Governors’ Budgets Demonstrate Caution after Consecutive Years of Sluggish Revenue Growth

Recommended budgets for fiscal 2018 are extra cautious as states contend with slow revenue growth and limited budget flexibility, in addition to substantial federal uncertainty. Under executive budget proposals, state general fund spending would increase just 1.0 percent in fiscal 2018 compared to current estimated spending levels for fiscal 2017 – the smallest increase recommended by governors since fiscal 2010, when states were in the depths of the Great Recession.

Fiscal 2016 and fiscal 2017 were marked by lackluster general fund revenue growth, resulting in numerous revenue shortfalls and requiring many states to make mid-year budget cuts in one or both years. States are forecasting modest improvement in revenue conditions in fiscal 2018, with some governors also recommending tax and fee changes. At the same time, governors’ budget proposals display a significant degree of caution as states grapple with the effects of the recent weakness in their tax collections.

States Experienced Lackluster Revenue Growth in Fiscal 2017; Modest Improvements Expected in Fiscal 2018

Fiscal 2017 revenue performance has been weaker than forecasted in states’ budget projections. General fund revenues from all sources, including sales, personal income, corporate income and all other taxes and fees, are coming in below original budget forecasts in 33 states, on target in four states and above projections in 13 states. This marks the highest number of states reporting revenues coming in below what was budgeted since fiscal 2010, and the second consecutive year where more states came in below forecast than above forecast. (See Figure 1.)

Figure 1.

<table>
<thead>
<tr>
<th>Year</th>
<th>Lower</th>
<th>On Target</th>
<th>Higher</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>12</td>
<td>36</td>
<td>9</td>
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<td>5</td>
<td>4</td>
</tr>
<tr>
<td>2017*</td>
<td>13</td>
<td>33</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: NASBO Fiscal Survey of States.

*Fiscal 2017 figures are based on estimated revenue collections as of spring 2017.
Sales tax collections – typically considered a relatively stable revenue source – are estimated to be $6.6 billion (2.5 percent) below budgeted levels for fiscal 2017. Personal income tax collections are estimated at $2.7 billion (0.8 percent) below forecast and corporate income tax collections are coming in $2.8 billion (5.7 percent) below projections. Data were collected prior to April tax collections coming in, so some of these figures may have changed. Preliminary reports and analyses indicate that many states have seen April personal income tax (non-withholding) revenues decline compared to the same month a year ago. Analysts attribute this – at least in part – to high-income taxpayers shifting income to next year, guided by an expectation of federal tax cuts for calendar year 2017.

A number of factors have contributed to the overall weakness in state tax collections over the past couple of years. Energy-producing states have encountered challenging revenue conditions due to the steep decline in oil and gas prices, as well as declining coal production. Sales tax collections have been especially weak, in part due to low inflation and a greater portion of economic activity falling outside the sales tax base of many states. While steady job growth has helped the withholding component of personal income taxes, other components like capital gains have been highly volatile, and corporate income tax collections are estimated to have declined outright for the second year in a row in fiscal 2017. Not all states have been equally affected by this softening in tax collections. From fiscal 2015 to fiscal 2017, 10 states saw their general fund revenues decline. However, over that same two-year period, eight states saw general fund revenues increase by more than 10 percent.

Overall, general fund revenues grew 1.8 percent in fiscal 2016, are estimated to grow 2.4 percent in fiscal 2017, and projected to increase 3.1 percent in fiscal 2018. Forty-seven states are projecting positive general fund revenue growth in fiscal 2018. The improved revenue situation expected for fiscal 2018 reflects continued job growth and signs of modest recovery in energy-producing states. In addition, governors in some states recommended tax and fee changes in fiscal 2018 such as increasing sales tax collections through rate hikes or base broadening, as well as increases in cigarette taxes, gas taxes, and other more targeted taxes. Compared to estimated fiscal 2017 collections, fiscal 2018 sales tax revenues are forecasted to grow 2.7 percent and personal income tax collections are projected to be 4.1 percent higher. (See Figure 2.)

Figure 2.

ANNUAL GENERAL FUND REVENUE PERCENTAGE CHANGE
BY FISCAL YEAR

Weak Revenue Performance in Fiscal 2017 Led At Least 23 States to Make Net Mid-Year Budget Cuts

Since almost all states are required to balance their budgets and few are permitted to carry over a deficit, budget shortfalls that arise during the fiscal year are addressed primarily by reducing previously appropriated spending. In fiscal 2017, 23 states reported net mid-year budget cuts totaling $4.9 billion. All of these states also reported general fund revenue collections for fiscal 2017 coming in below original budget projections. Twenty-three states reporting net mid-year budget cuts is a historically high number outside of a recessionary period. (See Figure 3.) At the time of data collection, some states were still making budget adjustments that could result in additional spending reductions before the end of the fiscal year.

Fiscal 2018 Budgets Projected to Grow Just 1 Percent Based on Governors’ Recommendations

State budgets are projected to increase just 1.0 percent in fiscal 2018 according to governors’ recommended budgets, the lowest nominal growth rate for general fund spending since fiscal 2010, when general fund spending declined due to the economic downturn and significant federal stimulus funds were provided to mitigate the full impact of that decline. State general fund spending is projected to be $828 billion in fiscal 2018 according to governors’ recommended budgets, compared to an estimated $819 billion in fiscal 2017. Overall, 15 governors called for nominal general fund spending decreases in fiscal 2018, signifying the fiscal difficulties a number of states face, particularly after two years of weak revenue growth.

Estimated general fund spending increased by 4.8 percent in fiscal 2017, the highest rate of growth since before the Great Recession, helping total general fund spending surpass its pre-recession peak level in fiscal 2008 for the first time in real terms, adjusted for inflation. 1 (See Figure 4.) However, total general fund spending growth in fiscal 2017 is driven heavily by an anomaly related to Illinois’s unique budget situation; excluding Illinois, general fund spending growth is estimated at a more moderate 4.1 percent. Total general fund spending growth for fiscal 2017 may also come in lower than these estimates once final data are available. Twenty-four states report estimated expenditures for fiscal 2017 that are still below their inflation-adjusted fiscal 2008 levels. 2

Figure 3.

Budget Cuts Made After the Budget Passed, Fiscal 1990 to Fiscal 2017

Source: NASBO Fiscal Survey of States

* Mid-year budget adjustments for fiscal 2017 are estimated and subject to change.
Governors have recommended extremely modest general fund spending increases in fiscal 2018, totaling only $8.7 billion across all programs – far lower than the $23.9 billion recommended by governors in their fiscal 2017 budgets. Most additional budget dollars are targeted at K-12 education, the largest category of state general fund spending, which would receive a $6.1 billion funding boost on net under governors’ budget proposals. Medicaid, the second largest component of state general fund spending, would only see a $1.6 billion increase in general fund spending, though this figure is largely driven downward by a fund accounting change in Ohio.

Governors also recommended a moderate net spending increase for corrections, as well as slight net increases for higher education and public assistance. Additionally, transportation would see a small bump in general fund spending; however, since most states rely primarily on other fund sources to finance transportation spending, general fund spending adjustments are not necessarily reflective of overall recommended state spending changes for transportation. Governors recommended a net decline in general fund spending for all other program areas totaling -$1.1 billion. (See Figure 5.)

Source: NASBO Fiscal Survey of States; Fiscal 2018 figure is based on governors’ recommended budgets. *Aggregate spending level in fiscal 2017 is estimated to surpass inflation-adjusted fiscal 2008 level ($807 billion) for the first time.
Governors Propose a Net Tax and Fee Increase of $3.7 Billion in Fiscal 2018

Governors are proposing a net tax and fee increase for fiscal 2018. As has been the case in recent years, governors were more likely to recommend tax hikes on general sales, cigarette and tobacco products, motor fuels, and alcoholic beverages, while recommending mostly reductions for personal and corporate income taxes. Fifteen states are proposing net tax increases of $4.9 billion, while 12 are proposing net decreases totaling $1.2 billion, resulting in a net tax and fee increase of $3.7 billion. (See Figure 6.) This net change is driven primarily by tax increases recommended by the governors of Oklahoma, Pennsylvania, and Washington State, which total $3.2 billion combined.

In addition to tax and fee changes, governors also recommended $4.8 billion in revenue measures for fiscal 2018; more than half of this total is accounted for by the Alaska governor’s proposed restructuring of the Alaska Permanent Fund. Revenue measures enhance or reduce general fund revenues but do not affect taxpayer liability.

Medicaid Spending Growth Outpacing Revenue Growth; States Start to Share in Medicaid Expansion Costs

Median general fund spending on Medicaid grew 2.7 percent in fiscal 2016 and is estimated to increase 5.2 percent in fiscal 2017, outpacing median general fund revenue growth of 2.4 percent in fiscal 2016 and 2.5 percent in fiscal 2017. Median Medicaid spending growth from all funds was 5.0 percent in fiscal 2016 and estimated at 5.3 percent for fiscal 2017. For fiscal 2018, the median growth rates projected in governors’ budgets for Medicaid are 3.5 percent from all funds, 4.8 percent for general fund spending, flat spending from other state funds, and 3.6 percent from federal funds.

For the first time in the Fiscal Survey of States, states that expanded Medicaid were also asked to report on their expenditures for the new adult eligibility group (including both “newly eligible” and “not newly eligible”), broken down by fund source. On January 1, 2017, states began paying five percent of the costs for newly eligible adults; under current law, the state share is set to gradually phase up to 10 percent by 2020. As states start picking up a larger share of the cost, states begin picking up a larger share of the cost,

Figure 6.

### SUMMARY OF RECOMMENDED STATE REVENUE CHANGES

<table>
<thead>
<tr>
<th>Category</th>
<th># of States Proposing Increases</th>
<th># of States Proposing Decreases</th>
<th>Net Change ($ in Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SALES TAX</td>
<td>8</td>
<td>7</td>
<td>+$1,685</td>
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<tr>
<td>PERSONAL INCOME TAX</td>
<td>5</td>
<td>12</td>
<td>-$1,205</td>
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<tr>
<td>CORPORATE INCOME TAX</td>
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<td>9</td>
<td>-$153</td>
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<tr>
<td>TOBACCO/CIGARETTE TAX</td>
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<td>+$791</td>
</tr>
<tr>
<td>MOTOR FUEL TAX</td>
<td>4</td>
<td>0</td>
<td>+$726</td>
</tr>
<tr>
<td>ALCOHOL TAX</td>
<td>4</td>
<td>0</td>
<td>+$104</td>
</tr>
<tr>
<td>OTHER TAX</td>
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</tr>
<tr>
<td>FEES</td>
<td>7</td>
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<td>+$134</td>
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Source: NASBO Fiscal Survey of States
Medicaid expansion spending from state funds (general funds plus other state funds) is estimated to total $6.2 billion in fiscal 2017 and $8.5 billion in fiscal 2018, compared to $4.5 billion in fiscal 2016. Federal funds for expansion increased from $74.1 billion in fiscal 2016 to an estimated $80.9 billion in fiscal 2017, and are projected to be $83.3 billion in fiscal 2018. (See Figure 7.) NASBO’s most recent State Expenditure Report provides details on total state Medicaid spending (including spending on expansion), broken down by fund source. In fiscal 2016, states spent $216 billion (39 percent) from state funds – which includes $158 billion in general funds and $58 billion in other state funds – and $342 billion (61 percent) in federal funds on Medicaid, for a total of $558 billion. (See Figure 8.) States continue to closely watch federal legislative efforts to repeal and replace the Affordable Care Act and reform the traditional Medicaid program funding structure.

Most States Continue to Strengthen Rainy Day Funds, Despite Slow Revenue Growth

Rainy day fund balances are a crucial tool that states heavily rely on during fiscal downturns and to address shortfalls. State balances in rainy day funds are estimated to remain relatively flat overall for the current fiscal year. Excluding Georgia and Oklahoma, which were not able to provide rainy day fund balance data for all three fiscal years, total rainy day fund balances for fiscal 2017 are estimated at $49.6 billion, compared to $49.7 billion in fiscal 2016. States are projecting a roughly $4 billion increase in rainy day fund balance levels in fiscal 2018, with governors’ budgets recommending balance levels totaling $53.5 billion; California’s projected balance increase of $2.7 billion accounts for about two-thirds of this expected growth. (See Figure 9.)

Governors continue to prioritize rainy day fund savings accounts to prepare their states for a future downturn or other unforeseen circumstances, in spite of recent weakness in revenue collections. States have made significant progress in bolstering their reserve funds since the Great Recession, when rainy day fund balances fell to $21.0 billion in fiscal 2010 (or just $3.0 billion when excluding Alaska and Texas). Rainy day fund balance levels vary considerably across states, with

* Under the Affordable Care Act, the federal government agreed to cover 100 percent of costs for newly eligible adults under Medicaid expansion until January 1, 2017, when states began paying five percent of those costs. The state share is set to gradually phase up to 10 percent by 2020 under current law.

Source: NASBO Spring 2017 Fiscal Survey of States

Figure 7.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Federal Funds</th>
<th>State Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal 2017</td>
<td>$74B</td>
<td>$88B</td>
</tr>
<tr>
<td>Fiscal 2018</td>
<td>$83B</td>
<td>$80B</td>
</tr>
</tbody>
</table>

Figure 8.

TOTAL STATE SPENDING ON MEDICAID
FISCAL 2016

Federal Funds $342B
State Funds $216B

Source: NASBO State Expenditure Report
a projected median of 6.0 percent as a share of general fund expenditures in fiscal 2018. (See Figure 10.) Twenty-seven states estimate increases in their rainy day fund balances in fiscal 2017, while 13 states reported decreases. For fiscal 2018, 28 states recommend increasing their rainy day fund balances, while just seven states propose declines.

States’ total balances – which include rainy day fund balances as well as general fund ending balances (both reserved and unreserved) - reached $80.8 billion in fiscal 2016, but are estimated to have declined to $69.4 billion in fiscal 2017, as some states drew down on their prior-year ending balances to help meet spending demands and close budget gaps while facing lackluster, lower-than-projected revenue growth. For fiscal 2018, governors’ budgets estimate that total balances will decline slightly further to $67.6 billion.

Source: NASBO Fiscal Survey of States

*FY 2017 and 2018 totals exclude Georgia and Oklahoma
Outlook: Spending Growth Constrained in Fiscal 2018 Budgets, with Uncertainty Ahead

Coming out of two consecutive years of widespread weakness in tax collections, states are approaching fiscal 2018 with caution. Governors proposed nominal general fund spending growth of just 1.0 percent for fiscal 2018 compared to estimated fiscal 2017 spending levels, though states’ enacted spending levels may come in slightly above this projection. NASBO’s Fall 2017 Fiscal Survey of States will provide an update on state fiscal conditions based on fiscal 2018 enacted budgets. Looking ahead, budget conditions are likely to remain tight as states contend with rising spending demands for pensions, health care, and other fixed costs, modest revenue growth, and federal uncertainty, while they also work to bolster their savings accounts to prepare for the next economic downturn.

1 In NASBO’s Spring 2016 Fiscal Survey of States, estimated general fund spending for fiscal 2016 was determined to slightly exceed the aggregate fiscal 2008 level after adjusting for inflation. However, actual general fund spending for fiscal 2016, as first reported in NASBO’s Fall 2016 Fiscal Survey, came in lower than previously estimated, and no longer exceeded the fiscal 2008 threshold in inflation-adjusted terms.

2 The state and local government implicit price deflator cited by the Bureau of Economic Analysis National Income and Product Account Tables, Table 3.9.4., Line 33 (last updated on April 28, 2017), is used for inflation adjustments. Quarterly averages are used to calculate fiscal year inflation rates.

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