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STATE BUDGET UPDATE: SUMMER 2012

Although the Great Recession ended three years ago, state finances have yet to enjoy a robust recovery. While there are signs of improvement, the turnaround has been slow and uneven across the nation. Moreover, the new found flexibility that lawmakers expect from improving revenues may be hobbled by mounting budget pressures. The bottom line: State budgets still face considerable challenges.

Fortunately, state budgets today are better positioned to handle these challenges. As reported by legislative fiscal directors, year-end balances are rising, with more states shoring up their rainy day funds. Revenue performance is improving and beginning to return to pre-recession levels. New budget gaps are rare and confined to a few states. State spending has remained within budgeted amounts. Overall, the economic outlook for the current fiscal year is stable for the vast majority of states.

Notwithstanding these encouraging developments, state budgets remain vulnerable to economic shocks, domestically or from international developments such as the European debt crisis. Unemployment rates remain high in many states. Already apprehensive about funding Medicaid, policymakers are concerned about implementing the federal Affordable Care Act. While the amounts and details are unknown, federal deficit reductions are expected to adversely affect state budgets. Although the full extent of these challenges has yet to be revealed, policymakers are wary.
State Year-End Balances

State year-end balances have two components: year-end closing balances and rainy day fund amounts. Looking at general fund year-end balances is one of the most common ways to assess state fiscal conditions. When shown as a percentage of general fund spending, these balances show the magnitude of state reserves and allow meaningful comparisons across states. Large year-end balances tend to indicate strong or stable fiscal conditions, while small ones can be a cause for concern, depending upon a state’s specific circumstances. Whether the balance is rising or falling from prior year levels also is important in gauging state fiscal health.

For the most part, states are projected to hold year-end balances at or above 5 percent for FY 2012 and FY 2013—the amount ratings agencies typically recommend (see figure 1). The cumulative projected balances for FY 2012 and FY 2013 show year-over-year growth, primarily driven by sizeable reserves in Alaska and Texas (more on the impacts of these two states on year-end balances can be found on page 3). However, in a majority of the states, these balances—as a percentage of general fund spending—are expected to fall from FY 2011 to FY 2012 and again from FY 2012 to FY 2013.

The rest of this section provides a snapshot of year-end balances for FY 2012 and FY 2013, along with a longer term view of these balances. More details can be found in Table 1.

FY 2012 Estimated Year-End Balances

The aggregate year-end balance, which combines general fund closing balances with rainy day funds, is estimated to rise 13.9 percent, increasing from $40.9 billion in FY 2011 to $46.5 billion in FY 2012, though this number could change when the fiscal year is officially closed.

- Ten states and the District of Columbia expect to finish FY 2012 with year-end balances of 10 percent or more. Alaska (214.3 percent), Wyoming (146.3 percent) and North Dakota (48 percent), states with strong natural resource based economies, boast the largest balances as a percentage of general fund expenditures.
- Officials in 19 states report FY 2012 year-end balances between 5.6 percent (Hawaii) and 9.3 percent (Oklahoma).
- Seventeen states expect to end FY 2012 with balances between 1 percent (New Hampshire) and 4.9 percent (Massachusetts).
- Alabama and Connecticut project to end FY 2012 with zero balances.
Officials in California and Washington currently project deficits at the end of FY 2012. In Washington, FY 2012 marks the midpoint of the biennium; the shortfall will be eliminated over the remainder of the biennium.

Thirty states expect their balances to decline from FY 2011 to FY 2012. In 10 states the drop is less than 1 percentage point, but in six others the drop is greater than 5 percentage points. Balances are forecast to rise in 20 states and the District of Columbia, although in seven states the increase is less than 1 percentage point. The large increase in Illinois (11.6 percentage points) is attributable to a negative year-end balance of $3.5 billion in FY 2011 compared to an estimated FY 2012 balance of $396 million.

**FY 2013 Projected Year-End Balances**
The aggregate year-end balance is projected to rise 17.8 percent, increasing from $46.5 billion at the end of FY 2012 to $54.8 billion at the end of FY 2013. If this projection holds, this would mark the fourth consecutive year of year-end balance growth.

- Ten states and the District of Columbia are projected to finish FY 2013 with year-end balances of 10 percent or more. Once again, the states with the largest year-end balances tend to be those with natural resource based economies.

- In 15 states, projected FY 2013 year-end balances range from 5.2 percent (Rhode Island) to 9 percent (New Mexico and South Dakota).

- Officials in 21 states expect to end FY 2013 with balances between 1.1 percent (Pennsylvania) and 4.8 percent (Utah).

- Arkansas and Illinois project balances of less than 1 percent. Alabama and Connecticut are forecast to end FY 2013 with zero balances.

- No state is expected to end FY 2013 with a deficit.

Thirty states and the District of Columbia project that their balances will decline from FY 2012 to FY 2013. In eight states the drop is less than 1 percentage point. Only four states—Alaska, Michigan, North Dakota and South Carolina—forecast a drop greater than 5 percentage points. Balances are expected to rise in 16 states; in 12 of these states the increase is less than 5 percentage points. Alabama, Connecticut, Kansas and Ohio expect no change in their FY 2013 year-end balances compared with FY 2012.

**A Longer View of Year-End Balances**
The most important external factor affecting state finances—and, consequently, year-end balances—is the national economy. The lowest levels reported in state balances during the last 30 years coincided with national economic downturns. During the recession in the early 1980s, state balances fell to 1.5 percent. They fell even further, to 0.7 percent, during the early 1990s recession. Balances fell slightly during the economic downturn that began in 2001, but not to the low levels experienced in previous decades. As the economy recovers, state finances typically improve and year-end balances tend to rise. One of the larger gains in recent history occurred after the recession that began in 2001. Aggregate year-end balances rose sharply from 3.5 percent in FY 2003 to 12 percent in FY 2006.
Year-end balances throughout the Great Recession and subsequent recovery have been more difficult to evaluate because of the influence of the American Recovery and Reinvestment Act (ARRA) on state finances (for more on the impact ARRA on state budgets please see the box on page 5). Balances declined to 4.8 percent in FY 2009, but most likely would have fallen further without these funds. Following the trough of FY 2009, year-end balances increased to 5.6 percent in FY 2010, 6.3 percent in FY 2011, 7 percent in FY 2012 and are now projected to rise to 8 percent at the end of FY 2013.

Additionally, in any given year, the fiscal situation in a handful of states might have a disproportionate affect on national totals. Two states—Alaska and Texas—hold well over half of all state rainy day fund balances, so their substantial reserves skew the national average. For example, when Alaska and Texas are omitted from the calculation, the aggregate year-end balance drops substantially to 3.5 percent in FY 2011, 4.2 percent in FY 2012 and 4.4 percent in FY 2013. Conversely, large negative year-end balances reported in California (FY 2011 and FY 2012) and Illinois (FY 2011) have the opposite effect of suppressing the national totals. When these four states are removed from the tally, the aggregate year-end balance for the remaining 47 jurisdictions is 5.7 percent in FY 2011, 5.8 percent in FY 2012 and a projected 5.1 percent in FY 2013—a more accurate representation of most state balances (see figure 2).

Figure 2. Year-End Balances as a Percent of General Fund Spending (for all jurisdictions, without AK and TX, and without AK, CA, IL and TX)
Revenue and Spending Changes in FY 2012 and FY 2013

In contrast to the unpredictability of recent fiscal years, FY 2012 has proven to be relatively stable as revenues and expenditures are only slightly higher than state budget forecasts predicted. Projected revenues and appropriations in FY 2013 also are expected to rise moderately above prior year levels. Despite these positive developments, the robust return of state revenue collections that typified previous recoveries remains elusive.1

FY 2012 Revenue Changes

FY 2012 general fund revenues increased 2.9 percent above FY 2011 levels. The original forecast estimated revenues would grow by 1.9 percent.

- Forty-four states reported year-over-year revenue growth in FY 2012. In five states, revenues grew by more than 10 percent, 14 reported growth between 5 percent and 9.9 percent while in half the states the growth was less than 5 percent.

- Six states and the District of Columbia saw year-over-year revenue declines in FY 2012, with two states experiencing drops of greater than 10 percent—North Dakota (-15.8 percent) and Wyoming (-12.5 percent). Officials in North Dakota note that the amounts reported are based on the enacted 2011-13 biennial budget and that final collections for FY 2012 are expected to exceed the estimate. In Wyoming, the decline is attributed to falling natural gas prices.

FY 2012 Spending Changes

FY 2012 general fund spending increased 3.1 percent compared with FY 2011 levels; the original forecast estimated spending to grow by 2.7 percent.

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1 Alabama provided information on its general fund and education trust fund budget. For the purposes of this discussion only the general fund is included in the analysis.
Forty-four states reported year-over-year increases in FY 2012 spending. Eight of these boosted general fund spending more than 10 percent, 19 had growth between 5 percent and 9.9 percent and 17 had growth between 0.1 percent and 4.9 percent.

Six states and the District of Columbia reported lower year-over-year general fund spending in FY 2012, with the declines ranging from -0.2 percent (Florida) to -12.5 percent (Wyoming).

FY 2013 Revenue Changes
FY 2013 general fund revenues are projected to increase 3.7 percent from FY 2012.

Forty-four states and the District of Columbia project year-over-year revenue growth in FY 2013. Of these, 36 states and the District of Columbia project revenue growth between 0.1 percent and 4.9 percent and nine states anticipate growth of greater than 10 percent. California’s projected growth rate of 10.4 percent assumes the passage of a tax initiative that would temporarily increase the sales tax and personal income tax for high-income earners.

Five states anticipate revenues to decline in FY 2013 ranging from -0.5 percent (Wyoming) to -13.5 percent (Alaska). In Alaska, the falling price of oil is the primary driver of the decline.

In Tennessee, revenues are projected to remain flat in FY 2013.

FY 2013 Spending
General fund spending in FY 2013 is projected to increase 2.4 percent over FY 2012.

General fund appropriations are expected to grow in 43 states and the District of Columbia. South Carolina (11.2 percent) is the only state forecasting spending to increase by more than 10 percent. Officials note that the growth rate is the result of additional revenues from FY 2011 and FY 2012 that were carried forward into FY 2013 appropriations. Thirteen states and the District of Columbia project spending growth between 5 percent and 9.9 percent; and 29 states project growth between 0.1 percent and 4.9 percent.

Six states reported lower year-over-year general fund appropriations in FY 2013, with the declines ranging from -0.1 percent (Delaware) to -15.9 percent (Texas). The decline in Texas is attributable to the state’s biennial budget process where the first year of the biennium (FY 2012) is front loaded.

In Mississippi, appropriations are projected to remain flat in FY 2013.

Table 2 provides further details on state general fund revenue and spending changes.

General Economic Outlook for FY 2013
Legislative fiscal directors also were surveyed on their general economic outlook for FY 2013. The outlook categories were pessimistic, concerned, stable, and optimistic. The prevailing economic outlook is one of continued growth but at a slow to moderate pace in most states.
At the same time, an air of uncertainty hangs over most economic outlooks for the new fiscal year as concerns linger over the European debt crisis, the potential impact from federal deficit reduction measures, and employment growth, to name a few. The following summarizes the responses.

- Fiscal directors in 32 states and the District of Columbia described their general economic outlook as **stable** (see Figure 3). In Maine, for example, economic forecasts have become more stable but project virtually no employment growth until calendar year 2013 and then only modest growth of less than 1 percent.

- Officials in 11 states are **concerned** about the general economic outlook for FY 2013. In New Mexico, for example, the economic recovery is stalling as employment and income growth remain slow. Moreover, the state relies substantially on transfer payments from the federal government and there are concerns about the impact of federal deficit reduction on these transfer payments. The New York forecast calls for tepid growth, with risks to the forecast coming from the European debt crisis and a potential surge in foreclosures.

- Six states have **optimistic** economic outlooks for FY 2013. They are Alabama, Iowa, Montana, Nevada, New Jersey, and North Dakota. Alabama officials report growth in both income and sales tax receipts. Officials in North Dakota report the state’s economy is expanding rapidly because of oil and gas activity, which has resulted in a growing workforce, increasing population, and expanding housing and business developments.

- No state reported a **pessimistic** economic outlook for the current fiscal year. Florida did not provide a response.

Table 4 presents the general economic outlook that legislative fiscal directors provided.

**Strengths and Challenges Affecting the FY 2013 Budget Outlook**

State general economic outlooks are influenced by the unique strengths and challenges that each possesses. Legislative fiscal directors were asked to identify these top strengths and challenges affecting their FY 2013 budget outlooks. The rest of this section summarizes their responses. Additional information can be found in Table 5 and 6.
Budget Strengths

Legislative fiscal directors identified at least 33 various issues as strengths; however, one strength—revenue growth—was by far the most frequently cited issue.

- Thirty-nine states reported that revenue growth or performance was a strength that affected their FY 2013 budget outlook. In Georgia, for example, the state recorded its eighth consecutive positive quarter of growth. In Ohio, income tax withholding grew by 4.5 percent in FY 2012 while sales tax revenue also grew strongly.

- Officials in 13 states reported reserves as a strength. Alaska reported that because of high oil prices in recent years, reserve balances are now roughly equal to three times the amount of its annual operating budget. Massachusetts officials noted the state has one of the higher reserve fund balances in the country, and lawmakers have taken steps to ensure volatile one-time revenues are dedicated to replenishing and growing the fund.

- Fiscal directors in a dozen states identified stabilizing or declining caseload growth as a strength. In Washington, caseloads are generally tracking well compared to previously budgeted levels, while in Kansas, though caseloads continue to increase, estimated growth is not as large as in previous years.

- Low or lower unemployment was reported as a strength in 11 states. In Virginia, total employment rose 0.8 percent from April 2011 to April 2012, and the unemployment rate is currently 5.4 percent, lower than the national average. In Colorado, the state continues to add jobs—albeit at a slower rate.

- Other strengths noted by legislative fiscal directors included a recovering housing market (Colorado and the District of Columbia) and strong bond ratings (Georgia).

Budget Challenges

Legislative fiscal directors identified at least 53 different challenges affecting their FY 2013 budget outlooks with Medicaid being chief among them.

- Citing rising costs or the implementation of federal health care reform, 22 states indicated Medicaid or other healthcare costs are a challenge affecting the FY 2013 budget outlook. In Connecticut, low-income adult population expansion could challenge current estimates. In Maine, FY 2013 savings initiatives are extensive and some rely on Medicaid waivers, which, if not granted, would need to be offset.

- Officials in 10 states responded that potential federal deficit reduction is an expected challenge. For Massachusetts, the uncertainty at the federal level and the impact of potential cuts to federal funding will provide the challenge of trying to maintain services without the same level of resources. Additionally, it is unclear how cuts to
defense spending will impact this relatively important segment of the state’s economy.

- Eight states reported pensions as a top issue influencing their budget outlook. In Montana, officials noted the state’s pension system is significantly underfunded.

- Eight states identified slow revenue performance as a challenge affecting their outlook, mostly because of possible outside risks affecting projections or slowing growth rates. For Nebraska, growth rates are weak relative to the historical norms of a post-recession recovery period.

- Other challenges include such issues as impending ballot measures (Alabama and California), delayed education payments (Minnesota), low energy prices (Oklahoma and Wyoming) and supplemental spending demands (Texas).

Collectively all of these strengths and challenges provide insight to what will likely occupy lawmakers during their legislative sessions in 2013 and in some instances, beyond.