

On the Brink: Alabama's Looming Budget Shortfalls

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If you want a state vehicle autographed by Arnold Schwarzenegger, you're about to get your chance. Auctions of state cars signed by California's governor will play a role in efforts to erase the state's \$26 billion budget deficit, but lawmakers plan to make up much of the shortfall with deep cuts to education, public safety and social services. California is an extreme case, but the nation's economic recession has forced most states to slash budgets. Vermont will close its courts for 12 days this year. Colorado, New York and North Carolina are among the states that will shut down some prisons to save money. And Mississippi plans to limit state troopers to a single box of ammunition per pistol this year.

Public services in Alabama have weathered the economic storm better than in most other states, but they're far from invincible. Rainy day funds and federal relief money from the **American Recovery and Reinvestment Act (ARRA)** have helped the state avoid massive budget cuts thus far. But with the economy still slumping and the ARRA money running out, Alabama soon could find itself facing the same kind of deep budget cuts that other states are making.

Little wiggle room: The effects of earmarks

Alabama has two separate state budgets – one for education-related programs and another for all other state services. State law requires both budgets to be balanced every year, meaning the state can spend only as much as it is projected to receive in revenue in a given fiscal year.

Almost 90 percent of Alabama's tax dollars are earmarked, leaving legislators little discretion to adjust spending to meet current needs. The **Education Trust Fund (ETF)** budget is bankrolled mainly by the so-called "growth" taxes – income tax and sales tax – that tend to ebb and flow depending on the strength or weakness of the economy. When the economy turns south, so do Alabama's education revenues. The **General Fund** budget gets revenues from a hodgepodge of taxes – including property taxes and oil and gas severance taxes – that are slow to grow, even in good economic times. When the revenue stream fails to keep pace with the normal rising costs of programs such as Medicaid and prisons, economists call the resulting gap a **structural deficit**.

Recession hits the budgets

Early signs of the current shortfall in Alabama's budgets began to appear in 2008. After several boom

years, ETF revenue growth slowed to 1.5 percent, well below the 5 percent that legislators had assumed when they wrote that year's education budget. To avoid **proration** of the ETF, Gov. Bob Riley drained all \$440 million in the Proration Prevention Account, a statutory rainy day fund for education created earlier this decade.

As the economy worsened, the threat of severe budget cuts loomed larger. In November 2008, state voters approved a constitutional amendment to create a rainy day account for the General Fund and expand the existing constitutional rainy day account for the ETF. Both accounts borrow their money from the **Alabama Trust Fund**, a state savings account for royalties and lease payments that Alabama has received from oil and natural gas drilling in its coastal waters.

Revenue collections have declined sharply in the current fiscal year, which began in October 2008. ETF tax collections through the first nine months of FY 2009 have fallen by 8.7 percent, while General Fund revenues have dropped 14.8 percent. **Legislative Fiscal Office (LFO)** director Joyce Bigbee in July 2009 called

Keywords

Alabama Trust Fund – a state savings and investment account that receives most of Alabama's royalties from off-shore drilling activities. Interest and capital gains transfers from the ATF are regular sources of revenue for the General Fund.

American Recovery and Reinvestment Act (ARRA) – a February 2009 federal law, also known as the recovery package or stimulus package, that provided for \$787 billion in spending and tax cuts to try to help lift the U.S. economy out of a recession. Alabama will receive about \$3 billion in ARRA funds through fiscal year 2011.

earmark – tax revenue set aside for a specific purpose by a statute or constitutional provision.

Education Trust Fund (ETF) – the part of the state budget set aside for education-related programs.

General Fund – the part of Alabama's budget for non-education-related programs that the Legislature can allocate at its discretion.

Legislative Fiscal Office (LFO) – a nonpartisan office of the Legislature that provides data on state appropriations, expenditures and projected revenues.

proration – the process of cutting agency budgets equally across the board when revenues fall short of expectations.

rainy day fund – money set aside in a budget or under constitutional or statutory law for emergency use.

structural deficit – the inability of a government's revenue system to keep up with the normal increases in program costs caused by inflation and population growth.

the state's revenue decrease "steeper and longer than anything we have ever seen." Bigbee also said the state's sales tax revenue downturn is about two and a half times larger than the previous record drop in 1954.

The plummeting tax collections prompted mid-year budget cuts to a range of state services. In December 2008, Riley ordered 9 percent proration in the ETF and 10 percent cuts for most General Fund agencies. In July 2009, he increased the ETF budget's proration to 11 percent. Riley also has released all of the newly enlarged ETF rainy day account to avoid even deeper education cuts this year.

With state reserves dwindling, lawmakers leaned on federal ARRA funds to balance the budgets for 2010. The state's \$6.2 billion ETF budget will include \$513 million in ARRA money, while the \$2.5 billion General Fund budget will contain about \$1 billion in ARRA funds. Even with the infusion of federal money, though, most agencies are set to get little more than level funding in 2010. Despite the name, level funding can act as a funding cut because it offers no additional money to account for factors like inflation, increasing benefits costs and population growth.

Not all programs will dodge cuts next year, even with ARRA funds on hand. Distance learning, indigent defense and the Alabama Math, Science and Technology Initiative all will receive less money in the fiscal year that begins in October 2009. Teachers will not receive their usual classroom supply money, and state textbook funding will be enough to cover little more than consumable workbooks for young students. Many state officials also expect ETF proration in 2010.

Alabama's budgetary future

If the economy stays in the doldrums, those cuts may be only the beginning of what Alabama could face in 2011 and beyond. The state's unemployment rate has topped 10 percent, with the nation's rate not far behind, and few economists foresee a quick end to the job losses. Budget woes abound across the country, with 48 states (all but Montana and North Dakota) facing shortfalls in FY 2009, FY 2010 or both. And the time that ARRA money bought for states to try to address their financial problems will run out in 2011.

Alabama likely will not be able to rely on ARRA money alone to prop up its budgets in 2011. Of the roughly \$3 billion in ARRA funds the state expects to receive, about \$659 million will remain in 2011, according to LFO estimates. The vast majority of that amount – \$511 million – will be set aside for the ETF budget. That will leave \$148 million in ARRA money to help

plug a General Fund hole that would have topped \$500 million in 2010 without federal funds. Even if the governor were to declare proration and drain the entire General Fund rainy day account, the budget still could face a shortfall if revenues do not rebound quickly. Further, across-the-board General Fund cuts could cost the state millions of dollars in federal matching funds for programs like Medicaid and ALL Kids. And if the recession stretches into FY 2012, the state easily could find itself with no financial cushion whatsoever.

Falling revenues will not be the only concern facing Alabama's budgets in the coming years. The state constitution gives lawmakers six years to replenish the ETF's rainy day account, and those repayments will cut into eventual revenue growth. A bear stock market has wiped out half of the Prepaid Affordable College Tuition (PACT) program's assets since 2007, prompting calls from many participants and observers for the state to guarantee tuition payments for contract beneficiaries. And if national reform efforts do not slow the growth rate of health care costs, ever-larger amounts of state money likely will be needed to maintain current service levels under Medicaid and ALL Kids.

How could Alabama fill future budget holes?

The state has a couple of short-term options to address expected budget shortfalls. One quick fix could be to borrow more money from the Alabama Trust Fund, but that move would require approval of a new constitutional amendment. It also would deplete the account further and would reduce the interest payments that provide support for the General Fund. Another possibility would be to urge the federal government to pass a second stimulus package with more money for states. The alternative – deeper state spending cuts – could slow the nation's economic recovery.

A longer-term solution would be to address structural problems in Alabama's tax system. Just as the Great Depression prompted Alabama to create income and sales taxes, many states are addressing shortfalls in the current recession with a combination of tax increases and spending cuts. Fewer earmarks and greater diversity in the funding sources for Alabama's budgets would leave the ETF less vulnerable to economic downturns and allow the General Fund to benefit more from revenue growth. Regardless, if the experts who predict continued economic woes are correct, Alabamians ultimately will face a choice at the heart of budget decisions in tough times: whether to cut funding for public services or raise more money to pay for them.

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