
Idaho Center on Budget and Tax Policy

226 East 1st St., Moscow 208-882-0492 (Moscow) 208-331-7028 (Boise) www.uvidaho.org

IDAHO'S STRUCTURAL DEFICIT: A PROBLEM THAT WON'T GO AWAY

by Judith Brown, Director
and Don Reading, Ph.D., consulting economist

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This Island, Idaho By M.Flinn



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Over the course of the past five years, Idaho's budget has lurched from surpluses and tax cuts one year to holdbacks and budget cuts the next, to temporary tax increases and other stopgap measures the next. Something is fundamentally wrong with Idaho's fiscal structure.

Governor Kempthorne called attention to this in his State of the State and Budget Address in January. He stated,

*We can agree that there's a **structural problem** in our budgeting process....¹*

More explicitly, Idaho's "structural problem" is a structural deficit. Its causes are to be found in policy decisions that have been made by state government, particularly since 2000. Its cure will be found in policy decisions yet to be made. These decisions need to be made over the next year to year and a half.

Idaho's Structural Deficit

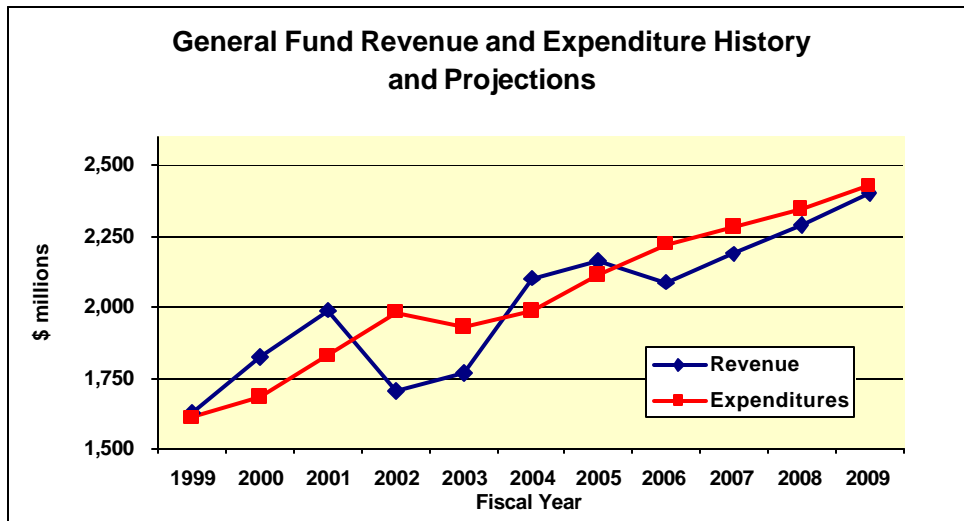
A structural deficit is defined as, "...a condition in which the revenues produced by a state's tax system ... are insufficient to maintain existing levels of services."² That is, a structural deficit occurs when there is a fundamental mismatch between the revenues generated by a state's tax structure and the revenues required to fund ongoing, essential public services. In order to meet the state's constitutional requirement for a balanced budget, this results in frequent tax increases and/or budget cuts, and in over-use of one-time monies to fund ongoing programs.

Figure 1 on page 2 illustrates Idaho's recent revenue and expenditure history. Revenues especially have lurched over the past few years. They dropped precipitously in 2002 as a result of the 2001 tax cuts and the recession, then rose markedly after 2003 as the economy recovered and the temporary sales and cigarette tax increases took effect. They will decline again after the temporary sales tax increase expires later this year. For the next several years thereafter, ongoing expenditures will exceed projected revenues. This is the "structural problem" Governor Kempthorne identified.

Figure 1 actually understates Idaho's structural deficit. The expenditure projections are unrealistically low, based on year-to-year growth of just three percent. Strictly maintenance of current operations (MCO) budgets for ongoing programs grow by 4.4% annually.³ Hence Figure 1 implies either that there will be additional, ongoing budget cuts of more than one percent per year—an unlikely scenario given the extent of budget cuts over the past several years and the inadequacy of current funding levels—or that the structural deficit is bigger than shown.

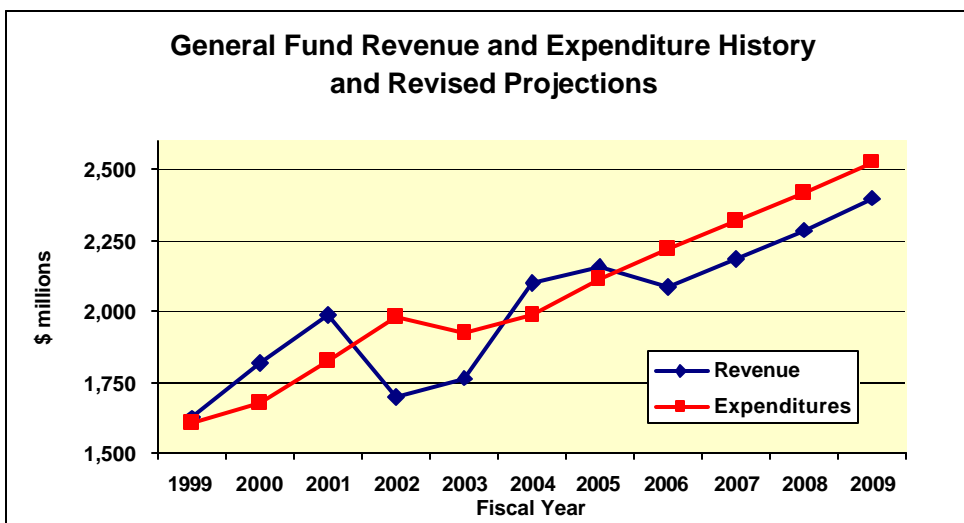
Figure 2 is a revision of Figure 1 to allow for MCO budgets. That is, expenditures are assumed to grow by 4.4% annually. The structural deficit is illustrated clearly now. Projected revenues are persistently and consistently less than sufficient to fund ongoing budgets at maintenance levels. The gap between MCO expenditures and projected revenues is \$136 million in FY 2007, and \$125 million in FY 2009. The structural deficit does not shrink significantly over time. Despite the fact that the recession has ended, the state is not projected to grow its way back to balanced budgets. The structural deficit resulted from policy choices made over the recent past and it will be resolved only by additional policy choices.

Figure 1



Source: Idaho Division of Financial Management, "Governor Kempthorne's FY 2006 Executive Budget Summary," January 10, 2005

Figure 2



Source: ICBTP

Idaho's Budget Crisis of 2001-2004 Had Both Cyclical and Structural Components

What, then, are the causes of Idaho's fiscal problems?⁴ In 2001, the longest economic boom of the post-World War II era came crashing to an end at the same time that the Idaho Legislature enacted large, permanent tax cuts. Due to this coincidence of factors, Idaho's ongoing budget crisis over the past several years has had both a structural component and a cyclical component. This has led to confusion and disagreement as to whether the budget crisis was caused by the recession or by policy choices (i.e., the tax cuts). It has also led to disagreement and unwarranted optimism that the state could grow its way out of its budget problems.

Structural deficits (defined above) and cyclical deficits are two distinct kinds of deficits, with different causes and different cures. A cyclical budget deficit is created when, over the course of the business cycle, the economy slows and goes into recession. In turn, due to sluggish economic activity—stagnant or declining incomes and sluggish sales—state revenue growth slows. Since ongoing funding commitments remain in place, a deficit results.

The distinction between structural and cyclical deficits is important because they call for different policy responses. Cyclical deficits tend to be temporary phenomena. At some point, the recession ends and the economy rebounds. Incoming tax revenues return to their pre-recession levels and revenues again match expenditures. During a recession, maintaining a balanced budget calls for temporary or one-time measures such as drawing down the Rainy Day fund and/or enacting temporary tax increases. Beyond this, however, it is possible for a state to sit tight, wait for the recovery and grow its way out of a cyclical deficit.

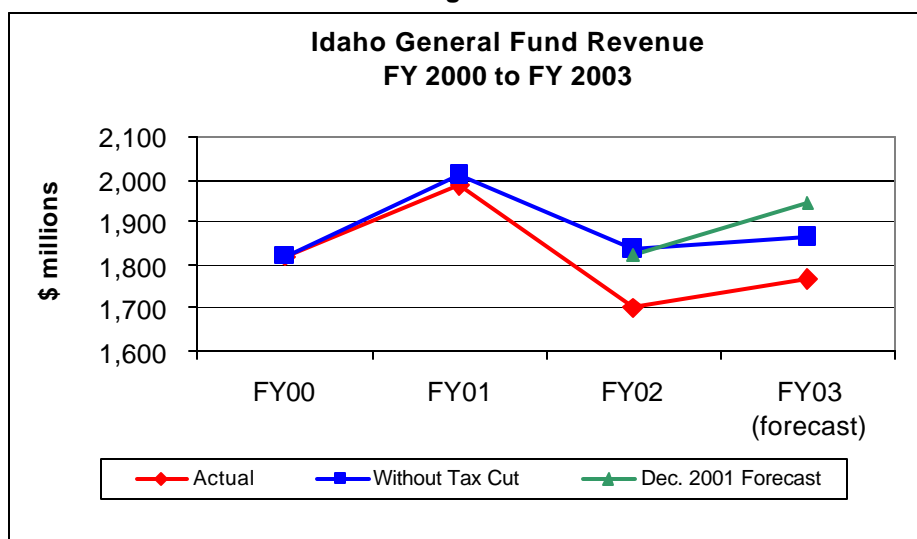
Structural deficits, in contrast, do not go away all by themselves. A state cannot grow its way out of a structural deficit. A structural deficit results from a flawed fiscal structure. Resolving the deficit requires fixing the flaws.

Figure 3 examines the extent to which Idaho's revenue shortfalls were due to structural factors and to cyclical factors over the critical period, Fiscal Years 2000 to 2003. It is based on revenue figures from the Division of Financial Management, which tracked actual revenues as well as what revenues would have been had the tax cuts not been enacted. The December 2001 forecast revised the July 2001 forecast to account for the worsening recession.

The red line shows actual revenues for FY 2000-2003. The green line shows what revenues would have been without the tax cuts and without the recession. The blue line shows what revenues would have been with the tax cuts but without the recession. Hence for FY 2003, the difference between the revenue projection in red and the revenue projection in blue is the proportion of the revenue shortfall due to the tax cuts. The difference between the revenue projection in blue and the revenue projection in green is the proportion of the revenue shortfall due to the recession.

According to this analysis, in FY 2003 55% of the total deficit was due to structural factors (the tax cuts) and 45% was due to cyclical factors (the recession). The permanent tax cuts enacted in 2001 greatly exacerbated Idaho's budget crisis.

Figure 3



Source: ICBTP analysis of Idaho DFM data

The recession ended late in 2001, about midway through Fiscal Year 2002. Thereafter, the cyclical component of the deficit phased out while the structural component remained. The Division of Financial Management did not continue to project what revenues would have been without the tax cuts beyond FY 2003. However, the changed relationship between Idaho personal income and General Fund revenue gives another clear indication of Idaho's ongoing structural deficit.

Marked Shift in Relationship Between Idaho Personal Income and General Fund Revenue Indicates Structural Change Too

Figure 4 shows the relationship between Idaho General Fund revenue and Idaho personal income, a measure of the state's economy and of the state's ability to pay for public programs. Historically General Fund revenue has grown more or less proportionally with personal income, as would be expected when a state has a sound fiscal structure. There were dips in revenues during the slowdown of the early '90s and again in the late '90s, but through the '90s revenues basically grew on trend with Idaho incomes.

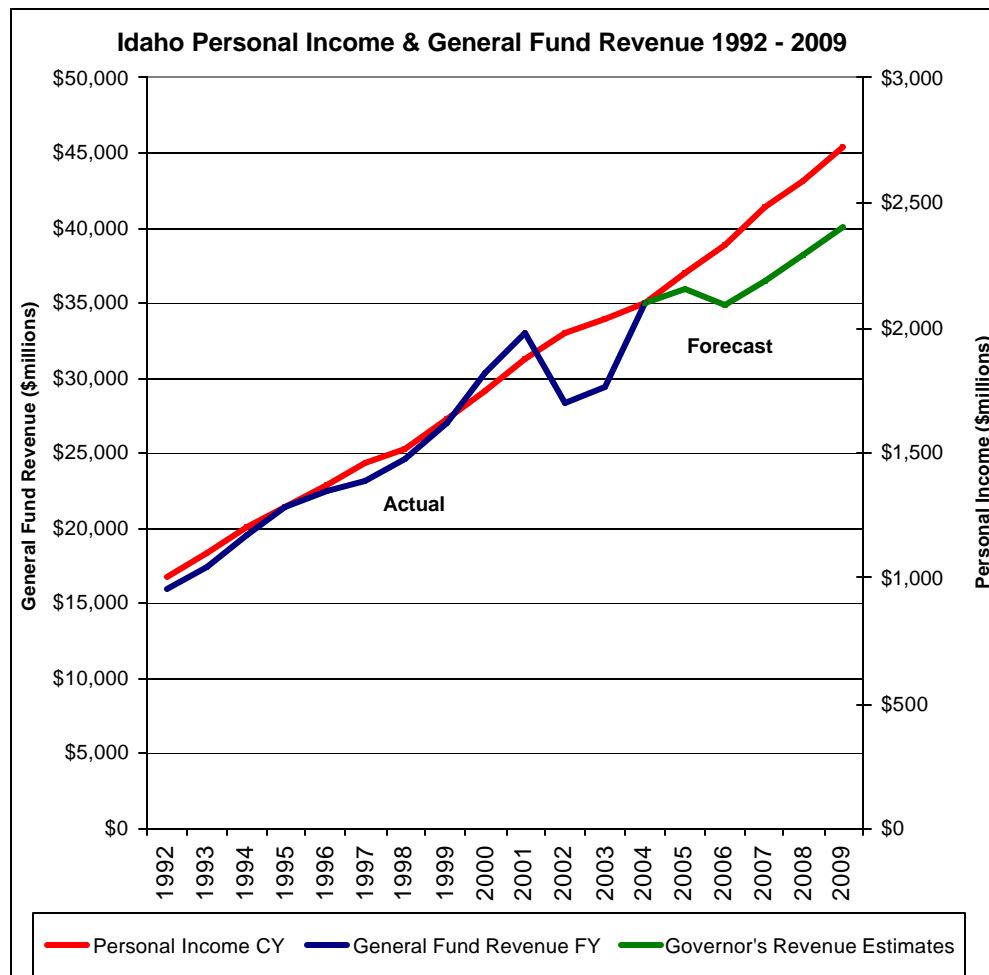
The economic boom reached its crescendo in 2000 and 2001, swelling the General Fund. At the same time, the General Fund received some additional windfall deposits from fortuitous inheritance tax collections and from taxes on employee stock bonuses. The state found itself with a sizable budget surplus.

Recognizing that the surplus was a temporary phenomenon and that the bust would not be far behind the boom, in 2000 Governor Kempthorne proposed to use the surplus to strengthen the Rainy Day fund. In addition, he proposed a modest one-time tax rebate. The legislature instead opted for one-time individual and corporate income tax cuts.

In 2001 the budget surplus was even larger than in 2000, even as economic indicators were showing that the boom was ending. Nonetheless, the Legislature expanded the temporary tax cuts of the year before and made them permanent. The 2001 tax cuts permanently removed approximately \$100 million from the revenue stream.

The timing of the 2001 permanent tax cuts could not have been worse. The recession hit at the same time the tax cuts took effect, causing the worst budget crisis in more than 50 years. As Figure 4 shows, General Fund revenues dropped precipitously in 2001. Thereafter they began to recover very slowly as the economic recovery began, until receiving a significant boost from the temporary, two-year sales and cigarette tax increases enacted in 2003. Revenues will again drop, however, when the temporary tax increases expire in 2006 before beginning to again grow with the economy—but on a new trend line. The permanent tax cuts of 2001 permanently changed the structural relationship between state revenues and income. This inhibited the ability of the state to meet ongoing funding commitments and resulted in a structural deficit.

Figure 4



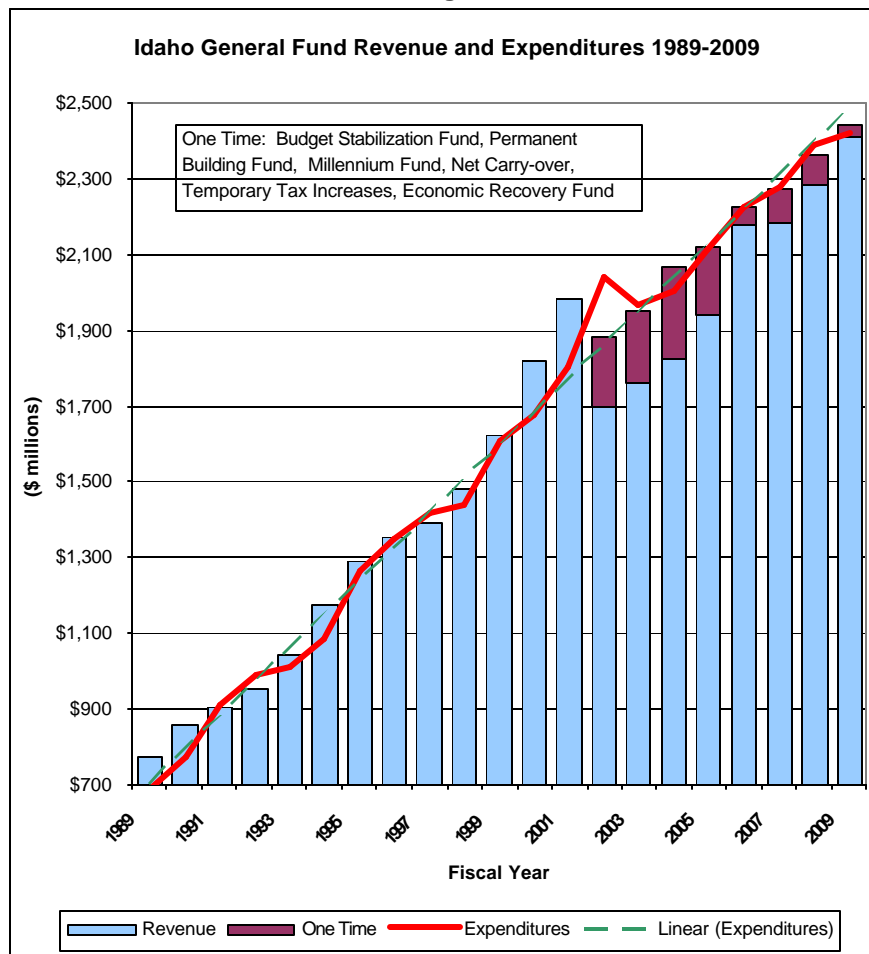
Sources: Idaho DFM Economic Forecasts and General Fund Revenue Books, various issues

Idaho state government is required by the state constitution to balance its budget each year. This has been accomplished despite the persistent structural deficit by resorting to unsustainable budget practices, including over-use of one-time monies to fund ongoing commitments and significantly reduced spending for essential public programs.

Structural Deficit Has Been Masked by Over-Use of One-Time Monies to Balance the Budget

Figure 5 shows the persistent use of one-time sources of revenues to balance the budget over the past several years, and the continuing use of one-time sources for several more years into the future. Planned, limited use of one-time monies to maintain funding commitments during a cyclical downturn is appropriate. Persistent, recurring use of one-time monies however is a sign of a structural imbalance and is inappropriate.

Figure 5



Sources: Governor's Executive Budgets, Sine Die Reports, 2005 State of the State and Budget Address

The over-use of one-time monies precludes the rebuilding of reserve funds that will be needed to buffer the next cyclical downturn in the economy, leaving the state vulnerable to future budget crises. Other sources of one-time monies diverted to the General Fund, such as Permanent Building funds, are intended to address specific critical unmet needs. Leaving those needs unmet cannot be continued indefinitely and is a bad budget practice.

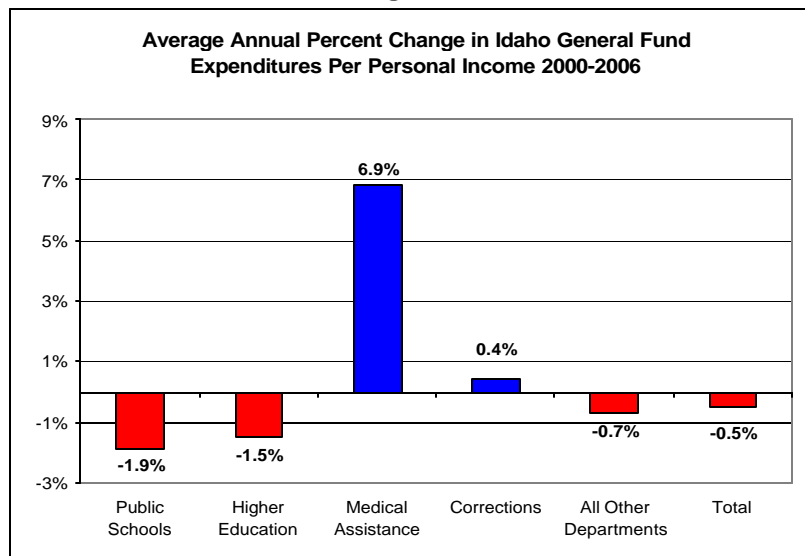
Structural Deficit Has Led to Significant Reductions in Spending on Essential Public Priorities

The recession ended in 2001 and the cyclical deficit has since phased out. However the structural deficit remains, and year after year the state continues to come up short of the revenues needed to adequately fund ongoing programs. As Figure 6 shows, the result has been significant reductions in spending. General Fund expenditures in relation to personal income have declined since 2000. Declines in spending on public schools and higher education have been much sharper, shortchanging the state’s young people and threatening the state’s prospects for future prosperity and economic development. These are the consequences of the ongoing structural deficit.

Conclusion

In 2001 the state chose to use a one-time budget surplus to cut taxes permanently, thus creating a structural deficit and an ongoing fiscal crisis. As a stopgap measure, in 2003 the state adopted a 2-year one cent increase in the sales tax rate—from 5 cents to 6 cents—that sunsets June 30 this year. Although the recession has ended, the state now finds itself in the same situation that it was in before the temporary increase in sales tax. Revenue growth has not caught up with ongoing spending needs. The state is again reverting to one-time funds in an attempt to close the gap and hope the state grows out of its budget problems.

Figure 6



Source: Governor’s FY06 Executive Budget

It appears the state has not learned from history. According to a recent analysis by the Joint Finance and Appropriations Committee (JFAC) staff, in order to balance the budget by the end of Fiscal Year 2007 revenues must grow at a robust rate of 5.8% with appropriations growing by only 2.3%.⁵ In addition, one-time monies are used again and naïve assumptions are made regarding Medicaid. If appropriations are allowed to grow by 4.4%, providing just maintenance of current operations (MCO) budgets for ongoing programs and avoiding additional harmful budget cuts, the budget shortfall by the end of fiscal 2007 will be \$168 million.⁶

Governor Kempthorne expanded somewhat on his comment in his State of the State and Budget address about the structural deficit. He stated,

*We can agree that there's a **structural problem** in our budgeting process that relies too much on one-time money. How much of that one-time money will we need in Fiscal 2007?*

That depends on how much we stimulate the state's economy.

*If not, we use the reserves. If the **structural problems** continue, then be fully prepared to have me come back next year with suggestions on reforms and a simplification of our tax structure.⁷*

Ample evidence exists that a significant structural deficit is still with us and that the state will not grow out of this deficit. Nor can one-time monies continually be drawn down to close the gap. Unless the structural problem is addressed directly, through tax reform, important programs will continue to be cut and the budget crisis will continue.

Some options for needed tax reform and simplification are already known. These include expanding the sales tax base, updating the bracket structure of the state personal income tax, and closing corporate tax loopholes. Additional reforms require a coordinated national approach, including a revised streamlined sales tax agreement among the states. Still other options will emerge from closer examination of Idaho's tax structure.

The first step is accepting the convincing evidence presented here that Idaho has a structural deficit that requires serious policy attention.

¹Governor Kempthorne, State of the State and Budget Address, 58th legislature, January 10, 2005. (emphasis added)

²Hal Hovey, *The Outlook for State and Local Finances*, National Education Association, 1998, p. 4.

³ Idaho Legislative Budget Book for Fiscal Year 2006, Idaho Legislative Services Office, 2005, p. 6.

⁴There had been earlier indications that Idaho was vulnerable to developing a structural deficit. In 1999 Hal Hovey came to the state to discuss the concept of structural deficits. He presented a study that indicated Idaho's state revenue stream was sensitive to economic activity in the state. Idaho's elasticity index for state and local general fund taxes, relative to personal income, was 103.3%, which ranked 2nd in the nation. This means Idaho's tax revenues increase (or decrease) 3.3% more (or less) than changes in personal income. Dr. Hovey also predicted that Idaho's economy would be one of the fastest-growing in the nation over the period 1998 to 2006 and, therefore, its funding needs to maintain current services would also grow significantly (3rd fastest in the nation). See Hovey, p. 21.

⁵Jeff Youtz, Idaho Legislative Services Office, handout to accompany presentation to Boise Metro Chamber of Commerce, Boise, March 18, 2005.

⁶Extrapolation from these JFAC figures indicates a structural deficit of \$168 million at the end of FY 2007. Figure 2 above indicates a structural deficit of \$136 million in FY 2007 and \$125 million in FY 2009. Figure 4 indicates a deficit of \$250 million in FY 2009. These figures help to put a range on the magnitude of the structural deficit. In all cases the deficit is too big for the state to grow out of it. The structural deficit will need to be addressed through conscious policy decisions.

⁷Governor Kempthorne, State of the State and Budget Address, 58th legislature, January 10, 2005. (emphasis added)

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