Arkansas Advocates for Children & Families
State Fiscal Analysis Initiative

PAYCHECK$ and POLITICS

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Arkansas' 2002 Budget Shortfalls

Managing the People's Money

Summary

Arkansas' state tax revenues took a nosedive during state fiscal year 2002. Net available general revenues for SFY 2002 were down 2.3 percent from SFY 2001, and were 6.2 percent less than originally forecast for the year. The shortfalls resulted from an already declining economy, the events of Sept. 11, and an unrealistic state general revenue forecast adopted during the 2001 legislative session.

Arkansas experienced three budget shortfalls during the year: a $142 million budget shortfall in November 2001, a $29 million shortfall in April 2002, and a $56 million in May 2002. The shortfalls required $171 million in budget cuts and the tapping of $56 million in one-time money and special accounts. The Public School and Human Services funds took the biggest budget cuts during SFY 2002 at $68 million and $39 million, respectively.

Rather than simply relying on across-the-board budget cuts, Arkansas should reconsider its process for dealing with revenue shortfalls. It should adopt new principles for dealing with state fiscal decisions in tough economic times. Such principles would help prevent budget cuts in programs serving the state's most vulnerable children and families.

By Richard Huddleston

The 2002 fiscal year (July 1, 2001 – June 30, 2002) was a rough one for the Arkansas state budget. After experiencing a strong economy and unprecedented revenue growth during the late 1990s, state tax revenues took a nosedive. The horrific events of Sept. 11, 2001, coupled with an economy that was slowing months before the attacks, caused revenues to drop way below expectations. Not only were revenues less than originally forecast, they were less than the previous year. It was the first time since 1960 that Arkansas' annual revenues had not surpassed the previous year.

As a result of the revenue shortfall, the Governor ordered the 2002 state budget cut in November of 2001 and again in April of 2002. With less than a month remaining in the 2002 fiscal year, Governor Huckabee also had to call an emergency three-day special session of the Arkansas General Assembly in May to find enough money to meet the state's obligations and keep the budget in balance for the remainder of the fiscal year (ending June 30th). Arkansas was not alone in this regard. Forty-six states and the federal government reported budget gaps during the year.

Before discussing the state's budget problems, some background information may be helpful. First, readers should understand the difference between gross general revenue and net available general revenue. "Gross general revenue" is the sum of all general revenue the state receives before any dollars are distributed for any purpose. When general tax revenues are received, the money for a few select purposes (such as taxpayer refunds, the Educational Excellence Trust Fund, etc.) is "taken off the top" or set aside before money is available for state agencies to spend. Once these monies are taken off the top, the remainder, known as "net available general revenue," is then available for distribution to state agencies to spend on services and programs.

During state fiscal year 2002, gross general revenues were about $3.94 billion. After taking $761 million off the top for various set asides, the remainder – about $3.182 billion – was available for distribution to state agencies.

For the first time in 42 years, the revenues collected in State Fiscal Year (SFY) 02 were less than those collected in SFY 01. Net available general revenues — the general revenue actually available to state agencies for providing services to children and families – declined by 2.3 percent in 2002.

Perhaps more importantly, especially for budgeting purposes, is that the actual revenues collected in 2002 were

less than the amount of money budgeted by the Arkansas General Assembly for programs in SFY 2002. During the regular legislative session held every two years, the General Assembly develops a budget for the next biennium (for each of the next two years) based on a revenue forecast produced by the Arkansas Department of Finance and Administration (DF&A). Each agency's budget for the coming year is, in effect, also based on this forecast. By law, the Budget and Revenue Stabilization law requires that expenditures not exceed revenues. If actual revenues collected are less than the forecast, there is a budget shortfall, and the difference has to be made up either through budget cuts to state agencies or by collecting new revenue.

During the 2001 legislative session, DF&A estimated that about $3.392 billion in general revenue would be available for distribution to state agencies. Governor Huckabee recommended, and the Arkansas General Assembly passed, a budget based on this amount. Unfortunately, the gross general revenues collected from various taxes were less than anticipated, and net available revenues were only $3.182 billion, a difference of –6.2 percent or $210 million.

What accounted for the budget shortfall? Some argue that the shortfall resulted because the 2002 revenue forecast developed by DF&A during the 2001 legislative session was overly optimistic (it had predicted net available general revenue growth of 4.1 percent over 2001). In fact, even before the 2001 legislative session ended, many legislators doubted the Arkansas economy would be able to generate enough revenues during SFY 2002 to fund the budget the legislature had adopted.

While the forecast may have been overly optimistic, it is fair to say that no one could reasonably have predicted the magnitude of the revenue shortfalls that were to occur in 2002 – especially not at the time the 2001 General Assembly adopted the 2002 budget based on the administration's forecast. The events of 9/11, combined, with a slumping U.S. and Arkansas economy, clearly helped fuel the large revenue shortfalls the state faced during SFY 2002.

The economic downturn impacted all of the state's major revenue sources. The state's three largest revenue sources – individual income taxes, corporate income taxes, and sales and use taxes – together typically generate 94 percent of state general revenues. Each of these produced less than anticipated revenues during SFY 2002:

- Individual income taxes declined by 0.8 percent compared to SFY 01 and were 4.7 percent less than originally forecast for SFY 02.
- Corporate income taxes declined by 6.8 percent compared to SFY 01 and were 15.7 percent less than forecast.
- Sales and use taxes remained stagnant, posting a slight gain of only 0.2 percent over SFY 01, but were 3.6 percent less than originally forecast.

STATE GENERAL REVENUES
In Millions, SFY 2001 vs. SFY 2002

	SFY 01 Actual	SFY 02 Actual	Change
Individual Income	$1,804.7	$1,790.4	-0.8%
Corporate Income	$234.5	$218.5	-6.8%
Sales and Use	$1,677.8	$1,681.8	0.2%
Alcoholic Beverages	$30.5	$32.2	5.6%
Tobacco	$96.8	$87.3	-9.9%
Insurance	$81.2	$79.5	-2.2%
Racing	$6.0	$4.1	-31.1%
Severance	$9.5	$6.6	-30.8%
Corporate Franchise	$7.9	$8.5	-7.9%
Estate	$9.4	$19.9	112.3%
Real Estate Transfer	$2.6	2.6	0.0%
Miscellaneous	$17.6	$12.1	-31.1%
Total Gross	**$3,978.2**	**$3,949.4**	**-0.9%**
Less Set-asides	$719.3	$761.0	5.8%
NET AVAILABLE	**$3,258.9**	**$3,182.4**	**-2.3%**

Source: DF&A
Note: "Set-asides" include dedicated expenditures, such as tax refunds, Educational Excellence Trust Funds, etc., taken off the top of gross general revenues. The remainder, "net available," is the revenue available for distribution to state agencies.

STATE GENERAL REVENUES
In Millions, SFY 2002 Actual vs. 3/29/01 Forecast

	SFY 02 Forecast	SFY 02 Actual	Difference
Individual Income	$1,879.6	$1,790.4	-4.7%
Corporate Income	$259.1	$218.5	-15.7%
Sales and Use	$1,744.5	$1,681.8	-3.6%
Alcoholic Beverages	$32.0	$32.2	0.6%
Tobacco	$87.0	$87.3	0.3%
Insurance	$72.0	$79.5	10.4%
Racing	$4.2	$4.1	-2.4%
Severance	$8.0	$6.6	-17.5%
Corporate Franchise	$8.0	$8.5	6.3%
Estate	$15.0	$19.9	32.7%
Real Estate Transfer	$2.6	$2.6	0.0%
Miscellaneous	$17.9	$12.1	-32.4%
Total Gross	**$4,127.9**	**$3,949.4**	**-4.5%**
Less Set-asides	$736.2	$761.0	3.4%
NET AVAILABLE	**$3,391.7**	**$3,182.4**	**-6.2%**

Source: DF&A
Note: "Set-asides" include dedicated expenditures, such as tax refunds, Educational Excellence Trust Funds, etc., taken off the top of gross general revenues. The remainder, "net available," is the revenue available for distribution to state agencies.

STATE GENERAL REVENUE BUDGET CUTS
SFY 2002

PUBLIC SCHOOL FUND	**$68,410,739**	**4.28%**
GENERAL EDUCATION FUND		
Department of Education	$160,781	1.28%
Educational Television	$53,165	1.28%
School for the Blind	$61,119	1.28%
School for the Deaf	$103,347	1.28%
State Library	$37,912	1.28%
Department of Workforce Education	$37,698	1.28%
Rehabilitation Services	$302,369	2.52%
Technical Institutes	$256,810	1.28%
Total	**$1,013,201**	**1.50%**
HUMAN SERVICES FUND		
Administration	$183,668	1.28%
Aging and Adult Services	$142,339	1.28%
Children and Families	$508,605	1.28%
Child Care/ Early Childhood Education	$7,030	1.28%
Youth Services	$1,635,892	3.84%
Development Disabilities	$552,282	1.28%
Medical Services	$60,941	1.28%
Grants	$34,614,088	8.52%
Mental Health Services	$680,498	1.28%
Services for the Blind	$23,588	1.28%
County Operations	$523,489	1.28%
Total	**$38,932,420**	**5.93%**
STATE GENERAL GOVERNMENT FUND		
Department of Arkansas Heritage	$57,773	1.28%
Department of Labor	$31,780	1.28%
Department of Higher Education	$36,486	1.28%
Department of Higher Education - Grants	$14,363,626	42.37%
Department of Economic Development	$126,823	1.28%
Department of Correction	$23,759,523	12.58%
Department of Community Correction	$398,010	1.28%
Livestock and Poultry Commission	$46,263	1.28%
State Military Department	$767,301	9.35%
Department of Parks and Tourism	$258,055	1.28%
Department of Environmental Quality	$47,543	1.28%
State General Services	$1,962,562	4.88%
Total	**$41,855,745**	**12.00%**
OTHER FUNDS	**$2,018,607**	**1.28%**
INSTITUTIONS OF HIGHER EDUCATION		
4-year Institutions	$13,894,236	3.27%
2-year Institutions	$3,524,537	3.98%
Technical Colleges	$1,350,520	5.25%
Total	**$18,769,293**	**3.48%**
GRAND TOTAL	**$171,000,006**	**5.08%**

Source: DF&A
Note: "Set-asides" include dedicated expenditures, such as tax refunds, Educational Excellence Trust Funds, etc., taken off the top of gross general revenues. The remainder, "net available," is the revenue available for distribution to state agencies.

How Did Arkansas Respond to Revenue Shortfalls?
Because of less than anticipated revenues, Governor Huckabee and DF&A announced revenue shortfalls three times during SFY 2002. Two of these shortfalls resulted in budget cuts. In November, the administration announced $142 million in budget cuts. In April, the state budget was cut by another $29 million, resulting in total budget reductions of $171 million for the year.

Even with a state general revenue budget that is nearly $3.3 billion annually, a cut of $171 million is not easy for state government to absorb. Public education and human services took the biggest hits:

- The Public School Fund – this fund absorbed about 40 percent (or $68.4 million) of the state's $171 million general revenue cut. This represented a cut of 4.28 percent compared to the amount budgeted for the agency at the beginning of the year. Generally these funds support education expenses for children k-12.
- The Human Services Fund – this fund took 23 percent ($38.9 million) of the $171 million in state budget cuts. This was a cut of 5.93 percent in the Department of Human Services (DHS) budget from the beginning of the year. Services such as Medicaid, childcare, foster care etc., were affected.

Proposed DHS Medicaid Cuts
While most state agencies took budget cuts during the year, the proposed cuts to the Medicaid program were especially controversial. Having no choice but to cut spending because of the state's budget stabilization law, DHS initially proposed elimination/ major reductions in several Medicaid programs that could have had major impacts on children. DHS recommended cutting Medicaid programs that are more optional in nature rather than those required under federal regulations governing Medicaid. These programs included:

- Reducing services for Child Health Management Services (CHMS).

CHMS provides day treatment, therapy, and diagnostic services for developmentally delayed, at-risk children (note: CHMS should not to be confused with the ARKids First program that provides basic health care coverage for uninsured children up to 200 percent of poverty). In November, DHS proposed eliminating payments for day treatment and therapy services, but continuing payments for diagnostic services.

- Eliminating the Medically Needy Program. This program pays health care costs for those who wouldn't normally qualify for Medicaid, but have catastrophic illnesses that generate large medical bills. The program serves about 33,000 Arkansans annually (half adults, half children). DHS proposed eliminating this category from coverage.

- Redefining coverage for the TEFRA (Tax Equity Fiscal Responsibility Act) program. This optional program, which derives its name from the federal legislation that created the category, serves children who have serious, chronic, and long-term medical conditions. The TEFRA program serves about 3,000 children annually. Children qualify based on their individual income rather than their parent's income which permits children from families with incomes above the eligibility level for any other Medicaid program to participate. DHS initially proposed eliminating the TEFRA program for the last three months of the state fiscal year 2002 and applying for a federal waiver to redefine the TEFRA program to allow cost sharing and income limitations.

Final DHS Cuts

Public pressure and legal challenges prevented DHS from implementing several of the more controversial changes originally proposed. The administration's proposal to significantly limit services to children under the CHMS program was challenged in federal court by CHMS providers. A federal court ruled in June that the state did not have to include CHMS day treatment and therapy services in state Medicaid plan, but that if a doctor prescribes the services for children who qualify for Medicaid, the state must pay for it with Medicaid funds. The decision may ultimately limit access to CHMS services (and reduce the money spent on the program) because some doctors may be hesitant to prescribe the services that the state doesn't list as part of the state Medicaid plan.

After much public outcry, the Governor decided not to eliminate the Medically Needy program. To make up the shortfall, the Governor initially proposed shifting $3 million from the state CHART plan to cover the Medically Needy program for the rest of 2002 (CHART is the voter-approved state plan for spending the tobacco settlement). An Attorney General's opinion declared such a move to be illegal, and the idea was dropped. Other monies were found in lieu of eliminating the Medically Needy program.

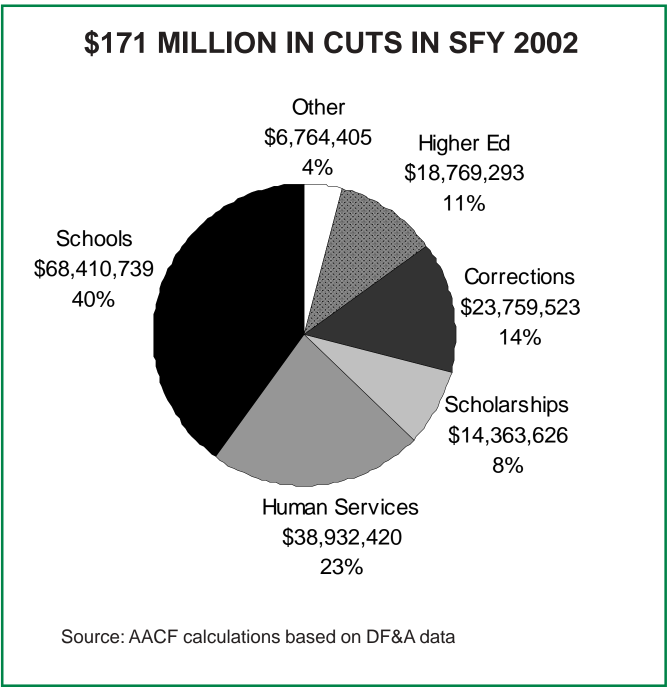
Again, numerous public rallies of affected TEFRA families pressured the administration to drop its proposal to eliminate or amend TEFRA coverage for 2002. DHS subsequently submitted a waiver to the federal government that will require monthly premiums for families with incomes above $25,000. The monthly premiums begin at 1% for families with incomes between $25,001 and $50,000 (i.e., premiums of $21 to $42) with a maximum premium of 2.75% for families with incomes over $200,000 (up to a maximum monthly premium of $458 for any family). Families at all income levels will be eligible for the program as long as their child meets the medical criteria. The federal government recently approved the waiver.

While the administration was unsuccessful in its efforts to cut spending on CHMS, TEFRA, or the Medically Needy programs during 2002, it did cut or limit the growth in Medicaid spending through other avenues, including:

1. DHS amended the Medicaid State Plan to reduce the amount Medicaid pays for prescription drugs. As part of the plan, the state reduced the rates for brand names to the average wholesale price minus 14 percent. For generic drugs, the rates were dropped to the average wholesale price minus 20 percent. The move is expected to save the state about $3 million annually in state general revenue.

2. DHS implemented a prior authorization ("gatekeeper") system for children's mental health services. Projected savings from this are $400,000 to $600,000 per year.

3. DHS tapped more federal funds through an "upper-payment limit" program that allows the state to collect more federal funds for Medicaid residents in county-owned nursing homes. This will allow DHS to capture $3.5 million more in federal Medicaid funds annually.



4. DHS worked out an agreement with University of Arkansas Medical Sciences (UAMS) to make a $1.5 million payment to DHS ahead of schedule. The money was earmarked for the TEFRA program.

5. DHS tapped $6.8 million in nursing home quality assurance fees (used to draw down federal dollars) that it had been holding as a reserve in case of a negative liability ruling in the Butterfield Trails case (case was eventually dismissed). Other Medicaid funds had temporarily covered this $6.8 million in nursing home expenditures.

Third Shortfall Requires Emergency Special Session
In May, Governor Huckabee announced another state budget gap of $56 million, raising the year's total shortfall to $227 million. With the third shortfall occurring so late in the state fiscal year, it would have been very difficult to cut state agency expenditures in such a short amount of time without immediate layoffs of large numbers of state employees. To avoid layoffs, the Governor requested an emergency session of the Arkansas General Assembly to find new monies to make up the budget shortfalls.

As expected, the Governor and the legislature were in no mood to raise taxes to make up the $56 million shortfall. The prospect of a Supreme Court decision in the Lake View school-funding case on the horizon (and the need to raise large amounts of new revenue), coupled with upcoming November elections, made it highly unlikely that the legislature would raise taxes to pay for the $56 million shortfall. Even if the legislature had wanted to raise taxes, it was so late in the fiscal year that any tax increase would have taken months to generate the needed revenue.

Rather than raise existing taxes or create new ones, the General Assembly tapped one-time monies from various accounts. These included:

- $15,000,000 from the Unclaimed Property Proceeds Trust Fund
- $5,900,000 from the Industry and Aerospace Development Fund
- $9,100,000 from the special project line item of the General Improvement Fund of the 83rd General Assembly
- $11,190,000 from the Merit Adjust Fund, a special fund for state employee merit raises
- $3,000,000 from the Red River Waterways Project Trust Fund
- $3,000,000 from the State Insurance Trust Fund
- $8,100,000 from the Budget Stabilization Trust Fund

In addition, the General Assembly also created the Arkansas Rainy Day Fund to be used for future Medicaid shortfalls. The Legislature created the fund by transferring $15 million from the state tobacco settlement.

What's the Best Fiscal Response?
Arkansas' General Revenue Stabilization law requires that state government spending be reduced whenever projected spending exceeds forecasted revenue. Rather than cutting spending (as the state did after the November and April revenue shortfall), Arkansas had the option of raising new revenue to meet a shortfall (as it did by tapping one-time monies in a special legislative session after a third revenue shortfall was announced in May). Similarly, the state had another option: it could have raised new taxes – provided it occurred early enough in the fiscal year to generate new revenue to meet a projected shortfall.

While hindsight is always 20-20, it's nonetheless fair to ask whether budget cuts and tapping one-time monies were the best responses to revenue shortfalls during a tight Arkansas economy. Contrary to the conventional wisdom among many policymakers, basic economic theory suggests that, at least in the short run, budget cuts (which are reductions in government spending on goods and services) are more harmful to the economy than either tax increases or reducing spending for transfer programs (such as unemployment insurance).

Why? A 2001 analysis by Peter Orszag and Joseph Stiglitz for the Center on Budget and Policy Priorities sheds light on this question (note: Orszag is a Senior Fellow in Tax Policy at the

A Year for the Unusual

Arkansas' revenue shortfalls during the past year led to some unusual politics over the budget.

After the first round of budget cuts was announced in November, Governor Huckabee announced the creation of a "Tax Me More Fund" to raise money for meeting budget shortfalls. While the governor said he was being "as serious as he can be" about creating the fund in a speech to the Arkansas Farm Bureau, there was debate among the Governor's staff and legislators as to that being a real strategy for raising state revenue.

The Governor acknowledged that he created the fund as a way for legislators who were critical of the budget cuts to make contributions in lieu of a tax increase.

The "Tax Me More" fund raised less than $2,000.

In another unusual move, the Governor sent a survey to state legislators seeking input about how they would offset state budget cuts. The House leadership dismissed the survey as a "gimmick" because the governor released the survey to the media before legislators had received it. Only 6 of the 135 legislators responded to the governor's survey.

Brookings Institution, while Stigliz is a Professor of Economics at Columbia University and the winner of the 2001 Nobel Prize in Economics).[1] In the short run, budget cuts reduce government spending on goods and services, thereby reducing economic activity and potential tax revenues. In contrast, tax increases are more likely to reduce savings rather than consumption, lessening the impact on economic activity in the short run.

What types of tax increases are better in the short run? The short answer, according to Orszag and Stiglitz, is that tax increases focused on those with lower "propensities to consume" cause less damage to a weakened state economy. Simply put, families with a lower propensity to consume are those who spend less and save more of each *additional* dollar of income they earn. In general, higher-income families tend to have a lower propensity to consume because they have more income to save than do lower-income families. Low-income families tend to spend more of their income each month just to meet basic needs. Because more of their income goes to spending, any tax increase on low-income families is more likely to result in reduced spending on goods and services, thereby hurting the state economy and tax revenues.

Orszag and Stiglitz ague that tax increases should be concentrated on higher-income families. They conclude that, "if anything, tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run."

In addition to this consideration, there is a more practical concern about the impact of budget cuts on low-income families during an economic downturn. That is, in tough economic times low-income families tend to be those with lower skill levels and those most likely to be laid off (or least have their hours cut back).[2] Since many low-income families are struggling to make it day-by-day even when they are working, the loss of income during a recession increases their need for supports such as unemployment insurance benefits, short-term TANF benefits, or subsidized health care. Budget cuts in programs that serve vulnerable families, such as Medicaid, only worsen their economic well-being and ability to care for their children.

Principles for State Fiscal Decisions inTough Times

Although economists predict an upswing in the Arkansas economy in early 2003, now is the time to consider ways to improve the state's fiscal decision-making process during tough economic times. There will always be tough choices when addressing state revenue shortfalls, especially in tight economic times. We recommend that state policymakers follow these principles when balancing the state budget:[3]

1. The state's budget decisions should not make the recession worse for those Arkansans least able to weather the downturn, especially low-income families with children, laid-off workers, and other vulnerable populations.

2. The state should use a combination of the three primary budget-balancing tools that are always available: raising new revenue through tax increases, using reserves, and cutting spending.

3. Tax increases are preferred over budget cuts. In the short run, budget cuts reduce government spending on goods and services, thereby reducing economic activity and potential tax revenues. In contrast, tax increases are more likely to reduce savings rather than consumption, lessening the impact on economic activity in the short run (see above section on "What's the Best Fiscal Response During a Tight Economy?").

4. Tax increases should be targeted to upper-income individuals. Tax increases on upper-income people are least likely to hurt the economy in the short run, while tax increases on low-income families threaten those that are already the most vulnerable.

5. Tax increases should be done as soon as possible in the state fiscal year in order to have enough time to generate the revenues to close any potential budget shortfalls.

6. When government spending must be reduced, across the board cuts should be avoided. Instead, spending cuts should be done cautiously and deliberatively, considering the possible consequences on the populations that state programs serve (note: this principle would likely require that the state change its General Revenue Stabilization law for balancing revenues and expenditures).

7. When spending cuts are necessary, the state should consider the impact on the state revenue match used to draw down federal funds, especially state funds used for programs like Medicaid that serve vulnerable families.

8. Budget balancing decisions should be informed by the economic or stimulus effect of the decision. Both spending cuts and tax increases take money out of the economy. In the short run, however, a $1 cut in government spending immediately takes $1 out of the state economy, whereas a $1 tax increase is likely to be offset by a partial reduction in savings to maintain consumption.

Notes:

1. Peter Orszag and Joseph Stiglitz, "Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-productive than the Other During a Recession?" Center on Budget and Policy Priorities, November 6, 2001.
2. John Springer and Heidi Goldberg, "Relieving the Recession: Nineteen Ways States Can Assist Low-income Families During the Downturn," Center on Budget and Policy Priorities, February 2002.
3. Nan Madden, "Principles for State Fiscal Decisions," Minnesota Council of Nonprofits, January 2, 2002, http://www.mncn.org/bp/fiscalp.pdf.

For More Information

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