



Budget balancing tactics

States use innovative ideas to stem the tide of red ink

BY SUJIT M. CANAGARETNA

The nation's sluggish economy has triggered the development of innovative budget strategies among state policy-makers. After a decade between March 1991 and March 2001 of sustained growth, unsurpassed in the nation's economic history, the United States economy continues to feel the lingering effects of the 2001 recession. While recent economic news has been encouraging, the nation continues to confront its longest hiring slump in more than 60 years.

After shedding almost 3 million jobs in the past three years, the nation's unemployment rate inched downward to 5.7 percent in December 2003, the lowest level in eight months. In the third quarter of 2003, the economy grew at a blistering 8.2 percent annual rate, the strongest pace in two decades. While productivity soared by 9.4 percent in 2003's third quarter, in November 2003 manufacturing activity leapt to its highest level since December 1983.

Yet, there are myriad problems that continue to beleague both the federal and state governments. At the federal level, the deteriorating fiscal position ranks very high. After running budget surpluses for four consecutive years, the federal government officially returned to the red in fiscal year 2002. For the 2003 fiscal year that concluded September 30, the deficit topped \$374 billion with estimates for 2004 indicating \$480 billion and a cumulative \$1.4 trillion by 2008. Another disturbing economic development involves the continuing erosion of the U.S. dollar.

States face dire choices

While their fiscal situation has improved slightly in recent months, states continue to confront dire choices. During the past three years, states closed a cumulative \$200 billion budget gap with a series of actions that ranged from slashing spending to tapping rainy day funds to raising taxes. States had to simultaneously tackle slumping revenues, rising unemployment numbers and exploding health care costs.

According to recent information, state budget scenarios have improved relative to last year. In November 2003, 10 states reported that they expected budget shortfalls totaling \$2.8 billion during the current 2004 fiscal year. That contrasts to November 2002 when 31 states indicated shortfalls totaling \$17.5 billion for fiscal year 2003. Notwithstanding these positive developments, the continuing effects of the cyclical downturn and the serious structural problems associated with state tax systems will batter state finances through 2004 and 2005. Already, California, Florida, Georgia, Illinois, Michigan, New Jersey, New York, North Carolina, Oregon and Virginia have announced potentially large budget shortfalls.

Unlike the federal government, practically every state is constitutionally required to balance its budget. Consequently, states adopted some of the more obvious budget-balancing strategies and then began deploying a number of innovative measures to meet their constitutional obligations.

Decoupling from federal policies

A number of recent federal fiscal actions have had negative impacts on states. The 2001, 2002 and 2003 federal tax cuts reduced state revenues by an estimated \$10 billion. The repeal of the federal estate tax credit in 2001 – to which all state estate taxes were tied – will lower revenues by an estimated \$4 billion through September 2004. Finally, the federal bonus depreciation provision will cut state revenues by an estimated \$14 billion between 2002 and September 2004. While a majority of states (37) have chosen to de-link their tax codes from the federal provisions, a number of others have yet to do so.

Leveraging technology

States are deploying technology to both enhance efficiencies and save money.

- California's Integrated Non-Filer Compliance system (INC) electronically matches data from W-2 forms, 1099s, real property sales, K-1 partnership returns and related records against filed tax returns to identify entities that did not file returns. INC has processed more than 160 million records and generated \$182 million since its inception.
- Iowa's Tax Gap Compliance Program uses customized software to identify entities that are supposed to file tax returns but did not and entities that filed but did not pay their taxes. This program generated \$26 million in tax revenue above baseline collections in three years.
- Florida's SUNTAX was designed to allow one-stop registration, cutting-edge accounting for all taxes, and maximization of World Wide Web and e-filing technology and services. Consequently, the Revenue Department has collected \$21 billion in revenue each year, served 1.2 million taxpayers, and processed 6 million transactions. SUNTAX has also generated

over \$70 million in collections by identifying noncompliance in the telecommunications industry.

Introducing tax amnesty programs

Tax amnesty programs are another popular revenue-enhancing strategy that entices individuals to pay their back taxes. Between 2002 and 2003, 19 states enacted amnesty programs. In Virginia, the 2003 program raised more than \$98 million, double the amount expected. Michigan's 2002 program generated \$30 million.

Innovative programs in transportation

- In Minnesota, Gov. Pawlenty released details of a proposal to let solo drivers pay to use the carpool lane along I-394. So-called HOT lanes – short for High Occupancy Toll – have eased congestion in California and Texas.
- Georgia could soon begin accepting proposals for privately financed road and transit projects, according to the state's Transportation Department. Companies could recoup their costs through tolls, transit fare or even long-term road maintenance contracts.



Creative financing techniques

- Illinois approved a pension financing plan this year that increases the state's general obligations to make payments to five state retirement systems. Otherwise, the pension debt obligations would have been paid from the general fund, costing the state \$1.9 billion in 2003 and 2004.
- Mississippi will save \$7 million to \$10 million a year by issuing variable-rate instead of fixed-rate bonds for its Nissan plant.
- Kansas authorized its governor to either accelerate property tax payments or delay tax refunds.
- South Dakota will now count investment income earned on state cash flow in the year it was earned.

Recouping costs from the estates of deceased persons

In 1993, Congress ordered states to recover from the estates of deceased persons some of the money spent on nursing home care by Medicaid. While minimal action on this directive was initiated in the past decade, more recently:

Continued on page 30

States continue to confront dire choices.

Employers and workers would share the increased burden.

“The sooner we start to solve the problem, the better off we’ll be,” said Kibbie, adding that higher contribution rates will be needed even if the state begins to earn greater returns on investments in the stock market.

A recent Ohio Retirement Study Council report found that contribution increases or benefit cuts were needed to keep three state public pension funds from falling short of future obligations. Meanwhile, the Ohio Legislature has been considering other reforms to the state’s retirement system in the wake of news reports detailing the questionable travel and spending practices of pension fund trustees.

“In the past few months, we’ve seen one news story after another about abuse of authority, mismanagement of funds and broken trust with respect to the state retirement systems,” wrote Ohio Sen. Lynn Wachtmann in a recent online column. “What happened at these organizations is outrageous.”

Separate legislative bills would increase



oversight powers of the state treasurer and attorney general while also requiring the state’s pension boards to implement new ethics policies and carry out reviews of management and investment practices.

Looking to the future

Despite the recent concerns and controversies, Brainard said the nation’s public retirement system is “generally healthy.”

“Funding a retirement plan is a long-term process, not unlike a mortgage for individuals,” he explained. “It’s not something you fund overnight; it takes place over many years.”

As a result, even a three-year fall in stock market prices can be made up over time. Some states, though, do have more troubling pension fund situations, due largely to the fact that they haven’t fully funded contributions in the past. Every state, too, must prepare for the influx of new beneficiaries with the retirement of baby boomers.

“A lot of people approach the phenomenon from the mindset of Social Security, but that has traditionally been a mostly pay-as-you go system, whereas public retirement systems are mostly pre-funded,” Brainard said.

“If you combine the pending large number of retirees with less-than-full funding for a retirement system, then you have a problem. Otherwise, though, these retirement systems will have anticipated these folks’ retirement and funded for it.”

— *Tim Anderson is publications manager for the Midwestern Office of The Council of State Governments. This article originally appeared in Stateline Midwest, a publication of CSG Midwest.*

Budget balancing tactics *Continued from page 13*

- Texas drafted rules to recover money from the estates of some deceased Medicaid patients.
- In Connecticut, hundreds of low-income elderly and disabled people opted out of the state’s prescription drug programs because of the move to recoup expenses from program recipient’s estates.

Inventive measures to maximize federal matching funds under Medicaid

States continue efforts to maximize their Federal Medical Assistance Percentage and produce additional revenue. In the area of nursing facilities, one of the more common strategies has been the use of upper payment limits in which local government providers are paid more money than they would otherwise receive, thus generating a greater FMAP. The local providers then return the excess money to the state.

Streamlining government services

- North Carolina disposed of state-owned surplus real property more efficiently generating \$10 million in revenue; consolidated employee death and disability benefit reserve funds saving \$55 million; implemented “prior

approval” and use of generics in Medicaid prescription drugs for a savings of \$97 million; and accelerated the state’s debt collection practices for \$50 million in additional revenue.

- A commission appointed by South Carolina’s Gov. Mark Sanford to improve the delivery of state services and generate revenue recently issued its final report. Recommendations contained an estimated savings of \$225 million in the first year and more than \$300 million annually thereafter.

Prescription drugs

- Lawmakers in Illinois created a statewide, centralized buying club to negotiate the best rates on prescription drugs for seniors and disabled persons. Illinois saves \$150 million annually by purchasing these prescription drugs centrally at a volume discount.
- Illinois, New Hampshire, Minnesota, Wisconsin, Iowa, Michigan, Vermont and West Virginia continue to press the federal government to permit the importation of lower-priced prescription drugs from Canada. Illinois estimates \$91 million in annual savings here.

Although the financial picture in many states remains murky and job

growth continues to be tepid, there is room for cautious optimism. In addition to the positive trends noted, after the two quarters that ended in September 2003, state revenues had increased by more than 9 percent, even though half this increase came from the federal aid to states and the other half from higher tax collections.

State and local spending, in contrast, increased at an annual rate of 1 percent during the same period. States have also increasingly looked to greater borrowing to bridge shortfalls, increasing from a total of \$48 billion in 1992 to over \$127 billion in 2002. Along with the improved state revenue picture, the boost to the economy from record low interest rates, enhanced productivity levels, and growing business and consumer confidence certainly creates buoyancy.

— *Sujit M. CanagaRetna is senior fiscal analyst at CSG’s Southern office, the Southern Legislative Conference in Atlanta. This article is based on a presentation he made before the Governor of Alabama’s Commission on Efficiency, Consolidation and Funding, November 21, 2003 at the Alabama Statehouse in Montgomery.*