Testimony of

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State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues

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Chairman Cohen, Ranking Member Franks, and members of the Subcommittee, thank you for inviting me to testify today on behalf of the budget and finance officers of the nation's fifty states and its territories. The National Association of State Budget Officers (NASBO) was founded in 1945 and serves as the professional organization for all state budget officers. NASBO collects data and publishes numerous reports on state fiscal conditions.

States Contribute to the Economy and Safety Net

State and local governments are an important part of our nation's service delivery system and are critical to the nation's overall economic health. State and local governments account for over 14 percent of total U.S. employment and they contribute approximately 12 percent to our national gross domestic product (GDP) with over $2 trillion in operating and capital expenditures. The fiscal health of states is therefore critical to the economy.

States Facing Unprecedented Fiscal Crisis

States are currently facing an unprecedented and extremely difficult downturn in their revenues and expenditures, the worst since the Great Depression. States have experienced a significant slowdown in revenue collections and we fully expect that state fiscal conditions will improve at a much slower and gradual rate than the economy as a whole. States are expected to take up to several years after the recession has ended to fully recover.

Our data shows that during the last two fiscal years, state general fund expenditures have shown an unprecedented decline even with the assistance of the federal government through the American Recovery and Reinvestment Act (ARRA). For two consecutive years revenues and expenditures have decreased dramatically. Fiscal 2009 general fund expenditures declined 3.4 percent compared to fiscal 2008 levels and enacted budgets for fiscal 2010 show a 5.4 percent decrease in general fund expenditures. These decreases in general fund expenditures are the largest declines in the history of our data collection. Prior to 2009, actual state general fund spending had only declined one other time, in 1983, by 0.7 percent. Overall, more than half the states (28) enacted general fund budgets with negative spending growth in fiscal 2009, and over two-thirds of states (37) enacted fiscal 2010 budgets with general fund spending lower than the previous year.

Painful Cuts and Other Actions

Nearly every state faced difficult fiscal conditions these past two years and very few states have escaped significant budget gaps and shortfalls. In fiscal 2009, 43 states reduced enacted budgets by $31.3 billion, while at least 36 states so far this year have reduced expenditures by $55.7 billion, with more expected to further cut budgets. Many states are spending considerably less now than they did in 2008. For example, Michigan's general fund budget was $9.9 billion in 2008 and for 2010 their expenditures are $8.1 billion.

As a result of declining state fiscal conditions along with the requirement that they must balance their budgets, state officials have actively addressed budget gaps in fiscal 2009 and 2010. States are required to balance their budgets and do not have the same tools available to the federal government to deal with fiscal crises. States cannot run large operating deficits. To deal with their fiscal problems, states have taken a variety of actions. Many have relied on targeted budget cuts, while more than half enacted across-the-board cuts, and half the states used rainy day funds to reduce or eliminate budget gaps. Other common strategies include furloughs, layoffs, and reductions in local aid. In addition, some states have raised revenues. Enacted tax and fee changes are expected to result in $23.9 billion in additional revenue for fiscal 2010 budgets.

Financial Management Responsibility

Many state expenses are pre-determined by federal requirements such as those in Medicaid regulations and by state requirements such as K-12 education formulas or court ordered spending. States work to deal with their fiscal problems as responsibly as possible despite the enormous constraints on their ability to manage a very difficult economic and financial crisis. For example, total state reserves and balances—which include state “rainy day” funds—were built up during the years of economic growth in the middle part of the decade. For example, in fiscal 2006 states saved $69 billion or 11.5 percent of general fund expenditures. The reserves and balances have been used by most states recently to ameliorate the pain of cuts and tax increases necessary to balance their budgets. In fiscal 2009, balance levels declined to 4.8 percent of expenditures. However, I should note that removing Alaska and Texas from this aggregate total, which represents 44 percent of total balances, reveals that total balance levels for the remaining 48 states equal only 2.7 percent of general fund expenditures for fiscal 2009.

Spending at the State Level is Predominantly Education and Medicaid

I should also note that when the breakdown of state expenditures is analyzed, the bulk of state spending is in just two areas – Medicaid and education. These areas represent 62% or more of state general fund expenditures and half of total state expenditures. When you consider all other significant state expenditures such as transportation, corrections, public health and economic development must fit within just 38% of general fund expenditures, it shows how difficult it is to ensure a balanced budget without significant impacts to most areas of state government. Therefore, there are many constraints on state budgets and the lack of flexibility makes balancing the budget a difficult exercise. Some areas of the budget are protected by various federal statutory provisions and other important areas of the budget are disproportionately cut.

Flexibility is Critical

We expect austere state budgets for at least the next several years ensuring tough competition for state general funds. While good things come from tighter budgets such as improved efficiencies and opportunities for reforms, states will still need every tool possible to use at their disposal to manage their difficult fiscal situation.

Financial management is important for states and they need as much flexibility as possible to deal with the current fiscal crisis. State elected officials and their appointed senior management teams should be allowed as much latitude as possible to do what they believe is in the best interest of their citizens. They are already constrained by significant numbers of federal requirements and mandates. They are also constrained by balanced budget requirements. While not all of these constraints are necessarily problematic, it is important to recognize their existence.

Therefore, changes to federal tax laws that put additional requirements on states should be avoided, especially during this difficult and unprecedented fiscal period for states.

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