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States in Fiscal Crisis

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While Washington fixates on the question of whether the Bush administration ignored warning signs of the Sept. 11 attacks, state capitals around the country are wrestling with a more down-to-earth dilemma: how to pay their bills.

The answer to Washington's question of the moment is equivocal: Yes, intelligence reports of al Qaeda plots were circulating and reached the White House, but so did a great many other alarms, and none was so specific that the hijackers could have been intercepted and arrested.

There's nothing equivocal about the fiscal crisis in the states. The National Governors' Association and the National Association of State Budget Officers reported last week that state budgets are in the worst fix in 20 years. And despite signs of an economic recovery, next year looks to be at least as tough as this one.

The states are being hit from all sides -- and Washington is doing little to help them.

Sales taxes, which are a major source of state revenue, are being eroded by the rapid growth in Internet sales, which usually escape state taxation. The states have been pressing Congress to "level the playing field" between the Internet and Main Street merchants, but so far Washington has balked.

A far greater problem is that the stock market slump has knocked the props from under the income taxes states were collecting on capital gains and stock options. Forty-eight of the 50 states found revenues in fiscal 2002 have fallen short of original estimates -- often by wide margins.

Because state revenues historically lag 12 to 18 months behind the first signs of economic recovery, Ray Scheppach, the executive director of the governors' association, said that fiscal 2003 likely will be even worse -- if only because the states have pretty well exhausted their one-time remedies in patching together this year's budgets.

Many have reached into the funds received in settling their suits with the tobacco companies, or tapped public employee pension funds, or drained their "rainy-day" reserves in order to meet the requirement in state constitutions that they balance their budgets. As a result, their year-end balances are two-thirds smaller than they were just two years ago -- barely 3.5 percent of expenditures.

The problem is not that states are profligate spenders. Indeed, 39 states cut their projected budgets by a total of $15 billion this year. Overall spending rose only 2 percent in fiscal 2002; next year it is expected to increase only 1.4 percent. That does not begin to cover the costs of inflation and population growth.

But the overall figure conceals a horrendous statistic: Medicaid spending rose 13.4 percent between 2001 and 2002, as part of a national explosion of health care costs, for which Washington is offering no solutions. That Medicaid runaway is threatening everything else in state budgets, including education, transportation and aid to local governments.

Because governors and legislators quake at the prospect of rolling back some of their hard-earned gains in reducing school class sizes, breaking traffic jams and funding parks and recreation and the arts in urban areas, states are beginning to do the hardest thing possible: raise taxes.

While congressional Republicans press to make permanent the 2001 tax cuts, passed in a haze of happy talk about continuing surpluses, Republican governors such as Kansas's Bill Graves have been battling for higher taxes to avoid what he calls "unconscionable" program cuts.

Last week Graves finally forced a quarter-billion-dollar tax hike through his legislature, a package that includes partial restoration of the inheritance tax -- the same "death tax" Republicans in Congress want to abolish at the federal level.

This gap between the tough fiscal realities of the states and the never-never land of Washington's make-believe budget is stunningly wide. Last fall governors and legislators had real hopes that the feds might offer some relief on Medicaid by increasing the federal share of its costs 1 percent. The House and Senate seemed sympathetic, but when President Bush decided to flex his muscle and insist that the post-9/11 supplemental spending bill be no larger than he had specified, that help disappeared. That is the same President Bush who backed down and signed an election-year farm bill far larger than he had wanted -- and far more costly than the states were seeking in Medicaid relief.

The rule seems to be: Billions for big growers, but not a nickel for the states.