NATIONAL CONFERENCE of STATE LEGISLATURES

The Forum for America's Ideas

STATE BUDGET UPDATE: NOVEMBER 2010

December 7, 2010

Although a recovering national economy is helping to stabilize state revenues in fiscal year (FY) 2011, serious budget challenges await state lawmakers in the New Year. This largely stems from fewer federal stimulus funds available for next year's budgets. And while state revenues are starting to pick up, the growth is unlikely to be sufficient to replace expiring American Recovery and Reinvestment Act (ARRA) funds or cover projected increases in program areas such as Medicaid and K-12 education. This means another round of budget gaps, certainly in FY 2012, but even beyond in many states.

State lawmakers closed a cumulative budget gap of $83.9 billion while crafting their FY 2011 budgets. For most states, this marked the third or fourth consecutive year of budget gaps. Now, midway through FY 2011, new gaps have opened in at least 15 states. The outlook for FY 2012 and FY 2013 reveals additional state budget gaps. At this point, it is difficult to forecast when the vast majority of states will no longer face budget gaps.

States will have $37.9 billion less in federal stimulus funds in FY 2012 than they had in FY 2011, according to figures provided by Federal Funds Information for States. This will create big holes in state budgets—what many officials are calling the "ARRA cliff." The stimulus funds have helped support state budgets since FY 2009, so their dramatic decline—they will be essentially gone by FY 2012—will pose additional budget challenges for state officials.

This report includes information on:

- New FY 2011 budget gaps.
- Revenue performance for major tax categories (through October for most states).
- The revenue outlook for the rest of FY 2011.
- Spending overruns in FY 2011.
- Summary of the current state fiscal situation.
- Projected budget gaps in FY 2012 and FY 2013.
- A discussion of structural budget gaps.

This report provides information on all 50 states and Puerto Rico. It is based on data collected from legislative fiscal directors in November 2010.

Although the national recession officially ended in June 2009, state finances will be slow to recover to pre-recession levels. History shows that state budgets continue to struggle long after a recession ends, and the current fiscal situation offers no exception to that trend. The information in this report is further evidence of that fact.

New FY 2011 Budget Gaps

As state lawmakers were crafting their FY 2011 budgets (in some cases enacting the 2011-2012 biennial budget), they faced large budget gaps. In most states these gaps were on top of the ones already closed in FY 2010 and FY 2009. Some states dealing with imbalances as far back as FY 2008. The states closed these gaps to enact balanced budgets, as they are required to do by statutory or constitutional provisions. This year, the improving national economic situation has helped lower the number of states reporting new FY 2011 budget gaps, but several still face ongoing shortfalls. Here are the numbers.

The Impact of Enhanced FMAP on FY 2011 State Budgets:

One of the provisions of the American Recovery and Reinvestment Act (ARRA) was a temporary increase in the Federal Medical Assistance Percentage (FMAP), the rate that the federal government pays for its share of Medicaid. This enhanced rate was scheduled to expire on Dec. 31, 2010. But early in the year Congress considered and, by all accounts, was on the verge of extending the enhanced FMAP through June 30, 2011 (the end of FY 2011 for 46 states). This federal conversation was occurring while states were in the process of enacting their FY 2011 budgets. Given the virtual certainly of the extension, many states included the more favorable federal rate in their budget assumptions.

Ultimately, Congress did not approve the fully enhanced rate for six months. Instead, it extended the rate until June 30, 2011, at a lower level, though still above the level it was scheduled to revert to on Dec. 31. This action created gaps in states where the enacted budget assumed the higher FMAP rate. At the same time, however, the federal action generated a windfall for those states that did not count on an extension.
More information on which states budgeted for the fully enhanced FMAP rate can be found at:

http://www.ncsl.org/default.aspx?tabid=20292

- Fifteen states reported new gaps since FY 2011 began. The sum of these imbalances currently stands at $26.7 billion. This is on top of the $83.9 billion gap already resolved for this fiscal year.
- So far, four states have gaps in excess of 5 percent of their general fund budgets, and one of these states has a gap greater than 10 percent. The largest imbalances are in Illinois (47 percent) and Arizona (9.7 percent).
- Budget gaps are resulting from a combination of factors including weak revenue performance, lower than anticipated federal funding for Medicaid and spending overruns. In Colorado, for instance, $57.5 million of the gap is the result of a revenue shortfall and $67.2 million is the result of lower than expected FMAP funds.
- Ten states have gaps between 4.6 percent (Texas) and 0.2 percent (Pennsylvania).
- Some states have closed all or a portion of their gaps. In Missouri, for instance, the governor withheld $300 million at the beginning of FY 2011 to close the budget gap. In Oregon, the gap was addressed through across-the-board cuts.
- Thirty-five states and Puerto Rico do not report a gap so far in FY 2011. A number of states note that revenue trends suggest a gap is unlikely before the fiscal year ends. In Massachusetts, no FY 2011 gap is projected due to unexpected FMAP funds and revenues running ahead of estimates. Likewise in West Virginia, collections are $95 million or 7.9 percent over estimated collections through October.

Table 1 provides more information on FY 2011 budget gaps since the fiscal year began.

FY 2011 Tax Performance

Revenues for the first few months of FY 2011 gradually are performing better than they have in recent years. In November 2009, NCSL reported that 10 states reduced their forecasts for all major tax categories and saw collections fail to meet lower targets; now, no state is in this position. As revenues improve, officials are using terms like "modestly upgraded" and "slightly above estimate" to describe the performance of major taxes. Others are even more positive about performance. This revenue recovery is welcome news for state lawmakers.

Though tax performance has improved in FY 2011, it has done so unevenly across the states. In Massachusetts, for example, tax collections across all categories are $413 million above benchmark; however, in Oregon, collections for personal and corporate income taxes were below a reduced estimate.

The rest of this section provides a snapshot of recent state revenue performance for personal income, sales and corporate income taxes. Information on the performance of other taxes is included for those states that provided it. More details can be found in Tables 2 through 5.

Personal Income Taxes

Personal income tax collections account for nearly 35 percent of state own-source revenues. Nine states do not levy a broad-based personal income tax.[1]

- Sixteen states reported that personal income tax collections exceeded the latest estimate. The forecast had not been revised in 10 of these states. Connecticut and Iowa saw collections surpass increased estimates.
- Twelve states saw collections come in on target, although three of those states—Arizona, New Mexico and Utah—had reduced their estimates since the beginning of FY 2011.
- Eleven states saw personal income tax collections below the latest target. Hawaii, New York and Oregon downgraded their forecasts, but receipts still were failing to meet the reduced target.

More information on personal income tax performance is shown in Table 2.

General Sales Taxes

General sales and use taxes represent about 32 percent of state collections. Five states—Alaska, Delaware, Montana, New Hampshire and Oregon—do not levy a state sales tax.

- Nineteen states saw general sales tax collections exceed the estimate. In 12 of these states, the forecast had not been revised. Connecticut was the only state to increase the forecast.

[1] New Hampshire and Tennessee do not levy a personal income tax but tax interest income and dividends. No information was provided on these taxes.

- Twelve states saw collections coming in on target, although Maryland and New Mexico had reduced their estimates.
- Sales tax receipts fell below the most recent forecast in 12 states. The forecast had been reduced in five states, yet collections still were below the lower estimate.

More information on general sales tax performance is shown in Table 3.

Corporate Income Taxes
On average, corporate income taxes account for about 5.6 percent of state tax collections. Alaska and New Hampshire, however, depend on them for more than 10 percent of collections.

- Eighteen states saw corporate income tax receipts above estimate, including New York and Vermont, which raised their forecasts.
- Eight states saw collections coming in on target, with half meeting forecasts that had been increased.
- Corporate income tax collections were below the latest target in 17 states. Four states—Connecticut, Hawaii, Idaho and Oregon—had decreased their forecasts for corporate income tax collections, but were still failing to meet the reduced targets.

More information on corporate income tax performance is shown in Table 4.

Other Taxes
States also rely on a variety of miscellaneous tax sources for income. These include taxes on oil and gas production, real estate transfers, tobacco products, meals and rooms, insurance premiums, motor fuel, estates and others.

- Fifteen states saw other taxes performing above estimate. Examples were energy-related taxes in Montana, North Dakota and Wyoming and cigarette taxes in Ohio, Pennsylvania and Wisconsin.
- In nine states, other tax sources were coming in on target.
- Other miscellaneous tax collections were below the latest target in 11states, with only Washington's business and occupation tax failing to meet a reduced target.

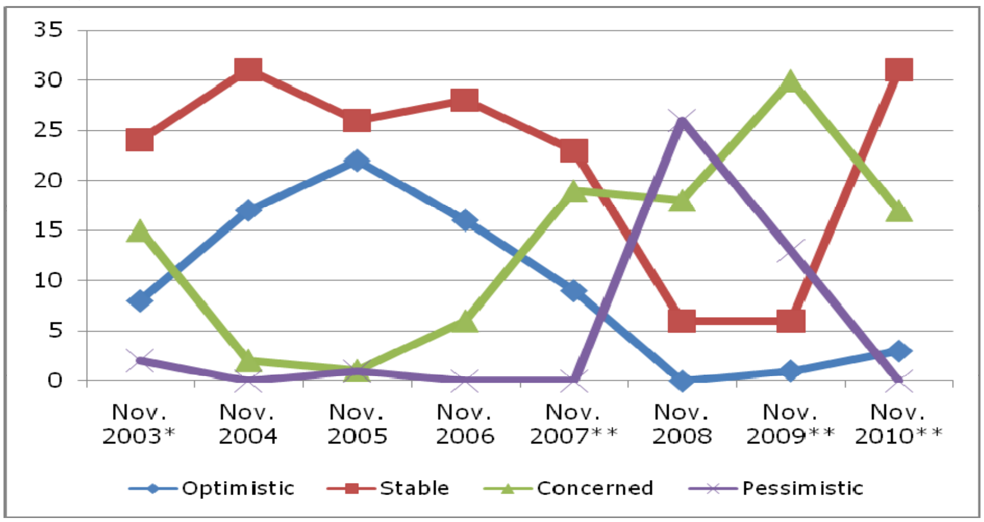
Table 5 contains more information on these taxes.

Revenue Outlook for the Remainder of FY 2011
Revenue performance is a key indicator of the current state fiscal situation, so it is important to get a sense of future expectations. As revenues continue their slow climb out of the trough of the recession, the outlook for the remainder of the budget year indicates steady improvement. In November 2009, NCSL asked legislative fiscal directors to comment on the outlook for FY 2010 revenues, and the most common response was that of "concern." With FY 2010 now in the rear view mirror, most legislative fiscal directors reported that the outlook is stable. Even in some states that are below the most current estimate, officials are

confident that collections will at least meet projections by the end of FY 2011. Although officials face significant budget challenges in the coming years, improving performance of state revenues is offering some relief.

- In a dramatic turnaround, 30 states and Puerto Rico are reporting a **stable** revenue outlook for the remainder of FY 2011, compared to just four states at this time last year (see Figure 1).
- Officials in 17 states are **concerned** about the revenue outlook for the remainder of FY 2011. This is a positive change compared to last November, when 30 were concerned.
- Fiscal directors in Maine, Massachusetts and Ohio described their revenue outlook as **optimistic** for the remainder of the fiscal year. Their optimism is based on collections that are exceeding projections.
- No state official was **pessimistic** about the outlook. This is a significant departure from the 13 states that indicated pessimism last November.

Figure 1. Revenue Outlook for the Remainder of the Fiscal Year (2003-2010)



Source: NCSL survey of state legislative fiscal offices, November, various years.

Table 6 contains more information on the states' revenue outlook for the remainder of FY 2011.

Spending Overruns in FY 2011

Some state budgets have been affected by weaker than anticipated revenues and shortfalls in projected federal stimulus funds for Medicaid, but a number of states also are reporting spending overruns. Through November, 25 states faced spending overruns in their FY 2011 budgets. Here are some examples:

- Eighteen states reported that Medicaid or other health care programs were over budget. Connecticut indicated that the Medicaid shortfall is projected at $185 million in FY 2011. Maryland reports a deficiency need of $239 million in its Medicaid program due to an increase in children's enrollment and a decrease in federal stimulus funds.

- Corrections or public safety programs were above budgeted levels in five states. Idaho reports that its corrections program was underfunded due to a lack of revenue in FY 2011. In Iowa, corrections spending is currently over budget by an unknown amount. Oklahoma noted that its Department of Corrections has submitted a supplemental appropriations request.
- Four states reported overspending in social service programs. This includes the in-home supportive services program in California that will be unable to achieve the full amount of budget reductions set for it in FY 2011. Kansas projects a shortfall from increased social service caseloads. Maryland estimates an underfunding of $36 million for its low-income energy assistance program, while Massachusetts is projecting a shortfall in its emergency housing assistance program.
- In Kansas, Louisiana, and Texas, education costs are exceeding budgeted levels. In Texas, K-12 formula funding is about $400 million (2.1 percent) over budget.
- Other programs over budget included employee compensation in California, the state public defender/indigent defense program in Iowa and the homestead exemption program in Nebraska.

Table 7 contains more information on state spending overruns.

Summary of the Current State Fiscal Situation

Table 8 in this report provides summary information on the current state fiscal situation. Legislative fiscal directors provided succinct and forthright comments to describe the current situation following the longest recession since the Great Depression. Some have continued to use terms like, "dire" and "difficult," while others have begun to use language such as "stable" and "cautiously optimistic" to describe the situation. Although the summaries vary, the general message from the states is one of continued challenges for state lawmakers in the upcoming sessions and beyond. Here are examples from officials in a few states:

- The situation is stabilizing in Alabama. Sales and use taxes and individual income tax withholding have begun to stabilize and even show slight increases compared to the same month in the previous year.
- In Arizona, the fiscal situation is improving slightly. After seeing general fund revenue decline by a third since FY 2007, revenues have been increasing slightly (although a large gap looms in the FY 2012 budget).
- The fiscal situation is guarded in Georgia and South Dakota.
- The fiscal situation in Illinois is described as dire.
- In Massachusetts, recent revenue trends have created optimism that natural revenue growth will go a long way to toward meeting the substantial budget gap in FY 2012.

- Pennsylvania describes revenues as relatively stable, but there is great concern about the loss of federal stimulus money in the next fiscal year, as well as an expected spike in pension costs.
- Rhode Island reports that revenues appear to be stabilizing, but FY 2012 poses a challenge due to the loss of enhanced FMAP funding.
- Officials in Wyoming describe the fiscal situation as stable and slowly improving.

Projected FY 2012 Budget Gaps

As state lawmakers convene their 2011 legislative sessions, they face yet another year of difficult budget balancing decisions. Recent revenue performance has improved the fiscal situation in a number of states, and in many, has even reduced previous budget gap projections. Unfortunately, this good news is tempered by the reality that these modest increases in revenue collections will not fill the budget holes created by the loss of ARRA stimulus funds and other one-time budget balancing solutions used in FY 2010 and FY 2011. Additionally, the number of states projecting gaps and the aggregate amount could rise as states face continued spending pressures.

The following highlights provide insights into the FY 2012 situation awaiting lawmakers next session.

- In total, 35 states and Puerto Rico currently project budget gaps in FY 2012. The sum of these projected imbalances for the 31 states (and Puerto Rico) that provided an estimate stands at $82.1 billion.
- Twenty-seven states and Puerto Rico project gaps in excess of 5 percent of their general fund budgets, with 21 of these anticipating gaps equal to or greater than 10 percent. The largest shortfalls are expected in Nevada (32.0 percent), New Jersey (26.0 percent) and North Carolina (20.3 percent).
- Five states have projected gaps between 4.7 percent (Iowa) and 1.2 percent (Tennessee).
- While budget gaps are expected in Illinois, South Carolina and South Dakota, official figures are unknown at this time.
- Some states already have addressed some or all of their projected gaps. In Virginia for example, the 2010 Legislature approved actions to close the previously estimated FY 2012 budget gap of $2.2 billion. In Kentucky, the projected budget gap for FY 2012 was addressed and the budget was balanced during the 2010 legislative session.
- Fifteen states do not currently project a gap for FY 2012. In some states, like New Hampshire, official budget estimates for the upcoming fiscal year have not been made. Missouri officials report that they cannot forecast a possible FY 2012 gap until the Consensus Revenue Forecast is received in December. Pennsylvania did not provide an official estimate but noted that budget cuts between $2 billion and $2.5 billion are anticipated.

Table 9 provides more information on projected FY 2012 budget gaps.

Projected FY 2013 Budget Gaps

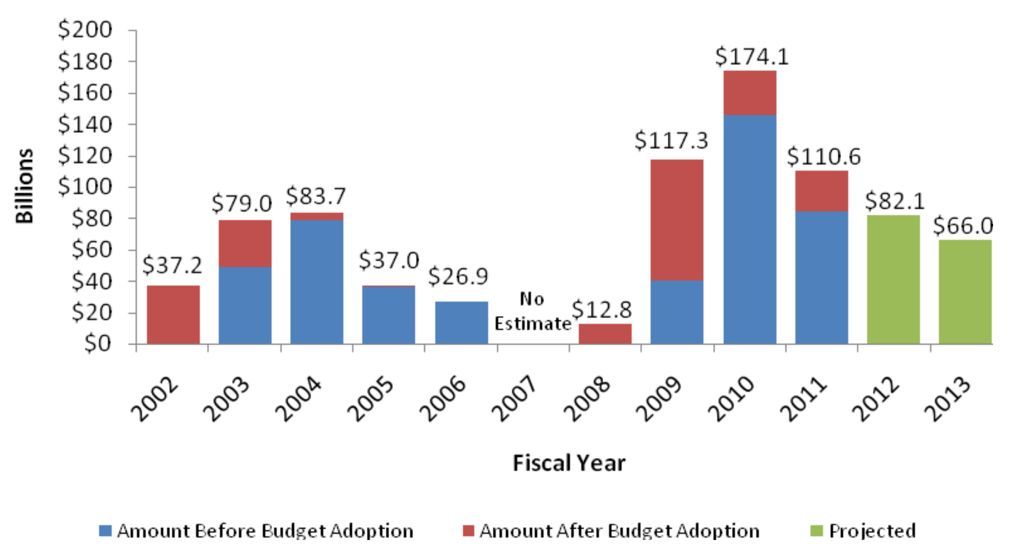
In a virtual replay of the FY 2012 scenario, many states project another round of budget gaps in FY 2013. Improving revenue performance may reduce or even eliminate gaps in some states. Additionally, measures taken to address FY 2011 and FY 2012 budget gaps will shrink the gaps in FY 2013.

The following provides additional information on projected FY 2013 budget gaps.

- In total, 24 states and Puerto Rico currently anticipate budget gaps for FY 2013. The sum of these projected imbalances for the nineteen states that provided an estimate currently stands at $66 billion.
- Eighteen states expect gaps in excess of 5 percent of their general fund budgets, with 13 states projecting gaps equal to or greater than 10 percent. The largest shortfalls are expected in Nevada (40 percent) and New York (20.4 percent).
- Two states have projected gaps between 2.6 percent (Hawaii) and 0.6 percent (Tennessee).
- At least four states and Puerto Rico report that although a shortfall in FY 2013 is expected, an official estimate is unavailable at this time.
- Twenty-six states do not currently project a gap for FY 2013. In most of these states, like Kansas, official estimates will not be made until later.

Table 10 provides more information on projected FY 2013 budget gaps. Figure 2 shows state budget gaps from FY 2002-FY 2013 (projected).

Figure 2. State Budget Gaps, FY 2002 to FY 2013 (projected)



Source: NCSL survey of legislative fiscal officers, various years.

Structural Budget Gaps

A recurring concern for states is structural budget imbalance. Structural budget gaps are caused when ongoing revenues are insufficient to cover ongoing expenses. Rising program costs coupled with revenue structures that do not often capture state economic growth have created this situation. A continuing discussion among lawmakers, fiscal staff and others interested in public finance is how prevalent structural deficits are. The latest state budget survey asked legislative fiscal directors whether their state faces a structural imbalance, the size of the structural gap and if any actions are being taken to address it. The following provides highlights on this special focus question.

- Fiscal directors in 30 states indicated that their state faces a structural budget gap in FY 2012. Another 20 states reported a structural imbalance in FY 2013. At least 14 states indicated that a structural budget gap projection exists for FY 2014 (based on a current revenue estimate and budget outlook). State officials in most states are expected to begin addressing these structural imbalances during the 2011 legislative session.

- California officials project multi-year structural budget gaps: $19.2 billion (18.7 percent) in FY 2012, $22.4 billion (20.2 percent) in FY 2013, and $20.4 billion (17.8 percent) in FY 2014.

- Colorado's structural imbalance of $1.1 billion (16 percent) for FY 2012 exists for two reasons: 1) Revenue that supports the state's operating budget and local schools is expected to increase more slowly than costs over the next few years; and 2) Many of the measures used to address previous and current shortfalls have been temporary in nature (as is the case in many states). These measures include federal stimulus funds, temporary budget cuts, temporary revenue increases and transfers from cash funds. Structural budget gaps are also projected for FY 2013 and FY 2014 but the amounts are unknown and will depend on actions taken during the 2011 session.

- Structural budget gaps in Maryland are projected for FY 2012 ($2.1 billion or 13.5 percent), FY 2013 ($1.9 billion or 11.8 percent), and FY 2014 ($1.8 billion or 10.9 percent). Proposed actions for addressing the structural budget gaps will not be known until the governor submits the new budget in 2011.

- New Jersey officials project that the FY 2012 structural budget gap is $10.5 billion (26 percent). Among the governor's plan for addressing the structural imbalance is a reduction of the state workforce by 1,200 positions on Jan. 1, 2011. The projected gap assumes continuation of all statutory requirements in the current budget.

- Structural budget gaps in New York are projected for FY 2012 ($9.0 billion or 14.6 percent), FY 2013 ($14.6 billion or 20.4 percent), and FY 2014 ($17.2 billion or 22.3 percent). No actions have been taken yet to address the structural gaps, although recent budget gaps have been partially addressed through multi-year tax increases.

See Table 11 for more information on state structural deficits.

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