NATIONAL CONFERENCE of STATE LEGISLATURES

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State Budget Update: March 2011

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Nearly two years into the US economic recovery, following the end of the Great Recession, state finances are showing encouraging signs of revenue stability. At the same time, budget gaps remain a daunting obstacle for some states. Much of the difficulty is explained by the significant drop in state revenue collections in the previous two fiscal years. The steady, but slow pace of revenue growth since, has not been sufficiently robust to offset the loss of American Recovery and Reinvestment Act (ARRA) funds or the increases in caseloads and related costs in program areas such as Medicaid and K-12 education.

State revenues continue to stabilize or grow, which is a welcome improvement after some of the most challenging budget years ever faced by states. The majority of major tax categories are now performing at or above estimates through the first seven months of fiscal year (FY) 2011. In particular, state personal income and general sales taxes, which account for two-thirds of state general fund revenues, are showing positive performance when compared to their latest estimates.

State officials expressed more confidence about the current fiscal situation than in recent years, possibly indicating that the most difficult times are behind them. A growing number of states report that their fiscal situations are stable or improving as revenue performance continues to meet or exceed projections. However, overall fiscal conditions remain weak and budget gaps continue to present challenges. The information in this report illustrates the budget paradox faced by many states: stronger revenues but persistent budget shortfalls.

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A longer term view of state finances shows reasons for concern, especially when analyzing projected return-to-peak revenue collections. Only two states expect their collections to return to peak levels this fiscal year. Another nine states expect a rebound in FY 2012. But nearly half do not expect to see peak levels until sometime between FY 2013 and FY 2016.

This report includes information on:

- FY 2011 budget gaps.
- Revenue performance for major tax categories (through February for most states).
- Spending overruns in FY 2011.
- Summary of the current state fiscal situation.
- Projected budget gaps in FY 2012 and FY 2013.
- Projected return to peak revenue collections.

This report provides information on all 50 states and Puerto Rico. It is based on data collected from legislative fiscal directors in March 2011.

FY 2011 Budget Gaps

As state lawmakers were crafting their FY 2011 budgets (in some cases enacting the 2011-2012 biennial budget), they faced budget gaps totaling $83.9 billion. This has meant that for three consecutive years, nearly every state has faced severe budget problems. But the improving national economic situation has helped lower the number of states reporting new FY 2011 budget gaps. Although several still face ongoing shortfalls, these mid-year shortages are less severe than past ones. However, they occur at a time when most states have depleted reserves, exhausted other one-time funding sources and imposed repeated spending cuts. Here are the numbers.

- Eighteen states reported new gaps since the beginning of FY 2011. The sum of these imbalances currently stands at $13.4 billion, half as much as the figure states reported in November 2010 of $26.7 billion.
- Six states have new FY 2011 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 (12.2 percent) and Alabama (8 percent).
- Twelve states have gaps between 0.2 percent (Pennsylvania) and 5 percent (Massachusetts).
- Nine states with budget gaps already have closed all or a portion of them. In Colorado, for instance, the General Assembly passed a supplemental budget package with $412 million in budgetary measures.
- Several states that previously estimated mid-year budget gaps have seen them eliminated by the improved performance of state revenues. In Connecticut, a deficit of $86 million was projected, but with revenues improving a surplus is now projected. Officials in Maine report that a supplemental budget was passed in early February, funded primarily by a 4 percent increase in general fund revenue.

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

FY 2011 Tax Performance

After several years of deep declines, state revenues are continuing to rebound. Increasingly, major tax categories are on target or exceeding estimates. The improvement in state tax collections is tied to the strong performance of personal income and general sales and use taxes. Thirty-eight states reported personal income tax collections were performing at or above estimate. Additionally, 37 states reported general sales tax collections are on target or above estimate.

Improvements in FY 2011 tax performance have been uneven across the states, however. This is especially true for corporate income taxes; more officials reported that these collections were below estimate (15 states) than in any other major tax category.

The rest of this section provides a snapshot of recent state revenue performance for personal income, sales, corporate income, severance, and real estate transfer 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 7.

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]

- Twenty states and Puerto Rico reported that personal income tax collections exceeded the latest estimate. Twelve of these states saw collections surpass increased estimates.
- Seventeen states saw collections come in on target; eight of those had increased their estimates since the beginning of FY 2011.
- Three states—Hawaii, New York and Vermont—saw personal income tax collections fall below the latest target. Hawaii and New York 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 total state collections. Five states—Alaska, Delaware, Montana, New Hampshire and Oregon—do not levy a state sales tax.

- General sales tax collections in 16 states exceeded the estimate. In 10 of these states, the forecast had been upgraded and collections were still surpassing estimates.
- Twenty-one states saw collections coming in on target; eight of these states had increased their estimates.

[1] New Hampshire and Tennessee tax only interest income and dividends. No information was provided on these taxes.

- Sales tax receipts fell below the most recent forecast in four states (Kentucky, Maryland, Missouri and Nebraska). In Maryland, sales tax revenues continue to grow on a year-over-year basis, but the rate of growth is weaker than expected.

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.

- Ten states and Puerto Rico saw corporate income tax receipts exceed estimates, including Alaska, North Carolina and Tennessee—states that had raised their forecasts.
- Eighteen states saw collections coming in on target. Ten of those states had previously increased their forecasts.
- Corporate income tax collections were below the latest target in 15 states. Seven states had lowered their forecasts, yet were still failing to meet the reduced targets.

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

Severance Taxes

A few states rely heavily on severance taxes. In these states, revenue performance is closely tied to energy commodity prices.

- Six states reported that severance tax receipts were above estimate, including Alaska, which raised its forecast.
- Collections were on target in 11 states, with increased forecasts in five of those states.
- Severance taxes in two states—Florida and Michigan—were below the latest target, though officials in Florida note that severance taxes are not a significant source of revenue.

More information on severance tax performance is shown in Table 5.

Real Estate Transfer Taxes

Real estate transfer tax performance can be an indicator of trends in the housing market.

- Eleven states saw real estate transfer tax collections come in on target; six of those states had decreased their estimates since the beginning of FY 2011.
- Collections in Florida and Nevada—two states hit hard by the housing market collapse—were coming in above the most recent estimates.
- Six states reported that collections were below estimates.

More information on real estate transfer tax performance is shown in Table 6.

Other Taxes

States also rely on a variety of miscellaneous taxes. These include taxes on tobacco products, meals and rooms, insurance premiums, motor fuel, estates and others.

- Five states reported other taxes performing above estimates. Examples include motor fuel taxes in Georgia, insurance premium taxes in Florida and estate taxes in New York.
- In nine states, these tax sources were coming in on target.
- Other miscellaneous tax collections were below target in eight states, with Indiana's riverboat wagering tax and Tennessee's privilege tax failing to meet reduced targets.

Table 7 contains more information on these taxes.

Spending Overruns in FY 2011

Twenty-three states reported spending overruns in Medicaid, other health care programs, corrections, social service programs and education, compared with 17 states that indicated spending overruns in the November 2010 report.

Here are some examples:

- Twenty states reported that Medicaid or other health care programs were over budget. As of March 1, 2011, Louisiana's Medicaid program was projecting a deficit of $195.2 million. In Maryland, the governor provided $68.4 million in additional funds to bolster lower-than-anticipated federal matching funds.

- Corrections and public safety spending were above budgeted levels in seven states. In Alaska, corrections spending was $9 million over budget. In Iowa, corrections and public safety were collectively facing a $17.2 million shortfall as a result of mid-year budget cuts ordered by the governor.

- In five states, social service caseloads surpassed budgeted levels. Maine reported that child development agencies did not have enough funding to meet program demands. Hawaii's Temporary Assistance for Needy Families (TANF) program also was over budget.

- In Texas, K-12 education funding was $600 million (2.3 percent) over budget.

Table 8 contains more information on state spending overruns.

Summary of the Current State Fiscal Situation

Table 9 summarizes information on the current state fiscal situation as described by legislative fiscal directors. The general tone is more positive than in recent surveys, with widespread use of terms such as "improving," "stabilizing" and "cautiously optimistic." At the same time, some officials continue to mention "dire circumstances" or "a difficult fiscal situation," which serves as a reminder that not all states have turned the corner on budget difficulties. Here are examples from officials in a few states:

- In Alaska, high oil prices are providing an opportunity to increase both spending and savings.
- The fiscal situation in Arizona is improving, but the road to recovery is expected to be long.
- California faces a budget deficit of at least $27.5 billion, so the Legislature will have to make difficult decisions on both its spending and tax commitments.
- In Maine, revenue performance continues to show improvement, exceeding upgraded forecasts. But concerns exist over the potential impact of high fuel prices and higher than anticipated Medicaid expenditures.
- Minnesota reports that although the budget situation has improved since the November forecast, the budget gap for the biennium remains at $5 billion.
- Ohio officials expect to finish FY 2011 with a larger year-end balance than originally estimated.
- Officials in Oregon describe the fiscal situation as difficult. The state's unemployment is above the national average and employment levels are not expected to reach pre-recession levels until the end of 2014.
- Texas officials reported that reduced revenues and growing demand in K-12 and Medicaid caused a significant gap between available revenues and spending demands.
- Officials in Wyoming describe the fiscal situation as solid and improving.

Projected FY 2012 Budget Gaps

Following on the heels of the significant shortfalls already closed in FY 2009, FY 2010 and FY 2011, projected budget gaps for FY 2012 continue to present an ongoing challenge for states. It is still uncertain when states will be free of the budget gaps that have dogged them since FY 2009. The loss of federal stimulus funds in FY 2012 plays a prominent role because state revenue growth has been unable to offset the expiration of enhanced Federal Medical Assistance Percentage (FMAP) or other ARRA funds. States also cite the use of one-time revenues in past fiscal years as a factor contributing to their projected budget gaps in FY 2012.

The following highlights provide information about the projected FY 2012 budget gaps.

- At least 31 states and Puerto Rico projected FY 2012 gaps. The sum of these imbalances is $86.1 billion.

- Nineteen states reported gaps of 10 percent or more of their general fund budgets—two of these states have gaps greater than 30 percent. The largest shortfalls are projected in Alabama (33.7 percent) and Nevada (31 percent). The gap in Alabama stems from the expiration of enhanced FMAP funds and the use of one-time revenues in FY 2011. Rounding out the five largest budget gaps are California (around 28 percent), Minnesota (18.8 percent) and Oregon (18.6 percent).
- Eleven states and Puerto Rico have gaps between 2.3 percent (Iowa) and 9.6 percent (Oklahoma). Maryland noted that upward revenue revisions and spending reductions reduced the shortfall estimate by $900 million.
- Nineteen states did not report a projected gap for FY 2012.
- Mississippi and New Hampshire indicated that it was unknown if a budget gap will exist for FY 2012.

Table 10 provides more information on projected FY 2012 budget gaps.

Projected FY 2013 Budget Gaps

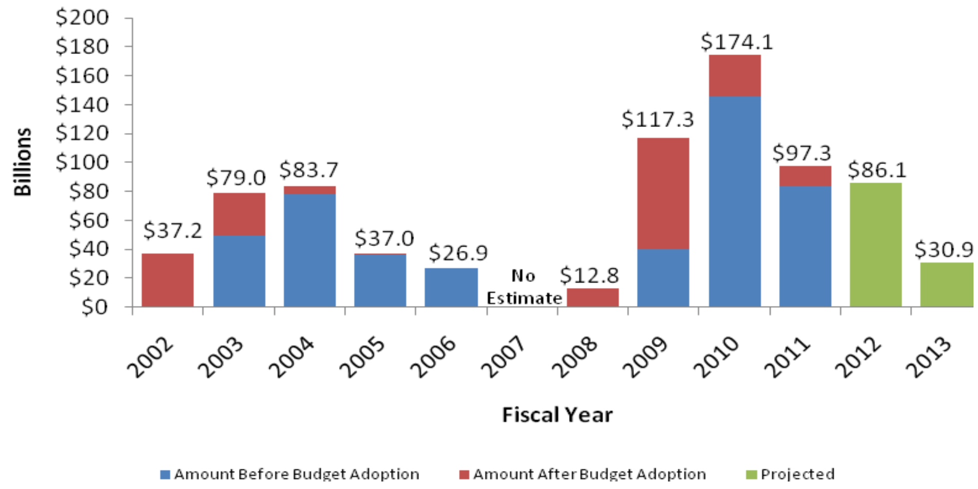
A large number of states project another round of budget gaps in FY 2013. This will mark the fifth year in a row that many states will have faced budget shortfalls. However, improving revenue performance is helping to reduce or even eliminate gaps in some states. Measures taken to address FY 2012 shortfalls also are helping to shrink the gaps in FY 2013.

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

- At this time, 19 states anticipate budget gaps for FY 2013. The aggregate gap currently stands at $30.9 billion. This compares with the $66 billion gap projected just four months ago.
- Eleven states project gaps greater than 10 percent. The largest shortfalls are expected in Nevada (35 percent) and Oregon (18.6 percent).
- Seven states have projected gaps between 1 percent (Tennessee) and 9.8 percent (Minnesota).
- Officials in Massachusetts noted that it is reasonable to assume a budget gap will appear in FY 2013, but it is too early to project how big it will be.
- Fourteen states do not currently project a gap for FY 2013. An additional 17 states report that no forecast is available or it is unknown if a budget gap will exist for FY 2013.

Table 11 provides more information on projected FY 2013 budget gaps.

Figure 1. State Budget Gaps, FY 2002 to FY 2013



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

Projected Return to Peak Revenue Collections

One way to view the health of state finances is to consider when revenues are expected to return to their previous peak levels. This is a pretty simple and straightforward comparison: When did nominal state revenue collections peak and when are they expected to reach or exceed that previous level? There are some obvious limitations to this assessment since it does not adjust for base or rate changes nor account for the effects of inflation. But from a policymaker's point of view, it can be helpful to know when collections are projected to reach pre-recession levels.

Peak Collections

When the latest recession began in December 2007, some states were already struggling with particular economic or fiscal factors that undermined their revenue performance. Examples are the struggling auto industry in Michigan or the residential real estate crisis in Arizona and Florida.

Here are the peak revenue collection years as reported by the states:

- FY 2000: Michigan
- FY 2006: New York and Florida
- FY 2007: Arizona, Nevada, Oregon and South Carolina
- FY 2008: 42 states
- FY 2011: North Dakota

It is not surprising that FY 2008 was the peak year for state tax collections in the vast majority of states: The budding recession had not yet choked state revenues. Even then, some states escaped its initial grip, especially those with natural resource-based economies. North Dakota is the only state that did not bear the full brunt of the recession as tax collections there never fell on a year-over-year basis.

Projected Return to Peak

The states' expectations of their return to peak revenue collections vary widely. Some expect a return in the current fiscal year while others not for at least five years or longer. Many do not even have a projection at this time. For those that do, however, it is important to note that the predictions are based on current economic forecasts and existing tax law, which obviously could change.

- FY 2011: Two states—Delaware and New York—expect revenue collections to reach previous peak levels during the current fiscal year. Delaware's peak year for revenues was FY 2008 while New York's peak was in FY 2006.
- FY 2012: Nine states—Arkansas, Hawaii, Iowa, Kentucky, Maryland, Ohio, Oregon, West Virginia, and Wisconsin—expect a return to peak collections in FY 2012. Officials in Iowa originally expected the return to be in FY 2013, but job growth is contributing positively and personal income and sales taxes are growing faster than previously estimated.
- FY 2013: Eight states—Kansas, Maine, Minnesota, Nebraska, Tennessee, Vermont, Virginia and Washington plus Puerto Rico—forecast a return to peak collections in FY 2013. Kansas, however, passed a time-limited sales tax increase that is set to expire at the end of FY 2013. In Maine, the December 2010 revenue revision significantly increased estimates, shortening the timeframe for recovery from FY 2015 to FY 2013.
- FY 2014: Ten states—Colorado, Connecticut, Florida, Georgia, Idaho, Illinois, Mississippi, Missouri, North Carolina and Texas—currently forecast FY 2014 as the year they will return to peak collections.
- FY 2015: Two states—Montana and New Mexico—expect revenues to rebound to peak levels sometime in FY 2015. In Montana, the outlook could change if oil production from the Bakken formation, which peaked in 2006, does not continue to decline.
- FY 2016: Two states—Arizona and Louisiana—do not expect revenues to return to peak levels until FY 2016. Arizona's previous revenue peak occurred in FY 2007, while Louisiana peaked in FY 2008.

Fourteen states currently do not have predictions for when tax collections will return to their peak levels. Here are some of the reasons:

- Alabama: Revenues peaked in FY 2008 at $7.8 billion. The estimate for FY 2012 is $6.8 billion, but there is no forecast beyond FY 2012, so it is unknown when revenues will return to peak levels.

- Alaska: Oil prices, which generated $11.5 billion in tax revenue in FY 2008 would have to exceed $150 per barrel for an extended period of time to reach that previous high collection mark.
- Michigan: Revenues are not likely to return to peak levels until FY 2020 or later.
- New Jersey: Estimated revenues in FY 2011 are still $4.9 billion below the peak of $33.2 billion in FY 2008. The number of years needed to return to the peak is unknown.
- Oklahoma: General revenue fund collections must increase approximately 15 percent above the FY 2012 estimate to reach the historical peak.
- Wyoming: Through the forecast period, revenues are not expected to reach the peak levels of FY 2008.

See Table 12 for more information on return to peak revenues.

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