BUDGET CRUNCH
Fiscal Conditions in the Midwestern States

A publication of The Council of State Governments’ Midwestern Office
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January 2003
How quickly the tide has turned. When lawmakers went to work on state budgets for the new biennium just two short years ago, few had any idea that the fiscal prosperity states had come to expect after a decade of unprecedented economic growth was about to come to a screeching halt. Collectively, the 50 states had posted a record year-end fund balance of almost $50 billion in fiscal year 2000, and as a new round of legislative sessions began, they were well on their way to another strong finish in fiscal year 2001.

Budget surpluses had become the norm, and state reserve funds were continuing to grow, even as lawmakers prepared to cut total state taxes for a seventh consecutive year. At the same time, total state spending was also on the rise, to the tune of more than 8 percent by the end of fiscal year 2001.

But change was on the way, and it arrived much sooner than most expected. Although the states posted a cumulative year-end budget surplus of more than $30 billion for a fifth straight year in fiscal year 2001, the $37.8 billion total represented a sharp decline from the record high of the previous year. And as a percent of total state spending, the aggregate year-end fund balance fell from 10.4 percent in fiscal year 2000 to less than 8 percent in fiscal year 2001.

A moderate slowdown in state revenue growth combined with spending pressures driven largely by rising health care costs contributed to these declines, but as lawmakers put the finishing touches on their fiscal year 2002 budgets, the states were still in good shape. The early warning signs, though, were soon followed by a fiscal crisis of dizzying proportions.

As the nation’s economy slipped into recession and the stock market tumbled, state revenues quickly fell short of expectations.

Just months into fiscal year 2002, it was increasingly apparent that the economic “good times” had ended. In state after state, revenue collections continued to slide, and despite early responses in a number of states, lawmakers across the country found themselves with two enormous challenges on their hands when they returned to work for the regular legislative sessions of 2002. The first was to close the ever-widening budget gaps in fiscal year 2002. The second was to craft 2003 budgets that reflected the troubling new fiscal realities.

Though the economy began to recover fairly quickly, despite the impact of the Sept. 11 terrorist attacks, state budget relief was hard to find. To make ends meet in fiscal year 2002, lawmakers were forced to enact steep cuts in previously approved budgets that originally anticipated robust growth on both sides of the ledger. By the end of the fiscal year, more than 40 states were confronted with revenue collections that fell short of budget expectations, while Medicaid cost increases in excess of 13 percent contributed to additional pressure on state spending. Eventually, all but four states were forced to close fiscal year 2002 budget gaps, which they did by cutting expenses, tapping reserves and tinkering with taxes.

When the dust eventually settled, total state spending for the year grew by just 1.3 percent, while 16 states experienced negative spending growth, a result that few could have imagined just a year earlier. At the same time, fiscal year 2002 year-end fund balances dropped to a combined total of $17.1 billion, less than half the fiscal year 2001 figure.

The 2003 budget challenge proved even more daunting as the depth of the state fiscal crisis became ever more apparent. Slow economic growth and sluggish stock markets continued to take their toll on capital gains taxes and other revenue sources that had fueled the fiscal boom times of the 1990s.

As lawmakers continued to cut spending and look for new efficiencies in government, they also resorted to a variety of short-term and one-time only revenue fixes to help ease the budget squeeze. Budget stabilization funds were tapped, tobacco settlement funds were securitized, dedicated revenue streams were redirected to the general fund and temporary tax hikes were approved. Some tax bases were expanded, some rates were adjusted and a few revenue sources, such as cigarette taxes, were raised aggressively. But as lawmakers held out hope for economic recovery, the election-year appetite for broad-based tax hikes remained in check.

Here in the Midwest, the fiscal crisis eventually touched every state. Though one or two were slow to feel the pinch, most were quickly caught up in the rising tide of red ink. Some measured the impact in historic terms. In Illinois, for example, a $700 million revenue drop in fiscal year 2002 resulted in the first year-to-year decline in state revenues in almost half a century. And in Nebraska, where revenues had grown by an annual average of more than 5 percent for the last 20 years, fiscal year 2002 receipts actually dropped below the 2000 level.

Like their counterparts elsewhere, Midwestern lawmakers resorted to a variety of remedies in confronting the crisis, but the solutions were sometimes as troubling as the problems. Budget cuts in Ohio eventually left more than half of all state agencies operating on smaller budgets in fiscal year 2003 than were approved in 2000, and Wisconsin ended up...
securitizing its entire, 25-year tobacco settlement before completing its budget work last year. Elsewhere, the budget cutting came in waves, with initial budget fixes quickly being overwhelmed by additional revenue shortfalls.

And by the time last year’s legislative sessions finally wound down, it was already clear that more of the same was in store for this year.

As fiscal year 2003 began last summer, the short-term outlook remained bleak. Despite continued signs of slow economic recovery, state revenue collections continued to lag behind projections, and by November, almost half of the nation’s states had already begun working on mid-year adjustments to their approved budgets.

That process is sure to continue as lawmakers gather for this year’s legislative sessions, but in the meantime, the National Association of State Budget Officers estimates that by fiscal year end, state fund balances could drop to less than $15 billion, or 2.9 percent of expenditures, their lowest point in more than a decade.

The only sure bet in the months to come is that budget debates will again command the attention of legislatures across the country. As lawmakers work to close fiscal year 2003 budget gaps and craft fiscal year 2004 spending plans, they’ll find the challenges to be even tougher than they were a year ago.

The quick fixes and short-term solutions have largely been exhausted. Difficult decisions and structural changes are more likely to be required this time around. Additional and sometimes painful spending cuts are sure to lie ahead, but lawmakers will also undoubtedly take a harder look at their tax options as well. In some cases, the budget process itself will come under closer scrutiny as the states work to shore up their fiscal futures.

This report offers a state-by-state snapshot of recent fiscal developments in the states that comprise the Midwestern Legislative Conference of The Council of State Governments. It also covers some of the key issues that are likely to shape this year’s budget debates.

The various fiscal numbers used in this report are based on information that was collected during the latter part of 2002; exact figures may have changed since the data were gathered.

Several staff members in the Midwestern Office of The Council of State Governments contributed to this report. The following is a breakdown of which section or sections each staff member wrote for the report: Tim Anderson, Illinois and Nebraska; Jeff Greco, Kansas and Wisconsin; Ilene K. Grossman, Iowa and Indiana; Laura Kliewer, Minnesota; Jacqueline M. Kocinski, Michigan and South Dakota; Laura A. Tomaka, North Dakota and Ohio.

In writing this report, staff relied heavily on the expertise and knowledge of state legislative and fiscal leaders, along with the work of organizations such as the National Association of State Budget Officers. The Midwestern Office greatly appreciates the time taken by legislators and various state budget agencies or departments. The information they shared — either through interviews, their own publications or written responses to our requests — proved to be invaluable.
Illinois lawmakers dealt with a deteriorating fiscal situation in 2002 that the state had not experienced in nearly 50 years. Now, budget numbers and economic analysts tell them, comes the hard part.

Late last year, the Illinois Economic and Fiscal Commission reported that lower-than-expected revenue collections along with increased spending pressures could create a $900 million budget hole by the end of fiscal year 2003. Worse, as of late 2002, the shortfall for fiscal year 2004 was estimated to be approaching $3 billion or more.

The daunting numbers will surely tax lawmakers, but they at least will be able to make use of the knowledge and experiences gained over the past year. Between fiscal years 2001 and 2002, state revenue collections fell by more than $700 million, marking the first year-to-year decline since 1955. The numbers were a drastic departure from what the state had seen in recent years, when revenue increased by a yearly average of 6.4 percent.

The state’s 2002 budget, which was crafted assuming revenue growth of between 3.0 percent and 3.7 percent, had a $1.6 billion revenue shortfall by the end of the fiscal year. As a result, the 2002 legislative session was dominated by discussions about the unappealing choices that had to be made regarding the 2003 budget.

Former Gov. George Ryan actually began addressing shortfalls in the 2002 budget through a series of cuts made in late 2001. After unsuccessfully seeking the legislative permission needed to cut state agency budgets by up to 5 percent (the law allows him to make 2 percent cutbacks), the governor used his existing authority to make nearly $500 million in reductions.

Early legislative proposals included a bill that would have temporarily raised the state’s personal income and corporate tax rates. This idea was rejected, though, and a combination of other revenue enhancers along with spending cuts was eventually enacted.

Two predictably acceptable tax increases were agreed upon: a raise in the cigarette tax of 40 cents per pack and additional taxes on riverboat casinos (estimated to generate $135 million). One of the largest revenue enhancers ($240 million) resulted from the state decoupling its business depreciation rules from federal tax laws.

Lawmakers also pumped additional money into the general fund by transferring dollars previously dedicated to special funds and by diverting road funds, some sales tax revenue that had gone to local governments and money from a tax on real estate transactions. Meanwhile, an early-retirement package, combined with attrition and layoffs, is expected to eliminate 7,300 jobs from the state’s workforce.

Perhaps most difficult for state legislators were the decisions related to spending cuts. Funding for both K-12 and higher
education was reduced. And for the first time in more than 10 years, the state froze its per-pupil foundation level for schools ($4,560).

Cuts also were made to address rising Medicaid costs. According to the Illinois comptroller’s office, reimbursements to nursing homes were reduced by $106 million.

In addition to the tax increases and spending reductions, Illinois policymakers authorized various types of borrowing necessitated by the fiscal year 2002 revenue problems. First, the state transferred $226 million from the rainy day fund that the Legislature had created two years earlier. Second, the governor, comptroller and treasurer used their authority to borrow $1 billion (at an interest rate of 1.43 percent) in order to pay overdue bills and make up for a shortage of cash.

This kind of short-term borrowing has been used extensively during past difficult economic periods and will likely be employed once again during the 2003 legislative session.

Lastly, in one of its more contentious budget moves last year, the General Assembly decided to issue $750 million in bonds that will be repaid by future tobacco settlement payments. One proposal had called for the state to securitize more than $2 billion of its tobacco proceeds.

Negative revenue growth, which was caused by a number of factors including the stock market’s precipitous plunge, has been cited as the primary culprit for the state’s current budget woes. Some critics, though, have said the state could have done a better job of reacting to signs that state revenues would be sluggish in fiscal year 2002.

Various tax relief proposals also garnered widespread approval. In 2000, for example, the state expanded its property tax assistance program for seniors, established an earned income tax credit for low-income families and provided property tax rebates to more than 2.3 million Illinois households.

According to the comptroller’s office, the state began the current fiscal year with 9 cents in its general revenue fund, and $1.2 billion of this year’s revenues will compensate for bills not paid in the previous year.

Newly elected Gov. Rod Blagojevich has ruled out general tax rate increases as a way of filling the projected budget deficit for fiscal year 2004. While spending cuts will surely be part of the solution, another series of revenue enhancers will almost assuredly be developed. Proposals could include an expansion of the sales tax base to include personal services, various fee increases, and the scaling back or elimination of some of the tax credits approved in recent years. In addition, the governor is expected to closely scrutinize various tax incentive programs for businesses and many state boards and commissions.

The state also could try to boost gaming revenue once again. A plan to sell the state’s 10th riverboat license was floated last year but ultimately rejected. Some also have recommended increasing the number of gambling positions at existing riverboat casinos and permitting slot machines at horse tracks in the state.
When the Indiana General Assembly convened in 2001, the state’s fiscal position was strong. State revenues had grown substantially in the mid- and late 1990s, and there was hope this would continue as policymakers crafted the current biennial budget. Instead, over the last two years, state leaders have had to grapple with some severe budget difficulties. Indiana Gov. Frank O’Bannon’s office has estimated that the latest recession will cost the state $3.5 billion by the end of fiscal year 2003.

In 2002, Indiana’s challenging budget year was only partly the result of slumping revenue collections. Lawmakers also had to deal with the results of a court decision that would have drastically raised property taxes in the state without a restructuring of the tax system. Both the revenue shortfall and restructuring were ultimately addressed during a special session of the Legislature.

The state’s budget deficit grew in 2002 as revenue forecasts declined; ultimately, Indiana tax collections decreased by 3.4 percent (inflation adjusted) between fiscal years 2001 and 2002, and lawmakers were given the task of making the most extensive mid-biennium corrections in years.

The state’s final solution included cuts to general fund agencies of about 7 percent. Through the Governor’s Deficit Management Plan, administrative reductions were made totaling $468.7 million in fiscal year 2002 and $671.5 million in fiscal year 2003. A state hiring freeze was imposed, various programs were consolidated, and some dedicated funds were tapped. In addition, certain fees — such as alcoholic beverage permits and licenses — were increased, as were permits issued through the Department of Natural Resources.

During a special session last May, the governor and Legislature also succeeded in passing a major tax restructuring plan, saving Hoosiers from significant raises in their property taxes by increasing the homestead and renters’ exemptions. The 2002 legislation increased the sales tax by 1 percent, the cigarette tax by 40 cents a pack and the gas tax by 3 cents per gallon.

Revenue also will be enhanced through a boost in the tax imposed on riverboats. Owners of the riverboats, in turn, were granted their request that dockside gambling be allowed.

In all, a total of $1.5 billion in taxes ($800 million alone from the sales tax increase) was raised, and $1 billion of that was earmarked for property tax relief. The state’s increase in the homestead exemption could not totally offset the tax implications of the court order mandating that property assessments be based on market value.

In response, lawmakers reduced local schools’ reliance on local property taxes. With the restructuring, 67 percent of the property taxes levied for a school general fund will be paid through a state property tax replacement credit. This will result in the state being responsible for 85 percent of the money placed in the school general fund.

The governor and the Legislature also sought to make Indiana a more attractive place to do business. For a number of years, companies had asked the state to eliminate its inventory tax. In response to these concerns, lawmakers decided to reduce and ultimately eliminate the tax (by 2007). In addition, the state abolished the corporate gross income tax, doubled its research tax credit and...
created a credit for venture capital companies that finance business startups.

State leaders hope these changes spur economic development and help lead to fiscal conditions more like what was seen during the latter part of the 1990s. During those more-prosperous times, lawmakers were able to make some tax modifications. Some of these changes, though, did impact revenue collection. In 1996, excise taxes on license plates — a source of local government revenue — were cut in half.

To replace revenue generated from this excise tax, the state has turned over funds ($236.2 million in 2001) to local governments. In addition, lawmakers enacted a personal property tax credit, and while it was repealed after just two years, the credit cost the state treasury $362 million.

Changes to the personal income tax included increasing deductions for dependents, the elderly, low-income taxpayers and renters, along with creating a new residential property tax deduction. While no large-scale new programs were implemented during this time period, several one-time payments were made for roads and unfunded pension liabilities.

The fiscal picture has changed substantially in recent years, as a look at the state’s rainy day fund illustrates. At the end of 2001, the fund had a balance of $526 million (it is limited to 7 percent of general fund revenues).

By the end of fiscal year 2002, the fund’s balance was $269.2 million. With general agreement among state officials, nearly $234 million from the rainy day fund was used to plug holes in the biennial budget.

Demanding fiscal negotiations and decisions will once again test lawmakers during the 2003 legislative session.

Late last year, a report from the bipartisan State Budget Committee found that the state would face annual deficits of $850 million based on estimated revenue collections and expenditures.

In part because of the tax changes made last year, the unwillingness to enact any tax increases in 2003 will be particularly strong.

The state will instead focus on controlling and reducing spending in order to eliminate the projected deficits. For example, the budget might not include any money for new programs.

Among the other steps to be considered are a broad range of state agency budget reductions, a continuation of the hiring freeze in state government, more program consolidation, and a repeat of last year’s strategy to tap dedicated funds and increase certain state fees.

In addition, O’Bannon says the state could save $23.5 million a year through an early retirement incentive program.

Lawmakers hope 2003 will be remembered as the beginning of the end of state fiscal woes and the start of an economic recovery. The late 2002 report by the bipartisan budget committee did contain some good news. Sales and individual income tax revenues were predicted to increase. And although a downward trend was still being reported for corporate income tax receipts, the committee was predicting an 8.2 percent growth in revenue between fiscal years 2003 and 2004. However, most of this revenue will go to property tax relief, and very little of it will go to the state general fund.

For the next year or two, Indiana will likely have to continue working in a fiscal climate that demands smaller budgets and offers very little opportunity to implement new state initiatives.
During the last two years, Iowa has faced fiscal problems that state officials could not have imagined in the late 1990s. The state’s financial situation forced the Legislature into a special session in November 2001 to balance the fiscal year 2002 budget, while two special sessions were called this past year to adjust the 2002 and 2003 budgets.

Although Iowa lawmakers have avoided tax increases, shortfalls in recent budgets have necessitated significant spending cuts and the heavy use of special or rainy day funds. This year, policymakers will search for ways to fill an estimated $400 million deficit (projected as of late 2002) for fiscal year 2004, continuing a budget-cutting process that has dominated Iowa politics since the 2001 special session.

During the 2001 special session, the Legislature and governor agreed to a 3.8 percent reduction in spending for the fiscal year 2002 budget. Earlier in the fall, the governor had made an across-the-board cut of 4.3 percent, but with the understanding that some reductions would be restored by legislative action (the governor does not have the authority to make such moves unilaterally). The Legislature agreed to reinstate $26.2 million in state spending, targeting high-need or priority areas such as K-12 education, corrections and state aid to counties for mental health.

Despite the cuts, state leaders came to Des Moines last year having to fill another shortfall in the fiscal year 2002 budget. It took two special sessions before agreements could be reached on how to balance a $219 million deficit in the 2002 budget and a projected $216 million deficit for 2003. The first special session stalled due to disagreement about whether to take $60 million from a road fund used for highway projects. Gov. Tom Vilsack said dollars from the fund would help finance state education and public safety needs, but opponents of the move argued that worthwhile, economically valuable highway projects would be threatened in the process.

During the second special session, final agreements on both budgets were reached. The 2002 budget was balanced through the use of cash transfers and by tapping the state’s two rainy day funds — $105 million from the Economic Emergency Fund and $90 million from the Cash Reserve Fund. These moves were criticized by some lawmakers who said more permanent solutions — such as additional spending cuts — should have replaced the use of funds that might be needed during future state emergencies.

Finding agreement on a fiscal year 2003 budget proved to be even more problematic. Ultimately, the road fund was not used; lawmakers decided to eliminate or suspend 27 state programs, made selected cuts in state services and approved 2.2 percent reductions in numerous state agency budgets. An unpaid furlough program also was instituted, with state employees taking a monthly half-day off from work. The state also offered an early retirement package for its workers. In addition, the final agreement dipped into the Economic Emergency Fund for an additional $25 million. Money from the settlement with tobacco companies, the senior living trust fund, the infrastructure account and the leaking underground storage tank fund were all put toward items in the general fund budget for 2003. Finally, a state Program Elimination Commission was created with the goal of achieving annual state budget savings of 2 percent.

### Sources of State Revenue

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<th>Revenue Source</th>
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<th>2003 (estimated)</th>
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Source: Iowa Department of Management

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**State Expenditures by Function**

- **Elementary & Secondary Education**: 17.8%
- **Higher Education**: 24.5%
- **Public Assistance**: 0.9%
- **Transportation**: 8.3%
- **Corrections**: 2.1%
- **Medical**: 13.4%
- **Other**: 40.1%

*Percentages are based on total expenditures, not just on spending from general fund.

**2002 (Actual)**

**2003 (Estimated)**

Source: Iowa Department of Management
The difficult budget cutting done over the last year and half underscores how hard hit Iowa has been by a reduction in revenue collections. The large decline in capital gains tax receipts, more than any other factor, is responsible for the current fiscal problems in the state.

Despite the new budget realities, state leaders have tried to uphold their increased commitment to education. For example, in 2001, the governor and Legislature put money in the budget for an initiative to increase teacher salaries. The first year of the program was funded mostly by borrowing from the tobacco settlement fund, but since then, money has come from the general fund to pay for the program, and the tobacco settlement fund must still be paid back. Budget discussions in 2002 included proposals to significantly cut the teacher pay program, but the new initiative was ultimately left intact.

Some legislative critics have traced part of the state’s current budget problems back to actions taken in 1998, when a series of tax cuts were passed while spending for some ongoing programs was increased. The most significant tax change was a 10 percent reduction in the personal income tax, but cuts also were made to inheritance taxes and other revenue streams. Tax cuts and expenditure increases effectively erased what had been a $450 million ending balance (outside of the state’s rainy day funds, which were at their limit of 10 percent of the general fund budget in 1998) in just a few years.

The revenue gains of the 1990s that had allowed for both tax cuts and spending increases are gone. Now, as it works on the fiscal year 2004 budget, the Legislature is looking for ways to save money.

If the Program Elimination Commission meets its goal, the state would save $100 million. The eight-person panel (primarily composed of people from outside of government) has not only looked at what state programs could be eradicated, but also at several other ways to control expenditures. For example, the commission has proposed changes to the state’s sentencing laws in order to reduce prison overcrowding or the need for new corrections facilities. Under the panel’s proposal, the Parole Board would be given the authority to recommend parole or work release for prisoners after they have served just half, instead of 85 percent, of their sentences. Members of the panel also have suggested steps to encourage greater use of generic drugs to hold down Medicaid costs, and they have recommended merging several of the state’s mental health hospitals.

Meanwhile, the governor is considering the merger of five state agencies into a department of administrative services. He proposed a similar consolidation plan last year, with savings estimated at $3.1 million annually, but the Legislature did not pass the proposal.

Numerous other budget cuts will be considered as well in order to address the projected $400 million deficit. With many one-time budget fixes already used up to address the budget problems of previous years, program areas that have been mostly protected from cuts — such as education, Medicaid and corrections — will be more vulnerable to reductions. Close to a third of the members of the Legislature are new in 2003, and they will face some difficult choices during their first year on the job.

### Ending General Fund Balance as a Percentage of Total Expenditures*

* Percentages for fiscal year 2002 are preliminary actual figures.

Source: National Association of State Budget Officers

### Budget Stabilization Fund

**Amount at Close of Fiscal Year 2002:** $140 million in the Cash Reserve Fund and $25 million in the Economic Emergency Fund

**Additional Notes:** Beginning in fiscal year 2004, a maximum amount of 7.5 percent of general fund revenue will be allowed in the Cash Reserve Fund and a maximum amount of 2.5 percent will be allowed in the Economic Emergency Fund. A simple majority vote is required to tap the Economic Emergency Fund and 40 percent of the Cash Reserve Fund; a three-fifths vote is needed to tap 60 percent of the Cash Reserve Fund.

Sources: Amount and some notes from Iowa Department of Management; other notes from National Association of State Budget Officers

### General Fund Revenues and Expenditures*

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* All numbers are in millions. 2003 numbers are budgeted figures, while 2002 numbers are preliminary actual numbers.

Source: National Association of State Budget Officers
Kansas is struggling to close a projected $312 million deficit (as of late 2002) for fiscal year 2003 that has already forced legislators to take the unpopular measures of raising taxes and cutting core services. Twice since the Legislature adjourned in mid-April, outgoing Gov. Bill Graves imposed unilateral spending cuts totaling $119 million. In late November, he offered recommendations for the Legislature to reduce spending this year by an additional $256 million.

Yet these rescissions are only a short-term solution to a problem that most Kansas legislators acknowledge is much deeper. If sluggish economic growth continues to negatively impact tax receipts, the Legislature could face a deficit of up to $600 million in fiscal year 2004, possibly necessitating steep cuts to previously untouchable areas and across-the-board agency reductions even larger than the 3.9 percent mandatory cut that Graves imposed late last year.

Kansas’ budget deficit reflects the unusually severe economic downturn that has plagued the state in recent years. The key agriculture and aerospace industries, among others, have been suffering, and revenue flows into the state treasury have been slow. The state’s struggling economy also has increased demands for key services and entitlements, stretching the resources of some state agencies to the limit.

At the same time, local governments faced with similar budget difficulties are increasingly unable to provide services of their own, especially in rural, depopulated areas. The current budget tensions were underscored in late 2002 by the filing of a lawsuit by city and county governments against the state. Part of Graves’ budget-cutting proposal in November sliced aid to local governments by $48 million — a move the cities and counties believe was not within the governor’s authority.

Only a few years ago, Kansas lawmakers and residents were enjoying the benefits of a strong state economy. In 1997 and 1998 alone, the Legislature approved almost $400 million in property tax reductions that were matched dollar-for-dollar by spending increases on education, transportation and a variety of other state services.

Revenue increases and growth estimates seemed to justify much of the spending, but now some are wondering if more could have been done to alleviate the current budget woes. For example, the state does not have a true budget destabilization fund, which most other Midwestern states have to offset deficits in less bountiful times.

Lawmakers also have been unwilling to tinker with budgetary “sacred cows” such as education funding (which accounts for just over half of the general fund budget) and income tax rates (which are among the lowest in the region).

In last year’s gubernatorial election, both candidates vowed not to raise taxes or cut education funding, limiting options available to Kansas lawmakers this year. They enter the 2003 legislative session after battling through a fiscal year some said was the worst in the state since the Great Depression of the 1930s.

The Legislature ultimately made some difficult fiscal decisions in 2002. With elections only months away, lawmakers raised taxes despite popular discontent and resistance from some colleagues. The final budget increased the state’s sales tax from 4.9 percent to 5.3 percent, imposed a tax on...
computer software for the first time, levied higher fees on corporations that do business in the state and imposed a new 15 percent inheritance tax on certain property transfers. The bill also included a 24-cent, per pack increase on cigarettes, a popular revenue-raising strategy in the region. A proposal to raise income taxes was rejected.

Kansas lawmakers also tapped the state’s ending balance fund. The fund is equivalent to 7.5 percent of the previous year’s total budget, or about $330 million in 2002. Unlike many rainy day funds in other states, the ending balance fund must be replenished annually. It exists to ensure that the treasury will contain sufficient revenue to pay for essential services at times when revenue flow is sparse or even, such as at the start of a new fiscal year or before individual income tax revenue flows in. Because it is more a cash management fund rather than a source of emergency revenue, lawmakers found that the only way they could tap into these resources was to amend the 7.5 percent rule.

When the Legislature ultimately did so — temporarily lowering the reserve percentage to 5 percent and freeing some $110 million for immediate use — critics charged that the maneuver would force the state to borrow from other, higher-interest funds and diminish the odds of returning to the 7.5 percent level. And, as in other states where legislators tapped into budget stabilization funds, many critics believed that the maneuver simply allowed the Legislature to postpone a difficult, but necessary, evaluation of its spending levels.

In late 2002, as lawmakers prepared for the new legislative year, some additional revenue enhancers remained under discussion. A consensus appears to have emerged that the state’s tax code contains too many loopholes.

Both Gov. Kathleen Sebelius and the Republican-controlled House and Senate are investigating ways of increasing revenue by closing some of these loopholes — either through wholesale changes or targeting specific exemptions.

Other ideas under consideration include scaling back income tax credits and applying the state’s sales tax to services as well as goods, reflecting a broader shift in the kind of economic transactions that now take place.

New estimates suggest that piecemeal rescissions and limited tax increases may not be sufficient to plug a deepening budget hole. Instead, legislators may have to revisit controversial solutions that have lacked consensual support in past years. An expansion of gambling, for example, was narrowly defeated in the last several legislative sessions, but the growing likelihood of longer-range budget difficulties may heighten the appeal of this new revenue source.

Legislators may also rekindle the income tax debate if other changes do not bring in enough revenue to improve the budget outlook.

But while current fiscal numbers are discouraging, lawmakers are optimistic about the Legislature’s ability to address the budget situation more forcefully than in past years. The election of a Democratic governor and a slightly more Republican Legislature evens out the political risk and could render a decisive outcome more likely.

Easy options have now been exhausted — the ending balance fund has been pared down, cigarette taxes increased and marginal programs cut back — forcing the Legislature to examine structural issues and critical priorities. Both legislators and their constituents have now had time to accustom themselves to deficits rather than surpluses, and have come to understand the challenges that lie ahead for the state.
In November 2001, when Michigan lawmakers found themselves having to fill a budget hole of about $550 million, some seasoned veterans may have thought back to 1991 — when the state faced a $1.8 billion shortfall — and figured things could be worse. But by December 2002, most lawmakers had to be wondering how much worse the budget picture could get.

The state now faces a structural deficit that will leave a once-robust Budget Stabilization Fund drained and state agencies, universities and local governments scrambling to contend with significant budget cuts.

The month following the Sept. 11 attacks, a special October 2001 consensus revenue forecasting conference announced a downward revision to Michigan’s spring revenue projections. As a result, it wasn’t long after policymakers had completed work on the state’s fiscal year 2002 budget that Gov. John Engler issued budget-cutting executive orders, the first time in eight years this had been done. (Michigan’s fiscal year begins Oct. 1.) With the required approval from the majority of members of the House and Senate appropriations committees, the reductions went into effect.

As a result of the cuts, a maximum security prison and branch offices of the secretary of state would close. The Legislature and judiciary were required to trim their budgets by 5 percent, and funding for community health programs was slashed.

The budget fix also included transfers from other reserve and restricted funds and the sale of some state land. In addition, legislation was passed that provided for up to $350 million to be withdrawn from the state’s rainy day fund to compensate for a shortfall in the School Aid Fund. The state’s constitutional requirement for a balanced budget had been met. Late last year, however, as analysts worked to finalize budget numbers for fiscal year 2002, it looked as if revenues would still come in another $100 million short of the $20.22 billion expected.

Filling this hole will require a further dip into the Budget Stabilization Fund, preventing the state from using the balance to help fix the expected fiscal year 2003 deficit as was planned.

The total rainy day fund withdrawal for the fiscal year 2002 general fund budget will come to about $460 million. This, combined with withdrawals for schools and the fiscal year 2003 budget, will mean the Budget Stabilization Fund balance will drop to zero during the current fiscal year. In July 2001, the fund had a balance of more than $1.2 billion.

When work began on the 2003 budget, a $350 million shortfall was predicted in the $9.1 billion general fund. As part of the patchwork fix for this hole, an early retirement plan was approved that, if half of those state workers eligible accepted, was expected to save the state $50 million a year. In fact, about two-thirds have chosen to retire.

The Legislature also agreed to another few key budget fixes. In addition to authorizing a $207 million withdrawal from the rainy day fund (along with a $32 million withdrawal for the separate budget for schools), the cigarette tax was increased and a scheduled reduction in the Single Business Tax rate was halted.

After much legislative wrangling, a 50-cent increase in the
cigarette tax was approved, bringing the rate to $1.25 per pack and giving Michigan the third-highest cigarette tax in the nation.

The tax hike is expected to bring in $150 million for the general fund and $107 million a year for Michigan’s School Aid Fund. The money for schools is handled through a separate budget, which is now actually larger than the general fund. To this point, all parties have agreed not to touch the appropriations for K-12 schools. About a 3 percent increase is in place for fiscal year 2003.

Though schools will see a modest funding increase, it is less than expected thanks to slower growth in sales tax revenues. In 1995, Michigan switched to a school funding formula in which the majority of the money the state sends to schools is derived from the sales tax, rather than property taxes.

Some school officials believe lawmakers should review the part of this arrangement that prohibits local voters from raising taxes to increase funds for schools.

Another fiscal year 2003 budget fix came by delaying, until 2004, the scheduled Single Business Tax. The SBT is Michigan’s modified value-added tax on business that considers a company’s payroll, sales and property.

In 1999, legislation was enacted that would reduce the SBT yearly for the following 23 years. Some lawmakers proposed also stopping the multiyear, phased-in reduction in the state income tax, though it was left in place.

On the revenue side, Michigan finds itself with an estimated $1.8 billion less in general fund revenue for fiscal year 2003 than had been generated in 2000. While a slowdown in the state’s economy is to blame for part of the problem, analysts say about 70 percent of this decrease can be attributed to the cuts in the single business and income taxes.

So, even with the budget-balancing steps taken to address the 2003 deficit, by the end of 2002 it was clear that earlier revenue estimates were not holding up.

In December 2002, the governor again received legislative approval for executive orders for a $460 million plan that includes $337 million in new spending cuts and $123 million in spending deferrals and fund transfers.

This budget fix means revenue sharing to local communities will drop by 3.5 percent, spending for most state departments will be trimmed by 2.5 percent, scholarship payments will be spread over two years instead of one, and assistance for public universities and community colleges will be reduced by 2 percent.

This last component of the plan is significant as there had been an earlier agreement to leave higher education funding at fiscal year 2002 levels if the universities agreed to keep tuition increases at or below 8.5 percent or $425, whichever was greater. Now, most expect tuition to skyrocket.

Looking ahead to fiscal year 2004, the picture is even bleaker. With the state’s Medicaid budget alone expected to be $600 million in the red and with a prison population growing at a faster than expected rate, the income tax reductions may be revisited and options such as securitizing the tobacco fund may be considered.

One thing is for sure, a predicted $1.8 billion deficit for fiscal year 2004 will mean few proposals are left off the table.
By the time the Minnesota Legislature convened on Jan. 29, 2002, then-Gov. Jesse Ventura had already warned legislators that he might order unilateral state spending cuts if they didn’t begin agreeing on reductions during the first week of the legislative session. Minnesota law does allow the governor to cut the budget without legislative approval in times of fiscal crisis, and a December 2001 revenue forecast by the state Finance Department had projected that spending would exceed tax receipts by $1.95 billion for the previously approved, $28 billion biennial budget.

In his State of the State address, Ventura stressed the desire to cut spending first, saying he would adamantly oppose the undoing of the major tax reforms passed the previous year.

The year before, Minnesota had received some indication of changing economic times. In June 2001, while the Minnesota Legislature was in special session to pass omnibus appropriations bills and decide what to do with a predicted $1.5 billion budget surplus, some state fiscal leaders were saying the surplus could be a mirage. They pointed to declining tax collections and unpromising predictions for national economic growth. So, while reducing property taxes an average of 15 percent for homeowners, cutting income taxes for the fifth year in a row and instituting one-time sales tax rebates, lawmakers also increased state reserves and left $250 million unspent.

The early signs of changing fiscal conditions in 2001 were followed in 2002 with the need to deal with some harsh budget realities. Ventura sought to balance the budget through a combination of $700 million in spending cuts, a gas tax increase of 5 cents a gallon, an increase in the cigarette tax by 29 cents per pack, the use of $667 million in reserves and a few one-time actions. He proposed further cuts and additional taxes to offset the projected deficit for the fiscal year 2004-2005 budget.

During a fast-moving first few weeks of the 2002 legislative session, initial harmony between the chambers broke down, with the Senate passing an omnibus plan to address the deficit and the House countering with 11 separate bills.

It appeared that the only issue that could be agreed upon was a state hiring freeze, and in mid-February, Ventura did announce a “hiring restriction,” leaving administration officials some flexibility to fill positions where there was a critical or legal need to do so.

Then, soon after, Senate and House majority leadership announced that they had reached a bipartisan, bicameral budget-balancing accord. Two days later, the bill — which did not include any tax increases — passed. It cut state spending by $374 million, used $1.3 billion in reserves and made a few other one-time changes to balance the current biennial budget’s $1.95 billion deficit.

The legislation also changed the way planning estimates for future budget cycles are made. Until the 1990s, inflation routinely was excluded from these estimates. The 2002 bill reinstated that prohibition. This was done so that lawmakers could concentrate on the immediate deficit and postpone some decisions on permanent spending cuts or tax increases.

While the bill met Ventura’s demand for speedy action, he said it spent too much of the state reserves and left imbalances for future years. He vetoed the measure, but the Republican-controlled House and Democrat-led Senate overrode it.

Minnesota budget forecasts are released twice a year, usually
in February and November. The February 2002 forecast showed that Minnesota was doing even worse than had been predicted in November 2001. It indicated that the state had been hit hard by the economic downturn and seemed to be recovering more slowly than the rest of the nation. The state was losing jobs at a faster rate than the U.S. average; for the first time in decades, the state’s economy was not doing as well as the nation’s economy. The current biennial shortfall had grown to $2.3 billion, meaning the budget fix already approved by the Legislature would not be enough.


The first budget reconciliation bill had used up many of the relatively painless solutions. While earlier expectations were that the Legislature would adjourn by Easter, that date came and went with no sign of compromise.

Finally, with less than a week left before the constitutional deadline for adjournment, the two houses announced they had come to an agreement. The accord, which again survived a gubernatorial veto, relied on a delay of 17 percent of state aid to schools and accelerated the collection of sales taxes paid by businesses. More than $1 billion of Minnesota’s tobacco settlement endowment was used for a cash flow account, and $300 million was left in the state’s reserve account. The agreement did little to address the projected shortfall for the next biennium, but legislative leaders said they wanted to wait and see if an economic recovery occurred.

Five budget areas consume 85 percent of Minnesota’s general fund budget: K-12 education, higher education, state aid for local governments, health care and human services. K-12 and higher education make up more than 50 percent of the state’s 2002-03 budget. Health care expenses, the fastest-growing spending item in the state budget, have increased 29 percent over the last biennium.

On Dec. 4, 2002, Minnesota’s fall economic forecast was released, and the outlook for the state is not good, although the law that was passed last year prohibiting officials from assuming inflation in the forecast prevented it from being worse. The Minnesota Department of Finance cited the weak stock market, a slow-to-rebound economy and higher-than-projected human services expenditures for ballooning the projected fiscal year 2004-2005 biennial deficit to more than $4.5 billion. Because $356 million of that is projected to occur within this biennium, newly elected Gov. Tim Pawlenty and the Legislature will need to find remedies before the close of the current budget biennium, June 30.

Pawlenty said he will present a budget plan by mid-February. It is expected to include various spending cuts realized by a combination of layoffs or state employee retirements, merging or abolishing certain Minnesota agencies, and shifting some state functions to other agencies or entities. The state also might redirect some of the funds from the settlement with tobacco companies.

The governor has pledged not to raise taxes, but some ideas circulated during the 2002 session — such as increasing the cigarette tax (which has not been raised in a decade) and the gas tax (which has not been raised since 1998) or instituting a clothing tax (Minnesota does not currently have one) — are likely to be reconsidered. Some legislative leaders already have indicated that they may wait until the next forecast is released before they begin work on the 2004-05 budget.

### General Fund Revenues and Expenditures*

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*All numbers are in millions. 2003 numbers are appropriate figures, while 2002 numbers are preliminary actual numbers.

Source: National Association of State Budget Officers
The negative revenue growth that Nebraska experienced between fiscal years 2001 and 2002 was enough to disrupt the state’s previously strong fiscal conditions. But what really astounded longtime economic analysts in the state — and underscored the seriousness of Nebraska’s budget woes — was the fact that 2002 revenue numbers did not even match those seen in fiscal year 2000.

The phenomenon was deemed “undeniably historic” by Nebraska Gov. Mike Johanns. Prior to the current economic slump, tax receipts had grown by an annual average of more than 5 percent over the last 20 years, and the last time the state had seen any year-to-year decline in revenue growth was 1981.

Nebraska’s dramatic reversal of fortunes gave leaders the unenviable task of filling significant holes in the state’s biennial budget. In less than a year, the Unicameral Legislature met for two special budget-cutting sessions and overrode the budgetary veto of a popular governor. The end result was the enactment of temporary tax increases, considerable spending cuts and various fund transfers.

In 2003, the governor and the Unicameral Legislature must craft a new biennial budget fully aware of the state’s gloomy fiscal picture. Reports as of late 2002 estimated that the shortfall could reach as high as $675 million (if current revenue predictions and spending patterns hold).

Considering the magnitude of the projected shortfall, lawmakers will likely incorporate several different ideas into their final budget package for the new biennium. This strategy already has been used to balance the current two-year budget, which the state will close the books on at the end of June.

Budget cutting has dominated discussions in Lincoln ever since Johanns called the Legislature into special session in October 2001. Then, lawmakers agreed to make $171 million worth of cuts. The new fiscal realities in Nebraska were encapsulated by the delay in implementing certain programs approved during stronger economic times. For instance, a loan forgiveness initiative for teachers and child care tax credits for businesses were postponed.

Close to half the savings measures enacted in late 2001 came from nearly across-the-board cuts to state agency budgets (4 percent in fiscal year 2002 and 5 percent in fiscal year 2003). The state’s higher education system was spared some, but not all, of the rescissions.

Legislators adjourned the 2001 special session knowing more would have to be done in 2002; eventually, an approximately $220 million shortfall had to be addressed. This time, lawmakers decided to balance the budget through a combination of spending reductions and revenue enhancers, arguing cuts in state services would be too severe without tax increases of some kind.

The final budget included a two-year, 30-cent, per-pack raise in the cigarette tax; a one-year, half-cent sales tax hike; and a one-year, 2.2 percent increase in income tax rates. With approval of the revenue enhancers, Nebraska became the first Midwestern state in 2002 to pass a general tax increase, and lawmakers did it by overriding a gubernatorial veto. About a dozen new services also were added to the state’s sales tax base. To preserve two existing revenue sources, the state decoupled its tax provisions from changes made at the federal level regarding the estate tax and a bonus depreciation measure for businesses.

Spending reductions came from another round of across-the-board agency cuts (this time 3 percent), although universities...
and state colleges once again faced smaller cutbacks. State aid to local schools was diminished, while some smaller state initiatives faced the budget ax. Finally, numerous transfers were made to boost the state’s general fund, including the use of $22 million from the state’s cash reserve fund.

Despite the Legislature’s actions, continuing revenue problems forced lawmakers back to the Capitol in July. Tax increases were almost immediately taken off the table, meaning a little more than $100 million in cuts or cash transfers would have to be made in order to balance the biennial budget.

Key actions taken in the special session included cutting the state’s university system by $15 million, tapping $14.4 million from the highway trust fund and making changes to Medicaid eligibility requirements. This last measure proved to be one of the more unpleasant budget cuts made by Nebraska lawmakers, but it also underscored growing concerns in the state about the rising cost of Medicaid. Among the many changes was the elimination of “stacking,” a practice in which a family’s income is split into subgroups so that they can still qualify for Medicaid.

Responding to a poll conducted late last year by the Omaha World Herald, many senators expressed a willingness to consider further changes to the Medicaid program in order to balance the state’s upcoming budget. Possible proposals include increasing co-payments, further stiffening eligibility requirements or curtailing certain services such as dental care. Adopting such changes will not be easy, though, because of the effects they would have on some of the state’s most vulnerable citizens.

Lawmakers will examine the possibility of more cuts to another big-budget item: the state’s higher education system. And as has happened in the past, state agency budgets will be looked at carefully. A study was conducted last year examining the merits of zero-based budgeting, which would require state agencies to justify all of their appropriations requests.

One program that some groups and lawmakers have said should be either modified or eliminated is a tax incentive initiative for businesses. Proponents argue that it creates jobs and spurs economic development, both of which are needed now to boost revenue in the state. Opponents, though, say the tax revenue generated from the program has not equaled the amount of money doled out to businesses.

Various revenue enhancers will be considered for inclusion in the new biennial budget; one possibility is to expand the sales tax base. This already was done in 2002, but some lawmakers believe additional services should be taxed and more exemptions eliminated. A decision also will be made on whether to extend the temporary tax increases enacted in 2002.

Proposals to bring casino gambling to the state will likely be considered in 2003, although similar measures in the past have been met with stiff, successful opposition.

When Nebraska was enjoying strong revenue growth in the latter part of 1990s, one way that policymakers used state money was to reduce local property taxes by offering more aid to local K-12 schools and community colleges. Fiscal conditions are much different now, but property tax relief continues to be an especially popular issue in Nebraska’s numerous rural areas and among the state’s older residents. As a result, the Legislature will likely be hesitant to enact measures that substantially raise local property taxes. Spending cuts to state programs, gambling and changes to the sales tax base appear to be more likely methods that the state may use to produced a balanced budget for the new biennium.
While North Dakota lawmakers were closely monitoring the economy and state revenue collections in 2002, they had a legislative year markedly different than the one experienced by counterparts in other states.

The North Dakota Legislature, which meets only every other year, was in its off year in the biennial cycle when the worst part of the fiscal crisis hit U.S. states. In addition, lawmakers in 2001 anticipated the need to address a possible deficit in the biennial budget and equipped Gov. John Hoeven with the authority to cover a shortfall. The move avoided the need to call a special legislative session in 2002.

Despite the state’s sluggish economy, along with the tightest fiscal conditions the state has seen in a decade, the severity of North Dakota’s budget shortfalls has not approximated the staggering deficits seen across the country.

Analysts say the fiscal crisis hit the state later and to a much lesser extent for several reasons. The state is not as dependent on the economy’s manufacturing sector, which has been especially hard hit by the recent downturn. In addition, the economic impact on the travel industry in the aftermath of Sept. 11 did not affect North Dakota to the extent that it did other states.

Throughout the recession, North Dakota has maintained one of the lowest unemployment rates in the nation. The state also has a relatively low debt burden along with a history of restraint in taxing and spending in both good and bad economic times, helping to even out the gains in boom years and losses in bust years.

Still, the national recession inevitably touched North Dakota. Based on July 2002 forecasts, state revenues were nearly $65 million below projections, largely due to the declining stock market and capital losses that resulted in decreasing personal income tax and corporate income tax collections.

In addition to this revenue shortfall, the budget crunch was exacerbated by larger-than-expected Medicaid spending, driven by pharmaceutical and in-hospital patient costs.

In part, the state has dealt with the budget gap by making use of the Bank of North Dakota, the only state-owned bank in the nation. In fiscal years 2002 and 2003, proceeds of more than $60 million from bank profits will be transferred to the general fund.

During the 2001 session, the Legislature made sure that the governor was given the means to address possible revenue shortfalls by allowing him to transfer up to an additional $25 million in contingency funds from the Bank of North Dakota to the general fund. Of that $25 million, as much as $22.9 is expected to be used.

In July, Hoeven took actions to offset the deficit and keep the budget balanced. Along with implementing across-the-board agency cuts — which saved the state more than $18 million — he exercised his authority to request the transfer funds from the reserves at the Bank of North Dakota.

Despite several signs that show a strengthening of the economy overall, and the relatively less severe budget problems in North Dakota, the state’s fiscal situation remains somewhat precarious. At the beginning of fiscal year 2002, North Dakota’s general fund balance was $62.2 million. The latest projections show that the Legislature must tackle an
Budget Crunch  Fiscal Conditions in the Midwestern States

estimated $67 million deficit in writing the upcoming biennial state budget.

One of the challenges for the Legislature in 2003 will be to follow through on a decision made by voters last November approving participation in a multistate lottery. Legislators must pass new laws to establish and regulate lottery games in the state. Participation in a multistate lottery, which may start in the fall of 2003, is expected to generate $5 million for the new biennium.

On Dec. 4, 2002, Hoeven released his $5 billion budget plan for the next biennium in an address to the Legislature. In it, he unveiled a proposal containing an increase in general fund spending of less than 1 percent. This is considered modest when compared to an average rate of growth over the last six biennial budgets of 8 percent. The governor’s budget also predicts revenue collections slightly higher than those released to legislators in projections a month earlier.

The governor has not suggested any increase in general taxes, and he has been vocal about his commitment to not borrow from North Dakota’s share of the tobacco settlement. He is proposing to deal with future deficits by increasing the state’s cigarette tax from 44 cents to 79 cents per pack. According to the administration, the increase would generate an estimated $30 million in revenue over two years and would be used to fund the cost of health care and education in the state.

He also has proposed to cut 100 full-time state employees through attrition and cut spending for two-thirds of the state’s agencies to levels lower than in the current biennium. In addition, the governor wants to revise the state’s corporate income tax, which currently has a top rate of 10.5 percent and allows for the federal corporate income tax to be deducted. Hoeven is calling for the elimination of the deduction and a lowering of the top rate to 6.8 percent.

In the end, the state would see no real change in corporate income tax collections, as some businesses would end up paying more and others less. Hoeven hopes, however, that the lowering of the top rate and the decoupling of the state and federal corporate tax will make North Dakota’s business climate more friendly.

Some key new spending proposals are part of the governor’s budget proposal as well. For example, Hoeven is asking for higher teacher salaries and a prescription drug program for needy elderly in North Dakota. In 2001, the state increased compensation for its teachers by providing school districts with $3,000 per instructor. Hoeven is now asking the Legislature to boost teacher pay by an average of $1,500, at a cost to the state of $31 million over two years. The governor also has included pay raises for state workers: a 1 percent pay raise next year, deferred for six months, and a 2 percent raise in 2005.

There has not been an increase in income or sales taxes in North Dakota since 1989, and neither the administration nor leaders in the Legislature are currently favorable toward raising general taxes as a source of revenue.

Hoeven’s proposal to increase the tobacco tax is likely to be met with opposition, as some members of his own party want to explore further spending reductions before considering any kind of tax increase. In addition, some lawmakers will likely question the governor’s plan to use an additional $60 million in funds from the Bank of North Dakota to help balance the budget.
When Ohio legislators returned to Columbus in January 2002 for the start of that year’s session, they had just finished correcting a $1.5 billion shortfall in the state’s $45 billion biennial budget the previous month. But few, if any, lawmakers believed the state’s fiscal crisis had been laid to rest. Even with the adjustments, revenues continued to decline, and legislators and the governor were anticipating the need to address even more significant shortfalls for the remainder of the biennium. By the end of the spring, the Legislature and Gov. Bob Taft’s administration had come to agreement on a second budget correction bill in six months’ time — this one closing a $1.9 billion budget gap.

As early as October 2001, Ohio was already nearing its largest fiscal crisis in a decade. The first quarter of the biennium had barely passed, and projections were pointing to a possible deficit in the billions of dollars. Even before the full financial impact of the Sept. 11 terrorist attacks was being experienced nationwide, a manufacturing recession had slowed Ohio’s economy, which has a significant industrial base.

While sales tax revenues were meeting forecasts, lower-than-expected personal income and corporate franchise tax collections, along with increased spending on social services, resulted in shortfalls and quickly took the budget off balance.

The December 2001 correction contained a variety of measures to shore up a $1.5 billion budget deficit. With passage of the bill, the Legislature granted the governor the authority to enter into a multistate lottery game, which is expected to generate $41 million in fiscal year 2003. In addition to the agency budget cuts included in the adjustment bill, an executive order made reductions of more than $650 million in agency spending.

The legislation also changed the way in which the sales tax is collected on leased vehicles, giving the state a one-time boost of more than $250 million. Finally, the bill closed some tax loopholes. For example, it discontinued the tobacco stamp discount for wholesalers and prohibited financial institutions from using subsidiaries to avoid paying taxes.

By early spring 2002, estimates indicated a growing deficit surpassing the one the Legislature had just addressed several weeks earlier. This time, policymakers were looking at a $1.9 billion budget shortfall. In May, the Legislature and the governor worked out an agreement that once again used a number of cuts, fund transfers and minor tax increases to fix the problem.

To cut agency budgets, the governor imposed a strict hiring freeze on all agencies, restricted year-end equipment purchases and banned travel. Overall, the bill contained nearly a half-million dollars in spending reductions. Revenue enhancements in the legislation included a 31-cent, per-pack raise in the cigarette tax and a temporary tax on trusts.

Several other changes were made as well in the second adjustment. Lawmakers included a provision that indexes the personal income tax rate to inflation beginning in 2005, thereby preventing taxpayers from being placed in a higher tax bracket by cost-of-living increases. They also prohibited the governor from cutting state aid to local governments.
Taft used his veto power to nix several other components of the budget bill passed by the Legislature in May. He line-item-vetoed a mandatory cap on state budget growth in future years; a requirement that tax receipts in excess of 3 percent growth be transferred to the rainy day fund or be returned to taxpayers as rebates; and a provision that would have prohibited the state from increasing spending for most state agencies in the next two-year budget.

In making the recent budget adjustments, lawmakers have used the state’s rainy day fund and money from the settlement with tobacco companies to supplement the general revenue fund. Overall, the state borrowed a total of $240 million from its share of the national tobacco settlement, with a requirement that the affected funds be repaid by fiscal years 2013-14. Another $345 million in tobacco settlement dollars was diverted from the Education Facilities Trust Fund to the general fund.

Meanwhile, the state tapped its Budget Stabilization Fund, which had grown to over $1 billion in the 1990s, leaving it essentially empty. Despite plans to rebuild it in future years, many are concerned about the present lack of an emergency fund.

Thus far, Taft and the majority of lawmakers have adamantly opposed any broad-based, general tax increases or the creation of new taxes to provide additional revenue streams to the budget. This sentiment is expected to still be strong as lawmakers work this year on crafting a new two-year budget.

Two of the biggest battles during the 2003 legislative session are likely to be waged over pay raises for employees and the institution of video lottery terminals at the state’s horse racing tracks.

The current contract with the largest state employee union expires at the end February, and negotiations between the union and the Taft administration began in December.

A proposal to allow video gaming at horse tracks stalled at the end of the 2002 session, but it is likely to come up again in 2003. The proposal has the support of many Republicans in the Legislature, but the majority party will likely need to garner the support of a number of Democrats in order to override a threatened gubernatorial veto.

Supporters argue that the video lottery terminals would add $500 million in revenue annually, in addition to reviving the state’s horse racing industry.

Several estimates have been made regarding the size of the deficit for 2004-05, with preliminary projections ranging anywhere from $1 billion to $3 billion. Whatever the exact number is, several factors will continue to constrain budget leaders. One is the increasing cost of Medicaid.

Along with projected increases in Medicaid caseloads, the state must deal with rising expenditures related to prescription drugs and long-term care programs.

The state budget also could be impacted by the recommendations of the Committee to Study State and Local Taxes, which will suggest improvements to the state’s tax structure.

In December, the Ohio Supreme Court handed down its fourth decision in the state’s decade-old school funding case. Justices once again ruled that the state’s school funding system is unconstitutional due to its overreliance on local property taxes. As a result, lawmakers will need to consider new funding mechanisms to satisfy the court’s latest ruling, while at the same time devising a budget consistent with the state’s currently tight fiscal outlook.

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* All numbers are in millions. 2003 numbers are budgeted figures, while 2002 numbers are preliminary actual numbers. Source: National Association of State Budget Officers
When all was said and done this past year, the South Dakota Legislature changed little of what Gov. Bill Janklow had proposed in his November 2001 budget address. The $877 million fiscal year 2003 general fund budget that passed called for little growth in state government, though a $36 million deficit required an equivalent transfer in reserve funds to ensure the state’s balanced budget requirement was met.

While many states point to the sputtering economy as the main culprit responsible for dwindling revenues, South Dakota faces a unique situation that accounts for about $25 million of the state’s shortfall: in 2000, voters repealed the state’s inheritance tax. The difference created by just this one tax is significant in a state with no personal or corporate income tax, no personal property tax and no business inventory tax.

South Dakota derives more than half of its revenue from the sales tax. Proceeds from video lottery also contribute greatly to state coffers. The state splits proceeds from gambling losses evenly with the businesses that own and operate the video machines. Lawmakers did not favor increasing the state’s share of the money to help ease the budget crunch, though 2002 was the first in many years where measures aimed at restricting or repealing video gambling were not introduced. Replacing the $100 million in state gambling proceeds would be difficult any time, let alone in the midst of mounting fiscal pressures.

During last year’s session, the Legislature had several budget-related issues to tackle. First, there was an $18 million hole in the fiscal year 2002 budget that had to be filled. Lawmakers made up the difference using a combination of $13.2 million in reserve funds (the Property Tax Reduction Fund and the Budget Reserve Fund), transfers from the state public broadcasting and children’s trust funds, and money not expended by the Department of Education.

Second, the fiscal year 2003 budget had to be approved. It was passed assuming that revenues would grow 2 percent in 2002 and 4 percent this year. South Dakota’s budget is based on state revenue estimates adopted once a year, in February. These estimates include a revision to the revenue estimate for the current fiscal year and a prediction for the fiscal year for which lawmakers are budgeting.

The fiscal year 2003 budget includes a variety of spending cuts that total just $2 million. Proposals for more severe reductions were rejected by the Legislature’s Joint Appropriations Committee. Among the suggestions was a 2 percent, across-the-board cut in spending from any general state tax funds; reducing the size of pay raises for state workers; and eliminating state government jobs where the position had been vacant more than one year.

Key areas of budget debate during the 2002 legislative session included providing the Department of Transportation the money it needed to draw down federal matching funds for road repair and construction. Its highway fund was running about $20 million short due to a combination of bad weather, higher gas prices and court-ordered refunds.

Proposals for a temporary gas tax or an excise tax on motor vehicles were scrapped in favor of dipping into the Petroleum Compensation Release Fund. A 1-cent pipeline
fee that was to sunset this year was also left in place. Revenues from that tax will benefit road construction as well as ethanol production.

When it came time for a vote on the budget, there was some discussion about adding a $3 million program to give bonuses to the state’s top teachers. Proponents offered to pay for the initiative using funds left over in the Education Department’s budget. The idea was ultimately rejected.

Some concerns about the budget process were raised at the end of the 2002 session. Lawmakers voted on the budget bill within minutes of it being introduced. This left some frustrated that there was not ample time to review or offer amendments to the legislation. There are those who suggest setting aside at least one day between the time the budget bill is introduced and its adoption.

The current budget process is actually the result of a change implemented some years back to make sure that legislators had a sense of proposed appropriations early on in the legislative session and thus more time to review them. Rather than work to craft a budget bill, the Joint Appropriations Committee drafts a report amending the General Appropriations Act (which is based on the governor’s proposed budget), which is included in members’ bill books at the beginning of session.

Still, some lawmakers have suggested that legislators not serving on the appropriations committees would benefit from weekly updates of their work.

A few factors have combined to leave South Dakota in better financial shape heading into 2003 than policymakers originally anticipated. Last fall, the governor announced that efforts to tighten spending coupled with better-than-expected economic growth meant that when the books were closed on the 2002 fiscal year, nearly $6.2 million was transferred into the state’s Budget Reserve Fund. The state brought in $3.4 million more than was forecast for 2002.

While sales tax collections grew only a modest 1.24 percent, more revenue from contractor excise taxes and insurance company taxes came in than was anticipated. At the same time, the state ended up spending $2.8 million less than was expected. The transfer brings the rainy day fund balance to $39.3 million.

The state was looking at a total of $72.6 million in reserve funds at the end of 2002. As a bonus, a federal settlement of an estate case that predated the inheritance tax repeal will net South Dakota an unexpected additional $18 million. Still, growth in the sales tax revenue is expected to continue to limp along. This is troubling, as many hoped the state could grow its way out of deficits before the reserve funds are depleted. State fiscal analysts believe that, holding all other revenue sources constant, growth in the sales tax by a rate of 1 percent above the rate of growth in the general fund budget would give the state five years to move past fiscal crisis before reserves run out.

At the same time, however, it is unreasonable to expect that state expenditures can remain fixed. Medicaid and prison cost increases, maintaining current Social Services Department programs and even a calendar quirk that means there’s an extra state payday in 2003 will cost an extra $20 million. Many say deeper spending cuts may not be avoidable in the coming budget year. Outgoing Gov. Bill Janklow announced in December that it may now take up to $43 million in reserve funds to balance the fiscal year 2003 budget, with a fiscal year 2004 deficit possibly reaching $50 million.

### General Fund Revenues and Expenditures*

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* All numbers are in millions. 2003 numbers are budgeted figures, while 2002 numbers are preliminary actual numbers.  
Source: National Association of State Budget Officers
Wisconsin’s budget process has become a target for legislators frustrated by the state’s difficulty in producing disciplined, timely budgets. After a long and tense session in the summer of 2002, legislators finally passed a $47 billion biennial budget that featured cuts in education and social spending and depleted the state’s entire share of tobacco settlement money.

The session, the outcome and — perhaps most significantly — the process left many legislators unsatisfied; a variety of proposals to improve the process are now under discussion and were featured prominently in many 2002 election campaigns.

However the Legislature decides to move forward with budget talks in 2003, it is clear the task will not be easy. In late 2002, outgoing Gov. Scott McCallum’s office estimated Wisconsin’s deficit for the next biennium at $2.8 billion, but Gov. Jim Doyle has said those projections are based on overly optimistic revenue collection estimates. Doyle has thus been planning on facing a deficit of up to $4.3 billion, a figure that dwarfs the $1.3 billion hole that legislators tackled in 2002.

The 2002 state elections focused on the budget crisis, with both major-party gubernatorial candidates ruling out tax increases and promising significant spending cuts. But media critics charged that neither candidate offered detailed explanations of how such a deep deficit might be reduced, a concern fed by the realization that last year’s budget-balancing strategy could not be replicated. That approach relied heavily on short-term, stopgap measures calculated to defer a more comprehensive (and politically painful) review of the state’s fiscal situation.

After first considering proposals to cut or restructure spending on biotech research, health care and local government assistance, last year’s budget-producing Joint Finance Committee eventually decided to use tobacco settlement dollars and an 8 percent cut in funds to the state’s higher education system.

The decision to tap the tobacco settlement fund proved to be a lightning rod for controversy; no other state depleted its entire share of the settlement, which, in Wisconsin, was valued at $5.9 billion over the next 25 years.

Critics argued that the $1.3 billion in proceeds yielded from the fund were a poor return on what might have been a lucrative, long-term investment. The state will earn 30 cents on the dollar by selling 30 years’ worth of tobacco settlement payments to private investors, forsaking the substantial interest that would have accrued. Opponents also noted that both the tobacco fund depletion and the education cuts did little to restructure the state’s overall spending patterns, further contributing to its budget growth problem and necessitating even deeper cuts in outlying years. On the positive side, the budget compromise did allow legislators to avoid raising taxes, and the tobacco funds limited the scope of the spending cuts.

Wisconsin’s budget woes are certainly not unique. However, short-term planning and a lack of institutional safeguards have been cited as contributing to the worrisome fiscal outlook. One key vulnerability is the lack of cash reserves available for use in an emergency. Legislators have long touted the advantages of a rainy day fund — one was
actually created several decades ago — but treasury officials report that only $201 has been deposited into the account. Rather than divert surplus dollars to such a fund, the money in past years was used in other ways. In 1999, for example, $700 million in surplus funds was returned to taxpayers in the form of a sales tax rebate.

More spending commitments were made as well in the 1990s. According to the Wisconsin Taxpayers Alliance, an independent watchdog group, the state spent an additional $2.7 billion on education from 1990 to 2001 and some $630 million more on corrections.

The budget process is another concern for lawmakers dissatisfied with recent outcomes. A Joint Budget Committee composed of legislators from both houses reviews the governor’s budget, makes changes and then sends the revised budget to the two houses, which then make additional revisions.

The budget must ultimately be reconciled in a conference committee, when still more changes and compromises are made. Throughout this lengthy process, legislators attach non-germane (but sometimes controversial) items to the budget in hopes that the measures will win approval from colleagues unwilling to hold up the overall budget. Sometimes, though, these items — such as campaign finance reform legislation last session — end up lengthening the debate period and jeopardizing the budget’s passage.

Following last session’s drawn-out budget negotiations, several reform proposals were developed for consideration this year. Both Doyle and several key members of the Republican legislative leadership now favor rainy day fund minimum holdings, to be expended only in exceptional cases (such as the present economic downturn).

Many victorious legislative candidates also are vowing to impose limits on the types of amendments added to the budget reconciliation bill, a reform that might impose greater fiscal discipline on appropriators. Some legislators even hope to impose monetary penalties on legislators to encourage the timely completion of the budget.

Since the election, Doyle has outlined several ideas to cut the state’s budget. He has pledged to abolish the Department of Electronic Government, reduce the number of state employees by 4 percent (a loss of about 2,500 jobs over the next two years and 10,000 over the next eight years) and restructure the state’s prescription drug program.

The new governor also is vowing to work with local governments to streamline the way they provide services. Wisconsin state government pays out some $1.04 billion annually in shared-revenue payments to cities and towns. This local aid was targeted by the former governor, who argued that if municipalities accepted cuts by even an average of 4 percent annually, the state could pay down a substantial portion of its budget deficit. Many observers believe that the shared-revenue budget is so large that a wide-ranging budget solution would be difficult to achieve without at least restructuring the way these funds are disbursed.

Whether such rescissions would be sufficient to balance the budget is debatable; even deeper, across-the-board cuts may well be necessary. But momentum is now on the side of reformers eager to avoid the rancor that characterized the 2002 legislative session, and Doyle’s budget framework combined with a legislative push for structural reforms could ease the path toward a balanced budget.
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