiking the state's sales tax and property tax rates.

In this vein, a recent report from the College Board announced that battered by government budget cuts, public colleges and universities across the country raised tuition by almost 10 percent this year; in contrast, tuition at private institutions rose by almost 6 percent. Buffeted by budget deficits, several states are planning on cutting back on the number of tests they plan to administer this school year. In Missouri, the state will save \$7.1 million by not paying for its science and social studies exams this year; Maryland middle schools may opt out of the state's 8<sup>th</sup> grade test, so long as they do not receive federal Title I funds; and in Georgia, the state Board of Education has voted to make the state's norm-referenced testing program optional for schools. Despite steep tuition increases to make up for a shortfall in state funding, Tennessee higher education is about \$100 million short to keep pace with neighboring states in per-student spending. In North Carolina, the General Assembly imposed \$52.3 million in cuts to the 16-campus University of North Carolina system during this past session. The cuts included eliminating hundreds of positions, closing computer labs, increasing class size and reducing course offerings.

## ■ Tapping Rainy Day Funds

In fiscal year 2002, 19 states around the country tapped into their rainy day funds to close out their budget gaps. It is estimated that in fiscal year 2003, 12 states would resort to this strategy. The reduced number is explained by the fact that states reduced their reserves considerably in prior years or completely exhausted their balances. In fiscal year 2002, Oklahoma, for instance, utilized \$268 million from its rainy day fund to bridge its budget shortfall; in total, in the past five years, the state spend \$571 million from its rainy day fund. North Carolina has used its rainy day fund in the past several years to address major expenditures and replace lost revenue; consequently, the state's rainy day fund was drawn down from \$522 million in fiscal year 1999 to \$125 million in fiscal year 2002. In Louisiana, Governor Foster secured approval from lawmakers to raid the state's rainy day fund for \$86 million (of the \$263 million currently in the fund) to cover shortfalls between revenues and expenditures. With revenue shortfalls of \$185 million and \$687 million in fiscal years 2001 and 2002, Kentucky was forced to cut spending and completely deplete its \$280 million rainy day fund to cover the gap. In Mississippi, the state has depleted all its one-time sources of funding for the current fiscal year since the state used \$166 million in "bridge money" to balance its budget last year. Maryland's governor announced in late November that the state would take nearly \$190 million from its rainy day fund to fix the state's current budget deficit.

## ■ Deploying Tobacco Settlement Monies

A number of states used the proceeds of securitizing their tobacco settlement monies to address mounting budget gaps in their budgets. While in fiscal year 2002, 12 states deployed this strategy, in fiscal year 2003, it is estimated that 16 states would do so. The rating agencies have frowned upon this practice of states using cash infusions from tobacco securitizations to realign their revenues and expenditures. According to the rating agencies, states leveraging their future settlement payments to obtain short-term revenue flows does not solve the longer-term problem of structural imbalances in their budgets. Missouri tapped \$139.2 million of its funds to offset its shortfall while Alabama secured \$30 million of its funds for Medicaid. To clinch a budget agreement and close the shortfall for fiscal year 2002, Tennessee used \$368 million received to date under the tobacco settlement agreement. In addition, the legislature decided to count \$160 million to be received every year under the agreement for the next 20 years as “recurring revenue” in its budget deliberations. Hence, the state will not have access to any tobacco settlement monies for any other initiative, whether health-related or agriculture-related.

## ■ Raising Taxes

In a striking difference from the last seven years, in fiscal year 2002, a number of states raised taxes to meet their budgetary obligations. This past fiscal year was the first since fiscal year 1994 that there was a net state tax increase, an indication of the difficult fiscal position states find themselves in. Some of the highlights from around the SLC states in this regard:

Only Oklahoma’s *Personal Income Taxes* went up this past session because of an automatic trigger adopted as part of a tax reduction act in 1998. In terms of *Corporate and Business Taxes*, Alabama increased business taxes by \$58 million by taxing interstate long-distance telephone calls.

In terms of *Sales and Use Taxes*, two SLC states remain prominent. In Tennessee, after a rancorous debate on introducing a personal income tax, a debate that has gone on in the Tennessee General Assembly for the past four legislative sessions, it was decided to raise almost \$1 billion in additional taxes to balance the fiscal year 2003. The state portion of the sales tax in Tennessee went up from 6 percent to 7 percent (groceries remain at 6 percent) while local governments can impose up to an additional 2.75 percent. The 9.75 percent sales tax rate in a number of Tennessee counties makes it the highest in the country.

In North Carolina, during this past session, it was decided to allow local governments to increase their portion of the sales tax to 2.5 percent with the state share remaining at 4.5 percent, a total of 7 percent, up from 6.5 percent. In one county, around Charlotte, the rate is slightly higher at 7.5 percent.

Two Southern states raised *Health Care Provider Taxes and Fees* in this past session. Missouri adopted a temporary pharmacy provider tax with variable rates up to 6 percent while South Carolina raised the tax on licensed hospitals. Tennessee also raised its wholesale tax on tobacco products, beer, wine and spirits by 10 percent in addition to increasing its professional privilege tax on doctors, lawyers, accountants and other professions from \$200 to \$400 a year. Florida postponed the previously approved reduction in the tax on intangible property to stave off further revenue shortfalls.

Re-elected Governor Huckabee in Arkansas shocked legislators in mid-November with the proposal to raise the state’s sales tax from 5.125 cents to 5.75 cents and generate \$474 million in new revenue.

## ■ Hiking Cigarette Taxes

While 19 states implemented higher cigarette taxes in 2002, 27 states have not increased their cigarette taxes for at least five years. Four SLC states increased their cigarette taxes in 2002 and they were Arkansas (34 cents), Louisiana (36 cents), Maryland (100 cents) and Tennessee (20 cents). Given their continuing fiscal difficulties, certain SLC states might raise cigarette taxes in the upcoming session. Governor Wise in West Virginia has proposed increasing his state’s cigarette tax to at least 55 cents per pack and using the all revenue from the increase to bail out the state’s Medicaid program. The following table presents information on cigarette taxes in the SLC.

SLC State	Cents Per Pack	National (1=Highest)	Date of Last State Tax Hike	FY 2001 Cigarette Pack Sales	FY 2001 Cigarette Tax Revenue
Alabama	16.5 cents	45th	July 1, 1984	402.3 Million	\$62.5 Million
Arkansas	34 cents	32nd	July 1, 2002	271.8 Million	\$82.5 Million
Florida	33.9 cents	33rd	July 1, 1990	1,255.8 Million	\$419.7 Million
Georgia	12 cents	46th	April 1, 1971	703.6 Million	\$81.8 Million
Kentucky	3 cents	50th	July 1, 1970	616.8 Million	\$16.8 Million
Louisiana	36 cents	29th	July 1, 2002	371.5 Million	\$78.6 Million
Maryland	100 cents	9th	June 1, 2002	307.8 Million	\$197.7 Million
Mississippi	18 cents	41st	June 1, 1985	267.0 Million	\$45.0 Million
Missouri	17 cents	43rd	October 1, 1993	603.0 Million	\$99.4 Million
North Carolina	5 cents	49th	August 1, 1991	806.1 Million	\$38.8 Million
Oklahoma	23 cents	37th	June 1, 1987	373.0 Million	\$61.1 Million
South Carolina	7 cents	48th	July 1, 1977	387.6 Million	\$24.9 Million
Tennessee	20 cents	39th	July 1, 2002	588.9 Million	\$74.2 Million
Texas	41 cents	28th	July 1, 1990	1,294.7 Million	\$480.8 Million
Virginia	2.5 cents	51st	August 1, 1960	666.3 Million	\$15.1 Million
West Virginia	17 cents	43rd	August 1, 1978	197.9 Million	\$32.1 Million

Source: Campaign for Tobacco-Free Kids

#### ■ Generating Funds Via State Lotteries

Tennessee became the latest state to move closer towards establishing a state lottery to pay for specific education initiatives when voters approved an amendment to the state constitution this past November. This clears the way for the General Assembly to create a lottery that would be constitutionally required to pay for college scholarships for qualifying students with any remaining revenue going to construction and technology projects in K-12 schools and after-school-programs. When this happens, Utah and Hawaii will be the only 2 states without any form of legalized gambling.

The victory of Congressman Robert Ehrlick as governor of Maryland in November made slots at the racetracks a real possibility. During his campaign, Governor-Elect Ehrlick listed revenue from slots as a source of additional funding for the state. In North Carolina, during this past session, a measure to place a referendum on the ballot on introducing a state lottery to fund education initiatives was defeated in the General Assembly.

## Part V looks at some of the positive features of the current economy

Policymakers at the state level grapple with a dramatic deterioration in their fiscal positions brought on by souring economic conditions. Rapidly diminishing revenue flows have resulted in reductions in public services and there is no respite in the short term. The federal government faces its own string of fiscal problems compounded by a range of national security concerns. Yet, the sense of gloom that permeates the financial and economic climate currently has to be tempered with the following items of positive news: the economy is still expanding and is likely to expand at a rate between 2.5 percent and 3 percent this year; inflation remains quite subdued; the record low interest rates that have propelled consumers to purchase homes and re-finance their mortgages; and finally, the efficiency and productivity gains of the late 1990s remain intact and the economy can build on those pillars to reach higher productivity levels and higher incomes in the future.

To elaborate on the last two items. The record-low mortgage rates, the lowest in decades, is another positive feature of the economy that deserves special mention here. These low rates have propelled a number of Americans to both purchase their first homes and also re-finance their existing mortgages. Consequently, the savings associated with the lower interest rates have freed up cash for other expenses. The following table compares mortgage rates in the SLC states in mid-May 1998 and mid-November 2002. While rates were considered very attractive and low in mid-May 1998, the rates now are even lower.

SLC State	30-Year Fixed		15-Year Fixed		1-Year Adjustable	
	May 1998	Nov. 2002	May 1998	Nov. 2002	May 1998	Nov. 2002
Alabama	6.91%	5.61	6.55%	5.06	5.70%	3.87
Arkansas	6.88%	5.61	6.55%	5.04	5.52%	3.82
Florida	7.03%	5.61	6.72%	5.04	5.78%	4.05
Georgia	6.84%	5.62	6.52%	5.04	5.43%	3.77
Kentucky	7.02%	5.61	6.73%	5.02	5.97%	3.83
Louisiana	6.96%	5.63	6.65%	5.07	5.34%	3.94
Maryland	6.91%	5.69	6.58%	5.12	5.42%	4.05
Mississippi	6.95%	5.59	6.59%	5.03	5.62%	4.06
Missouri	7.20%	5.66	6.92%	5.09	6.01%	3.99
North Carolina	6.98%	5.61	6.64%	5.04	5.75%	3.96
Oklahoma	7.10%	5.62	6.73%	5.04	5.73%	3.76
South Carolina	6.91%	5.60	6.59%	5.03	5.55%	3.73
Tennessee	6.84%	5.63	6.50%	5.06	5.36%	3.83
Texas	6.90%	5.61	6.56%	5.04	5.47%	3.88
Virginia	6.99%	5.66	6.66%	5.10	5.50%	4.06
West Virginia	7.03%	5.64	6.68%	5.09	6.05%	3.86
SLC Average	6.97%	5.63%	6.64%	5.06%	5.64%	3.90%
U.S. Average	6.97%	5.64	6.65%	5.07	5.67%	3.98

Source: Bank Rate Monitor Data, May 20, 1998 and November 13, 2002

American productivity has continued to post impressive gains recently and the 4 percent growth in productivity in the third quarter of 2002 brings the annual rate over the past year to a remarkable 5.3 percent, the best performance in nearly two decades. The effects of strong productivity growth remain crucial in the long run as it determines the economy's capacity to expand without igniting inflation. The production surge results in companies squeezing out better profits despite stagnant or low sales, a development that both rallies the value of these companies and the overall stock market. Eventually, companies will be driven to increase their capital spending, a trend that will spur the economy's growth levels. On the negative side, the greater efficiencies mean that companies can delay hiring new workers for a longer period, a situation that does not bode well in lowering unemployment rates.

Federal Reserve Bank Chairman Alan Greenspan has been a fervent proponent of the theory that the American economy has entered an era of stronger productivity growth. Specifically, Chairman Greenspan notes that over the past



seven years, output per hour has been growing at an annual rate of more than 2.5 percent, on average, compared with a rate of roughly 1.5 percent during the preceding two decades. Hence, it is important to factor the long-term implications of these productivity gains into our future prospects and not focus solely on the tepid economic recovery that is currently underway.

A real-life example using a mid-sized, Atlanta, Georgia-based company, helps illustrate the efficiency gains and productivity improvements Chairman Greenspan has been talking about recently. **CyberStarts** is a technology holding company that has launched and runs e-finance businesses. Of its four subsidiary units, **eDebt**, specializes in the sale, placement, and management of charge-off, sub-performing, and performing receivables through the use of web technology; **Bridium**, is a software developer of insurance solutions and services for the insurance financial services industry that permits insurance administrators, employers, healthcare providers and others in the claims administration processes to fully manage claim and medical files in real time and integrate information from third party sources, data content providers, suppliers, customers and others (**Bridium's** approach reduces costs and improves employee efficiency and productivity, saving customers up to 30 percent on direct and indirect expenses); **Sunaro, Inc.** is an employee benefits company which delivers, over the Internet, a full spectrum of employee benefits solutions that include enrollment, administration and communication; and, **FiWare, Inc.**, is an e-finance infrastructure company specializing in secure web-enabled business-to-business payments, providing secure, web-enabled applications involving multi-location e-payment and e-billing solutions. The activities performed by these companies clearly exemplifies the tremendous efficiencies attained by American companies in bringing essential services to both consumers and companies. Formerly, the tasks completed by the Cyberstarts' companies were carried out by whole departments in a score of companies. Companies actually eliminated, either completely or partially, their Accounts Receivables and Employee Benefits departments by retaining the services of the Cyberstarts companies. Using technology as the basis, these multiple tasks and responsibilities have now been centralized into a much more cost-effective, efficient and user-friendly operation. These are the kind of efficiency gains that contributed to the recently achieved productivity gains, the best performance in nearly two decades.

#### **Conclusion:**

In closing, while the current fiscal dilemmas confronting states remain the worst in at least a decade (the worst since World War II according to the National Governor's Association), the healthy fiscal situations states found themselves in the 1990s certainly prepared them for the onset of these grim fiscal times. Most states built up healthy rainy day funds even though they have been forced to draw down these balances in the last two years. Yet, the situation is not all gloom and doom and there are several positive features about the current economy that have to be factored into overall calculations. Given no major disruptions, the economy will continue to grow and gather steam in the latter half of 2002.