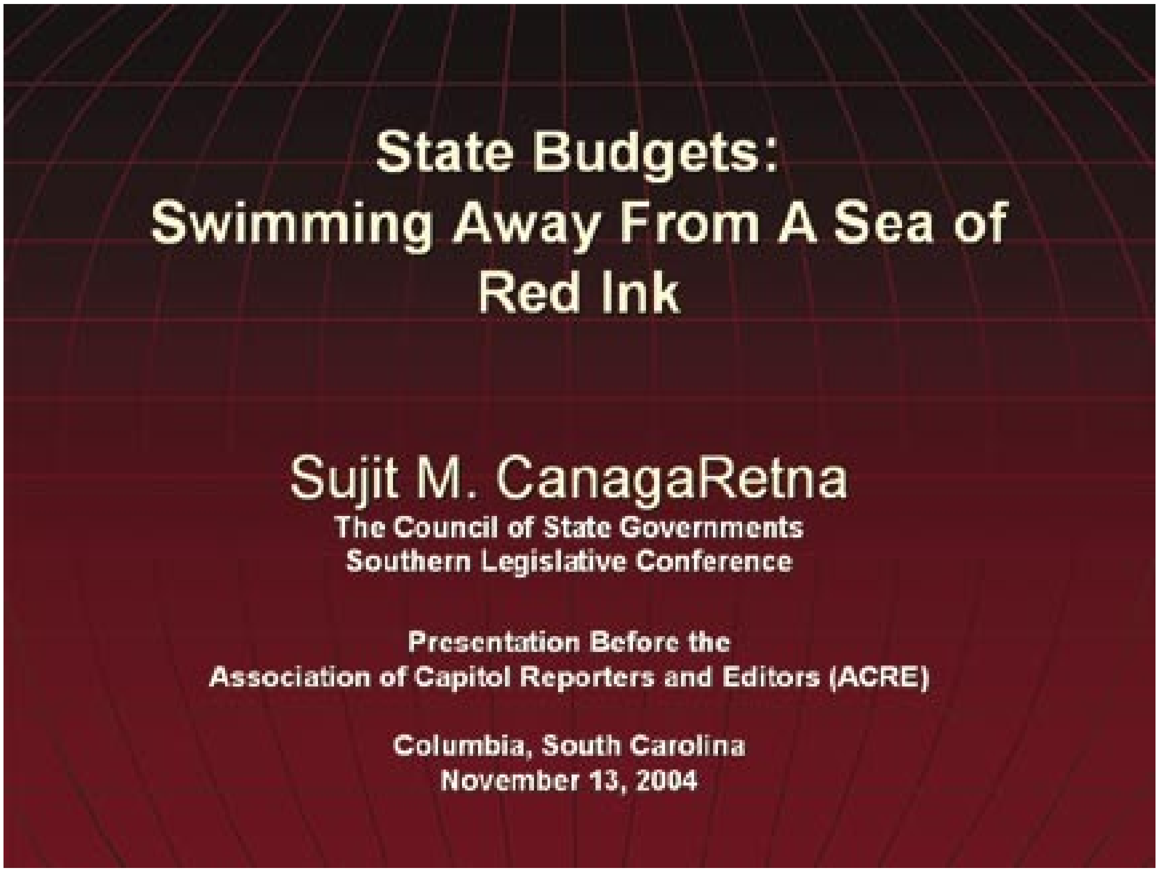

Transcript of remarks

It is an honor to be here this morning and I thank ACRE for extending this invitation to me and to The Council of State Governments. Established in 1933, The Council works primarily with state legislatures in tracking trends, carrying out research and analysis and promoting state interests through continuing education. While I work for The Council's Southern Office, the Southern Legislative Conference (SLC) in Atlanta, The Council is headquartered in Lexington, Kentucky and also has regional offices in New York, California, Illinois and Washington, DC.

My remarks this morning deal with the bleak fiscal winds that swept across states some four years ago and provide some insights into what states might tackle when they go into session in 2005. Broadly, my presentation comprises four interconnected parts. Part I focuses on the crushing fiscal blows that pummeled states and some of the measures states adopted to deal with these setbacks. Part II looks at some broad national economic trends and their potential impact on states. Part III describes three fundamental structural shifts taking place in state finances, shifts that have sizable impacts on state revenue systems and finally, Part IV presents several key issues that state lawmakers will grapple with in their upcoming legislative session.

Part 1

After a **decade** of sustained growth, unsurpassed in the economic history of the country, March 1991 to March 2001, both the national and state economies continue to feel the lingering effects of the 2001 recession. This fiscal downturn hit states particularly hard forcing them to bridge budget shortfalls that cumulatively approached $236 billion in the past four years. The plunging revenues, soaring unemployment rates and exploding healthcare costs made these past few years the worst fiscal downturn experienced by states in decades. While struggling to balance their budgets, states slashed spending, raised taxes, expanded gaming, hiked tobacco taxes, tapped rainy day funds, deployed tobacco settlement monies, cut funds to local governments and racked up huge amounts of debt. While the revenue picture has improved in the past few quarters, states still have a long way to go before emerging fully from the budget setbacks of the recent past.

Part II

In formulating their budgets for the current fiscal year (2005), states had a considerably easier time than in the prior four years since they only had to overcome shortfalls that cumulatively reached about $36 billion. As noted earlier, the revenue picture has certainly improved. For the July through September 2004 quarter, compared to the year before, state tax revenues grew by 8.4 percent or 4.5 percent when adjusted for inflation. For this first quarter of FY 2005, most states had solid growth with personal income taxes outperforming projections, sales taxes coming in on target and corporate income taxes doing well in many states. Severance tax collections, as expected, have roared back very strongly in states like WY, MT, LA, AK and other energy producing states. However, while state tax revenue growth is healthy again, states have a long way to go to fully overcome the setbacks suffered during and after the recession.

The latest national economic trends indicate a very mixed picture. On the positive side, GDP output has been strong, productivity growth has been impressive, interest rates continue to be at historic lows (despite the four rate hikes this year that pumped the Fed funds rate to 2 percent) and inflation is under control. Yet, there are a number of negative developments that continue to cause concern including the anemic job creation levels and rapid increase in oil and natural gas prices. The surge in oil prices is disturbing because a great deal of the economy's growth path in recent years has been driven by consumer spending. Hence, surging oil prices (up from $30 a barrel a year ago to $55 a barrel recently) act like a tax on the economy, reducing consumers' purchasing power and raising firms' costs. In fact, the rate of economic expansion has slowed recently and experts partially attribute this to rising oil prices. Sluggish economic growth eventually has the effect of negatively affecting state finances as a result of falling personal, sales and corporate tax revenues and increasing unemployment insurance and healthcare expenses. At a more structural level, the mammoth deficits in both the federal budget and the current account have the potential to stymie a return to more balanced and robust economic expansion at the national and, eventually, state levels. All these developments could derail the progress of state economies, just as they raise their heads from the punishing fiscal blows of these past few years.

Part III

As I mentioned, the steep drop in state revenues during the downturn, both in terms of depth and length, posed incredible challenges to states. Notwithstanding the healthier revenue trends recently, there are a number of structural changes that are transforming state fiscal systems in a manner that is posing, and will continue to pose, serious challenges in the future. These structural changes require citizens to decide on what kind of state government they want, create adequate revenue streams to finance these state government operations **or** fundamentally reconfigure their expectations of state government. I will address three of the most significant trends here.

- In general, state sales taxes do not cover a wide range of services. Over the past four decades, the role of services in the economy has grown tremendously, from 40 percent in 1959 to almost 60 percent in 2000. Two points illustrate the emerging role of services in the economy. First, in 1955, the top company in the Fortune 500 list was General Motors, a manufacturing company; some 50 years later in 2004, the top company on this Fortune list was Wal-Mart, a service company.

Second, in September 2004, the federal government announced the introduction of its first new economic indicator in 40 years, a new, quarterly survey to track the impact of services in the economy. Both these developments clearly reflect the fundamental shift of the American economy towards services. Even in the global economy, a similar shift towards services is steadily in progress. However, despite the rapid movement towards a service driven economy, the traditional sales tax is being applied to an increasingly shrinking proportion of economic activity. As noted in a Federation of Tax Administrators study a few years ago, there are 164 different services taxed across the country. Of the 45 states that employ a retail sales and use tax, three states taxed more than 140 services, 13 states taxed more than 60 services and the remaining 29 states taxed fewer than 60 services. Consequently, in the last few years, there has been an effort towards broadening the sales tax to include services – while sometimes lowering tax rates – in an effort to mitigate the long-term decline of sales tax revenues. In this regard, AR, IN, NJ, OH, NE, WA, for instance, have expanded their sales tax to include services ranging from Botox injections to dry cleaning to landscaping to pest control to locksmiths to various installation charges.

- The second fundamental trend involves Internet and catalog purchases which have grown exponentially in the past few years. Yet, due to federal legislation and U.S. Supreme Court rulings, states and local governments generally cannot charge a sales tax on these purchases. Recent research by the University of Tennessee indicates that states and local governments lost and continue to lose billions of dollars as a result of this restriction. Specifically, in 2003 combined state and local revenue losses from e-commerce is estimated to be between $15 billion and $16 billion. By 2008, these losses are forecasted to balloon to between $22 billion and $34 billion.
- The third trend transforming state fiscal systems involves the dwindling revenue flows from corporate taxes into state coffers. While this is a trend that has been developing for decades, at both the federal and state levels, corporate tax revenues as a percent of total states revenues have declined by 30 to 40 percent over the last 15 years or so; in fact, in 2003, the average for the 50 states stood below 5 percent.

As a result of these important, fundamental shifts, state fiscal systems are being transformed radically, a development that demands the attention of state policymakers and citizens alike in figuring out the specific services and programs they expect from their state governments.

Part IV

During their 2005 legislative sessions, states will grapple with a number of important issues including the following:

1. Exploding healthcare costs.
    - State healthcare costs, led by Medicaid expenditures, the nation's largest public health insurance program serving 52 million low-income individuals, have been increasing steadily recently. As indicated in the latest Kaiser Commission survey, for the fiscal year that just concluded, FY 2004, Medicaid spending increased on average by 9.5 percent, matching the 9.4 percent growth in FY 2003. While the latest growth rate was slower than the 11.9 percent rate averaged between FY 2000 and FY 2002, Medicaid expenditures outpaced both state expenditure growth and state revenue growth. The major costs drivers here, as in prior years, were rising enrollment levels, mounting prescription drug costs and increasing costs of medical services. For the current FY 2005, states expect to implement additional cost containment measures to curb their Medicaid budgets.
    - A number of states are already debating the issue of rising healthcare expenditures even before the start of their 2005 legislative sessions. In late September, news that MD's health department had drafted a $480 million list of potential program cuts alarmed a number of people. In KY,

after a special session in October, a health insurance plan for 229,000 state employees and teachers was clinched that did not change benefit and premiums levels. In MS, Medicaid will need an extra $103 million to operate next year, even after eliminating a drug coverage program for 65,000 people to balance this year's budget. In special session last week, AL approved the cost-savings recommendations ($300 million over a five-year period) forwarded by the board that oversees state employees' health insurance program. In mid-October, Georgia announced that the health plan that covers more than 641,000 state employees, dependents and retirees faces a projected deficit of $446 million in the next fiscal year, the largest shortfall in the state benefit plan's history. WV will go into special session next week to curb soaring prescription drug costs by negotiating discounts with pharmaceutical companies for state-managed healthcare plans. And, in perhaps the most significant healthcare news at the state level, TN Governor Bredesden announced a few days ago that he had set in motion steps to dissolve TennCare, the state's financially troubled almost $8 billion healthcare plan. TN will now revert back to a traditional Medicaid program similar to what's offered in a majority of the states. As many as 430,000 enrollees out of a total of 1.3 million enrolled could lose health coverage once the conversion occurs. When it was created back in 1994, TennCare expected to use managed care principles to deliver health care to a larger number of people for the same amount of money.

2. Another issue on the radar screen in 2005 involves the unfunded liability in state retirement and workers' compensation systems.
   - To reinforce their depleted retirement systems, systems that had taken a beating in the bear market of 2000 through 2002, a number of states issued bonds. IL sold $10 billion in bonds recently to buttress its public pension plans, considered the most underfunded of any state in the country, and plans on issuing more bonds this year to cover a $600 million increase in contributions. OR's 2003 pension bond offering of $2 billion was the largest in its history and WI's recent $1.8 billion bond offering was designed to boost its depleted public retirement system. Then, CA proposes borrowing nearly $1 billion to cover payments owed to public pension funds while KS borrowed $500 million earlier on this year to enhance its public employees' pension fund. With the first wave of baby boomers retiring in a mere 4 years and the fact that Social Security, personal savings and corporate pension plans remain on very shaky ground, state legislatures will undoubtedly be forced to deal with the increasing liability levels in their retirement systems.
   - A number of states also face serious financial questions regarding their workers' compensation systems. Earlier on this year, CA and TN enacted legislation to reform their systems and OK, TX, OR, WV along with a number of others will continue these efforts in 2005. For instance, when WV began looking at its system, the state faced an unfunded liability of $3.6 billion, a staggering amount that could easily cripple the state's system.
3. Education, both K-12 and higher education, is another issue under tremendous financial pressure, that will confront lawmakers.
   - In fact, school finance legislation has affected practically every state in the South and in response to court orders, so many states had to initiate – and continue to initiate – reforms to adequately finance education. TX contemplated a special session to initiate reforms in its school finance system. AR dealt with this problem in a special session this year and is one of the most recent states to be sued because of a lack of equity funding among schools. The state funded its measures with large tax and fee increases and now in AR, education must be funded first, ahead of every other expense category. Talking about AR's educational reforms, my colleague that tracks education

informs me that the AR Democrat-Gazette's coverage of the special session, both in terms of informing the public about this complex issue and keeping the pressure on legislators, was exceptional.

- In response to funding shortages, states have been forced to cut higher education funding and/or raise tuition rates. According to the College Board, tuition at the nation's public universities increased by an average of 10.5 percent in 2004, the second largest increase in more than a decade. Last year's rise was 13 percent, the highest. In Georgia, last month, the state even considered an unprecedented mid-year tuition hike to overcome a $65 million shortfall.

4. Transportation issues will also be important, particularly given the absence of long-term surface transportation reauthorization in Congress, i.e., the successor to TEA-21. In fact, voters supported 44 of 55 transportation funding-related ballot initiatives (involving $28 billion in new revenue) at the polls earlier on this month. Medical malpractice reform will also be important; MD and MS have already signaled their interest in visiting this issue. Economic development activities will be critical too, as states are now fiscally in a better position to attract and retain corporations. Very recently, NC offered a $242 million package of incentives over 10 years to Dell Computers to build a 2,000 worker assembly plant in the Piedmont Triad; OH also announced plans by Dell Computers to build a facility for its printer ink business in Butler County that would employ almost 700; Honda announced plans to build a brand new $100 million plant in Tallapoosa, GA and begin a $100 million expansion of its Russells Point, OH facility; in CA, voter approval 10 days ago to borrow $3 billion for research on stem cell technology over the next decade (about $295 million a year) is expected to be a boon to biomedical businesses; in MS, the legislature went into special session earlier on this week to debate a $108 million bond package to expand Northrop Grumman operations in Pascagoula; MI recently announced six new major economic development projects, expected to create over 1,200 new jobs with more than $79 million in private investment; in an effort to compete with the South, which has attracted most of the recent automotive investments, MI announced a six-step program to attract new automotive production and research jobs to the region; and, NJ initiated a $50 million bond issue to create jobs in the biotechnology and life sciences industries.

Conclusion

In closing, even though the fiscal crisis that swept across states in the past few years has abated and the state revenue picture has improved, the severity of the crisis will continue to haunt state finances for many years. In the short term, the impact of the economy on state finances remains mixed. Alongside the favorable GDP numbers, productivity increases and low interest rate and inflation scenarios, the specter of rising energy costs and a very sluggish job market looms large. Then, in the longer term, state finances will be roiled by the sharp structural changes that are in progress both at the federal and state levels. Hence, even though states are moving from a period of fiscal crisis into a period of fiscal recovery, the challenges and decisions they must contend with are certainly not any easier. In anticipation of resolving these complex issues, state policymakers and citizens alike have to continue seeking innovative solutions and policy experiments, solutions and experiments that in the past led to states being described as the "laboratories" of democracy. Thank you for your attention.