States are facing the worst fiscal conditions since World War II. Structural problems in states' budgets are to blame.

It's been widely reported over the past few weeks that governors across America are battling the worst fiscal conditions since World War II. Revenues are down and expenditures are up. Budget shortfalls are mounting - $50 billion this year and $60-70 billion next year. The problems are so widespread among the states they can no longer be considered just regional issues or to be wholly caused by local factors.

But what's hard for most people to figure out is why the states' economic problems are so severe yet the recent recession was one of the mildest in terms of declines in Gross Domestic Product, which is the broadest measure of economic activity in the country.

The underlying reason for the dichotomy is that the states' fiscal problems were only partly due to the cyclical downturn in the economy. Two longstanding structural problems - an eroding tax base and the explosion in health care costs - are the major causes. Both of these problems were camouflaged by the phenomenal economic growth in the second half of the 1990's. The recession unmasked the problems, but it was not the reason for the swift and steep decline in the state fiscal situation. This recession, however, was rather unique from a state perspective since not only did all revenues fall, but there was a virtual collapse of both capital gains tax revenues and corporate tax revenues. For example, the latter actually fell 30 percent in the first quarter of 2001. The combination of all these factors is reflected in the fact that state revenues were down 6 percent in 2002, the first full year that states have witnessed a decline as long as credible statistics are available back to the Second World War.

On the spending side of the ledger, health care represents about 30 percent of the average state budget. Medicaid alone represents 20 percent of this cost. Total health care costs are growing at 13 percent this year, which follows an 11 percent increase last year. The spiraling costs of health care are a national problem leaving few options available to states to control
costs- articularly given the political difficulties with reducing benefits and eligibility for Medicaid recipients.

Few Americans understand that Medicaid is now larger than Medicare in terms of the number of people covered - 44 million vs. 40 million, and in totaling spending - $230 billion vs. $215 billion. Medicaid eligibility is also growing twice as fast as Medicare. The high cost of long-term care and the cost to serve low-income individuals who are enrolled in both Medicaid and Medicare, the so-called "dual-eligibles," adds to the problem.

In the short-run, states have no option but to take emergency type action to meet their balanced budget requirements. In the long-run it is critical that Congress reform Medicaid. There are recent signs that Medicaid reform is moving up on the national agenda. For example, NGA recommended creating a high-level Medicaid Commission to spearhead reform and the Senate adopted a resolution on a commission earlier this year. Furthermore, Senator John Breaux, chairman of the Aging Committee, is advocating long-term care reform. More important is a bill passed last year by the U.S. House of Representatives that would have the federal government pay for drug benefits of the "dual-eligibles," saving states more than $43 billion over the next 10 years. While it did not become law, momentum for change is growing.

Unfortunately, states are facing a perfect storm with deteriorating tax bases, an explosion of health care costs, coupled with a virtual collapse of capital gains tax revenues and corporate profit taxes. The bottom line is that the current problem is long-run and structural, and will take states at least three to five years to make the needed changes. In the short-run they have no alternative but to cut spending and enact bold and progressive public policy initiatives. But in the long-run, Medicaid needs major reform because states no longer have the fiscal capacity to support it.

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