Introduction

It is an honor to appear before you this morning and I thank you for inviting me and The Council of State Governments' southern office, the Southern Legislative Conference (SLC). My testimony presents information on some of the actions taken by states in grappling with the serious fiscal challenges that have arisen in the past few years. It will consist of two interconnected parts. Part I looks at broad national economic trends and some trends at the state level. Part II delves into some of the more innovative strategies adopted by policymakers to overcome the budget shortfalls that have plagued states for almost four consecutive years now.

Part I

After a decade of sustained growth, unsurpassed in the economic history of the country, March 1991 to March 2001, the U.S. economy continues to feel the lingering effects of the 2001 recession. While the economic news in the past few weeks has been somewhat encouraging, the nation continues to confront its longest hiring slump in more than 60 years. After shedding almost 3 million jobs in the last three years, in October 2003, the nation's unemployment rate inched downwards to 6 percent. Employment last month grew by 126,000 jobs, the best showing in months, and signaled the first time since late 2000 that the economy added workers for three straight months. Yet, these employment gains remain modest and are not large enough to keep up with the growth of the labor force.

On the GDP front, the news was heartening too. In the third quarter of 2003, the economy grew at a blistering 7.2 percent annual rate, the strongest pace in two decades. Hence, analysts expect growth to hover around the 3 percent range for the year as a whole in 2003. Productivity levels also reached unprecedented heights in the most recently completed quarter, continuing a trend that has been in place for the past year or so. Finally, while both the manufacturing and construction sectors registered impressive growth rates, consumer and business confidence also appears to be rising.

Yet, there are myriad problems that continue to beleaguer both the federal and state governments. At the federal level, the deteriorating fiscal position ranks very high. After running budget surpluses for four consecutive years (FY 98 through FY 01), the federal government officially returned to the red in FY 02 when the deficit hit $159 billion. For the just concluded FY 03, the Congressional Budget Office indicated that it was $374 billion. In addition, CBO estimates that the federal deficit would reach $480 billion in FY 04, the current fiscal year, and reach a cumulative $1.4 trillion by FY 08.

At the state level, the fiscal situation these past few years has been equally dire. During the past three years, states have had to close a cumulative $200 billion budget gap with a series of actions that included slashing spending, raising taxes, tapping rainy day funds, deploying tobacco settlement monies, hiking cigarette taxes, cutting funds to local governments, racking up debt and generating funds via gaming. States had to simultaneously tackle slumping revenues, rising unemployment numbers and exploding Medicaid and healthcare costs. According to recent information, while the revenue situation—propelled by tax increases—has marginally improved in some states, the continuing effects of the cyclical downturn and the serious structural problems associated with state tax systems, will continue to batter state finances through FY 04 and most likely into FY 05. For the current fiscal year, the cumulative budget shortfall is estimated to be in the $25 billion to $40 billion range. In fact, given that state revenues lag behind national trends, revenue growth is expected to be anemic in the next several quarters and it is not until the first quarter of 2005 that revenue growth is expected to be robust (about 6 percent). Already, Florida, Georgia, North Carolina and Virginia in the South have announced potentially large budget shortfalls for the current fiscal year. Hence, spending in FY 04 is expected to be well below 2001 levels as states make further reductions in core services.

Part II

Since almost all states are constitutionally required to balance their budgets, unlike the federal government, what were some of the innovative measures that states adopted? In order to obtain this information, I polled fiscal analysts in a number of the SLC states. In addition, I secured information from outside the South as well. It should be noted that some of these measures are one-time fixes and may not have applicability in Alabama. Also, please note that the SLC does not recommend any of these measures in Alabama but is only reporting on some of the steps taken by other states to deal with their fiscal problems. I will present several general categories first and then provide specific examples from across the country.

Decoupling from federal policies

A number of recent federal actions have impacted negatively on state finances, because of the historic linkage between federal and state tax codes. For instance, the 2001, 2002 and 2003 federal tax cuts reduced state revenues by an estimated $10 billion. Then, the repeal of the federal estate tax credit in 2001--to which all state estate taxes were tied—will affect state finances negatively by an estimated $4 billion through September 2004. Finally, the federal bonus depreciation provision, enacted in 2002, that allows businesses to immediately deduct 30 percent of the cost of equipment purchase as opposed to writing off the cost over a number of years, will cause a dip in state revenues by an estimated at $14 billion between the provision's enactment and September 2004. While a majority of states (37) have chosen to de-link their tax codes from the federal provisions and minimize the negative effects of these federal actions, a number of other have yet to do so.

Leveraging Technology

A number of recommendations being considered by states involve using technology to both enhance efficiencies and save money. The expectation here is that any technology that improves state government operations—exploiting data mining, for instance—also improves the states' fiscal capacity. For instance,

- California's Integrated Non-Filer Compliance System (INC) electronically matches data from W-2 forms, 1099s, real property sales, K-1 partnership returns and related records against filed tax returns to identify entities that did not file returns. Once non-filers are identified, the system creates and manages their cases, calculates their potential tax liability, chooses the best cases to pursue and places questionable cases in a review status. The system also generates and sends notices of non-compliance and requests-to-file-a-return to entities identified as non-filers. The system has processed more than 160 million records and generated $182 million since deployment.
- Iowa's Tax Gap Compliance Program uses customized software to identify entities that are supposed to file tax returns but did not and entities that filed but did not pay their taxes. This program is credited with generating $26 million in tax revenue above and beyond baseline

collections during its 3-year project development and implementation period.

- Also, Virginia continues to streamline purchasing and procurement through an electronic system called *e-VA*. This system also seeks to consolidate the state's IT functions and staff into one agency. While state government agencies benefit from consistent, reliable services from a consolidated, centralized IT "factory", taxpayers and customers benefit from improvements in and deployment of seamless, integrated systems and services, particularly Web-enabled solutions, promoting ease of use. Taxpayers will reap the benefits of the considerable cost-savings over the long-term, estimated in excess of $100 million annually.

<u>Introducing Tax Amnesty Programs</u>

Tax amnesty programs are another popular revenue-enhancing strategy in a number of states in these fiscally austere times. The programs encourage individuals to pay their back taxes by giving them a break on the penalties and interest owed to the government. Just during the last two years, 2002 and 2003, 19 states across the country, including several in the South (Florida, Kentucky, Missouri, Oklahoma, South Carolina and Virginia) have enacted amnesty programs. In Virginia, the amnesty program that just concluded raised almost $10 million during the first four weeks of its operation. Then, Michigan's program in 2002 brought in $30 million in net new revenue.

Innovative Transportation Programs

- According to the state's Department of Transportation, Georgia could begin accepting proposals for privately financed road and transit projects as early as December 1, 2003. Officials hope to speed up urgent transportation projects at a time when funds are scarce by enticing private companies to finance them. Companies, in turn, could recoup their costs through tolls, transit fares or even long-term road maintenance contracts.
- North Carolina's DOT just completed a study that proposed charging drivers tolls to drive on I-95 through eastern North Carolina. The tolls secured would have paid for the highway's much-needed $3 billion overhaul.

- In Minnesota, Governor Pawlenty released details of a proposal to let solo drivers pay to use the carpool lane along I-394. So-called HOT lanes-short for High Occupancy Toll-have eased congestion in California (Los Angeles and San Diego) and Texas (Houston) by filling the car pool lane and relieving congestion on the rest of the road.

Raising the Gasoline Tax

As anathema as raising the gas tax is, in the absence of federal action on transportation funding, at least 11 states are considering legislation that would hike the gas tax. Among the SLC states pondering this option are Georgia, South Carolina, Texas, Maryland, Tennessee and Virginia.

Creative Financing Techniques

- Illinois approved a unique pension financing plan this year. The measure increases the state's general obligation bond authority and grants permission to use proceeds from the borrowing to make payments to five state retirement systems. Otherwise, the pension debt obligations would have been paid from the general fund.

The proposal saved the state $1.9 billion in its 2003 and 2004 budgets.

- Mississippi will save $7 million to $10 million a year by issuing variable-rate instead of fixed-rate bonds for the state's Nissan plant in Canton. Until now, the state had only used fixed-rate debt but lawmakers permitted the use of some variable-rate bonds, which generally have lower interest rates, this year. To ward off against a potential rise in interest rates, the state could switch to fixed-rate bonds in a few weeks, if necessary.
- Michigan lawmakers hope to implement a pilot project currently in effect in a single county across the state. The Claim-it-Correctly Program seeks to close a tax loophole in which homestead exemptions were being used improperly by multiple homeowners or out-of-state residents.
- In Kansas this year, the governor was authorized to either accelerate property tax payments or delay tax refunds.
- In South Dakota, lawmakers ended the state's practice of counting investment income earned on state cash flow

the year after it was earned. To help balance the budget, they decided to account for the income in the year it was earned.

Recouping Costs from the Estates of Deceased Persons

In 1993, Congress ordered states to recover some of the money spent on nursing home care by Medicaid from the estates of deceased persons. Congress also decreed that spouses, dependent children and disabled adult children be allowed to remain in the homes of these deceased Medicaid recipients for a specified time. States were allowed to exempt homes below a state-established minimum value. While minimal action on this directive was initiated in the past decade, more recently:

- Texas is drafting rules to recover money from the estates of some deceased Medicaid patients and offset the cost of their care in nursing homes. State officials are mulling over competing proposals in terms of the homes' exemption level; the number will probably be between $90,000 and $150,000.
- In Connecticut, hundreds of low-income elderly and disabled people opted out of the state's prescription drug

programs because of a new law—effective July 1, 2003—that allows the government to recoup expenses from program recipient’s estates.

<u>Inventive Measures to Maximize Federal Matching Funds under Medicaid</u>

States continue to employ inventive financial mechanisms to maximize their Federal Medical Assistance Percentage (FMAP) and bring in additional revenue. In the area of nursing facilities, one of the commonly used strategies has been the use of upper payment limits (UPL), i.e., paying certain local government providers more money than they would otherwise receive (thus generating a greater FMAP) and then having the local entities return the excess money to the state. Another popular method employed involves intergovernmental transfer payments, or borrowing money from county governments with large nursing homes and then using those funds to draw matching federal funds. Finally, the nursing home provider tax, one of the more widely used techniques employed by states to enhance federal assistance, also remains important here.

Now, some specific examples from around the states.

Florida

- Analyzed the state's trust funds and eliminated trust funds that were either outmoded or redundant. While this freed up revenue that could revert to the state's general fund to be spent on other programs, it enhanced the state's flexibility in dealing with revenue shortfalls.
- Moved gradually to activity based budgeting and allowed the state to compare the cost of similar activities being performed by different agencies. In addition to determining the most cost effective and efficient agency performers, the state now has the option of either eliminating or modifying lagging agency operations. This format also permitted the state to benchmark costs against external standards, including other states and the private sector.
- Performed a service level management analysis of the state's IT services, deploying a set of private sector tools to examine the cost of IT services within agency base budgets. Costs that did not fall within certain specifications were either reduced or eliminated.

- SUNTAX, the country's first state-of-the-art, truly integrated revenue administration system, running off a Custom-Off-The-Shelf (COTS) package, which was designed and implemented to allow one-stop registration, cutting-edge accounting for all taxes, and maximization of World Wide Web and e-filing technology and services. This system facilitated increased state revenue collections, lower administrative costs, a more uniform tax collection process, increased voluntary compliance, exceptional customer service, and flexibility to adapt to ever-changing legislation, court decisions, and regulations. SUNTAX has enabled the Department to collect more than $21 billion in revenue each year, serve more than 1.2 million taxpayers, and process more than 6 million transactions. SUNTAX has also generated over $70 million in collections in its initial years primarily by identifying noncompliance in the telecommunications industry. The Department also reduced the number of employees needed to administer taxes at all levels of government due to efficiencies offered by electronic filing and centralized collection. Before the advent of SUNTAX, the Florida Department of Revenue used as many as 10 different computer systems to administer and collect 36 separate taxes.

<u>Arkansas</u>

- Closed or consolidated a number of local offices of the Revenue Department and the Employment Security Department.
- Implemented a new statewide accounting system, replacing one that had been in place since the mid-1970s.
- Merged six technical institutes with institutions of higher education.
- Implemented performance-based-budgeting system with a limited number of agencies coming on board in 2001 and more in 2003.
- Obtain car tags, hunting and fishing licenses on the Internet.
- Authorized the use of state bonds for toll roads this past year.

North Carolina

- Eliminated the boot camp IMPACT, since studies indicated that recidivism rates were higher for offenders at IMPACT compared to those in alternate community correction programs (savings - $4 million)
- Closed older prisons (savings - $5 million)
- Disposed of state-owned surplus real property more efficiently (revenue - $10 million)
- Consolidated employee death and disability benefit reserve funds (savings - $55 million)
- Reduced prison staffing by revising relief formula (savings - $4.3 million)
- Implemented “prior approval” and use of generics in Medicaid prescription drugs (savings - $97 million)
- Replaced general funds appropriations for need-based scholarships in UNC system with funds from Escheats (savings $21 million)
- Accelerated the state’s debt collection practices, reducing the $370 million accounts receivables backlog with an anticipated collection of $50 million in new revenue

Georgia

- During the recession in the early 90s, Georgia's budget writers implemented a process called "redirection." Departments and agencies identified a percentage of their budget to "redirect" into more efficient and streamlined modes of doing business. While duplicative services were eliminated across agencies, the savings were merged with other revenues to fund other policy priorities.
- One of the state’s best hopes for savings hinges on leveraging technology. The previous Administration created the Georgia Technology Authority to consolidate, oversee, and foster operational and fiscal efficiencies through technology. The Authority was funded with a $13 million universal fund settlement paid by BellSouth as a reimbursement for overcharged rates. The Authority gets little direct appropriation except to provide infrastructure, but charges each agency and department for services.
- In the past two fiscal years, Georgia has attempted to better utilize state funds to secure greater matching

federal funds, particularly in areas where the state had been very conservative or had not leveraged those funds effectively. Some examples here, Upper Payment Limits and contracts to charge Medicaid-eligible school-based services.

- Another policy shift occurred with Georgia's tobacco settlement funds, previously used for very specific purposes and minimally used for on-going expenses. In FY 04, the state changed that policy in order to restore a 10 percent provider reimbursement rate cut to hospitals. In order to minimize the impact of those cuts, the state took $30 million in tobacco funds and used it to bridge the shortfall in the school nurse program. Hospitals, in turn, had to pay the Department of Education $30 million for the school nurse program and the state was able to leverage the federal match for hospitals.

Tennessee

- The Corrections Department could potentially save $23.4 million with the early release of some state prisoners and requiring others to serve community-based sanctions.

- The Department of Mental Health hopes to generate $12 million in new revenue by increasing fees that behavioral health organizations pay per patient in the state's mental health institutions.

<u>Texas</u>

For the 2004-2005 biennium, Texas faced an unprecedented $9.9 billion budget shortfall. Rather than the traditional performance-based budgeting approach, budget writers requested state funded entities to submit budget requests within an allotted amount of money and prioritize services. In addition, the state's legislative leadership issued a directive of no new taxes. Consequently, lawmakers

- Passed the supplemental appropriations bill for FY 03, reflecting a seven percent across-the-board budget reduction (savings $1.4 billion)
- Moved the System Benefit Fund to the Treasury (savings $186 million)
- Changed the Permanent School Fund to a total return investment strategy (savings $474 million)
- Changed the point of collection for motor fuels tax (savings $35 million)

- Raised the cap on the Telecommunications Infrastructure Fund (savings $250 million)
- Delayed the Foundation School Program payment without impacting services (savings $800 million)
- Closed a loophole in the property tax system by requiring values to be reported for the purposes of property tax liability (savings $13.7 million)
- Closed a loophole in the auto sales tax system (savings $176 million)
- Consolidated health and human services agencies (savings $95 million)
- Changed the date after which unclaimed wages and abandoned property becomes state-owned (revenue about $13 million)

Also, Texas has a sunset provision, where each agency is functionally audited, typically every 12 years, or more frequently, if necessary. While most oversight is concerned with agency compliance with legislative policies, it also raises a more fundamental question: Is the agency needed and are its functions providing an essential service? About 20-30 agencies go through the sunset process every session.

South Carolina

In June 2003, Governor Sanford issued an Executive Order creating the Management, Accountability and Performance Commission (or MAP Commission), a bipartisan panel of 12 private sector leaders to draft recommendations to improve the delivery of state services and generate savings. The Commission recently issued its final report and with the enactment of the hundreds of recommendations, estimates savings of $225 million in the first year and over $300 million annually thereafter. An additional $650 million in savings is estimated from the recommended elimination of the Teacher and Employee Retention Incentive program.

Legislative staff also alerted me that they regularly review the Malcolm Baldridge Award Program. The Baldrige Award is given by the President of the United States to businesses—manufacturing and service, small and large—and to education and health care organizations that apply and are judged to be outstanding in selected areas. A number of state agencies from across the country have been recognized for their innovative, cost effective and efficient programs and South Carolina seeks to learn from these entities.

Illinois

- Lawmakers created a statewide, centralized buying club to negotiate the best rates on prescription drugs for all seniors and disabled persons who wished to participate. After paying an annual $25 fee, members get an ID card to use at any participating local or mail-order pharmacy. Illinois saves $150 million annually by having a centralized purchasing agency securing volume discounts on these medications; formerly, the state had 9 different state agencies buying the same drugs. Seniors saved 60 percent on certain drugs compared to regular pharmacies and over 80 percent at mail-order pharmacies.
- There is also a move in Illinois, and a number of other states including Minnesota, Wisconsin, Iowa, Michigan, Vermont and West Virginia, to press the federal government to permit the importation of lower-priced prescription drugs from Canada. A study just released by the Illinois governor's office indicated that the state could

save $91 million a year by buying prescription drugs for state workers and retirees from Canada. In fact, a number of these states are moving proactively to import prescription drugs from Canada and save their states' money.

Conclusion

Even though the financial picture in many states remains murky, there is room for cautious optimism given the signs that the national economy may be turning around. In addition to the positive trends mentioned at the outset, after the two quarters that ended in September 2003, state revenues had increased by over 9 percent, even though half this increase came from the federal aid to states and the other half from higher tax collections. State and local spending, in contrast, increased at an annual rate of 1 percent over the same period. States have also increasingly looked to greater borrowing to meet their budget gaps (increasing from a total of $48 billion in 1992 to over $127 billion in 2002) with California's new governor indicating that he will seek voter approval to borrow billions to erase his state's deficit. Of course, this strategy has its own disadvantages.

Hence, the forecast is not all gloom and doom. Along with the improved state revenue picture, the boost to the economy from record low interest rates, enhanced productivity levels and growing business and consumer confidence, allows some room for optimism. In closing, while a number of these measures might have relevance as y'all continue your deliberations and discussions to grapple with Alabama's fiscal dilemmas, a number of them might not. Yet, I hope that my remarks have been helpful in illustrating that practically every state in the country faces fiscal pressures and continues to devise adequate responses. Thank you for your attention.