Cautious Optimism

The verdict is still out on whether states are on track to make a full fiscal recovery.

BY TODD HAGGERTY

Driven by improving revenues and on-target expenditures, states entered fiscal year 2014 in better economic shape than they have been in years. Despite this good news, lawmakers remain cautious about the budget outlook for the year ahead, unconvinced the stronger revenue growth rates of last year are sustainable.

Revenue forecasts for this year reflect this concern and indicate that states are likely to continue along a path of slow and steady revenue growth that has distinguished the current economic recovery from previous ones. And with spending needs expected to continue to outpace revenue growth, lawmakers will receive little relief from the many fiscal challenges states face.

The Real Thing?

Partway into FY 2013, lawmakers learned that tax collections were outpacing projections, in some cases by substantial amounts. This was due in large part to a healthy performance by the personal income tax that, by March 2013, had met or exceeded the forecast in nearly every state. The reports were even better after the April personal income tax receipts were tallied.

Although stronger revenue collections were a welcome relief from the financial drought of recent years, they were somewhat unexpected. When states developed their FY 2013 budgets, total revenues were estimated to grow 3.7 percent from FY 2012. But actual growth reached 5.3 percent, and 41 states, the District of Columbia and Puerto Rico reported year-over-year general fund revenue growth. In nearly half these states, revenues grew by more than 5 percent, and in five, growth exceeded 10 percent. Many states used the unexpected excess to supplement appropriations or fortify their rainy day funds.

Revenue growth is not always what it appears to be, however. It can result from several factors. The strong revenue growth in FY 2013 was partially a result of taxpayers pushing as much of their income into tax year 2012 as they could to avoid an anticipated increase in federal tax rates in 2013. Lucy Dadayan, a researcher with the Rockefeller Institute of Government, remarked that this "bubble in personal income tax receipts would most certainly burst. Fortunately, forecasters in many states did not treat the growth as recurring money and instead projected

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Fiscal Favorites

Legislative fiscal officers are keenly attuned to the budget demands and fiscal pressures confronting legislatures. They identified the following issues as high priorities for lawmakers in the 36 states with regular legislative sessions in 2014. (Montana, Nevada, North Dakota and Texas meet only every other year.)

Medicaid and Health Care—Lawmakers in at least 29 states will focus on how to pay for expanding Medicaid, an optional provision in the federal Affordable Care Act. States will also be dealing with changes made to the percentage of costs they must cover in certain federal programs.

Pensions and State Employee Compensation—Funding for retirement systems will be on the table in five states, while lawmakers in another four states will consider adjusting employee salaries.

Education—Principals will command attention in 12 states, along with adequate funding levels, school finance formulas and increased student enrollment.

Taxes and Revenues—Lawmakers in least 11 states will be reviewing tax expenditures, addressing the end of temporary tax increases, or debating the pros and cons of various tax reform measures.

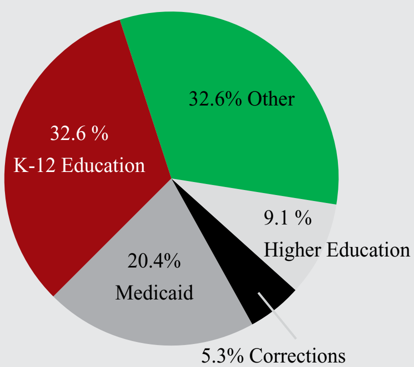
Other Issues—Other concerns expected to top fiscal agendas include how to finance infrastructure improvements, fund corrections, tackle structural budget problems, and save for a rainy day.

much slower growth in income tax receipts in fiscal 2014 and beyond."

State fiscal officials projected general fund revenues to grow, on average, by only 1.3 percent in FY 2014. (Although officials in New Jersey, North Dakota, Oklahoma, the District of Columbia and Puerto Rico forecast revenues to increase by more than 5 percent.) The silver lining for states with slow growth is that, for most of them, it will be the second year in a row on the uphill swing.

Where the Money Goes

The Major Components of General Fund Appropriations, FY 2014



Source: NCSL

Spending Pressures Continue

Any discussion of state expenditures usually starts with the biggest components of general fund budgets: elementary-secondary (K-12) education and Medicaid. Together, these two categories receive 53 percent of all states' general fund spending.

Last year, K-12 education spending increased 5.5 percent. In FY 2014, growth is budgeted at 2.4 percent, and total state support for K-12 education is budgeted to grow in 46 states, the District of Columbia and Puerto Rico.

Propelling K-12 spending are changes to funding formula, development of new programs, increases in per-pupil rates, higher pension costs, the use of state money to replace one-year grants, and increases to the state share of education funding.

In Nevada, for example, lawmakers increased funding to boost the English Language Learner Program, expand full-day kindergarten and reduce class sizes.

Medicaid constitutes the second largest share of general fund budgets and is currently the fastest growing category of state spending. States have budgeted for an average 6 percent increase in general fund support for Medicaid this year.

Driving up the cost of Medicaid in several states are the expansion options in the Affordable Care Act. In Minnesota, for example, the growth rate is expected to increase 13.7 percent not only because of expanded eligibility requirements in the ACA, but also because of a general increase in the number of people who qualify and enroll. Elsewhere, general medical inflation, more frequent use of benefits by enrollees and a spike in the number of caseloads have pushed Medicaid costs upward.

As Medicaid spending grows, so does the program's share of state general fund budgets. In FY 1994, Medicaid consumed 13.9 percent of state general fund budgets. Two decades later, that proportion has increased to 20.4 percent. Not surprisingly, state officials are concerned about this trend.

Representative Greg Wren (R) Alabama

"In FY 2004, Alabama spent $270 million on Medicaid," says Representative Greg Wren (R). "This year, the figure is close to $615 million. In the last 10 years, the percentage of general fund spending on Medicaid has doubled from 17 percent to 34 percent.

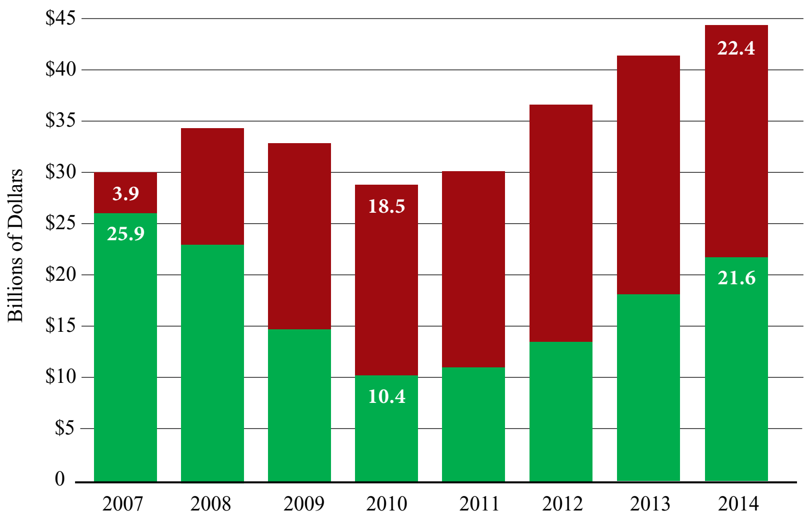
"At this rate, in eight years, Medicaid will consume three-quarters of the state's general fund budget. Inevitably, as the share of state funds for Medicaid grows, funding for other programs is likely to become scarce," he says.

The Other Half

Although K-12 education and Medicaid attract a lot of attention and receive the lion's share of spending, there is still the rest of the state budget to consider. Having weathered years of cuts or flat funding, higher education received the second largest increase in FY 2014 general fund appropriations. This underscores a cyclical trend unique to higher education: When fiscal

Rainy Day Fund Balances

FY 2007 to FY 2014 (Projected)



Alaska and Texas All Other States and Territories *Source: NCSL*

conditions weaken, higher ed funding takes a disproportionately harder hit, but when state budgets recover, higher ed experiences more robust growth than other programs.

Until recently, growth in corrections spending had been steady—requiring 5 percent to 6 percent of general fund budgets every year over the last decade. After essentially no growth in FY 2013, spending on corrections is projected to increase by 2.4 percent in FY 2014, driven by increases in inmate health care costs, the opening of new facilities and other factors.

The Next Rainy Day

The basic concept of a rainy day fund is straightforward: Save surplus money when finances are healthy to use when the economy falters. Strong economic conditions in the late 1990s, for example, helped saturate rainy day funds so when the fiscal drought hit in 2001, and revenues dried up, lawmakers were able to tap these funds to help balance their budgets.

State officials drew from these funds again during the Great Recession. The collective state rainy day fund balance declined from $34.1 billion in FY 2008 to $28.9 billion in FY 2010. These collective amounts appear relatively high, thanks to large reserves in the Alaska and Texas funds throughout the recession and slow recovery, which skew the totals. In FY 2007, these two states together accounted for 13.1 percent of all rainy day fund balances, but by FY 2012 this figure had climbed to 63 percent. When the balances of Alaska and Texas are removed from calculations, the states' rainy day fund total falls from $25.9 billion in FY 2007 to $10.4 billion in FY 2010.

As state budgets have stabilized, rainy day fund balances have grown, even when accounting for Alaska and Texas. Last year, the aggregate rainy day fund balance grew 13 percent, from $36.5 billion at the end of FY 2012 to $41.3 billion. When the current fiscal year ends this summer, rainy day fund balances are projected to have grown by 6.8 percent and total $44 billion.

In some instances, the growth in these funds is because of deposits from year-end budget surpluses, or repayment requirements as a result of a previous withdrawal. Other states have built up their reserve balances to offset the budgetary hits from federal sequestration, which applied automatic, across-the-board cuts of 10 percent to most appropriations beginning March 1, 2013.

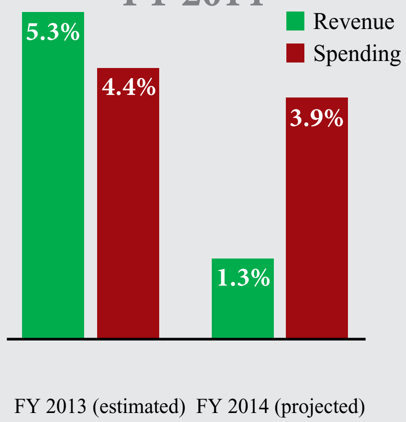
Sequestration hits Maryland harder than most states. Not only does the state budget feel the impact of federal aid being cut, but revenues could drop as federal agencies and contractors in the state reduce their spending on employees and procurements. "Because of this threat to our budget," says Maryland Senator Richard Madaleno (D),"the General Assembly created a special $100 million add-on fund to our existing reserve accounts as a rainy day fund to offset potential repercussions from the congressional budget stalemate. … While this will help us survive the current fiscal year, continued congressional inaction will do significant damage to the regional economy and the budgets of D.C., Maryland and Virginia."

The New Normal?

Although state fiscal conditions are better than they have been in years, several questions remain. Have states made a full recovery from the Great Recession? Will state economies ever return to their previous highs or is this the new normal? Have state officials done enough to prepare for the next downturn? Are there risks that could derail state efforts to shore up their economies?

Unfortunately, these questions, like most fiscal ones, do not have easy answers. In the short term, most state budgets look set to return to a trajectory of modest but stable growth. In the long term, states still face myriad challenges that are likely to occupy lawmakers during this year's legislative sessions and beyond.

Change in Revenues and Spending, FY 2013 and FY 2014



Source: NCSL