STATE BUDGET UPDATE: FALL 2011

(Free condensed version)

NATIONAL CONFERENCE of STATE LEGISLATURES

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Fiscal Affairs Program
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The National Conference of State Legislatures is the bipartisan organization that serves the legislators and staffs of the states, commonwealths and territories.

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- To promote policy innovation and communication among state legislatures.
- To ensure state legislatures a strong, cohesive voice in the federal system.

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State Budget Update: Fall 2011

State fiscal conditions continue to improve, but at a very slow pace. A fall 2011 survey of state legislative fiscal officers found that the deterioration that dominated state finances in recent years has eased. Revenue performance has improved, expenditures in most states are stable and, in a significant departure from past years, few states are reporting budget gaps in the early months of fiscal year (FY) 2012. However, despite these positive developments, the effects of the Great Recession continue to linger. State tax collections still remain well below pre-recession levels.

> This report is based on data collected from legislative fiscal officers in October and November 2011. It includes information on:
>
> - New FY 2012 budget gaps
> - FY 2012 revenue performance
> - Revenue outlook for the remainder of FY 2012
> - Spending overruns in FY 2012
> - The state fiscal outlook for FY 2012
>
> This report provides complete or partial information on all 50 states and Puerto Rico.

With the enactment of their FY 2012 budgets, lawmakers successfully closed a cumulative budget gap of $91 billion. This is on top of shortfalls that states began addressing in FY 2008. In total, lawmakers have resolved an aggregate gap of more than $500 billion over four consecutive years. But the tide may be turning. Halfway into the second quarter of FY 2012, new gaps are practically non-existent.

Better revenue performance is driving the improvement in state finances. Collections in most states have stabilized or are growing, and the general revenue outlook for the remainder of the fiscal year reflects confidence in continued modest growth. However, recent global economic volatility is generating concern among state officials about the rate of revenue growth. In fact, several states reported that revenue projections, as they enter the second quarter are not as optimistic as they were just a few months ago.

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Budget officials expressed concern about the strength of economic growth. Unemployment remains stubbornly high and uncertainties about the European debt crisis have created turmoil in financial markets and shaken investor confidence. There are also questions about what impact congressional action (or inaction) to reduce the federal deficit reduction will have on state budgets. Any significant negative developments could stall recent improvements in state fiscal conditions.

State Contingency Plans in the Event of Federal Cutbacks

Actions taken by Congress to reduce the federal deficit likely would have a significant impact on the states. Uncertainty about potential recommendations by the Joint Select Committee on Deficit Reduction, or possible sequestration, prompted policymakers in eight states—Hawaii, Maine, Maryland, Massachusetts, Tennessee, Utah, Vermont and Virginia—to develop contingencies in the event of federal cutbacks. Of these states, many have replenished rainy day funds or have plans to reserve funds in the event of federal cutbacks. In Vermont for example, reserve funds have been set aside to meet such contingencies (about 1 percent of spending). In Utah, lawmakers passed legislation in the 2011 session that requires state agencies to develop contingency plans in the case of hypothetical federal reductions of 5 percent and 25 percent.

The actions Congress takes to reduce the federal deficit will most likely occur in FY 2013, which is why several states indicated that this matter is likely to be a significant issue in 2012 legislative sessions. For additional resources on federal deficit reduction please click here.

New FY 2012 Budget Gaps

Some of the most welcome news from this survey is the absence of any new budget gaps. Even last year, as signs of financial recovery began to surface, several states already were facing new budget gaps early in the fiscal year. For the first time in four years, lawmakers will not be spending the early part of their legislative sessions addressing current budget shortfalls. More information on new FY 2012 budget gaps can be found in Table 1.

- Only four states—California, Missouri, New York and Washington—report that a budget gap has appeared since the fiscal year began. This compares with 15 states that had gaps this time last year.
- The cumulative new budget gap for FY 2012 is $4.4 billion, compared with $26.7 billion for FY 2011 in November of last year.
- California's budget gap of $3 billion is because of lower than projected revenues and unrealized budget savings.
- Mother Nature is responsible for the budget shortfall in at least one state. Missouri's 0.5 percent gap stems from tornado recovery efforts. Vermont officials noted the state did not currently have a budget gap, but one might develop due to flood damage caused by Tropical Storm Irene.
- Other states expressed concern that a budget gap could develop before the end of the fiscal year. In Maine, for example, a pending revenue revision based on a more pessimistic economic forecast will likely produce a new shortfall.

FY 2012 Revenue Performance

Revenue performance remained solid for most states through the first quarter of FY 2012. The majority of states report that they expect to meet or exceed general fund revenue targets. It is worth noting, however, that the aggregate revenue growth rate for FY 2012 was relatively low. At the time of budget enactments, total state revenues for FY 2012 were projected to increase 1.9 percent.

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.

Personal Income Taxes

Personal income tax collections account for nearly 34 percent of state own-source revenues. Nine states do not levy a broad-based personal income tax.[1]

- Seventeen states reported that personal income tax collections exceeded the latest estimate. Fourteen of these states had not revised their forecasts. Arizona and Hawaii raised the target and still saw collections surpass estimates. However, Hawaii's information is skewed by a delay in 2010 personal income tax refunds. Colorado reported collections above a lowered estimate.
- Sixteen states saw collections come in on target, even though California, Iowa, Kansas, Kentucky and Rhode Island had raised their estimates. Delaware, New Mexico, New York and Oregon had reduced their estimates since the beginning of FY 2012.
- Nine states and Puerto Rico saw personal income tax collections below the target. Both Idaho and Massachusetts had revised the forecast upward and were failing to meet new projections, although collections for the first four months in Massachusetts exceeded the original benchmark.

Table 2 contains more information on personal income tax performance.

General Sales Taxes

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

- Eighteen states saw general sales tax collections exceed the revenue estimate. In 14 of these states, the forecast had not been revised. Massachusetts and Wyoming were exceeding increased estimates. Arizona and Colorado were exceeding lowered estimates.

[1] Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming do not levy a personal income tax. New Hampshire and Tennessee do not levy a personal income tax, but tax interest income and dividends. Tennessee did provide information on the performance of the personal income tax.

- Seventeen states and Puerto Rico saw collections coming in on target. Kansas and New Mexico were meeting targets that had been revised upward. California, Florida, Iowa, Kentucky, New York, Rhode Island and Washington were meeting reduced estimates.
- In 10 states, sales tax revenues were coming in below estimates. Hawaii and Idaho were failing to meet targets that had been raised, while Connecticut's revenues were below a reduced forecast.

Table 3 contains more information on general sales tax performance.

Corporate Income Taxes

On average, corporate income taxes account for about 5 percent of state tax collections. Alaska and New Hampshire, however, depend on them for more than 10 percent of collections. Six states—Nevada, Ohio, South Dakota, Texas, Washington and Wyoming do not levy a corporate income tax.

- Nineteen states saw corporate income tax receipts above estimates, including Hawaii and Idaho, which raised their forecasts. Similar to the personal income tax performance, Hawaii's information is skewed by a delay in 2010 corporate income tax refunds.
- Sixteen states saw collections coming in on target. California, Colorado, Iowa, Kentucky and New Mexico were meeting targets that had been revised upward, while Arizona, Florida, Oregon and Rhode Island had reduced their estimates.
- Corporate income tax collections were below the latest target in nine states and Puerto Rico. Massachusetts was failing to meet a target that had been raised and Delaware and New York were below a reduced estimate.

Table 4 contains more information on corporate income tax performance.

Other Taxes

States also rely on a variety of miscellaneous taxes for revenue. These include taxes on oil and gas production, real estate transfers, tobacco, meals and rooms, insurance premiums, gambling, estates and others.

- Ten states reported severance taxes performing above estimates, and in Wyoming, collections were above an increased estimate. Five states saw severance taxes coming in on target, and in three states—Michigan, Oklahoma and South Dakota—these taxes were coming in below the latest estimate.
- Seventeen states reported real estate transfer taxes coming in on target or above expectations. Only four states—Hawaii, Michigan, New Jersey and Pennsylvania—reported transfer taxes below the current forecast.
- Five states and Puerto Rico saw other miscellaneous taxes performing above estimate. Examples include tobacco taxes in Utah and rooms and meals taxes in Vermont.

- In eleven states, other tax sources were coming in on target.
- Miscellaneous tax collections were below the latest target in ten states.

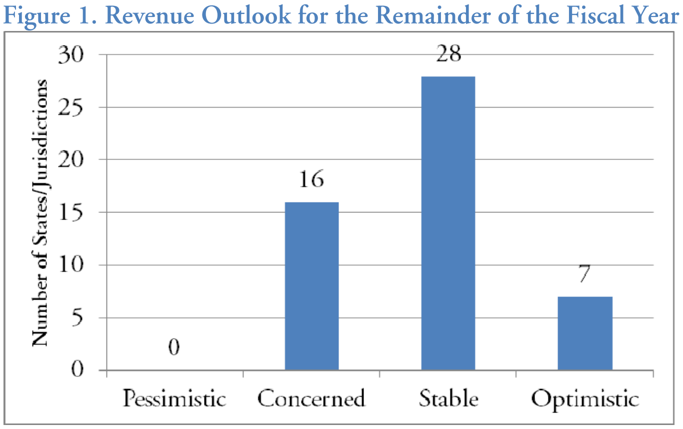
Tables 5, 6 and 7 contain more information on these taxes.

Revenue Outlook for the Remainder of FY 2012

Revenue performance is a key indicator of the 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 reminder of the budget year indicates continued improvement. Revenues are not expected to increase as much as they did last year, but they are expected to keep growing in most states.

- Twenty-seven states and Puerto Rico report that revenues are **stable** and are likely to meet FY 2012 revenue estimates (see Figure 1).
- Officials in 16 states are **concerned** about meeting their projections. Some states noted that while revenues were growing slower than projected, they were still up from the previous year.

Figure 1. Revenue Outlook for the Remainder of the Fiscal Year



- Fiscal directors in seven states 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, providing more reinforcement to the notion that state revenues are recovering.

Table 8 contains more information on the revenue outlook for the remainder of FY 2012.

Spending Overruns in FY 2012

Very few states are dealing with spending overruns so far in FY 2012. Through October, only 11 states and Puerto Rico faced spending overruns compared with 25 states at this time last year. Here are some examples:

- Four states reported overspending in social service programs. Kansas indicated that human services costs were revised upward by $58.7 million. Maine projects that its Child Development Services will request supplemental funding this fiscal year. Maryland's Department of Human Resources will need at least $143 million more to cover federal Temporary Assistance for Needy Families (TANF) overestimates, depleted reserve balances and higher caseloads for temporary cash assistance and low income energy assistance programs. Massachusetts noted that its emergency homeless shelters were over budget in FY 2012.

- Six states reported that Medicaid or other health care programs were over budget, compared with 18 states last year. Georgia indicated that its State Health Benefit Plan (for state and school employees) was over budget this fiscal year, but actions were already being taken to correct the imbalance. California officials assume that the state will be unable to achieve budget savings in Medi-Cal, the state's Medicaid program. Colorado, Maine, Maryland and North Carolina reported that their Medicaid programs had costs above the budgeted level for FY 2012.
- Colorado, Iowa and Tennessee indicated that corrections programs were over budget, with Iowa reporting a 2 percent overage on corrections spending so far this fiscal year.
- Other programs over budget include indigent defense programs in Iowa and Maine.

Table 9 contains more information on state spending overruns.

Summary of the State Fiscal Outlook for FY 2012

Table 10 in this report provides information on the current strengths and challenges facing state budgets in FY 2012.

Budget Strengths

Thirty-five states and Puerto Rico reported that revenue growth or performance was a strength so far in FY 2012.

Here are examples from officials in a few states:

- Alabama reports that growth in income and sales tax revenues has continued through September and that employment has increased slightly. Officials remain cautiously optimistic that a slow recovery will continue in FY 2012.
- In Arizona, the FY 2011 shortfall was eliminated, freeing up more than $300 million in FY 2012. Revenues continued to be relatively strong in the first quarter of FY 2012.
- Officials in Kansas report that individual income, general sales and severance taxes continue to perform above expectations and a recent cconsensus revenue estimate increased projected FY 2012 revenues.
- Massachusetts notes that strong revenue growth has continued into FY 2012, allowing for a recent $395 million upgrade in the revenue forecast.
- In Minnesota, revenues have exceeded the forecasted amount since the February forecast revision.
- Oil and gas activity is resulting in increased tax collections in North Dakota.

- Tennessee officials reported that September marked the 14th consecutive month in which total revenue collections exceeded budgeted estimates.

Other budget strengths noted by legislative fiscal directors included adequate reserves (Alaska, Maine, and Nebraska), a leveling in the corrections population (Virginia), strong agricultural growth (Iowa and South Dakota), and employment growth (Michigan, Oklahoma and Virginia).

Budget Challenges

FY 2012 budget challenges varied considerably, from declining oil production (Alaska) and transportation funding (Maine), to provider tax refunds (New Hampshire) and declining federal funds (Wyoming). Other budget challenges reported by legislative fiscal directors include debt service cost increases (Hawaii), a structural budget imbalance (Louisiana), volatile energy revenues (New Mexico), and an unemployment insurance loan repayment (South Carolina).

Fastest Growing Areas of State Budgets in FY 2012

The most significant change for FY 2012 budgets was the absence of American Recovery and Reinvestment Act (ARRA) funds. Some states reported large appropriations increases as they attempted to restore some of the spending previously supported by these federal stimulus funds. It is not surprising that the fastest growing area of state budgets was a program significantly supported by ARRA funds—Medicaid (34 states). In addition to Medicaid, officials also noted K-12 education (13 states), state employee retirement and benefits costs (10 states) and various health and human service programs (seven states) as the fastest growing areas of the budget in FY 2012.

More information on the fastest growing areas of FY 2012 budgets, reasons for the growth, and actions policymakers are taking to manage the growth will be released in a forthcoming report.

Here are additional examples from officials in several states:

- In Arkansas, Medicaid funding poses a growing challenge in FY 2012.
- In Georgia, the most critical budget challenges include increases in higher education enrollment, Medicaid and the State Health Benefit Plan.
- Challenges noted in Kansas include a possible slowing of the economic recovery, which would decrease revenue and continue to increase human services caseloads.
- South Dakota officials identified Missouri River flooding as a challenge to revenues as well as expenditures. Additionally, a statewide smoking ban continues to affect revenues from cigarette taxes and gambling revenues.
- Washington officials have had to revise forecasts downward twice, totaling $2 billion.

Table 10 contains more information on budget strengths and challenges.

Overall Fiscal Outlook

Legislative fiscal directors were also surveyed on the overall fiscal outlook for FY 2012. The outlook categories included **pessimistic**, **concerned**, **cautiously optimistic**, and **positive**. Their general message was state budgets continue to recover, albeit at a slower pace than the rapid decline that marked the beginning of the Great Recession. The following summarizes the responses.

- Fiscal directors in 23 states described their overall fiscal outlook as **cautiously optimistic** (see Figure 2). In Iowa, for example, revenues continue to grow, but the rate of growth has slowed. Officials in Mississippi noted that tax collections are meeting estimates, but estimates are for slow growth.
- Officials in 20 states and Puerto Rico are **concerned** about the overall fiscal outlook for the remainder of FY 2012. In Washington, for example, the governor has called a special session to address the projected budget shortfall.
- Seven states have **positive** fiscal outlooks for the rest of FY 2012. They are Massachusetts, Montana, North Dakota, Oklahoma, Texas, West Virginia, and Wyoming. With the exception of Massachusetts, the states in this category have large energy resource that benefit their economies.
- No state official was **pessimistic** about the fiscal outlook for the current fiscal year.

Overall Fiscal Outlook for FY 2012 (definition of terms)

A **pessimistic** outlook indicated all or nearly all fiscal indicators are weak and do not suggest a positive change in the near term. State officials that marked **concerned** were noting that there are still numerous fiscal challenges confronting their state that are worrisome to policymakers. State respondents answered **cautiously optimistic** if indicators were favorable but downward risks could change the outlook. States with a **positive** overall fiscal outlook had all or nearly all strong economic and fiscal indicators.

Figure 2. Overall Fiscal Outlook for FY 2012

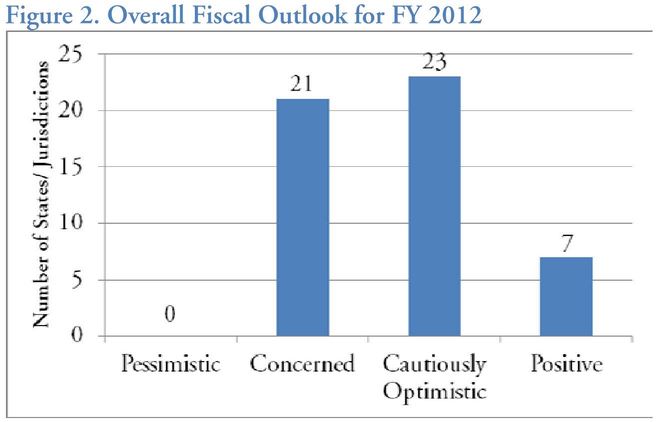


Table 11 presents the overall fiscal outlook that legislative fiscal directors provided.

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