State General Fund Budgets Finally Surpass Pre-Recession Levels after Adjusting for Inflation

Most state budgets continue to grow at a moderate pace after several years of slow recovery in the national economy following the Great Recession. For the first time, estimated state general fund spending and revenues in fiscal 2016 surpassed their fiscal 2008, pre-recession peak levels in real terms, after adjusting for inflation. States were finally able to reach this milestone after eight years due to estimated general fund spending for fiscal 2016 growing by its highest rate since before the recession. However, progress has been uneven across states due to a combination of factors, such as population and demographic changes, regional disparities in the Great Recession’s impact and recent economic performance, the negative impact of declining oil prices on energy-producing states, and differing fiscal policies. Though aggregate, 50-state, general fund expenditures and revenues have reached their pre-recession peak levels, after adjusting for inflation, 29 states fiscal 2016 general fund expenditures remain below fiscal 2008 figures and 23 states report general fund revenues lower than their fiscal 2008 levels.

While state fiscal conditions have largely stabilized in recent years, long-term spending pressures in areas such as health care, education, pensions and infrastructure continue to pose challenges for many states that will require difficult budgetary decisions. With slower revenue growth expected to continue in the upcoming fiscal year, governors’ proposed budgets for fiscal 2017 are cautious, recommending modest spending increases for core government services.

ANNUAL GENERAL FUND SPENDING

*Fiscal 2017 spending is based on governors’ proposed budgets.

**For the first time, real aggregate spending levels in fiscal 2016 surpassed the pre-recession peak level of fiscal 2008, which was equivalent to $789 billion after adjusting for inflation.
Total General Fund Spending Grew 5.5 Percent in Fiscal 2016, but Most State Budgets Grew Slower Than the Average

In fiscal 2016, general fund expenditures are estimated to have increased by 5.5 percent, the highest rate of growth since before the Great Recession and in line with the historical average since NASBO began collecting Fiscal Survey data in 1979. However, this growth rate is partially driven by significant one-time spending increases and technical adjustments in several large states. Most states saw general fund spending growth below this average, with the median growth rate across all 50 states a more modest 3.8 percent in fiscal 2016.

After six consecutive years of budget growth, estimated general fund spending for fiscal 2016 for the 50 states combined has finally surpassed the pre-recession peak in real terms, meaning after accounting for inflation. At an estimated $797.7 billion, fiscal 2016 general fund spending exceeds the previous inflation-adjusted peak in fiscal 2008 of roughly $789 billion by about 1.2 percent.

Revenue Growth Slows Down in Fiscal 2016 after Strong Performance in Fiscal 2015

Most states saw revenue growth accelerate in fiscal 2015, partially due to the strong stock market performance in calendar year 2014, with total general fund revenues having increased 4.9 percent. Meanwhile, general fund revenue performance in fiscal 2016 has been more modest, with an average growth rate of 2.8 percent. Thirty-two states estimate positive general fund revenue growth of less than five percent, while 10 states estimate growth greater than five percent. The remaining eight states estimate general fund revenue declines, with most of these being energy-producing states. At the time of data collection, 24 states reported general fund revenue collections coming in above original budget projections, 19 states were below projections, and seven states were on target.

Despite modest revenue growth, estimated general fund revenues in fiscal 2016 are on track to surpass the pre-recession fiscal 2008 peak in real terms for the first time. Fiscal 2008 general fund revenues totaled roughly $780 billion in inflation-adjusted terms, compared to $787 billion in general fund revenues estimated for fiscal 2016.

Revenue growth is expected to remain limited in fiscal 2017. Recommended budgets show revenue collections are projected to total $810.1 billion in fiscal 2017, reflecting an increase of 2.9 percent. The two largest state revenue sources – sales taxes and personal income taxes – together make up more than 70 percent of general fund revenues. According to governors’ proposed budgets, sales tax revenues are projected to grow 4.4 percent and personal income tax revenues are expected to increase 3.9 percent in fiscal 2017.

**With Limited Revenue Growth Expected, Governors Recommend Modest Spending Increases in Fiscal 2017**

Governors in 43 states have called for higher general fund spending in their fiscal 2017 budget recommendations compared to fiscal 2016 estimated levels. However, new spending is expected to be constrained by limited revenue growth, with few additional budget dollars available to address competing spending demands. Once again, governors’ proposed budgets for fiscal 2017 direct most additional dollars to boost funding for K-12 education and Medicaid, the two largest areas of state general fund expenditures. Thirty-six states proposed spending increases for K-12 education and 32 states proposed increases for Medicaid, for net increases of $8.9 billion and $7.6 billion, respectively. Spending increases were recommended for all other program areas of the budget in fiscal 2017 as well.

**States Again Made Minimal Mid-Year Budget Cuts in Fiscal 2016**

State budget gaps that arise during the fiscal year are primarily solved through a reduction in previously appropriated spending. Mid-year budget cuts have subsided compared to the years immediately following the recession, when states had to make substantial cuts and take other actions, such as expend rainy day funds, to balance their budgets. Similar to recent years, mid-year budget reduction amounts were minimal in fiscal 2016, with 18 states making net mid-year budget cuts totaling $2.2 billion. While the number of states with net mid-year budget cuts in fiscal 2016 was higher than has been
observed in recent years, the total amount of budget reductions remained relatively small. Also, mid-year budget reductions do not always reflect fiscal stress or even true spending cuts, but sometimes result from changing spending priorities, revised caseloads, or fund transfers or other technical adjustments. In sharp contrast to fiscal 2009, 2010 and 2011, states have enacted minimal mid-year cuts over the last several fiscal years, indicating that states’ fiscal situations have stabilized, and most states are successfully adapting to the current economic and budgetary environment.

Governors Recommend a Mix of Tax Increases and Decreases in Fiscal 2017

Similar to last year, governors recommended a mix of tax increases and decreases in their fiscal 2017 budgets. Thirteen states proposed net tax and fee increases, while 15 states proposed net decreases, resulting in a recommended net tax increase of $3.2 billion. This net change is primarily driven by $2.7 billion in tax increases recommended by the governor of Pennsylvania, as well as a $1.2 billion sales tax increase in Louisiana. Meanwhile, Ohio’s continued phase-in of personal income tax cuts accounted for the largest tax decrease. States again were more likely to propose tax increases on general sales, cigarettes, motor fuel, and alcohol, while more states proposed tax decreases on personal income and corporate income.

While Some States Tapped Reserves to Smooth Revenue Volatility, Most Continue to Bolster Rainy Day Funds

Total balances include ending balances and the amounts in states’ budget stabilization or “rainy day” funds. Total balances reached a recent low in fiscal 2010 due to the severe decline in revenues and rise in spending demands linked to the Great Recession. Since that time, states have made significant progress rebuilding their reserves. In fiscal 2015, total balances reached an all-time high in actual dollars, resulting in part from larger-than-anticipated ending balances as revenue collections came in above budget projections in most states. After rising to $77.7 billion or 10.3 as a percentage of general fund expenditures in fiscal 2015, total balances are estimated to have declined to $68.9 billion or 8.9 as a percentage of expenditures in fiscal 2016. For fiscal 2017, governors’ budgets project that total balances will decline slightly to $65.7 billion.

While total balances declined this fiscal year, balances in states’ rainy day funds – set aside specifically to respond to an economic downturn or other unforeseen event – increased from $45.1 billion in fiscal 2015 to an estimated $49.3 billion in fiscal 2016. This increase occurred despite Alaska’s continued drawdown of its large budget reserves in response to falling oil prices. Since rainy day fund balances fell to $21.0 billion in

<table>
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<th>Revenue Type</th>
<th># of States Recommending Increases</th>
<th># of States Recommending Decreases</th>
<th>Net Change ($ in millions)</th>
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<tr>
<td>Sales Tax</td>
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<td>Alcohol Tax</td>
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</table>
fiscal 2010 (or just $10.7 billion when excluding Alaska), states have made significant progress in bolstering their rainy day funds. In fiscal 2016, 25 states increased their rainy day fund balances, while eight states reported decreases. For fiscal 2017, 27 states have recommended increasing their rainy day fund balances, while just six states project declines.

**Conclusion: State Fiscal Conditions Are Stable Overall, but Progress is Uneven and Challenges Remain**

State fiscal conditions have significantly improved and largely stabilized since the tough years during and immediately following the Great Recession. In fiscal 2016, for the first time, general fund spending and revenue levels in the aggregate are estimated to have finally surpassed their pre-recession peaks, after adjusting for inflation. However, many individual states still report general fund expenditures and revenues below their fiscal 2008 levels in real terms. Looking ahead, states across the country continue to face budgetary challenges, including: spending requirements on K-12 education, health care and other core service areas growing faster than state revenues; unfunded pension liabilities; a pent-up need for infrastructure investment; and the fiscal and economic impacts of declining oil prices. With slow revenue growth expected to continue in fiscal 2017, governors are recommending mostly modest spending increases for the next fiscal year, with many also calling for increasing rainy day fund balances to help prepare for the next economic downturn.

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