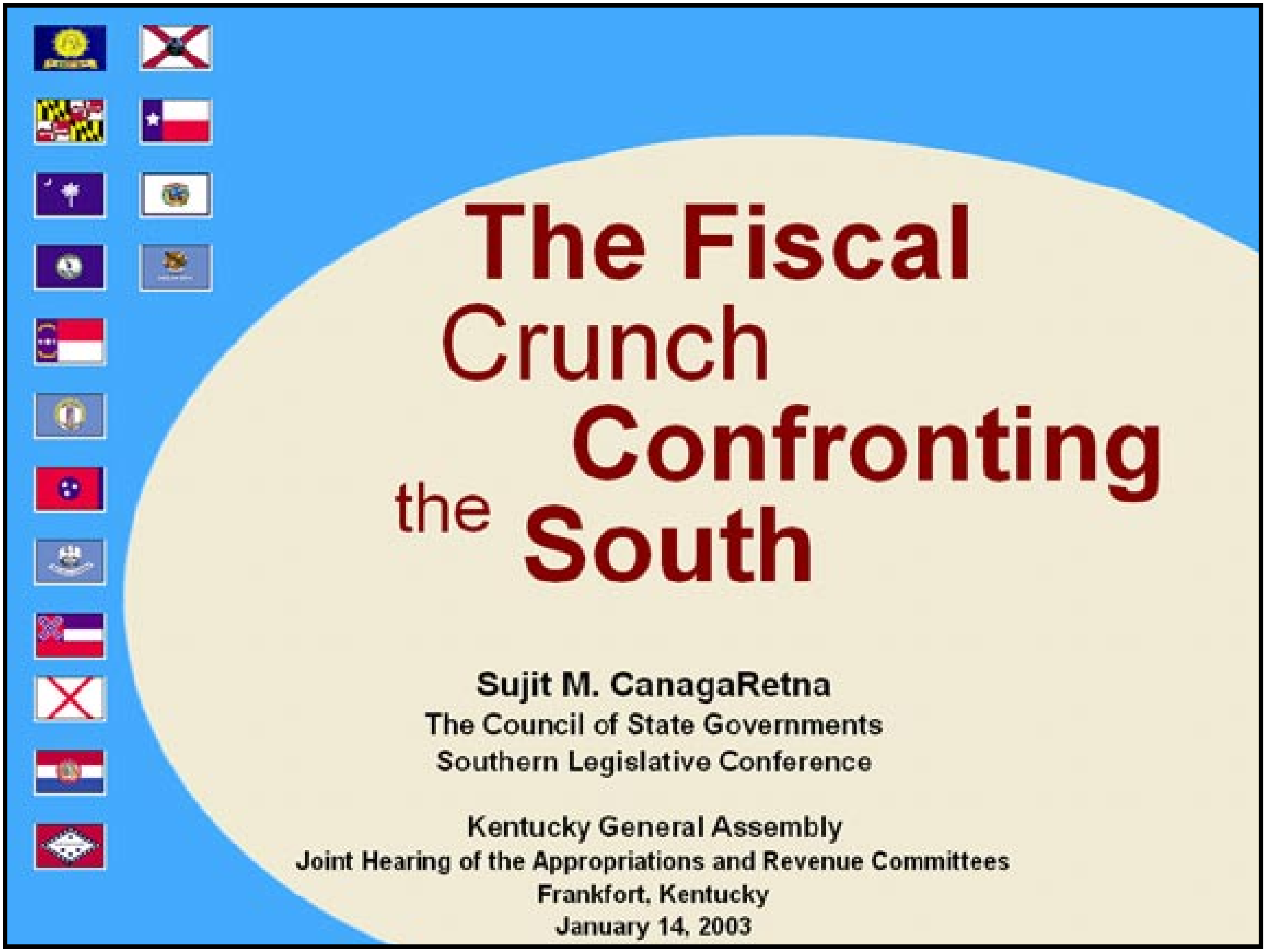


It is a great honor to be here this morning at the Joint Hearing of the Appropriations and Revenue Committees of the Kentucky General Assembly. I would like to thank the Co-Chairs Senator Sanders and Representative Moberly for extending this invitation to me and to The Council of State Governments' Southern Office, the Southern Legislative Conference (SLC).

My remarks this morning deal with the bleak 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 interconnected parts. Part I reviews some aspects of the longest economic expansion in the history of the country that extended for most of the 1990s. 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 my presentation looks at the decade of economic expansion

After a decade of sustained 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 land in 2001. 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 this decade of expansion, an unparalleled level of prosperity facilitated soaring personal incomes and corporate profits; dwindling unemployment, low inflation and rapid economic growth; 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. Revenue 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. The $246 billion state tobacco settlement was another factor in pushing state budgets toward 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.

During this decade, there were several years, particularly in the late 1990s, when national GDP growth rates were very impressive. Specifically, annual growth rates 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, these stellar economic growth levels were achieved without an accompanying rise in inflation, a development that defied conventional economic wisdom.

For the 16 SLC states, a review of gross state product (GSP) data indicates that a number of them were high-fliers during this boom period. Between 1999 and 2000, GSP growth in Virginia, Texas and North Carolina were the leaders here and their growth rates were significantly higher than the U.S. average of 3.8 percent.

Another key measure of the decade's success involves the low rate of unemployment both in the U.S. and in the SLC states. In fact, unemployment rates at the national, regional and individual SLC state levels were all at historic lows. The Nation's unemployment rate declined steadily in the 1990s, specifically from 5.6 percent in November 1995 to 4 percent in November 2000. This trend tracked the growth path taken by the American economy which grew steadily during this time period. Even in terms of the SLC states for the same period, it appears that the average unemployment rate generally mirrored the trends depicted by the national rate. After reaching 5.5 percent in November 1995, the average unemployment rate in the SLC states began declining steadily in the next five years to 4.1 percent in November 2000.

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. Total returns on the Standard & Poor's 500 Stock Index for the five-year period 1995 to 1999 averaged almost 29 percent.

Part II focuses on our current predicament 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 seriously challenge policymakers.

After running budget surpluses for 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, will propel the federal government into a deficit for the next three years. This past year's $131 billion plunge in federal tax revenue was considerably steeper than the economy's own fall. In 2001, 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. 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 forecasting in 2002 that the federal government surplus will only amount to about $1 trillion between fiscal years 2003 and 2012.

After reaching a high of $290 billion in FY 1992, the highest level in 40 years, the federal budget deficit began declining steadily thereafter. The surplus began in FY 1998, peaked at $237 billion in FY 2000 and slipped to $127 billion in FY 2001. For the just concluded FY 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 FY 1997. Private forecasters indicate that for FY 2003, factoring in the president's latest economic stimulus package and a possible war with Iraq, the federal budget deficit could reach a whopping $350 billion.

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 recently concluded fiscal year (2002). States then struggled to close budget gaps totaling $50 billion while enacting their FY 2003 budgets; an additional $17.5 billion in deficits have opened up in states in the last few months. For the upcoming fiscal year, FY 2004, the estimates are even more staggering with states expected to face deficits in the range of $60 billion to $85 billion, representing between 13 and 18 percent of all state expenditures. California faces a shortfall of monumental proportions, almost $35 billion in the next 18 months; the City of New York faces a deficit of $1.1 billion this fiscal year and $6.4 billion in FY 2004. 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 have been forced to slash spending, raise taxes and continue to deplete reserve funds.

A few examples from around the South help reinforce the dismal choices confronting states. Virginia faces a budget shortfall of up to $2 billion in the current fiscal year and the next and the governor has already made substantial program and personnel cuts. In Texas, the state's budget shortfall will probably reach a staggering $12 billion when lawmakers gather for their biennial session today. Maryland's new governor and General Assembly face a budget shortfall close to $1.9 billion for the current fiscal year and the next. 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 upcoming fiscal year. Alabama faces a shortfall in the hundreds of millions in its FY 2004 budget if lawmakers want to preserve state schools and services at current levels. Geogia faces a $620 million deficit in FY 2003 and in 15 of the last 18 months, Georgia experienced negative inflows from tax revenues and fee collections; even in the three positive months, revenue growth was less than 3 percent. In North Carolina, while budget writers used more than $800 million in non-recurring revenue to fund ongoing expenses in the FY 2003 budget, a deficit that could exceed $1.5 billion is a real possibility next year. Missouri's shortfall is expected to top $300 million this fiscal year, a development that has already resulted in layoffs and withholdings.

Several other economic indicators confirm the lethargic performance of the economy. Given the recession that swept the country in 2001, national GDP growth has been much more subdued. Growth in two consecutive quarters in 2001 was in negative territory, a scenario that met the technical standards for an economic recession. Even though the GDP increase in the third quarter of 2002 was the fourth in a row for the economy, the gains were somewhat less than experts had predicted. The decision of the Federal Reserve Bank to cut interest rates by a hefty 50 basis points at its November 2002 meeting was an attempt to stave off the likelihood of the economy recoiling into negative growth territory.

Furthermore, The Conference Board reported that consumer confidence declined again in December 2002 after plunging to a nine-year low in October 2002.

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 December 2002, the U.S. Department of Labor just reported that the number of unemployed persons stood at 8.6 million and that the unemployment rate was 6 percent, the same as the prior month.

Yet another indication of the economy's depressing composition is the bludgeoning of the stock market. As previously mentioned, inflows into state coffers from stock market transactions in the 1990s had been especially plentiful. Alongside the economy's contraction, a trend further accelerated by the September 11 terrorist attacks, uncertainties over confrontations with Iraq and North Korea, higher oil prices and a spate of corporate scandals, the stock markets have taken a major beating recently. In fact, the 2000-2002 bear market is the worst since World War II and in history, only surpassed by the shellacking administered to the markets during the Great Depression. From January through mid-December 2002, the stock market lost 20 percent of its value, or $2.6 trillion, the third consecutive year of losses.

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 and squeezing state finances. Consequently, almost all states, have to contend with such developments as dwindling revenue flows, rising unemployment numbers and exploding Medicaid caseloads.

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, services) experienced serious setbacks with state revenues immediately feeling the pinch. In FY 2002, the SLC states were–on average–almost 4.5 percent under their revenue estimates. While Southern state revenue inflows have improved marginally in recent months, they remain well below the boom years.

Most recently, in November and December 2002 in 15 SLC states, revenues declined in seven and increased in eight. Yet, except for North Carolina and Tennessee, which saw tax hikes, the revenue increases in the remaining states were quite lackluster.

Tens of thousands of Americans currently find themselves unemployed. The economy's slowing in the past few years has had a distinct impact on unemployment levels and this is evident in the SLC states too. During 2001 and 2002, when the economy began its contraction, unemployment rates in the Southern region began rising too. For instance, after increasing to 5.4 percent in November 2001, the rate decreased slightly to 5.3 percent in November 2002. The SLC states most hard hit on the unemployment front in November 2002 were Louisiana, Mississippi, North Carolina, South Carolina, Texas and West Virginia, whose unemployment rates were all above the national average of 6 percent. Virginia's 3.9 percent, closely followed by Maryland's 4 percent, represented the opposite side of the spectrum.

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, plays such a critical role in the lives of low-income people, the cutbacks end up affecting the more vulnerable segments of the population.

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 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.

Consequently, for the second year in a row in FY 2002, Medicaid spending rose by more than 10 percent. 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 percent between 1990 and 1992 to 10 percent between 1992 and 1995 and then 3 percent between 1995 and 1997, the average annual growth rate has begun a steady upward path. From 5 percent between 1997 and 1999 to 9 percent between 1999 and 2001 and finally, to 13 percent in 2002, the increase in a number of component items has resulted in the rise of overall Medicaid spending. The increase in FY 2002 was the highest in a decade.

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. As they did in FY 2002, states will enact a range of cost containment measures in FY 2003 such as pharmacy controls, provider payment cutbacks, co-payment increases and benefit reductions to curb their Medicaid budgets. Early estimates indicate that due to major reductions in Medicaid programs, approximately one million low-income individuals will lose health insurance coverage this year.

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

States have adopted a number of actions to deal with the ongoing slowdown. While policymakers continue to be extremely wary of raising taxes, 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**
  From the $6 billion trimmed from the Virginia budget to the nearly $900 million pared from the Missouri budget in the last two years, SLC states face the unenviable choice of slashing essential programs on account of serious revenue shortfalls. The governor in Louisiana cut $75 million at 19 state agencies last fall; the state's Department of Health and Hospitals

faced the biggest cut, almost $49 million, a trend that negatively affected the largest areas of Medicaid spending. Unfortunately, since Louisiana relies on state spending to secure matching federal funds, total state losses in health care will surpass $160 million. Later on, the governor ordered an additional round of $82 million in cuts on account of revenue shortfalls. Given the budget shortfall in Texas, very likely $12 billion, Governor Perry's attempts to secure input from state agency heads on facing 3 to 5 percent reductions in their upcoming budget requests, resulted in a flood of alarming scenarios that the state would have to contend with. Some of the possible scenarios forwarded include cutbacks in education, health care and public safety. Given that Texas ranks 50th 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 enacted $858 million in emergency spending cuts, including laying-off almost 1,900 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. Last week, Governor Warner in Virginia proposed an additional $400 million in cuts. Due to serious revenue shortfalls in its current fiscal year, Oklahoma's State Office of Finance announced across-the-board budget cuts totaling 9 percent. Oklahoma has also cut $600 million from its FY 2004 budget. In Georgia, an SLC state that has pursued very conservative revenue estimates for over a decade now, Governor Barnes ordered state agencies to cut spending by 3 percent in July 2002; then, in mid-November, he ordered another 2 percent reduction in state spending. Missouri laid-off almost 900 state workers and is looking at further layoffs in the areas of foster care, law enforcement and freezing aid to public schools. In Maryland, legislative analysts 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 and 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 in 2002 even though tuition at private institutions rose by about 6 percent. This is reflected in a number of SLC states too, and college students in North Carolina, Tennessee, Missouri, Florida and Virginia feel the pinch of higher fees.

- **Tapping Rainy Day Funds**
  In FY 2002, 19 states around the country tapped into their rainy day funds to close out their budget gaps. It is estimated that in FY 2003, 12 states would resort to this strategy. In FY 2002, Oklahoma utilized $268 million from its rainy day fund to bridge its shortfall; in total, in the past five years, the state spent $571 million from its rainy day fund. North Carolina 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 FY 1999 to $125 million in FY 2002. In Louisiana, Governor Foster secured approval from lawmakers in November 2002 to raid the state's rainy day fund for the first time by using $86 million of the $263 million currently in the fund. Maryland's governor announced in late November that the state would take nearly $190 million from its rainy day fund to partially 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. While in FY 2002, 12 states deployed this strategy, in FY 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 pay for day-to-day operations. Missouri tapped $139 million of its funds to offset its past budget shortfall and is working on securing another $350 million for this year. Alabama secured $30 million of its funds for Medicaid. To clinch a budget agreement and close the shortfall for FY 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 previous seven years, in FY 2002, a number of states raised taxes to meet their budgetary obligations. This past fiscal year was the first since FY 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: 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 were prominent here. In Tennessee, after a rancourous debate on introducing a personal income tax, the state raised almost $1 billion in new taxes to balance its books for FY 2003. The state portion of the sales tax in Tennessee went up from 6 percent to 7 percent while local governments can impose 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 the 2002 session, local governments were allowed to increase their portion of the sales tax to 2.5 percent with the state share remaining at 4.5 percent for a total of 7 percent. North Carolina also just raised its motor fuels tax in the 2002 session while South Carolina expects to raise it during this year's session. Governor Holden in Missouri is calling for eliminating corporate loopholes, a move that could bring in $100 million while Maryland is looking at saving $200 million in lost corporate tax revenue from companies creating out-of-state holding companies. The new speaker in Arkansas has proposed removing the income and capital gains tax cuts passed in 1997 and 1999. Arkansas is also reviewing the hundreds of millions of dollars ($584 million according to a recent study) in sales tax exemptions granted to a range of entities. Georgia lawmakers are mulling over proposals to raise the state's gas tax by 6 percent and raise an estimated $450 million. Georgia's gas tax is among the lowest in the nation and has not been raised for 31 years. Soon after he was reelected in November last year, Arkansas Governor Huckabee shocked legislators with his proposal to raise the state's sales tax 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 (1 dollar) and Tennessee (20 cents). Governor Wise in West Virginia has proposed increasing his state's cigarette tax to at least 55 cents per pack and using all the revenue from the increase to bail out the state's Medicaid program. Texas is considering raising its cigarette tax to $1 per pack, a move that could generate $1 billion in new revenue. Similarly, South Carolina expects to generate $150 million from increasing its cigarette tax and there are proposals to do the same in Georgia.

- **Generating Funds Via State Lotteries**
  When Tennessee voters approved an amendment to the state constitution in November 2002, it cleared the way for the General Assembly to create a lottery that would be constitutionally required to pay for college scholarships. When this happens, Utah and Hawaii will be the only 2 states without any form of legalized gambling. The new governor of Maryland campaigned on slots at the racetracks and this is a real possibility in the state.

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 primarily 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 will expand at a rate close to 2.7 percent in 2002; inflation remains quite subdued; record low interest rates have propelled consumers to purchase homes and refinance 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.

If I may elaborate on these last two items. The record-low mortgage rates, the lowest in some four decades, is an important positive feature of the economy. These low rates have propelled a number of Americans to both purchase their first homes and also refinance their existing mortgages. In fact, home ownership stands at a record 68 percent of all households. The savings associated with lower interest rates have freed up cash for other expenses. A comparison of mortgage rates in the SLC states in mid-May 1998 and early-January 2003 indicates that while rates were considered very attractive and low some five years ago, the rates now are even lower.

American productivity has continued to post impressive gains recently and the 4 percent growth in productivity in the third quarter of 2002 brought the annual rate 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. 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. 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. Using technology as the basis, these productivity gains have facilitated multiple tasks and responsibilities being centralized into much more cost-effective, efficient and user-friendly operations.

Conclusion:

In closing, while the current fiscal dilemmas confronting states remain the worst in years (the worst since World War II according to the National Governors' Association), the healthy fiscal situations states found themselves in the 1990s did prepare 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 few 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 and there are certainly a number of potential

The Fiscal Crunch Confronting the South

Sujit M. CanagaRetna
The Council of State Governments
Southern Legislative Conference

Kentucky General Assembly
Joint Hearing of the Appropriations and Revenue Committees
Frankfort, Kentucky
January 14, 2003

Presentation's **Five** Main Parts

1. Where We Were
2. Where We Are
3. What these New Conditions Mean for States
4. What Measures States Have Taken
5. What Can We Expect

I. Some Measures of the **Boom Years**

- Impressive GDP Growth at both the National and State Levels
- Extremely Favorable Unemployment Rates at both the National and State Levels
- High-Flying Stock Market
- Soaring Personal Incomes and Corporate Profits
- Low Inflation Rates
- Rising Revenue Flows to All Levels of Government-Federal, State and Local

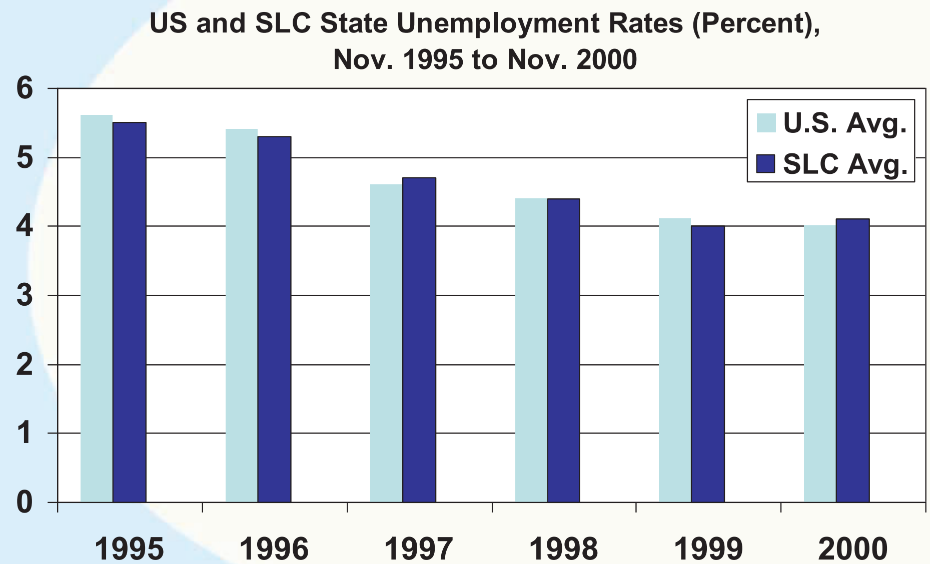
I. Focus on the Specifics:

GDP

- National GDP Growth
  1991= -0.5% 1994 = 4.0%
  1997= 4.4% 2000 = 3.8%
- SLC States Average GDP Growth
  1998 = 5.3% 1999 = 5.6%
  2000 = 6.1%
- In 2000, Virginia = 8.6%; Texas = 8.4%; North Carolina = 8.1%
- Actual GDP in 2000 (Current Dollars)
  Texas = $742.3 Billion; Florida = $472.1 Billion
  Georgia = $296.1 Billion; North Carolina = $281.7 Billion; Kentucky = $118.5 Billion

I. Focus on the Specifics:

Unemployment Rate (Percent), 1995 to 2000



I. Focus on the Specifics:

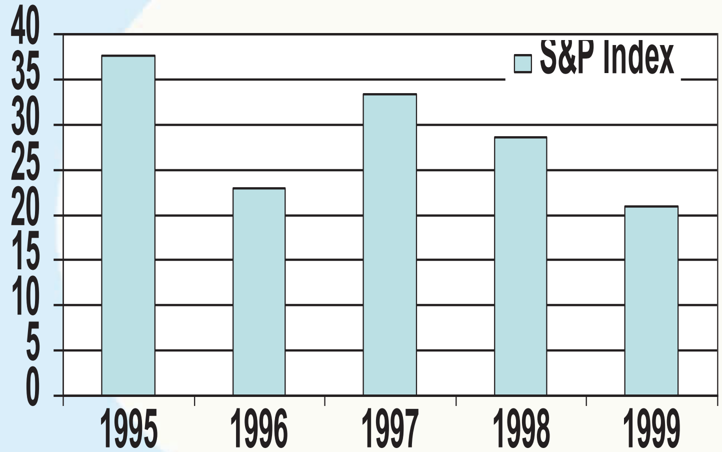
Low Unemployment Rates in SLC States, November 2000 (Percent)

AL = 4.6%	MO = 3.5%
AR = 4.2%	NC = 3.9%
FL = 3.6%	OK = 2.9%
GA = 3.4%	SC = 3.3%
KY = 4.1%	TN = 4.2%
LA = 6.0%	TX = 4.0%
MD = 3.8%	VA = 2.1%
MS = 5.6%	WV = 5.6%

I. Focus on the Specifics:

Total Returns on the S & P 500 Stock Index

Average Growth = 29% Between 1995-99



Stock Market's Growth Brought in Tremendous Revenue Flows into Government Coffers with Increased Capital-Gains Taxes and Withholding Taxes

II. Current Predicament:

Federal

- Federal Budget Deficits Loom (FFY)
  1992 = $-290.4 Billion   1996 = $-107.5 Billion
  1998 = $69.2 Billion   1999 = $125.5 Billion
  2000 = $125.5 Billion   2001 = $127.1 Billion
  2002 = $-159 Billion 2003 = $-350 Billion(?)
- In January 2001, CBO predicted a federal budget surplus of $5.6 Trillion between 2002 and 2011
- In late 2002, that surplus shriveled to only about $1 Trillion between 2003 and 2012

II.Current Predicament:

State

- At least 46 states struggled to close a cumulative budget gap of $37 Billion in FY 2002
- For FY 2003, the estimated cumulative budget gap is almost $68Billion
- For FY 2004, the estimated shortfall is a staggering $60 billion to $85 billion, some 13 to 18 percent of all state expenditures
- Highlights from outside the region:
  - California faces an almost $35 billion shortfall in the next 18 months
  - New York City alone faces a budget gap of $7.5 billion in the next 18 months

II.Current Predicament:

Selected SLC State FY 2004 Deficit Estimates

State	Deficit (Millions)	% of Budget
Alabama	$1,300	24.2%
Arkansas	$223	7.0%
Florida	$2,000	10.1%
Georgia	$900	5.8%
Maryland	$1,200	11.0%
N. Carolina	$1,700 to $2,000	12.4% to 14.6%
Oklahoma	$800	15.9%
S. Carolina	$700	13.6%
Virginia	$1,116	9.3%
W. Virginia	$200	7.1%

II. Current Predicament:

Signs of the Weakening Economy: Subdued GDP Growth

Two Consecutive Quarters of Negative GDP Growth in 2001 Met the Technical Requirements for a Recession

2001				2002		
Qtr.1	Qtr.2	Qtr.3	Qtr.4	Qtr.1	Qtr.2	Qtr.3
1.5%	-0.1%	-0.4%	0.1%	1.4%	2.2%	3.2%

II.Current Predicament:

Other Signs of Weakening Economy

- Plummeting Consumer Confidence, Nine-Year Low in October 2002
- Number of People Below the Federal Poverty Threshold in 2001stood at 32.9 Million, or 11.7% of Total Pop., first increase since 1991/92 recession
- Plunging Stock Market-Worst Bear Market in Since World War II

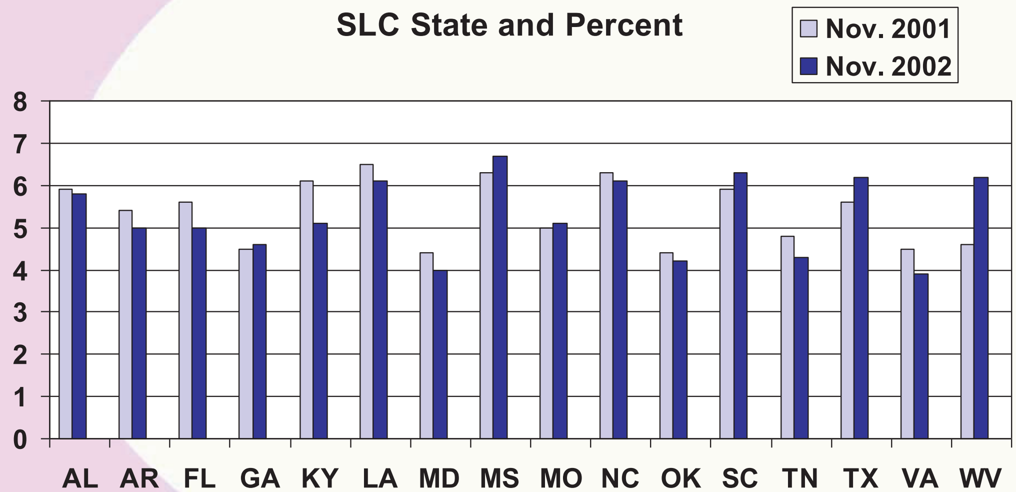
III.Implications for State Finances: Anemic Revenue Inflows

AL	Total Revenues increased by 9% between Dec. 2001 and Dec. 2002 and increased by 5% between the first three months of FY 2002 and FY 2003
AR	Net General Revenues increased by 4% between the first six months of FY 2002 and FY 2003 (July-Dec. 2001 vs. July-Dec. 2002)
FL	Net Revenue increased by 2% between the first five months of FY 2002 and FY 2003 (July-Nov. 2001 vs. July-Nov. 2002)
GA	Net Revenue decreased by 4% between the first six months of FY 2002 and FY 2003 (July-Dec. 2001 vs. July-Dec. 2002)
KY	Tax Receipts increased by 6% between the first five months of FY 2002 and FY 2003 (July-Nov. 2001 vs. July-Nov. 2002)
MD	Between Nov. 2001 and Nov. 2002, Sales and Use Taxes decreased by 2% but increased by 2% for the first four months of FY 2003 and FY 2004 (Aug.-Nov. 2001 vs. Aug.-Nov. 2002)
MS	Total General Fund Revenue Transfers increased by 2% between the first five months of FY 2002 FY 2003 (July-Nov. 2001 vs. July-Nov. 2002)
MO	Between Dec. 2001 and Dec. 2002, General Revenue collections decreased by 1% and decreased by 3% between the first six months of FY 2002 and FY 2003 (July-Dec. 2001 vs. July-Dec. 2002)

III.Implications for State Finances: Anemic Revenue Inflows (Cont.)

NC	State Tax Revenue collections for Nov. 2002 decreased by 7% over Nov. 2001. Between the first five months of FY 2002 and 2003, Tax Revenue collections increased by 11%
OK	Total General Revenues barely increased (0.3%) between Nov. 2001 and Nov. 2002. Between the first five months of FY 2002 and 2003 (July-Nov. 2001 vs. July-Nov. 2002), total General Revenue declined by 8%
SC	Total Revenue increased by 2% between the first five months of FY 2002 and 2003 (July-Nov. 2001 and July-Nov. 2002).
TN	Total Revenues increased by 8% between Nov. 2001 and Nov. 2002
TX	State Sales Tax Net Collections decreased by 1% between Dec. 2001and Dec. 2002 (Texas has no Income Tax)
VA	Total General Fund Revenues decreased by 4% between Nov. 2001 and Nov. 2002. Between the first five months of FY 2002 and FY 2003 (July-Nov. 2001 vs. July-Nov. 2002) revenues declined by 1%
WV	Revenues for Dec. 2002 were $4 million over estimates and $1million over estimates for the first six months of FY 2003

III.Implications for State Finances: Rising SLC State Unemployment Rates (Percent), November 2001 and November 2002



III. Implications for State Finances:

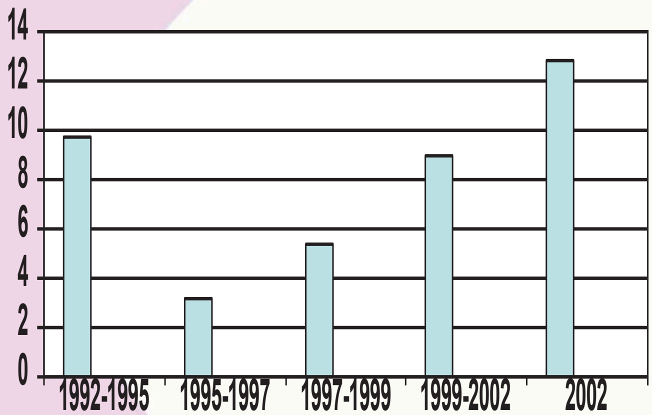
Rising Unemployment Rates (Percent), November 2001 and November 2002 (Cont.)

- Average SLC Unemployment Rate Still Lower than National Rate in November 2002 (5.3% vs. 6%). They were 5.3% and 5.4% respectively in November 2001
- SLC States Most Hard Hit in November 2002: Louisiana, Mississippi, North Carolina, South Carolina, Texas and West Virginia, all above 6%

III.Implications for State Finances: Exploding Medicaid Costs

- Major Reasons Cited by States for Exploding Medicaid Budgets: Prescription Drugs (44 states) and Increased Enrollment (39 states)
- Some Cost Containment Actions Taken by SLC States in FY 2002:
  - Pharmacy Controls (12 states)
  - Provider Payment Reductions (8 states)
  - Clamp Down on Fraud/Abuse (6 states)
- Similar Measures Can Be Expected in FY 2003 along with cutbacks in Medicaid eligibility

III. Implications for State Finances: Exploding Medicaid Costs (Cont.)



- Average annual growth rates of total Medicaid spending has been rising
- The almost 13% increase in 2002 is the highest in almost a decade
- After dropping from the high of 27% in the early 1990s to 3.2% in the mid 1990s, the rates are rising again
- Almost all the SLC states have seen double-digit increases in enrollment between Dec.1997 and Dec. 2001

IV. Measures Adopted by SLC States to Deal with Budget Shortfalls

- Slash Spending
- Tap Rainy Day Funds
- Utilize Tobacco Settlement Monies
- Raise Taxes
- Hike Cigarette Taxes
- Establish State Lotteries

IV.Measures Adopted by SLC States to Deal with Budget Shortfalls: Slash Spending

- LA imposes across-the-board cuts of $75 million followed by an additional $82 million
- TX seeks input from agencies on cutting 3% to 5%
- VA cuts $858 million in spending with agencies facing budget reductions of 11%-15% with another $400 million in cuts to follow
- OK makes across-the-board cuts totaling 9%
- GA agencies face budget reductions totaling 5%
- MD considering a number of measures including cutting all employee pay by 1 percent, withholding aid to local governments, scaling back scholarships, raising income taxes on the wealthy and hiking the state's sales tax and property tax rates
- MO laid-off almost 900 workers and is looking at further layoffs

IV. Measures Adopted by SLC States to Deal with Budget Shortfalls: Tap Rainy Day Funds

- In FY 2002, 19 states around the country tapped into their rainy day funds to close out their budget gaps
- It is estimated that in FY 2003, 12 states would resort to this strategy
- In FY 2002, Oklahoma, utilized $268 million from its rainy day fund; in the past five years, OK has used $571 million
- North Carolina drew down its rainy day fund from $522 million in FY 1999 to $125 million in FY 2002
- In Louisiana, Governor Foster secured $86 million of the $263 million currently in rainy day fund
- Governor Glendening in Maryland decides to use $190 million from rainy day fund

IV. Measures Adopted by SLC States to Deal with Budget Shortfalls: Deploy Tobacco Settlement Monies

- In FY 2002, 12 states used the proceeds of securitizing their tobacco settlement monies to address mounting budget gaps in their budgets
- In FY 2003, it is estimated that 16 states would do so
- Missouri tapped $139 million of its funds to offset its shortfall and hopes to use another $350 million
- Alabama secured $30 million of its funds for Medicaid
- Tennessee used $368 million of its funds to close the shortfall in fiscal year 2002. 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

IV. Measures Adopted by SLC States to Deal with Budget Shortfalls: Raise Taxes

- Personal Income Taxes went up in OK because of an automatic trigger adopted as part of a tax reduction act in 1998
- AL increased Business Taxes by $58 million by taxing interstate long-distance telephone calls
- Sales Taxes went up in TN and NC. In certain counties in TN, the sales tax is 9.75%, the highest in the country. In NC, the sales tax could be as high as 7.5%
- AR's governor, after re-election, proposed raising state's sales tax and generating $474 million in new revenue
- MO, MD and AR reviewing a number of corporate exemptions to bring in additional revenue
- New Speaker in AR wants to remove the income and capital gains tax cuts passed in 1997 and 1999

IV. Measures Adopted by SLC States to Deal with Budget Shortfalls: Hiking Cigarette Taxes

- 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: Arkansas (34 cents, Louisiana (36 cents), Maryland (100 cents) and Tennessee (20 cents)
- Governor Wise in VW 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
- Proposals in GA, TX and SC to raise the cigarette tax and secure additional revenue

IV. Measures Adopted by SLC States to Deal with Budget Shortfalls: **Establishing State Lotteries**

- Tennessee became the latest state to move closer towards establishing a state lottery to pay for specific education initiatives
- New Governor in Maryland campaigned on slots at the racetracks as a source of additional funding (possibly $800 million per year) for the state
- South Carolina voters approved a state lottery to finance education initiatives a few years ago
- In North Carolina, during the 2002 session, a measure to place a referendum on the ballot on introducing a state lottery to fund education initiatives was defeated

V. What Can We Expect?

- Both the federal government and states will face significant budgetary problems in the next few years
- The economy is not expected to begin generating jobs in a substantial manner for the next 12-15 months
- Yet, there are several positive features of the current economy which should not be disregarded
  - (1) Inflationary pressures are minimal
  - (2) The economy is still expanding
  - (3) Record-low interest rates, lowest in some 40 years
  - (4) American productivity gains continue to be very impressive

V. What Can We Expect?

(1) Inflationary pressures remain minimal with the CPI expected to rise by just 2.6% in 2002

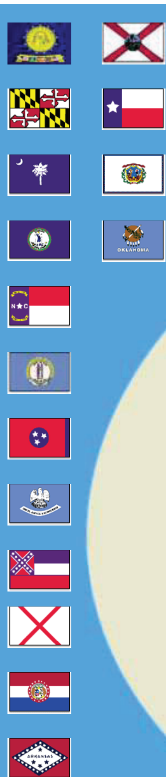
(2) GDP growth for the U.S. economy is expected to be close to 2.7% in 2002; in 2003, it is expected to be close to 3%

(3) Low mortgage rates have sustained the explosive growth pattern of the housing market as more and more Americans purchase their first homes and re-finance their existing mortgages. Between May 1998and January 2003, rates on a 30-Year fixed mortgage plunged with the U.S. average declining from 6.9% to 5.6%; the SLC average also dropped rom 6.9% to 5.6%

V. What Can We Expect?

(4) Productivity Improvements

- 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 based on the technological advances reached in the 1990s
- 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



For More Information

Please Contact

Sujit M. CanagaRetna

404/266-1271

or

scanagaretna@csg.org

www.slcatlanta.org