



Budget Shortfalls: Strategies For Closing Spending and Revenue Gaps

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This information brief updates a prior version originally published in March 2002. This brief highlights new budget balancing strategies and examples of measures that states are taking to close spending and revenue gaps. NASBO will continue to track budget shortfall strategies and provide updates to members periodically. New and partial additions are highlighted in italics.

The weak economy compounded by the events of September 11, 2001 and a declining stock market severely strained state budgets in fiscal 2002. In most states, conditions are worse in fiscal 2003. Economic growth is wavering, revenues are faltering, costs for health care (particularly Medicaid) and new homeland security continue to rise—further exacerbating fiscal problems that plagued nearly every state in fiscal 2002. Most states instituted yet another round of belt-tightening actions to deal with budget problems in fiscal 2003. Many of the actions are one-time-only measures, further exhausting the options available to bring budgets back into balance and making decisions in the near future more difficult.

When revenue growth declines, states rely heavily on several standard budget adjustment tools. In fiscal 2002, 26 states used across-the-board cuts, 26 states tapped rainy day funds, 15 states laid off employees, five states offered early retirement, and 13 states reorganized programs. Thirty-one states implemented a variety of other methods, such as delaying expenditures, reducing travel, imposing hiring freezes, and in some cases, increasing taxes (particularly “sin” taxes) and fees to address shortfalls.

Since revenue increases are difficult to enact midyear, states rely on budget cuts and other strategies to generate short-term savings. Making cuts to enacted budgets is the most widely used strategy in states, and has the greatest immediate impact. Thirty-seven states cut more than \$12.6 billion from their fiscal 2002 budgets. This represents the highest number of states (and the largest amount in terms of dollars) to have made cuts to enacted budgets in any given year.

Traditionally, when cuts are made, K-12 education, higher education, Medicaid, debt service, public safety, and aid to towns and cities have been exempted. Due to political pressures against tax increases and as states exhaust budget reduction strategies, exempted programs are increasingly becoming subjected to budget cuts.

Anemic revenue growth coupled with severe spending pressure is forcing states to replace short-term budget solutions with more creative, innovative, and long-term adjustments. Aside from the usual budget balancing tools, states have a wide variety of other tools at their disposal. In this NASBO report, both short-term and long-term strategies are separated below into four categories: general, revenues, expenditures, and other.

General (represents the most commonly used approaches):

BUDGET BALANCING STRATEGIES	EXPLANATION/EXAMPLES
Across-the-board cuts	A fixed percentage cut imposed on all or most state agencies.
<i>Targeted cuts</i>	<i>Cuts to state employee pay raises, eliminate or reduce funding for lower priority programs or high priority programs (e.g., optional Medicaid services, drug treatment and rehabilitation programs for prison inmates, reduce flu vaccine stockpile, reduce pay for substitute teachers, delay school start date, support for people with developmental disabilities by reducing staff or closing offices, and reduce state assistance to the aged, blind and disabled, reduce programs for troubled youth). Also, defer or cancel capital projects.</i>
<i>Budget stabilization fund/other reserve funds or borrowing against them</i>	<i>Loans taken from the budget stabilization fund to be reimbursed annually until loan is paid off.</i>
Tobacco settlement funds	States may draw down or borrow from tobacco settlement trust funds or endowment funds to cover shortfalls. States can also securitize state tobacco settlement funds. States can also securitize tobacco settlement funds by issuing bonds backed by future tobacco settlement payments, in exchange for cash up-front. This strategy is short-term and future expenditures will require a steady funding source or another revenue windfall. Increased debt service, substantial bond broker commissions and fees, and other tax implications will also result.

BUDGET BALANCING STRATEGIES	EXPLANATION/EXAMPLES
Revenue transfers	Transfers of excess revenues from various special

	funds to the general fund (e.g. transfer money from a trust fund, which serves as a clearinghouse for unclaimed property; tap capital projects fund to make up for education funding cuts; shift money in unemployment taxes from the compensation trust fund into general fund, draw from health care account designed to pay for future benefits to retired public employees; and dip into dedicated accounts, such as insurance failure and hospital construction accounts).
<i>Layoffs, furloughs, early retirement, and hiring and salary freezes</i>	<i>Removing personnel from the state payroll (layoffs), require state employees to take a specified number of unpaid days off (furloughs), and freeze all hiring or create a “freeze committee” to review every state government job opening to determine if the position can remain unfilled. Also, by allowing state workers to start collecting their pensions at age 55 it can achieve a significant reduction in monthly state salary expenses (early retirement).</i>
Travel freezes	Reducing or suspending out-of-state travel for state government employees.
<i>Program streamlining and reorganization</i>	<i>Restructuring and overhauling government functions to address overlapping jurisdictions, management inefficiencies, and costly administrative overhead. (e.g. closing or consolidating divisions and programs creating compliance efficiencies, costs savings; revamp child care programs to keep rising costs in check and to aid more struggling families; develop a commission to comb state government top to bottom to find waste and make services more efficient; pursue budgeting, fiscal, tax, and human resource policies that improve performance; re-examine basic business practices and operations including payroll, travel reimbursements, purchasing strategies).</i>
Cut local government aid	Delaying or reducing payments made to local governments for specific programs (education, environmental grants), or decreasing general tax sharing. Can be used as either a short-term cash flow measure (delay of payments) or a permanent reduction in the state budget (reduced local aid).

BUDGET BALANCING STRATEGIES	EXPLANATION/EXAMPLES
<i>Privatization and contracting-out</i>	<i>Private sector assumes responsibility for public services. Public-private funding is viable for a</i>

	<p>variety of highway and bridge construction projects in the state. Most commonly, public-private toll roads, although in some cases there are "phantom tolls," or annual fees paid by the landowners who benefit from the new or expanded roadways. Also, contracting-out for personnel (e.g. retired individuals on a part-time basis).</p>
<p><i>Tax and fee increases</i></p>	<p>Expanding the base and increasing the rates for existing sales, personal income, corporate income, and other taxes, or raising user fees. Also, creating new taxes. Other tax changes include expanding tax bases to items that are currently exempt from taxation (e.g. labor charges; auto repairs; dry cleaning; cleaning of carpet, draperies, buildings and maintenance of buildings; pest control; home security and landscaping; barbering and cosmetology; message; tanning; tattoos, photography studio services; pet grooming; horse boarding and training; fishing and hunting guide services; golf lessons; tennis; flower arranging lessons; movie tickets; bowling leagues; cruise ships; and escort and dating services) and extending taxes that are set to expire soon. Raising user fees for services such as vehicle registration and licensing, state parks, subscriber access to online services (e.g. residents requesting uniform commercial code filings records must pay an annual subscriber fee of \$50 for an individual organization to access information), health care examination and licensing; electronic waste; vehicle environmental impact fees; and increasing college tuition. Also, eliminating sales tax vendor compensation fees. Increase excise taxes for alcoholic beverages, cigarettes, and motor fuel.</p>
<p><i>Freeze state spending</i></p>	<p>Unlike a cut, the freeze keeps the money in an agency's budget but blocks it from being spent, maintaining the agency's base budget in the next fiscal year (i.e. limiting expenditures on travel, professional services, supplies, acquisitions, and/or major repairs of the various agencies in the executive branch of state government).</p>
<p>BUDGET BALANCING STRATEGIES</p>	<p>EXPLANATION/EXAMPLES</p>
<p><i>Tax increase referenda</i></p>	<p>To increase taxes, put it to a vote by the citizens in the form of a referendum. This helps to alleviate negative political fallout from increasing taxes, and allows the people to decide.</p>

<i>Spending controls</i>	<i>Cap state spending at 1 to 2 percent of the previous year's budget. Other examples, would be to cap permanent fund dividend checks, restrict state spending growth to the percent of state population growth and an inflation factor, and limit the spending growth of government by establishing a revenue target based upon personal income growth that applies to both state local governments</i>
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Revenues (adjustments that directly affect revenues):

Close corporate income and individual income tax loopholes	Examples include closing loopholes in corporate income tax deductions that allow out-of-state companies to profit in state without paying state income taxes; putting a cap on the losses suffered in any year that a company can deduct from profits in following years to reduce state income tax; ending consolidated filings that allow multi-state companies to count losses in other states to lower their tax burden in their own state; change the law to require limited liability firms to pay franchise and excise taxes on net worth and profits just like corporations, thwarting companies that were forming LLC's to avoid paying taxes.
Corporate tax surcharge	Initiate a percent surcharge on corporate tax incentives (e.g. require companies to pay a 20 percent surcharge on millions of dollars of tax breaks they have qualified for under business incentive programs). Takes breaks are provided to companies that make capital investments of a specified dollar amount and create new jobs. The more jobs created and money invested, the more potential for tax credits.
Change state tax filings	Change state tax filings to reclaim revenue that would be lost as a result of congressional action, such as the depreciation-tax deduction.
Delay tax cuts	Delay the claiming of tax credit for job training expenses for two years. Also, institute a trigger rule that would postpone tax cuts in the event of a revenue shortfall.
BUDGET BALANCING STRATEGIES	EXPLANATION/EXAMPLES
<i>Debt finance</i>	<i>Use of debt (general obligation and/or revenue bonds) to finance ongoing capital projects, freeing up cash for general fund obligations. Also, issuing short-term tax anticipation notes to offset general fund deficits. Tax anticipation</i>

	<i>notes are short-term, tax-exempt notes issued to offset general fund deficits — similar to a line of credit with a bank. For example a state government would issue short-term debt to finance fixing the roads knowing that it could repay the debt with the taxes it will receive in the next month or two.</i>
Add income tax bracket	Add an additional income tax bracket for high-income taxpayers.
Create state lotteries and gaming	<i>Create a state lottery or join multi-state lotteries, or increase other gaming options (e.g. increase tax on riverboat gaming receipts; increase riverboat gaming admission fee; and eliminate loss limit on riverboat gaming; require slot route operators to pay a tax on gross receipts rather than a flat fee per slot machine).</i>
Creative tax adjustments	<i>Implement a state sales tax (raise tax above) coupled with an earned-income tax credit to offset its regressive effects; levying a commuter tax on non-residents that work in one state and live in another; withhold state reimbursements to cities and counties by moving up a local-option sales tax that would currently be available to communities at a later date to an earlier date; removing earmarking provisions from certain taxes; and decoupling the state’s tax code from federal accelerated depreciation changes.</i>
Amnesty programs	Institute an amnesty program to collect overdue taxes. Amnesty program participants agree to pay past-due taxes and fees but escape paying fines or interest. The state promises not to file criminal or civil charges against anyone who paid up during the 60-day amnesty.
Enhance penalties	Enhance penalties on non-filers and those that underpay taxes. Also, stiffening penalties for income tax planners who aid in filing fraudulent documents.
Enhance standards for exemptions	<i>Change the state’s property tax exclusion provisions to now require animal waste management systems to meet certain effectiveness standards to qualify for an exclusion from the property tax base.</i>
BUDGET BALANCING STRATEGIES	EXPLANATION/EXAMPLES
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Loosen legislation on local government	Adopt a proposal to loosen limits placed on local government that will allow them to generate more revenues mitigating state financial obligations (e.g. loosen school districts' property-tax-rate limits in light of plans to cut state school aid).
Divert a portion of the sales tax	Divert a portion of the state sales tax (could be a half-cent or whole cent) now dedicated to another program (e.g., transportation).
Sell or sale -leaseback	Sell or do a sale-leaseback on certain state property (e.g. sale of state owned planes).
Bond refinancing	Refinance existing state bonds to take advantage of low interest rates.
<i>Speedup tax collections</i>	<i>Require businesses to accelerate their tax payments once a year. (e.g. create a bill that would require businesses by June 25 to pay 75 percent of the taxes they expect to collect during June instead of waiting until July 20 to pay. This is assuming the fiscal year begins July 1. Payments could be made on sales taxes, use taxes, payroll withholding taxes, insurance premium fees, etc.) Also, changing the timing and collection methods for existing taxes gives state's a better opportunity to earn investment income.</i>
<i>Step up donation solicitations for colleges and universities</i>	<i>Encourage increased financial support from alumni, parents, corporations, foundations and other private sources.</i>
<i>Use multi-year forecasting</i>	<i>Allow decision-makers to assess the affordability of policy decisions, such as expanding programs or reducing taxes.</i>

BUDGET BALANCING STRATEGIES	EXPLANATION/EXAMPLES
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Expenditures (adjustments that directly affect expenditures):

<i>Appropriation controls</i>	<i>Appropriate less than 100 percent of estimated revenues and limit expenditures to less than 100 percent of revenues, dedicating the remaining portion to a reserve fund; develop contingency</i>
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	<i>budget reductions (If a revenue shortfall should occur, this would immediately trigger an action, like budget cuts, to bring the budget back into balance.</i>
State employee retirement and benefits adjustments	<i>Reduce or suspend employer contributions to the state employee retirement system for a specified amount of time or raising state employee contributions to health care plans (e.g., reduce the rates used to determine how much the state contributes to the system. The effect is much like when refinancing at a lower interest rate reduces a homeowner's mortgage payment; asking the retirement system for a short-term bridge loan; reschedule retirement contributions. Recent investment declines have increased actuarial contributions to pension systems. However, due to prior gains, pension system funding may actually be ahead of schedule; restructure contributions to the public employee's retirement system with the state agreeing to repay the money over the next 30 years and bolster inflation protection for current and future retirees beginning in 3 to 4 years).</i>
Delay program expansions	<i>Delay program expansion (e.g. delay a plan to extend Medicaid coverage to low-income parents for two years).</i>

BUDGET BALANCING STRATEGIES	EXPLANATION/EXAMPLES
<i>Use of technology</i>	<i>Use of technology (E-Governance and streamlining administrative processes) to reduce the number of FTE's and improve service delivery practices; create savings by consolidating computer systems and providing more government services online; better planning, budgeting and tracking of information technology spending; increase federal research and development funding to industry and state colleges and universities; increase</i>

	<i>commercialization of intellectual property from laboratories, entrepreneurs, colleges and universities; fostering economic development in rural areas by developing high-speed wireless internet access.</i>
Alter end of year spending practices	Change state expenditure practices to prevent end of year spending by state agencies.
Use of one-time revenues	Using one-time, non-recurring revenues to fund ongoing expenditures.
Bond sells	Sale bonds to finance capital spending and/or operating expenditures. Also, bond fund prior capital authorizations. If there are prior year general fund authorizations for capital projects that have not been expended, bonds can be authorized to support the project and the general funds used to support the budget.
<i>Defer or cut reimbursements</i>	<i>Defer or cut the distribution of reimbursements for business personal property taxes or for hiring special education teachers.</i>
<i>Suspend tax credits and deductions</i>	<i>Scale back or temporarily suspend tax credits and deductions (e.g. new business property tax credit; homeowner income tax deductions; teacher tax credit; business equipment income tax deductions).</i>
Close parks	Close state parks.
Freeze COLA for programs and employees	Freeze cost-of-living adjustments for programs (e.g. health and welfare programs). Also, freeze state employee annual cost-of-living adjustments for employees.
<i>Delay payments</i>	<i>Delay pay to state employees and payments to vendors.</i>
<i>Defer tax refunds</i>	<i>Defer tax refunds until the beginning of the next fiscal year.</i>
Keep vacancies unfilled	Keeping unfilled jobs open.

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<i>Review contracts</i>	<i>Reviewing contractual services for cost savings or deferment possibilities (e.g. negotiate reductions in bank fees and all purchasing contracts, such as computer contracts).</i>
<i>Cut, reducing, or suspending K-12 and university programs</i>	<i>Suspending college scholarship programs, eliminate or reduce programs, provide fewer and bigger classes, use more teaching assistants instead of faculty in classrooms, and make Kindergarten a half-day program..</i>
Prolong in-state-tuition qualifications	Make it harder for out-of-state students to qualify for cheaper tuition rates by prolonging the

	number of years that a student must live in the state to qualify for in-state-tuition costs. Many students qualify for in-state tuition after a year of paying out-of-state rates.
Providing fiscal incentives to save	Develop fiscally responsible incentives for saving money (e.g. bonuses to employees who save money, agencies get to keep a certain percentage of all money saved at the end of the fiscal year; hold chief financial officers to higher certification standards to bolstering teacher training and improving fiscal accountability at schools).
Accelerate capital projects	Accelerate capital projects for positive economic effect.
Stimulate tourism	Use of grants to local municipalities seeking matching funds for tourism and entertainment-related projects, such as convention centers.
Reduce allotments	Reduce allotments for all state agencies.
<i>Suspend training</i>	<i>Suspend employee training (e.g. teacher training).</i>
Eliminate state-subsidies	Dropping one of two or more state-subsidized trains.
<i>Material cutbacks</i>	<i>Cutback on supplies, equipment (including computer system upgrades), and energy.</i>
<i>Change funding formulas</i>	<i>Change funding formulas based on automatic cost escalators. Usually in programs that are open-ended in costs and eligibility.</i>

BUDGET BALANCING STRATEGIES	EXPLANATION/EXAMPLES
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Medicaid Cost Containment Measures

<i>Medicaid cost containment measures</i>	<i>Measures taken to control escalating costs: requiring or increasing co-payments; use of generic drugs; develop preferred lists of drugs; make it more difficult for doctors and patients to select expensive medicines; use pharmacy benefit managers; reduce pharmaceutical payments; reductions or limits to provider payments</i>
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	<p><i>(hospitals, doctors, nursing homes); rely on prior authorization mechanisms; increase market share through purchasing coalitions; change drug rebate formulas; reduce refill supply days; reduce the number of prescriptions per month; permit the ability to return unused drugs for a refund; place caps on pharmacy dispensing fees; restrict eligibility (e.g. children who use to be able to stay on Medicaid for a year at a time, regardless of whether their family's income went up, must now report income changes right away); eliminate programs that publicize eligibility for Medicaid and CHIP (e.g. take signs off the sides of buses); increase the number of years before a recipient may get a new pair of glasses or eliminate them altogether; eliminating optional benefits, such as dental, chiropractic care, podiatry; vision care; mental health services; and treatment of speech and hearing problems; and require Medicaid patients to pay a copay for transportation that takes them to hospitals and doctor's visits.</i></p>
	<p><i>Other measures include cutting child-care subsidies, limiting adult mental health case management to four hours a month, and restrict access to adult and physically disabled "waiver" services.</i></p>

BUDGET BALANCING STRATEGIES	EXPLANATION/EXAMPLES
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Revenue and Expenditures

<p><i>Develop a baseline</i></p>	<p><i>The approach of developing a baseline more accurately assesses balances over a long period of time (usually five years). Under this concept, both expenditures and revenues are projected under current law. Developing a baseline and multi-year projections would highlight both cyclical and structural problems.</i></p>
<p><i>Revenue forecasting</i></p>	<p><i>Use consensus forecasting in order to bring together varying perspectives on the economy and thereby minimizing risks. Also, be relatively conservative in assessing revenue expectations.</i></p>

Error analysis	<i>Identify risks with both revenue and expenditure forecasts by comparing actual revenues or expenditures to the forecasted amounts in order to analyze fluctuations in percentage and dollar terms from the forecast due to economic, technical, and estimating errors.</i>
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Other minor adjustments:

These types of adjustments are high in visibility but usually have a very low impact.

- *Close the museums, zoo, and other attractions an hour earlier than usual.*
- *Reduce hours of operation or eliminate historical education centers, museums, libraries, and guided tours.*
- *Provide inmates with peanut butter and jelly sandwiches instead of meat.*
- *Installing thermostats in many state government buildings that are timed to change temperatures automatically (After normal work hours and on weekends, the heat in state offices will automatically adjust to 60 degrees rather than 72 degrees).*
- *Taking out lights from soft drink machines.*
- *Switching to smaller more fuel-efficient automobiles.*
- *Eliminate purchasing new computers and other office equipment.*
- *Scale back school field trips and sports programs to accommodate midyear budget cuts.*
- *Eliminate school bus routes and stops.*
- *Close public libraries.*
- *End efforts to eradicate marijuana grown on state land.*
- *In lieu of cuts to adoption services, increase foster care terms.*
- *Require patients who need drugs (e.g. anti-depressants), to get tablets that are twice as strong as they need, then break the pills in half.*
- *Reduce number of agency reports.*

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