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State Budget Shortfalls Present A Tax Reform Opportunity

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Executive Summary

A year ago, with predictions of no recession or at worst a mild one, many state lawmakers relied on optimistic estimates of tax revenue for fiscal years 2009 and 2010 and made spending commitments that in retrospect appear imprudent. Now unpleasantly surprised by the revenue shortfall, they are forced to take actions to balance their budgets.

The National Conference of State Legislatures (NCSL) reported in January 2009 that 40 states must address shortfalls in their 2009 budgets and that 34 states faced shortfalls in their 2010 budgets. Only five states have balanced both budgets. (Every state except Vermont requires a balanced state budget, and Vermont does so out of tradition.)

As revenues drop and demand for some state services increases, states react in a variety of ways to balance their budgets. Some seek a federal bailout; some propose targeted tax increases; some call for hiring freezes or other

Key Findings

- *Forty-five states face budget shortfalls of varying degrees, totaling approximately $132 billion through fiscal year 2010. However, every state but one expects revenues in 2010 to be higher than in 2006, and all but nine states have seen revenues grow faster than inflation from fiscal years 2006 to 2009.*
- *States hit hardest are those that relied most heavily on growth in unstable revenue sources like taxes on capital gains, high-income earners, and corporate profits.*
- *Punitive taxes on unpopular groups, such as smokers, drinkers, or high-income earners, are poor tax policy and a source of instability because they force a small group of people to pay for government services broadly available to all citizens. Shifting the burden of paying for these programs away from most taxpayers can result in demands for more government than people are actually willing to pay for.*
- *State and local officials are more frequently using the "Washington Monument" ploy—threatening to cut politically popular services to create pressure for tax increases.*
- *Broadening tax bases, lowering rates, and eliminating targeted tax credits can generate extra revenue without unduly harming a state's economic performance.*

austerity measures; a few call for tax increases; and one has called for major tax reform.

In fact, a budget squeeze is an opportunity for fundamental tax reform. By broadening tax bases and lowering rates, states can generate extra revenue while bringing the state tax system back to the basic principles of good taxation: simplicity, transparency and neutrality.

During good economic times, states have used their tax codes to bestow windfalls on particular groups of voters. Those practices are bad at any time, but they are intolerable when taxpayer resources are scarce. Targeted tax increases on small, unpopular, already overtaxed groups are equally to be discouraged.

States should reduce reliance on unstable and volatile sources of revenue that are now ebbing (see Figure 1). Those states hardest hit by the recession are those that relied most heavily on taxes on capital gains, high-income earners, and corporate profits. Reducing this reliance is least painful now, and it could prevent future spending run-ups that contribute to boom-bust budget cycles.

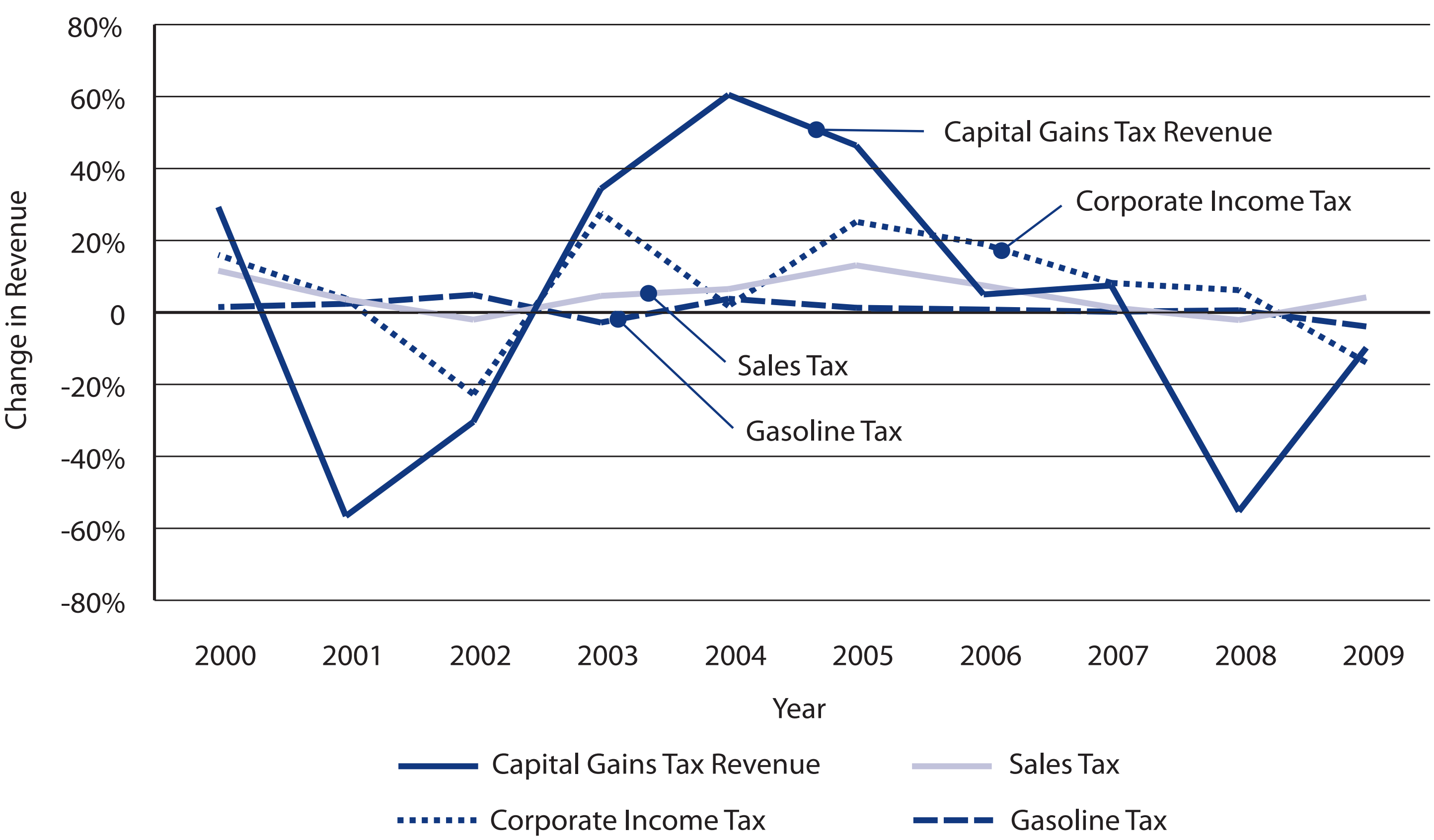
Forty-Five States Addressing Budget Shortfalls

In its January 2009 update, the National Conference of State Legislatures (NCSL) reported that ten states had balanced their fiscal year 2009 budgets: Arkansas, Florida, Iowa, Louisiana, Montana, North Dakota, Oklahoma, Texas, West Virginia and Wyoming.[1]

The NCSL further reported that 16 states are not forecasting budget gaps for fiscal year 2010: Alabama, Alaska, Arkansas, Illinois, Indiana, Kentucky, Mississippi, Missouri,

Figure 1

California's Heavy Reliance on Capital Gains and Corporate Income Tax Revenue Causes Budget Instability



1 National Conference of State Legislatures, *State Budget Update: January 2009*, available at http://www.ncsl.org/programs/fiscal/StateBudgetUpdate0109.htm.

Table 1

State Operating Revenue, FY 2006 to FY 2010
In millions of dollars

State	FY 2006 actual	FY 2007 actual	FY 2008 estimated	FY 2009 projected	FY 2010 proposed	Budget Growth FY 2006-09
Alabama	$ 6,971	$ 7,946	$ 8,535	$ 8,376	n/a	20%
Alaska	7,468	8,794	9,137	13,068	$ 10,498	75%
Arizona	22,167	23,541	24,117	24,923	26,132	12%
Arkansas	11,772	13,136	13,507	13,953	n/a	19%
California	119,612	129,967	127,194	115,133	128,375	(4%)
Colorado	$ 15,288	$ 16,297	$ 17,105	$ 18,616	$ 19,157	22%
Connecticut	14,743	16,567	17,597	18,222	n/a	24%
Delaware	3,169	3,290	3,625	3,332	3,060	5%
Florida	65,740	73,637	70,831	69,961	n/a	6%
Georgia	34,503	39,430	37,753	40,805	n/a	18%
Hawaii	n/a	$ 10,692	$ 10,370	$ 10,992	$ 11,110	n/a
Idaho	$ 4,744	5,145	5,527	5,905	5,788	24%
Illinois	45,551	48,831	49,713	51,127	n/a	12%
Indiana	22,116	23,385	24,923	26,091	25,576	18%
Iowa	7,207	7,722	8,387	8,676	n/a	20%
Kansas	$ 11,968	$ 12,688	$ 13,600	$ 13,242	$ 12,881	11%
Kentucky	20,298	21,565	25,092	24,605	24,790	21%
Louisiana	20,114	26,069	34,262	30,119	n/a	50%
Maine	6,668	6,729	6,888	6,949	n/a	4%
Maryland	26,174	29,379	29,723	30,790	31,184	18%
Massachusetts	$ 35,730	$ 36,956	$ 38,819	$ 43,047	n/a	20%
Michigan	41,320	41,945	43,578	44,032	n/a	7%
Minnesota	24,452	25,211	26,852	29,543	$ 29,710	21%
Mississippi	13,799	14,300	16,715	20,142	20,419	46%
Missouri	19,143	20,048	21,752	23,095	n/a	21%
Montana	$ 3,191	$ 3,629	$ 3,863	$ 3,906	$ 4,112	22%
Nebraska	6,933	7,270	7,691	8,121	8,132	17%
Nevada	7,033	8,815	8,085	9,421	8,582	34%
New Hampshire	4,552	4,794	5,045	5,154	n/a	13%
New Jersey	42,505	45,336	46,804	47,242	n/a	11%
New Mexico	$ 11,470	$ 12,747	$ 13,752	$ 14,780	$ 14,798	29%
New York	113,536	114,056	115,423	116,586	120,120	3%
North Carolina	34,539	36,761	40,687	41,404	n/a	20%
North Dakota (b)	5,752	(c)	6,477	(c)	7,709	34%
Ohio	59,040	59,255	60,830	61,010	n/a	3%
Oklahoma (a)	$ 6,217	$ 6,760	$ 7,043	$ 7,089	$ 6,759	14%
Oregon (b)	62,665	(c)	56,100	(c)	59,195	(6%)
Pennsylvania	57,639	60,530	61,922	63,274	65,067	10%
Rhode Island	6,507	6,564	6,982	6,919	n/a	6%
South Carolina	18,232	19,605	21,015	20,981	20,754	15%
South Dakota	$ 2,958	$ 3,048	$ 3,133	$ 3,614	$ 3,670	22%
Tennessee	23,788	25,204	28,049	27,878	n/a	17%
Texas	72,275	72,784	82,156	87,597	84,842	21%
Utah	8,899	9,874	11,320	10,979	10,604	23%
Vermont	4,936	5,336	5,363	5,585	5,827	13%
Virginia	$ 31,991	$ 35,094	$ 36,003	$ 37,614	$ 38,799	18%
Washington (b)	60,517	(c)	68,703	(c)	73,682	22%
West Virginia	11,660	14,070	14,690	18,210	n/a	56%
Wisconsin	25,372	26,840	28,419	29,307	n/a	16%
Wyoming (b)	6,322	8,441	(c)	7,925	(c)	25%
District of Columbia	$ 8,427	$ 8,980	$ 10,565	$ 10,826	n/a	28%

(a) General fund only.
(b) Two-year budget.
(c) Second year of a biennial budget.
Note: Numbers are taxes and federal funds, not including amounts expended on local governments or insurance trusts.
Source: Tax Foundation compilation of state revenue reports and Governors' statements. The author would like to thank William McKelvey for his assistance in compiling this data.

Montana, New Hampshire, New Mexico, North Dakota, Ohio, Pennsylvania, West Virginia, and Wyoming.

Five states appear on both lists, indicating a balanced budget for the current fiscal year and the next: Arkansas, Montana, North Dakota, West Virginia and Wyoming. Since the November report, Alaska, Indiana, Michigan and Oklahoma have reported budget shortfalls, leaving six states with balanced budgets for the next year and a half.

A budget squeeze is an opportunity for fundamental tax reform. By broadening tax bases and lowering rates, states can generate extra revenue while bringing the state tax system back to the basic principles of good taxation: simplicity, transparency and neutrality.

The NCSL also reports that states closed some $40 billion in budget gaps during 2008, but that leaves $47 billion in gaps for the rest of FY 2009 and an additional $84 billion for FY 2010. Caution should be exercised in using these numbers because states report shortfalls using different measures. Some states assume spending growth, while others assume spending freezes or cuts. The NCSL numbers generally do not account for use of rainy day funds.

In most states tax revenues are coming in below projections, although that varies by state and by particular tax. Down the most are particularly unstable sources of revenue, such as taxes on capital gains, high-income earners, and corporate profits. Individual income taxes overall are down slightly with sales tax revenues mostly flat.

Table 1 lists state budget revenues for the past few fiscal years. It shows that many of the shortfalls states face are in *projected* spending derived from extrapolating revenue trends from good years. Few states are experiencing a decline in revenues compared to a few years ago.

Who's in Surplus?

Surprisingly, in some states the 2009 budget dispute will be about how to fix the *surplus*. Arkansas is considering using surplus revenue to reduce the sales tax on groceries, an unwise and costly but politically popular move. Montana's budget surplus has dwindled from the projected $1 billion, but the state government remains in the black. North Dakota's growing surplus, partly from oil production and partly from overall economic growth, may be used for some combination of income tax and property tax reductions. Texas may use its $2 billion budget surplus (on top of a $9 billion rainy day fund) for new spending and new programs like film tax credits. West Virginia and Wyoming also enjoy surpluses, primarily due to taxes on natural resource extractions.

Many States Freeze Hiring and Cut Spending Growth

With tax revenues well below budget projections, current annual and biennial state budgets are in deficit in many states. Since the summer, states with shortfalls have tackled them in ways similar to individuals who struggle to balance their personal budgets.

Just as a family would begin economies by postponing or cancelling new spending, the first steps for state government often include a freeze on new hiring, which NCSL reports that 19 states had done as of November. Specific items can be targeted: Govs. Bob Riley (R-AL) and Mitch Daniels (R-IN) have imposed strict limits on out-of-state travel by government employees, and four states have banned state worker pay raises. Governors may also push for across-the-board cuts in government budgets, and in some cases this results in zero spending growth from the previous budget. Tennessee has had the largest proposal: Gov. Bredesen has called for a 20-percent cut in all budgets except the biggest, education.

States that replenished rainy day funds in good times can draw them down, although many states are holding off in case the recession worsens. One-time sources of revenue can also be considered, such as sales of government assets or tax amnesties. Connecticut's tax amnesty, as one example, seeks to collect back taxes by waiving penalties and interest. While sometimes generating a welcome but alarmingly large amount of revenue, tax amnesties are not a good policy in the long run. If taxpayers come to expect them, amnesties undermine compliance with future tax obligations.

Michigan's Worst-Ever Washington Monument Ploy

In 2007, Michigan Department of Human Services (DHS) Director Marianne Udow warned that unless the state's budget crisis were resolved, she would be forced to cut money for food banks and homeless shelters, or cut money for burials for the dead.

"It's a terrible choice to have to make," Udow was reported as saying by the *Lansing Journal*.

Her statement came two weeks after Michigan had announced plans to spend $38 million providing iPods to schoolchildren. The state also spends approximately $80 million per year subsidizing film productions.

Some States Use Accounting Gimmicks

The most prominent example of how not to address a state budget is California, which has "balanced" its budget for years with borrowing and accounting tricks. A common trick is to count in the current year revenue that will actually be received in future years. In 2004, California even borrowed $15 billion in long-term bonds to pay for short-term operating expenses. These gimmicks are poor tax policy because they postpone and exacerbate the budget problem. Time seems to be running out for California; as volatile revenue sources drop once again, lenders are unwilling to lend, and no rainy day fund can be drawn upon.

Playing the "Washington Monument" Game

One popular gimmick increasingly seen at the state level is the "Washington Monument" ploy. This is a catch-all term describing a tactic governments use to protect their budgets. Officials warn that unless new revenue is found, vital and politically popular government programs will have to be curtailed or eliminated. The intention is not to close these programs but rather to create public pressure against spending cuts and for tax increases. The name comes from the U.S. Park Service's successful efforts in the mid-1990s to prevent budget reductions by warning that they would force a reduction in operating hours at the Washington Monument.

The school system in Detroit is the author of the most outrageous Washington Monument ploy of the new year: they announced that budget cuts have forced them to beg parents of Detroit schoolchildren to buy toilet paper for the city schools. Of course, toilet paper is undoubtedly plentiful at City Hall, and it is probably plentiful in the school system too. The announcement of a toilet paper shortage is a publicity stunt designed to force politicians to give the school system more money.

Governors in Illinois, Maryland, Ohio and Washington State have already used the Washington Monument ploy to varying degrees in 2008. Gov. Rod Blagojevich (D-IL) threatened to close 12 historic sites and seven state parks (saving $2 million) as his way of reducing a $2 billion shortfall. In 2008, Gov. Martin O'Malley (D-MD) urged voters to pass a state-operated slot machine initiative, warning that if it didn't pass Maryland would have to cut funding for care of the disabled, reduce hours at the Baltimore Zoo, eliminate helicopter search-and-rescue efforts, and fire 283 police officers. Gov. Ted Strickland (D-OH) has talked about closing six prisons and ceasing nursing home inspections, and Gov. Chris Gregoire (D-WA) has warned about massive program curtailments even though the budget is still a 1-percent increase over the previous budget.

Smokers: The Poorest Group of Taxpayers But Every Politician's Favorite Tax Target

Already many state officials are announcing plans to resort to a shockingly regressive and punitive tax—cigarette tax increases.

As of January 1, 2009, the average state cigarette tax was $1.18—eight times what it was a quarter century ago in 1983. In those 25 years, 46 states and D.C. raised their cigarette taxes faster than inflation; 14 states and D.C. now have cigarette taxes that are at least ten times higher than they were in 1983 (see Figure 3 on page 9). In New York City, cigarette taxes alone are $4.25 per pack.

Studies show that cigarette taxes are one of the most regressive ways to fund government programs. It should be remembered that low-income earners are much more likely to be smokers. The fairness of taxing a small group of politically unpopular people to fund government programs for all should also be considered.

Higher cigarette taxes also mean more smuggling, as many states are learning. Today a pack of brand name cigarettes can be had for as little as $1.25 in low-tax jurisdictions around the world. When smugglers move just one shipping container containing 200,000 packs into the U.S., the profit potential is a cool $1 million.

Cigarettes are often the product of choice for thieves since the development of an active black market creates a place where they can quickly be sold for cash. Across the country cigarette tax hikes have been accompanied by tobacco-related crime waves that threaten truck drivers and retail clerks and other innocent people along the cigarette distribution chain.

Cigarette tax increases are often justified as a way of compensating society for costs imposed by smokers. A series of studies, however, argue that nearly all the costs of smoking—health care, higher insurance premiums, lower productivity at work—are borne by smokers themselves.

The reality is that most states support cigarette tax increases because they want more revenue. This is precisely why huge cigarette taxes are poor tax policy: allowing the majority to shift the costs of government programs on to other people can result in instability as citizens demand more government than they are willing to pay for.

Popular, expensive, broadly available public programs should be paid for with broad-based taxes.

State governors may increasingly use the Washington Monument ploy to create pressure for a federal bailout of the states and, eventually, for tax increases.

Taxes on Unpopular Groups Are a Frequent Recourse

In the new year we are likely to see a plethora of targeted taxes on unpopular groups. Such actions are politically safe for politicians but distort economic decision-making, invite retaliation from other states, and ultimately harm economic activity and commerce.

Groups subject to punitive taxation include smokers (cigarette taxes), drinkers (liquor taxes), gamblers (lotteries, slots and casinos), eaters (fat taxes, meal taxes and soda taxes) and high-income earners (taxes on "luxuries" and "millionaires," which can scare off revenue rather than collecting it). Out-of-state taxpayers are another popular target via taxes on online purchases, hotel rooms and car rentals. Florida, Kentucky, Mississippi, Oregon, South Carolina and Virginia have already proposed cigarette tax increases for 2009. Business taxes are less popular but still easier to pass than a hike in the personal income tax, sales tax or property tax.

Shifting tax burdens away from residents artificially lowers the cost of government to them. The more non-residents pay, the lower the cost of government to residents, which can lead to their demanding even more government services, far more than they are willing to pay for. Additionally, many of these revenue sources are volatile, and increasing state reliance on them can cause budget problems down the line.

A Few States Propose Tax Increases

Governors Arnold Schwarzenegger (R-CA), Ted Kulongoski (D-OR) and David Paterson (D-NY) have already proposed a patchwork of tax increases for 2009. Many state officials are reluctant to seek tax increases for fear of harming economic activity; indeed, states with the severest budget shortfalls tend to be those with

**The Maryland Solution Doesn't Work:
Tax Increases Fail to Solve Shortfall**

In 2007, Maryland's legislature approved a series of tax increases to finance spending on new programs. In doing so, the state increased its reliance on unstable revenues, seeking to shift tax burdens to a small minority of taxpayers. Effective early 2008, Maryland added four new rates and brackets to its state personal income tax, raising the highest rate from 4.75 to 6.25 percent. With their highest-in-the-nation county income taxes that hover around 3 percent, Maryland taxpayers now face top rates that reach 9.45 percent of taxable income. The state also raised the corporate income tax from 7 to 8.25 percent, doubled the cigarette tax from $1 to $2 per pack, and raised the general sales tax and the vehicle titling tax fom 5 to 6 percent. The state rejected calls to broaden the sales tax to services or rely less on high-income earners and businesses.

Officials hoped that the tax increases would bring nearly $1 billion in additional revenue to the state government. For example, in 2007 the $1 cigarette tax generated $269 million in revenue, and Governor Martin O'Malley (D) predicted that a $1 increase would generate an additional $255 million. After the tax was passed halfway through FY 2008, the increase generated just $100 million additionally. For FY 2009, the 100-percent cigarette tax increase is expected to bring in just 55 percent more revenue. The Comptroller of Maryland has noted that cigarette sales are down 26 percent. He wishfully suggested that a decline in smoking was the cause (even though non-cigarette tobacco product sales are up 7 percent). More realistically, he cited out-of-state sales and smuggling as likely culprits for low revenue.

Other tax collections are also down. Vehicle titling tax revenues have dropped by over 20 percent since that tax was raised in 2008, and even lottery revenues are down 3 percent. Even the 18-percent increase in volatile corporate income taxes led to a 1-percent decline in revenue. State revenues from 2007 to 2009 are essentially flat, despite the massive tax increase.

Maryland's larger problem, however, is the spending increases locked in as a result of the 2007 tax increases. Even though Maryland's projected 2010 general fund revenues will be 10 percent higher than in 2005, and overall revenues will be 19 percent higher than in 2006, O'Malley is warning that severe budget cuts are necessary to balance the budget. Far from solving Maryland's budget woes, tax increases seem to have worsened them.

Because Maryland relied on distortive and non-neutral tax increases (dropping the state from 24th to 45th in the Tax Foundation's *State Business Tax Climate Index*), the state may have a harder time attracting the capital and jobs it needs now and in the future.

large tax burdens and the most distortive tax systems. Tax increases may also fail to close shortfalls, as Maryland discovered in 2008 when its new tax increases fell far short of projections, suggesting they may have caused some loss of economic activity (see sidebar, "Maryland Solution Doesn't Work").

A tax increase that broadens the tax base is preferable to one that piles ever-higher taxes on a narrowly defined, already overtaxed group of taxpayers. Politicians too often have an incentive to shift tax burdens from constituents to disfavored groups, violating the principles of sound tax policy and harming broad-based economic growth. A broad-based tax increase at least forces a public debate on budgeting priorities and is the most likely to be checked by the voters if it is excessive. Tax increases that hit only smaller segments of the population (such as high income earners), or are imposed indirectly (such as on corporations) undermine this democratic check and can result in citizens' demanding more government than they are actually willing to pay for.

Taxpayer protections are often crucial in serving this function. Arkansas, California and Rhode Island require a legislative supermajority to pass the budget, preventing stealth proposals that do not have public consensus. Many states also have multiple reading requirements or voter approval requirements for local taxes.

Fundamental Tax Reform Is a Better Option

As state governors go hat in hand requesting additional revenues from their constituents and federal officials, fundamental tax reform offers a good alternative. Broadening bases and lowering rates, and eliminating credits designed for picking winners and losers can generate extra revenue while also improving simplicity, transparency, and neutrality. If tax increases look inevitable, it would be helpful for long-term growth for taxpayers to insist upon a sound tax system in return.

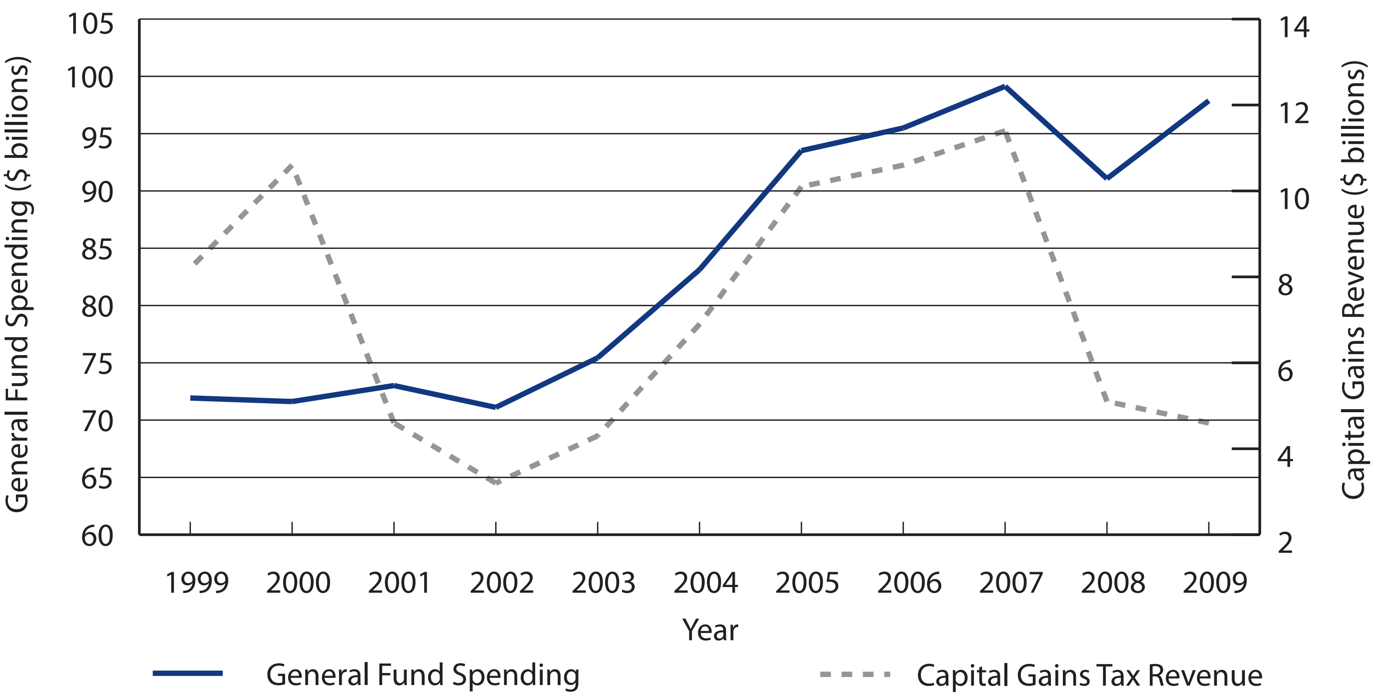
Faced with the need to raise revenues or cut spending to balance their 2009 and 2010 budgets, officials in many cases may have to make hard decisions to eliminate programs or increase taxes. Many changes could raise revenue to address a short-term shortfall and at the same time improve the state's tax system for the long term.

The Tax Foundation's *State Business Tax Climate Index* ranks each state on how well its tax system complies with the sound tax principles of simplicity, neutrality, transparency, stability and growth promotion. Ideally, a state's income tax should tax each dollar of income once and only once. An ideal state sales tax should tax each good or service sold in the state once and only once. These and other taxes should not fluctuate wildly for the taxpayer or the government each year.

Unfortunately many states use their tax codes as a way to pick winners and losers, and not just to raise revenue. Some favored industries and interests are exempted from certain taxes while others are taxed multiple times. Colorado, Michigan and Ohio recently warned about huge budget deficits but also announced new incentive packages and subsidies for favored industries. Colorado has proposed using state funds to recapitalize banks, Michigan spends $80 million per year on film production subsidies, and Ohio is pushing additional job creation subsidies.

Extensive use of such targeted tax credits is a warning sign that the state's tax code is broken. Business should not have to receive special exemptions from the state's tax system to be willing to invest and create jobs in a state. A far more effective approach for state lawmakers is to systematically improve the business tax climate for the long term by repealing incentives and subsidies. Consequently, existing in-state employers are no longer taken for granted and stuck paying higher taxes while officials roll out the red carpet for new businesses. The tax code would thus be used just for raising revenue, not for changing economic behavior. The revenue saved could be used for addressing the budget shortfall or for cutting tax rates.

Figure 2
Unstable Capital Gains Revenue Helped Drive Up California Spending

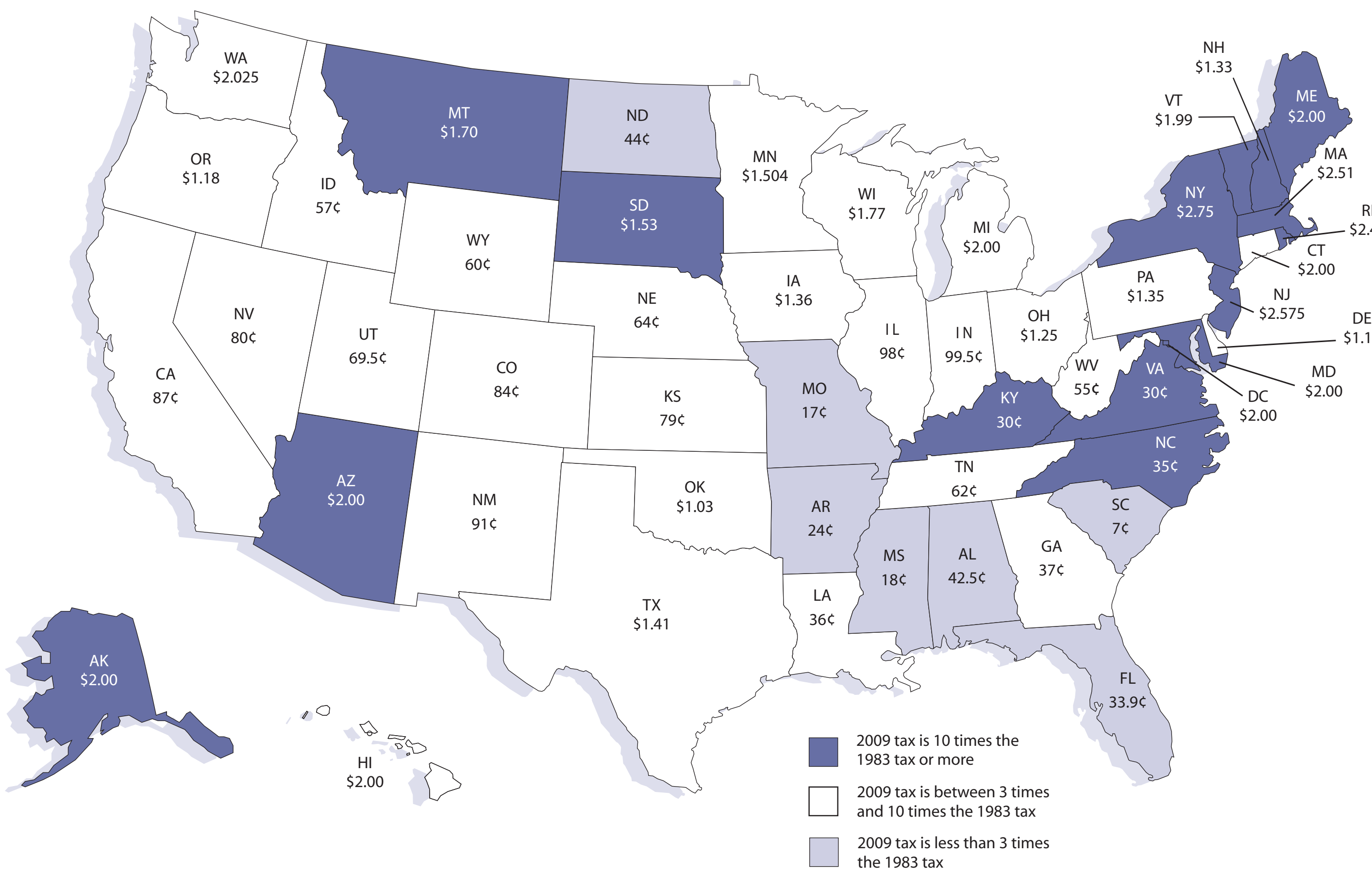


In addition to reducing or eliminating targeted tax credits, states should rely less on unstable sources of revenue. Revenue from taxes on capital gains income, high-income earners, and corporate profits does spike during times of economic boom, but it plummets during a bust. States without spending controls get into trouble by assuming for spending purposes that the years of revenue windfall will continue. California ramped up spending during the tech boom of the late 1990s and never adjusted it after tax revenue from capital gains, high-income earners, and corporate profits fell dramatically (see Figure 2). It may be easier today to reduce long-term reliance on such volatile revenue sources since they are currently in the doldrums.

Fiscal Snapshots State by State

Most state fiscal years run from July to June, six months ahead of the calendar year, so fiscal year 2009 begins on July 1, 2008, and runs to June 30, 2009. The five exceptions are Alabama, Michigan and the District of Columbia (fiscal year begins on October 1), New York (April 1) and Texas (September 1). Most states adopt annual budgets, but 21 states adopt budgets for the next two fiscal years at once. North Dakota, Oregon, Washington and Wyoming adopt 24-month budgets. Arkansas switches to annual budgeting beginning in 2010.

Figure 3
State Excise Tax Rates on Cigarettes
Tax Per 20-Cigarette Pack as of January 1, 2009



Note: Local option taxes and federal cigarette tax not included
Source: Tax Foundation; State Revenue Departments; Orzechowski and Walker

Alabama Governor Announces Education Proration and Budget Reductions

Alabama Gov. Bob Riley (R) has announced a hiring freeze (reducing state workers from 39,000 to 36,000); a ban on merit raises; travel curtailment; and a cut to spending in a targeted manner by 10 percent. Education, which faces a $795 million shortfall, will be cut across the board by 12.5 percent but supplemented by drawing down half of the $437 million Education Rainy Day Fund. On net, the reduction would be 9 percent. Alabama requires proration (across the board spending cuts) to access rainy day funds, and general proration has not yet been declared. In 2003, Alabama voters rejected Riley's proposal to raise $1.2 billion per year by increasing taxes on property, personal income, corporate income and cigarettes, and imposing a new tax on intangibles.

Alaska Modestly Cuts Spending; Budget Assumes Oil Price Rebound

Alaska Gov. Sarah Palin (R) has proposed a 7-percent spending cut in the $11.2 billion general budget to close a $402 million shortfall (the comparison does not count $746 million in checks mailed out last year from windfall profits tax proceeds). Alaska's general fund derives much of its revenue from oil revenue and taxes, and the budget unrealistically assumes the price of oil will be $64 in 2009 and $74.41 in 2010. (The current price of oil is about $45.)

Arizona Considering Spending Cuts

Negotiations recently broke down between outgoing Gov. Janet Napolitano (D) and the legislature over $400 million of spending cuts to the $9.9 billion general fund budget. Officials estimate a $1.2 billion shortfall. In the last five years, Arizona's government spending has grown at twice the rate necessary to keep up with inflation and population increases.

Arkansas Forecasts Surpluses

Arkansas Gov. Mike Beebe (R) has introduced a balanced $4.4 billion general fund budget, including $145 million in unfunded spending, and a $30 million cut in the sales tax on groceries from 3 percent to 2 percent (the general sales tax is 6 percent). The budget also proposes adding $120 million to the state's rainy day fund over the next two years.

In most states tax revenues are coming in below projections, although that varies by state and by particular tax. Down the most are particularly unstable sources of revenue, such as taxes on capital gains, high-income earners, and corporate profits.

California's Perpetual Budget Crisis Continues

California's budget hasn't been balanced in a decade, with each year involving some combination of accounting tricks and borrowing to paper over the shortfall (now estimated to be $15 billion this year and $25 billion next year, out of a $103 billion annual general fund budget). In 2004, voters approved $15 billion in long-term borrowing to pay for short-term expenses, but the accompanying spending controls were weak. (California's spending has grown faster than its population and inflation for many years. During the late 1990s, state officials spent the soaring tax collections that the tech boom brought in, and more recently, the state has promised more local funding to replace a car tax rollback while at the same time interest payments were rising.)

Following recent credit rating downgrades, California is having a tough time finding new borrowers. A lawsuit is also pending over an order from Governor Arnold Schwarzenegger (R) for state employees to take two unpaid days off each month starting in February. The legislature seems determined that raising California's already high taxes must be part of the budget solution, and legislators in December attempted to ram through $9 billion in sales and gas tax increases. That would have illegally circumvented a constitutional requirement that two thirds of the legislature approve budget bills. Negotiations continue since Schwarzenegger vetoed the legislature's proposal. He objected that spending was not cut back sufficiently, and he suspended $4 billion in capital projects spending. There has also been talk of withholding tax refunds and instead issuing IOUs.

The most prominent example of how not to address a state budget is California, which has "balanced" its budget for years with borrowing and accounting tricks. In 2004, California even borrowed $15 billion in longterm bonds to pay for short-term operating expenses.

Schwarzenegger has also organized a reform commission to analyze why the state's budget swings so wildly in booms and busts. The volatility is primarily a result of over-reliance on unstable corporate and capital gains tax revenues. In FY 2000, for instance, nearly *15 percent* of California's general fund budget came from capital gains tax revenue, a source that plummeted the following year after the collapse of the tech boom.

Colorado Continues Questionable Credits and Subsidies Despite Shortfall and Across-the-Board Cuts

In November, Colorado Gov. Bill Ritter (D) unveiled a $19.2 billion budget proposal for FY 2009-10, of which the general fund portion is a 5-percent increase over FY 2008-09. The FY 2009-10 proposal includes a $386 million shortfall. Ritter estimates that the state also faces a $77 million shortfall in the current FY 2008-09 budget, but legislative analysts put the gap at $604 million. The difference is primarily due to different assumptions about economic performance, especially the volatile capital gains revenues. Ritter has taken some frugal actions, imposing a hiring freeze and asking departments to cut spending by 2.5 percent and identify another 10 percent in potential cuts. But he has also proposed spending money on a series of state-run incentive programs: job creation credits, using state funds to recapitalize banks, green jobs training, and clean energy subsidies, not to mention conducting six town hall meetings where state officials give advice to small businesses on how to survive the recession. Ritter has also been vocally supportive of a federal stimulus bill, even submitting a $1.4 billion wish list to the Obama transition team.

Connecticut Considering Options for Large Shortfall

In November, Connecticut legislators held a special session and approved $71.8 million in cuts and a tax amnesty program expected to generate $40 million, but lawmakers rejected a move to seize $40 million in unclaimed deposits on bottles and cans. Since then, the shortfall in the current $18 billion budget has reopened and now stands somewhere between $288 million and $320 million. The FY 2010-11 biennial budget (unveiled in February 2008) reportedly has a staggering $6 billion shortfall ($2.6 billion the first year and $3.3 billion for the second year). Gov. M. Jodi Rell (R) has requested that all state departments cut their 2010-11 budgets by 10 percent, but she has ruled out tax increases and layoffs. She has also called a lame-duck special session for January 2 to address the current year's shortfall. Connecticut has a $1.4 billion rainy day fund that remains untapped.

Delaware Hurt by Falling Corporate Tax Revenue, Shifts Funds From Future

In mid-December, outgoing Gov. Ruth Ann Minner (D) announced $55 million in budget reductions to reduce a $109 million shortfall in the current $3.4 billion budget, including a $23 million accounting trick that shifted Medicaid payments from the end of the month to the beginning. The 2010 budget shortfall consequently became larger, and it now stands at $560 million. Corporate income taxes are especially hard hit, down two thirds from last year, and the recent adoption of state slot machines in Pennsylvania and Maryland will probably hurt Delaware's gambling tax revenues.

Minner has asked state agencies to cut spending by 7 percent this year and by 15 percent in 2010. Former State Treasurer and now Governor Jack Markell (D), sworn in as governor on January 20, said he considers a sales tax adoption to be off the table. Delaware is one of five states with no state-level retail sales tax, and its retail sector has thrived on the borders, attracting shoppers from nearby states.

Florida May Borrow and Pile Taxes onto Smokers and Gamblers After Mortgage Stamp Tax Revenue Falls

Florida Gov. Charlie Crist (R) recently announced his plan to close a $2.3 billion shortfall in the current $70 billion budget ("the People's Budget") by borrowing $600 million from tobacco settlement money, drawing down reserves, and cutting spending 4 percent. He also claims $135 million in savings by allowing expanded Seminole gambling and by shifting prison construction from a current-year budget item to one that is financed by selling bonds. Aside from a proposed cigarette "fee" increase that is properly called a tax hike, Crist's plan includes no new taxes or fees. However, the FY 2009-10 budget is currently estimated to have a $5.8 billion budget gap. One cause of the volatility in revenue is a heavy reliance on document stamp taxes (on mortgages).

Georgia Orders Spending Cuts, Considers Borrowing

State officials say that in its current $21 billion general fund budget, Georgia faces a shortfall of approximately $1.7 billion. Gov. Sonny Perdue (R) has ordered agencies to cut spending by 8 percent and to expect cuts in their 2010 budget requests. Perdue has unveiled plans for borrowing to spend on new capital projects and raising taxes on hospitals.

A tax increase that broadens the tax base is preferable to one that piles ever-higher taxes on a narrowly defined, already overtaxed group of taxpayers.

Hawaii Reduces Spending and Considers Curtailing Credits

Hawaii Gov. Linda Lingle (R) recently unveiled a $22.4 billion FY 2010-11 biennial budget that reduces discretionary funding by 14 percent, draws down $75 million from the state's rainy day fund (leaving it at $15 million in 2011), and borrows from bottle/can deposits and 911 fees. She had previously called for a two-year salary freeze for top state employees and a reduction in the state's ethanol tax credit.

Idaho Cuts Spending, Preserves Rainy Day Fund

Idaho Gov. C.L. "Butch" Otter (R) in December ordered state agencies to cut 3 percent from their budgets, on top of a 1-percent reduction ordered in September, and plan for a 6-percent cut in 2010. The $82 million savings, in addition to $22 million of other cuts, balances the newly revised $2.77 billion general fund budget for this year. Otter has said he opposes scaling back an expansion of a grocery credit. He also opposes drawing on the state's $300 million rainy day funds until the 2010 budget, which will be unveiled early in 2009.

Illinois Budget in Crisis as Governor Clings to Office

Now impeached and removed from office, former Gov. Rod Blagojevich (D) announced in August the closure of 12 state historic sites and seven parks to save $2 million, along with layoffs in the Department of Children and Family Services and other agencies (including 85 state employees fired over Thanksgiving weekend). These miniscule but highly visible cutbacks were ostensibly to help close a $2 billion shortfall in the state's $49 billion budget, but the state's budget shortfall remains. The state is also increasingly having trouble paying its bills. Observers hope a solution will be possible with the swearing in of the new governor, former Lt. Gov. Pat Quinn (D).

Indiana Imposes Modest Cuts to Balance Budget

After announcing that the FY 2010-11 biennial general budget of $13.3 billion faced a shortfall of $763 million, Gov. Mitch Daniels (R) proposed a 3-percent cut in executive agency budgets (on top of a 7-percent cut earlier imposed), a 3-percent reduction in grants and subsidies, a ban on out-of-state travel unless approved by budget officials, spending and hiring restrictions, and a pay freeze for 2009. Daniels promised no cuts to key state programs and declined to consider raising taxes or tapping the state's $1.4 billion rainy day fund. Daniels is also pursuing a remarkable effort to consolidate Indiana's excessively duplicative local government functions.

Iowa Cancels Some Spending to Address Shortfall

In December, Gov. Chet Culver (D) outlined $75 million in spending cuts to cover a $38 million drop in expected revenue and unexpected spending on disaster relief (a total $100 million shortfall in the $6.05 billion general fund budget). The largest items are the cancellation of a $37 million office building for state employees and a hiring freeze and overtime reduction that saves $12 million. Lawmakers will soon begin crafting the 2010 budget, which the State Auditor estimates has a $600 million shortfall, assuming only legislated spending increases. Iowa has a $620 million reserve fund.

Kansas Imposes Cuts, Studies Agency Consolidation

Gov. Kathleen Sebelius (D) announced recently that the state's budget this year faces a $211 million shortfall, and the 2010 budget faces a shortfall of over $1 billion (out of $12.8 billion total). In addition to ordering 3-percent across-the-board cuts, Sebelius is also studying agency consolidation possibilities. Unable to make payments to school districts, the state in December began borrowing from various dedicated funds.

Kentucky Governor Urges Cigarette Tax Increase

Kentucky Gov. Steve Beshear (D) has proposed a 233-percent hike in the cigarette tax, from 30 cents to $1 per pack, as part of a package to address a $456 million shortfall in the $19 billion biennial general fund budget. Other actions he recommends include $147 million from a 4-percent spending cut and moving the use of $144 million in rainy day funds from next year to this year.

Louisiana Governor Stands by Tax Cuts and Tax Credits, Holds Off Using Rainy Day Fund

Louisiana Gov. Bobby Jindal (R) faces a currently estimated shortfall of $1.3 billion, but he expects that to worsen. He has urged efficiencies such as $25 million from a hiring freeze and other cuts, and he is also studying program elimination. Jindal has refused to consider drawing down the state's $280 million rainy day fund until next year, nor will he use $800 million in reserves or postpone $380 million in "Stelly rollback" income tax cuts that take effect next year. He remains supportive of Louisiana's costly film tax credit, and he has cautioned income tax repeal proponents of the need to replace the revenue.

Maine Awaits Proposals to Address Looming Shortfall

To balance the current $6.26 billion FY 2008-09 biennial general fund budget, Gov. John

Baldacci (D) has proposed $140 million in budget cuts. That includes laying off some correctional officers and cutting $27 million from education, as well as drawing on $45 million in reserves. On January 9, Baldacci will discuss ways of addressing an estimated $838 million shortfall in the $6.82 billion FY 2010-11 biennial general fund budget. He has said he wants to avoid broad-based tax increases, but businesses nevertheless worry that they will be targeted for tax and fee increases. A recent editorial notes that Maine's population is growing at an anemic pace and is about to be surpassed by New Hampshire's. In November, Maine voters rejected a beverage tax that the state was trying to sell as a funding mechanism for health care expansion.

Maryland Tax Increases Can't Keep Up With Spending Increases

In early 2008, Maryland raised just about every state tax to raise $976 million to fund additional spending and close a "structural" budget shortfall (the current general fund budget is $827 million larger than the previous budget, a 4 percent spending increase). Officials now estimate a $415 million shortfall this year and $1.9 billion next year, assuming spending grows at 0.7 percent. Most alarmingly, revenue from the 2008 tax increases is running substantially under projection, suggesting a loss of economic activity from the increases. (see sidebar "Maryland Solution Doesn't Work"). O'Malley has conceded that he may have to scale back his plans for new education and health care programs (including health coverage for the uninsured and Chesapeake Bay cleanup) and end a tuition freeze at Maryland universities.

In the fall, O'Malley put a referendum on the ballot to authorize state-owned slot machines and pulled a Washington Monument stunt, warning that unless it passed, he would have to cut funding for caregivers who help the disabled, reduce hours at the Baltimore Zoo, eliminate helicopter search-and-rescue efforts, and fire 283 police officers. The referendum passed, but apparently the $700 million annually it was projected to generate isn't enough. Meanwhile, Democratic legislative leaders are advising O'Malley to keep spending growth under 2.5 percent and to cut 1,000 state jobs.

Massachusetts Eliminates Programs; Governor Open to Gas Tax Rise

Gov. Deval Patrick (D) in early December ordered cuts to close a $1.4 billion shortfall in the current budget. The cuts included several programs and $624 million in "9C" cuts whereby the governor can reduce spending without legislative approval. The current general fund budget is $1.3 billion larger than the previous budget. For future years, Patrick has indicated he is open to raising the state gasoline tax.

The school system in Detroit is the author of this year's most outrageous budget-related publicity stunt: they announced that budget cuts have forced them to beg parents of Detroit schoolchildren to buy toilet paper for the city schools.

Michigan Shutters Prison But Continues Credits and Subsidies to Favored Businesses

Lawmakers have approved $134 million in cuts recommended by Gov. Jennifer Granholm (D), including closing one prison. The shortfall now stands at somewhere around $106 million (as estimated by Granholm) to $266 million (legislative estimate), out of the state's $9.7 billion general fund budget. Granholm opposes new taxes, having raised the income tax in 2007. Nevertheless, Michigan remains at the forefront of using tax policy to pick winners and losers, with $105 million in new credits announced in mid-December, along with $335 million in support for the auto industry and $80 million in tax rebates provided to film production companies.

Minnesota Cuts to Balance Current Budget, Seeks Input for Next Budget

Minnesota's $37 billion FY 2010-11 general fund biennial budget is expected to have a $4.85 billion shortfall, with revenues falling and spending slightly up from the current budget. Gov. Tim Pawlenty (R) and many legislators agree that tax increases are unlikely and unable to fix the entire shortfall. Lawmakers have created a website to seek input on how to balance the budget. To fix the current budget's $426 million shortfall, Pawlenty has proposed drawing down the remaining $155 million in reserves and cutting $271 million in spending, especially state aid to local governments. K-12 education and public safety are exempt from the cuts.

Mississippi Considering Hiring Freeze and Cigarette Tax Increase in New Budget

With tax collections down, Mississippi legislators have proposed a hiring freeze in their first draft of a $5 billion general fund budget proposal for 2010. In November, Gov. Haley Barbour (R) imposed $42 million in cuts to balance the current budget. Barbour supports a cigarette tax increase in the 2010 budget.

Missouri Uses Some of Past Surplus But Not Enough to Close Shortfall

In May, legislators approved and Gov. Matt Blunt (R) signed an $8.94 billion general fund budget with a $700 million shortfall, expecting tax growth to continue and to use $833 million in accumulated surpluses. Instead, corporate income taxes are down 14 percent, sales taxes are down 8 percent, and income taxes are basically flat at 1-percent growth. New Governor Jay Nixon (D) has proposed using $281 million from the surplus to close part of the now $621 million shortfall and has pledged to create a balanced budget without the expectation of receiving a federal bailout. He has also launched a new program to lend state funds to small businesses.

Montana Cuts Spending as Budget Surplus Dwindles

Analysts estimate that Montana's state revenue is running $50 million under projection for the current general fund budget ($5.72 billion overall for FY 2009-10). Gov. Brian Schweitzer (D) has ordered $193 million in spending reductions, and the budget's surplus is now projected to be one-quarter of the originally estimated $1 billion.

Unfortunately many states use their tax codes as a way to pick winners and losers, and not just to raise revenue. Some favored industries and interests are exempted from certain taxes while others are taxed multiple times.

Nebraska Budget in Balance with Large Rainy Day Fund

Nebraska state revenues for the FY 2008-09 budget have been as expected, if flat. Nebraska has a $7.6 billion biennial general fund budget and a rainy day fund of $574 million that officials prefer to tap before considering tax increases. Gov. Dave Heineman (R) has also pushed for additional federal infrastructure and Medicaid aid.

Nevada Closes Immediate Gap but May Face Tax Increases Soon

In December, Nevada lawmakers closed a $341.7 million shortfall in the current $18.2 billion biennial budget by cutting some expenditures, seizing half of the sales tax reimbursement to businesses, and borrowing $160 million. Combined with other actions since the year began, the budget now stands at $17.2 billion; the previous biennial budget was $15 billion. Officials are now stating that revenues are expected to be 34 percent below spending for the next biennial budget (although this number doesn't seem to be verified anywhere), and some are pressing for tax increases. This pressure may succeed, though Gov. Jim Gibbons (R) has limited his proposals to hotel and car rental tax increases while supporting limited raises for state employees.

New Hampshire Facing Tax Increase Pressure for Modest Shortfall

Legislators meeting in early January must come up with options to close a remaining $100 million shortfall in the current FY 2008-09 $10.3 billion biennial budget and then begin work on the FY 2010-11 budget (estimated to be about $400 million short). Gov. John Lynch (D) won approval earlier in 2008 for a higher cigarette tax, a tax on poker games, and diverting education funding to the general fund, but his proposal to defer raises for workers was rejected by the legislature. Some $50 million in cuts have been made, including suspending jury pay. Lynch has said layoffs or tapping the $89 million rainy day fund will be a last resort. He opposes adopting an income or a sales tax, and despite calls to expand slots, Lynch is opposed to expanding state gambling.

New Jersey Governor Cuts Some Spending But Hints Tax Increases Are Likely

In mid-2008, New Jersey approved a slightly increased $33.5 billion general fund spending plan that included $2 billion in property tax rebates and increased spending in a number of areas but no tax increases. That makes it the first New Jersey budget in six years to make that claim, though it follows massive tax increases in 2006. Since then, corporate income tax revenue is running 16 percent under projection, personal income tax revenue is under by 14 percent, the financial institutions tax is under by 55 percent, and the realty transfer tax is under by 38 percent. Gov. Jon Corzine (D) estimates the total shortfall will be $1.2 billion. He is urging delays to capital expenses and cutting spending by $500 million. Corzine has said he will keep "all things on the table" (read: tax increases) to resolve an estimated $5 billion shortfall in the $35.1 billion FY 2009-10 general fund spending plan. New Jersey also recently made some positive changes to its corporate income tax.[2]

New Mexico Moves from Surplus to Shortfall

A year ago, New Mexico Gov. Bill Richardson (D) estimated that the 2009 $6 billion general fund budget would be $369 million in surplus, and he urged that this "new money" be spent wisely. A year later, that 6.5-percent spending growth turns out to have been a bad idea with that same budget now in a $454 million shortfall. Revenues aren't expected to hit $6 billion again until 2012. Richardson has thus far refused to consider rolling back income tax cuts that went into effect in 2003, which reduced revenues by $400 million per year. In the meantime, there seems to be confusion about the extent of the current pay freeze for government workers.

New York Plans to Raise Taxes and Fees

Gov. David Paterson (D) recently unveiled his proposals to close an estimated $15.4 billion shortfall in the $120 billion proposed budget (a 1.1-percent increase over the current budget). These include a lengthy series of tax and fee increases, notably an unjustified tax on non-diet soda, and higher taxes on out-of-state transactions, including sales over the internet and on Indian reservations.[3] The budget also includes reductions in school aid, laying off 571 state employees, and expanding state gambling. New York City has also proposed higher income, sales and property taxes.[4]

2 *See* Josh Barro, "New Jersey Takes One Step to Improve Its Business Tax Climate," *Tax Foundation Tax Policy Blog* (Nov. 25, 2008), at http://tinyurl.com/njthrowout.

3 *See* Josh Barro, "Gov. David Paterson's Tax and Fee Increases a Mixed Bag," *Tax Foundation Fiscal Fact,* No. 159 (Jan 22, 2009), at http://www.taxfoundation.org/publications/show/24230.html.

4 *See* Josh Barro, "NYC May See Higher Income, Sales and Property Taxes," *Tax Foundation Fiscal Fact,* No. 155 (Nov. 12, 2008), at http://tinyurl.com/nyctaxes.

North Carolina Ponders Options

Officials say state revenue is running $320 million under projection so far (out of a $7.2 billion general fund budget), and Gov. Mike Easley (D) estimates that the final shortfall will be about $1.2 billion. Easley is going ahead with capital spending projects, but he has held up 5 percent of agency budgets. Newly elected Gov. Bev Perdue (D) has said she plans on lobbying for federal aid.

Extensive use of targeted tax credits is a warning sign that the state's tax code is broken. Business should not have to receive special exemptions from the state's tax system to be willing to invest and create jobs in a state.

North Dakota Debates How to Spend Growing Surplus

North Dakota's government has been running consistent surpluses, as we documented in our report on Measure 2, a proposal to cut income taxes that did not pass in November.[5] The current biennial budget will end with a $392 million surplus, even after a $111 million transfer to the state's already $600 million rainy day fund. Gov. John Hoeven (R) recently proposed spending the surplus on capital projects, and he unveiled a $2.75 billion general fund budget for FY 2010-11 (a 9-percent increase over the previous budget). That includes $100 million in targeted income tax reductions, $300 million in property tax reductions and $130 million in increased K-12 spending. Analysts report that even if oil prices remain at $40 a barrel for the next two years, North Dakota's combined surplus will still exceed $800 million.

Ohio Governor Expands Tax Incentives, Threatens "Washington Monument" to Get Federal Aid

Gov. Ted Strickland (D) has instructed state agencies to cut a total of $1.9 billion from the current biennial $116 billion state budget, including a recent order to close a $640 million shortfall. Strickland has also warned that the FY 2010-11 biennial budget faces a $7.3 billion shortfall, outlining a "worst-case scenario" of closing six prisons, slashing education subsidies and hiking tuition, stopping nursing home inspections, and pushing hundreds of mentally disabled individuals out of state care facilities. Strickland has used this "Washington Monument" ploy to push for $5 billion in federal aid, but he doesn't plan to roll back some recently phased-in income tax reductions. Additionally, state officials are seeking a reorganization of school funding and $1.57 billion in subsidies to favored businesses as stimulus.

Oklahoma Emphasizes Spending Cuts

Oklahoma's state treasurer recently estimated that state revenue is already $250 million short halfway through this year's $7.1 billion budget, and it could be as much as $310 million short for the next fiscal year's $6.76 billion budget. (The Board of Equalization certifies the budget to the legislature in Oklahoma.) Part of the loss, $104 million, is from a modest income tax reduction that took effect on January 1; further reductions in 2010 may not happen. But the biggest drop is the $154 million reduction in gross production taxes on natural gas. The treasurer and Gov. Brad Henry (D) said that the state will resist calls to dip into Oklahoma's $600 million rainy day fund, and Henry has said he will oppose raises for public employees but will also oppose furloughs and layoffs.

5 *See* Joseph Henchman, "North Dakota's Measure 2: How Would Rate Cuts Affect the Peace Garden State's Competitiveness?" *Tax Foundation Fiscal Fact,* No. 151 (Oct. 17, 2008), at http://tinyurl.com/ndmeasure2.

Oregon Governor Recommends Tax and Spending Increases

Legislators in January will be considering Gov. Ted Kulongoski's (D) proposed $15.8 billion FY 2010-11 general fund budget, balanced but a 7-percent reduction from the current biennial budget. The budget includes tax increases: higher hospital taxes, a higher corporate minimum tax, a 2-cent hike in the gasoline tax and 2.5 cents on cigarettes. There are also fee increases on hunting and fishing, car registration and occupational licensing. He would even divert 911 fees to the general fund. The budget also has some layoffs but expands education spending, targets tax credits to pick winners and losers, and hikes transportation spending by $1 billion.

Taxpayer protections are often crucial. Arkansas, California and Rhode Island require a legislative supermajority to pass the budget, preventing stealth proposals that do not have public consensus.

Pennsylvania Reduces Some Spending Growth But Banks on Federal Bailout

Gov. Ed Rendell (D) estimates that the current FY 2008-09 general fund budget faces a $1.6 billion shortfall (out of $28.3 billion, a 4-percent increase over the previous budget). His plan to reduce the shortfall involves budgetary freezes, additional natural gas concessions, drawing down $375 million from the rainy day fund (half of it), and an expectation of receiving $450 million as a federal bailout of state governments. Rendell has been one of the most vocal governors in pushing for a federal bailout, even going so far as to put a precise number in the state budget. Even with these changes, the budget is still a 2.2-percent increase over the previous budget.

Rhode Island Determined to Keep Spending While Studying Reforms

Gov. Don Carcieri (R) has proposed a series of funding reductions for local government and health care cuts to close a general fund budget shortfall estimated to be $366 million this year (out of $3.40 billion) and $486 million next year (out of $3.27 billion). Contributing to the large shortfall is a determination not to cancel over $570 million in capital projects spending and even to expand it, a new state loan program for small businesses, and a recent court ruling limiting Gov. Carcieri's ability to lay off state employees. On the other hand, Carcieri recently negotiated greater freedom to spend federal Medicaid dollars, is studying a broader sales tax base and a lower rate, is considering options to address chronic state overspending, and has pledged not to raise taxes or eliminate a new optional flat income tax.

South Carolina Cuts Spending, Considers Tax Reform Plan

In December, the South Carolina State Budget and Control Board, a unique entity that administers state government in lieu of the governor, ordered a $383 million across-the-board reduction in state spending to balance the $7 billion general fund budget. Since July, ordered cuts have totaled $1 billion. Legislators are going without travel and expense payments. Gov. Mark Sanford (R) has proposed a tax reform plan designed to improve the state's long-term economic growth while remaining revenue neutral for the short term. The plan, as initially announced, includes an optional flat income tax, a phase-out of the corporate income tax and its assorted credits, abolition of sales tax holidays, and inflation-indexing of tax brackets.[6]

South Dakota Draws Down Reserves, Cuts Spending Increase

Gov. Mike Rounds (R) plans to draw down $26 million in reserve funds to balance this

6 *See* Josh Barro, "Sanford Proposes to Vastly Improve South Carolina's Business Tax Climate," *Tax Foundation Tax Policy Blog* (Dec. 9, 2008), at http://www.taxfoundation.org/blog/show/24020.html.

year's budget and $32 million to balance the $3.7 billion 2010 budget, leaving just $4.5 million in the reserve fund. Pay raises will be cut to 1.5 percent from 3 percent, and unnecessary travel will be curtailed including Rounds's own trip to President Obama's inauguration. The budget also includes a $6.3 million property tax increase, increased Medicaid spending, and the expectation that South Dakota will be hurt less by the recession than other states.

Tennessee Cuts Non-Education Spending, Hopes for Future Federal Bailout

Gov. Phil Bredesen (D) is now estimating a budget shortfall of between $884 million and $1.02 billion (out of a $27 billion budget). The estimate has grown, with Bredesen in August warning departments to cut spending by 3 percent, revised to 10 percent in November, then 15 percent, and now 20 percent. The state may extend a hiring freeze, and the rainy day fund may be exhausted just to close this year's budget. K-12 education spending is exempt from the cuts. Bredesen hopes that increased federal Medicaid spending as part of a stimulus or bailout of the states will allow Tennessee to shift $500 million from Medicaid to other budget items.

Texas Faces Calls to Spend Surplus

Halfway through the $170 billion FY 2008-09 biennial budget, Texas officials are now estimating a $2 billion surplus, down from earlier estimates as high as $11 billion. The state also has $9 billion in a rainy day fund and $3 billion set aside for property tax relief. The new and problematic gross receipts margins tax is collecting $1 billion less than expected, but the sales tax is bringing in $1 billion more. As lawmakers convene on January 13 for their first legislative sitting since May 2007, they will be facing calls for additional spending on a variety of programs, including the request by Gov. Rick Perry (R) for a new movie incentive program.

Utah Cuts Spending, Hopes for Stimulus Money

Gov. Jon Huntsman, Jr. (R) has pushed a $1 billion reduction in spending from the $10.6 billion state budget. Huntsman set a 7-percent budget reduction goal, to be met with layoffs, a 3-4 percent cut in education spending, cutting $4.7 million from a $12 million tourism-promotion budget, and even not filling judicial vacancies. Huntsman is also pushing for $14 billion in federal stimulus funding for various projects.

Vermont Makes Cuts, Considers Income and Gas Tax Increase

Over the opposition of Gov. Jim Douglas (R), Vermont lawmakers are discussing possible increases to income and gasoline taxes to address a budget shortfall estimated to be $66 million this year and $200 million next year out of a $4.3 billion general fund budget. Douglas has proposed $20 million in cuts to various social service programs and urges additional cuts. (Note: Vermont is the only state where a balanced budget is not required by law, although the state traditionally balances its budget.)

Virginia Makes Modest Cuts, Proposes Cigarette Tax Hike

Although Gov. Tim Kaine (D) played Santa Claus in giving state workers the day off on Christmas Eve, he warns of a $2.9 billion budget shortfall over the next two years out of a $73 billion biennial budget. His budget proposes layoffs and cuts to education (primarily state-funded K-12 administrators, leaving local districts discretion for where to make other cuts), law enforcement, and transportation, while hiking the cigarette tax by 100 percent and increasing grants to charities.

Washington Governor Goes for the "Washington Monument" Ploy

Gov. Chris Gregoire (D) is probably using the Washington Monument ploy to increase pressure for a federal bailout of the states when she dramatically announced $3 billion in reductions from the $33.5 billion biennial general fund budget, including a suspension of K-12 class size reductions as well as government worker pay raises (already the subject of a lawsuit). She also threatens health care cuts and closings of 13 state parks. Gregoire warned that the gap could grow to $6 billion if revenues continue to decline. However, the budget is still a 1-percent spending increase over the previous one. The plan also assumes $1 billion in federal aid. Gregoire did not address questions of whether she would support tax increases or tax credit elimination.

West Virginia Hikes Spending as Surpluses Continue

West Virginia has a budget surplus, and Gov. Joe Manchin (D) will unveil an update in February. Revenues are running so far ahead of projections that they are expected to cover any future budget shortfall next year. However, sales, corporate and severance tax collections are down, and the government recently announced an expansion of state Medicaid spending.

Wisconsin Governor Boosts Spending, Hopes for Federal Bailout

Gov. Jim Doyle (D), in urging Congress to approve a bailout for state governments, reported that the state faces a $5.4 billion budget shortfall over the next two years in a $28 billion budget. This shortfall estimate has been criticized for including $4 billion in new spending increases, but tax collections are down. Hardest hit have been corporate tax collections (down 30 percent); sales tax collections are down just 1.8 percent. How much of the state's budget crunch is due to the recession and how much is due to mismanagement and a poorly designed tax system is debatable. Doyle has in the past infamously proposed a destructive windfall profits tax and raising taxes by 50 percent, and he is a big proponent of using the tax code to pick winners and losers. (Doyle's film tax credit, for instance, has enabled him to be linked with popular actor Johnny Depp.) Doyle doesn't appear to be considering solutions other than a federal bailout. In related news, a judge recently ruled that Doyle's transfer of revenue from a dedicated fund to the general fund to balance the budget was legal.

Wyoming Pushing to Spend Continuing Surplus

Wyoming banked a $500 million surplus from the first half of 2008, thanks in part to high energy prices, which adds to an accumulated surplus from past years. Gov. Dave Freudenthal (D) has proposed an additional $500 million in spending on top of the $8 billion two-year budget in effect, including raises, a new prison and a property tax cut. He also urged longer-term spending restraint in preparation for a drop in tax revenue from lower energy prices and the recession.

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