States Enacted Cautious Budgets for Fiscal 2018 Following Two Consecutive Years of Sluggish Revenue Growth

Building and adopting fiscal 2018 budgets proved an especially challenging task for many states during 2017 legislative sessions, requiring a number of them to call special sessions to deal with their spending plans, and leading 11 states to start the fiscal year without a fully enacted budget and two states to go well into the fiscal year before fully completing their budgets. Enacted budgets reflect substantial limitations and caution on the part of policymakers as states contend with the effects of two consecutive years of sluggish revenue growth and particular spending pressures. State general fund spending is projected to grow 2.3 percent in fiscal 2018 compared to fiscal 2017 spending levels, the lowest spending increase since fiscal 2010, when state spending declined during the Great Recession. The median growth rate is even lower, at 1.7 percent. At the same time, most states are forecasting moderate improvements in their general fund revenue collections in fiscal 2018, with total growth of 4.0 percent and a median growth rate of 3.2 percent. Roughly a quarter of this revenue growth can be attributed to tax and fee increases and other revenue measures enacted by states in the 2017 legislative session. Many states are also continuing to strengthen their reserves, despite the recent revenue slowdown, while others have turned to their rainy day funds to help address shortfalls.

Figure 1.

ANNUAL GENERAL FUND EXPENDITURE GROWTH (%)

Source: NASBO Fiscal Survey of States; Fiscal 2018 figure is based on states’ enacted budgets.
Most States Enacted Budgets with General Fund Spending Growth Below 2 Percent in Fiscal 2018

In fiscal 2018, state resources remain tight as policymakers wrestle with the impacts of the recent weakness in their tax collections. Some states are also working to restore structural balance after facing revenue shortfalls over the past couple years. According to enacted budgets, state general fund spending is forecast to total $830.2 billion in fiscal 2018, representing a 2.3 percent increase compared to preliminary actual spending levels for fiscal 2017. (See Figure 1.)

Overall, 26 states enacted budgets with general fund spending growth below 2 percent in fiscal 2018, and the median growth rate for all 50 states was just 1.7 percent. Though only five states forecast general fund revenue declines in fiscal 2018, 15 states enacted general fund spending declines. Among the states that budgeted for spending declines, some are energy producers that continue to contend with fiscal challenges related to the weakening of the industry, while others are in areas of the country where economic, population and job growth is underperforming the national average. Only 11 states enacted general fund spending increases of greater than 4 percent, a modest threshold by historical standards; most of these states are in the faster-growing regions of the Southeast and West. Several other states with faster spending growth, including Connecticut, Illinois and Kansas, passed significant tax hikes to help address long-term fiscal challenges and rising spending demands. (See Figure 2.)

Slow revenue growth coupled with rising spending requirements for areas such as pensions, health care, and elementary and secondary education translated into limited budget flexibility for states coming into this fiscal year. For fiscal 2018, states approved general fund appropriation increases totaling $12.7 billion across all program areas compared to fiscal 2017 enacted budget levels. This amount is only about half of the total program area spending increases enacted last year ($25.8 billion, as reported in NASBO’s Fall 2016 Fiscal Survey of States), and demonstrates states’ fiscal constraints and cautious budget approach after two
consecutive years of sluggish revenue growth. (See Figure 3.) The limited new funds in fiscal 2018 were mainly directed to K-12 education – the largest single portion of state general fund spending; 38 states enacted spending increases for K-12, with 10 enacting decreases, resulting in a net increase of $8.6 billion. For Medicaid, the second largest general fund spending category, 30 states enacted increases while 17 states enacted decreases, with a net increase of $2.6 billion – however, this figure would rise to be $5.2 billion absent a large shift in spending from the general fund to other state funds for Medicaid in Ohio resulting from a tax law change to conform to federal requirements. States also enacted net increases in general fund spending for higher education, corrections, public assistance, and transportation, with a net decrease in spending in the “all other” category. Budget decreases do not always represent true spending cuts, as they may sometimes reflect caseload changes, fund transfers, or other technical adjustments.

### Sluggish Revenue Performance in Fiscal 2017 Helped Drive 22 States to Make Net Mid-Year Budget Cuts

Lackluster revenue performance in fiscal 2017 was the primary cause for 22 states making net mid-year budget reductions totaling $3.5 billion in fiscal 2017, marking the highest number of states reporting net mid-year cuts since fiscal 2010. (See Figure 4.) The vast majority of states cannot end the fiscal
year without a deficit, while a few states are permitted to do so under certain conditions. Shortfalls that arise during the fiscal year are addressed primarily by reducing appropriated spending. Most of the states making mid-year budget cuts also reported that general fund revenue collections came in below projections. However, in a few states, the mid-year reductions were not due to a revenue shortfall or other source of fiscal stress; rather, they reflected budget adjustments due to lower than expected costs, timing of transfers or other technical changes, or creating resources for an upcoming fiscal year.

General fund spending increased by a modest 3.5 percent in fiscal 2017, considerably lower than the 4.8 percent growth rate previously estimated in NASBO’s Spring 2017 Fiscal Survey, in part due to these mid-year budgetary actions. (A change in how Illinois reported on its fiscal 2017 expenditures also contributed to the disparity.) Despite these mid-year reductions, aggregate general fund spending in fiscal 2017 surpassed pre-recession fiscal 2008 levels in inflation-adjusted terms for the first time, but just barely. (See Figure 5.) However, budget conditions continue to vary significantly across states. In fiscal 2017, 27 states still reported general fund spending levels below their fiscal 2008 levels in real terms, with 11 states more than 10 percent below their pre-recession levels, while at the same time, eight states reported general fund spending last year exceeding their fiscal 2008 inflation-adjusted levels by more than 10 percent.

**Moderate Revenue Growth Forecasted in Fiscal 2018, After Weak Tax Collections Over the Past Couple of Years**

General fund revenue collections are projected to grow moderately in fiscal 2018 according to states’ enacted budgets, following two consecutive years of sluggish performance. Forty-five states forecast revenue increases for fiscal 2018. Enacted budgets for fiscal 2018 estimate general fund revenues totaling $829.6 billion, a 4.0 percent increase over preliminary actual collections for fiscal 2017. (See Figure 6.) The median growth rate for fiscal 2018 is lower at 3.2 percent, in part because the total growth rate is driven by a nearly 19 percent increase in Illinois following two consecutive years of revenue declines during the state’s budget impasse.

States experienced two consecutive years of lackluster revenue growth, with general fund revenues growing 2.3 percent in fiscal 2017 and 1.8 percent in fiscal 2016. General fund revenues declined outright in eight states in fiscal 2017, after declining in 14 states in fiscal 2016. For the second year in a row, more states saw revenues come in below than above original forecast, with 27 states reporting that preliminary actual general fund revenue collections came in under budget.
projections in fiscal 2017. (See Figure 7.) Most states reported collections below the original budget estimates for personal income, sales, and corporate income taxes. For sales and corporate income taxes, this is the second consecutive year that collections were below budget for most states. Numerous economic factors have contributed to the recent weakness in state tax collections, including: extremely low inflation and slow wage growth; a greater portion of economic activity falling outside the sales tax base of many states; continued weakness in the energy and agricultural sectors; possible changes in taxpayer behavior with respect to non-wage income in anticipation of future lower rates at the federal level; and slower-than-expected economic growth overall.

**Tax and Fee Hikes in Some States Contribute to Fiscal 2018 Revenue Growth**

Roughly a quarter (one percentage point) of the aggregate 4.0 percent general fund revenue growth forecasted in fiscal 2018 can be attributed to tax and fee changes and revenue measures enacted by states. Twenty-one states enacted net increases in

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taxes and fees in fiscal 2018, while 13 states enacted net tax and fee decreases, resulting in a net increase of $9.9 billion for the current fiscal year for all states funds, including $5.7 billion in additional general fund revenues. (See Figure 8.) This marks the largest 50-state tax increase since fiscal 2010. Eighteen states also adopted various revenue measures for fiscal 2018 that are estimated to increase general fund revenues by $1.9 billion, while reducing other funds by $0.5 billion. Revenue measures generally do not affect taxpayer liability, and include actions to enforce existing laws, tax amnesties, additional audits and compliance efforts.

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. When NASBO last conducted its Budget Processes in the States survey in fall 2014, 47 states reported having at least one budget stabilization fund or reserve account established to supplement general fund spending during a revenue downturn or other unanticipated shortfall (if the specific restrictions on the use of the fund are met). However, in the last couple of years, the three remaining states – Arkansas, Kansas and Montana – have each taken steps to create a separate rainy day fund. Other states have also taken deliberate policy actions recently to strengthen their reserves such as refining methods of deposit and tying target fund size to revenue volatility. These recent developments help demonstrate that building up reserves has been regarded as a priority at the state level since the Great Recession.

This trend can also be observed by looking at state rainy day fund balances. From fiscal 2011 to fiscal 2017, the median rainy day fund balance went from 1.9 percent of general fund spending to 5.4 percent. Based on enacted budgets for fiscal 2018, total rainy day fund balances are expected to grow in
dollar terms, though the median as a share of expenditures falls slightly to 5.3 percent. Twenty-six states forecast higher rainy day fund balance levels by the end of this fiscal year relative to last year, and eight states are budgeting decreases. In fiscal 2017, 28 states boosted their rainy day fund balances, while 12 states recorded declines. Many of the declines occurred in energy-producing states whose tax revenues and economies have been impacted by declining oil and gas prices and coal production, leading them to tap their reserves to help fund government services. Alaska, by far the most reliant on severance tax revenues, saw its rainy day fund balance drop by $10.9 billion from fiscal 2014 to fiscal 2017, and is projecting another $2.3 billion decline in fiscal 2018. In all, 17 states reported using their rainy day funds as a budget management strategy in fiscal 2017, and 10 states used or plan to use them in fiscal 2018. Nevertheless, most states have managed to strengthen their rainy day fund balances in recent years, despite slow revenue growth. (See Figure 9.)

Outlook: Stable but Tight Fiscal Environment in States Likely to Continue

Looking ahead, fiscal 2018 budgets expect revenues to improve alongside moderate economic growth. While still early in the fiscal year, most states reported their general fund revenue collections coming in on target or above budget forecast for fiscal 2018. The recent growth in the stock market may help state revenues and pension funds, though taxpayer behavior may contribute to continued weakness in non-withholding income tax collections due to the potential for federal tax cuts. At the same time, fixed costs for items such as pension contributions and health care continue to grow faster than revenues, meaning limited budget flexibility at the state level. Variation in fiscal conditions across states will also persist, tied to differences in demographic trends, economic performance, and state policies. States also continue to face uncertainty with respect to the federal budget and tax policy changes that can have numerous implications for state budgets in both the short and longer terms.


3 Adjusted for inflation, the aggregate general fund spending amount in fiscal 2008 was $810.9 billion, 0.1 percent below the $811.6 billion preliminary actual figure for fiscal 2017 reported in this survey. 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 October 27, 2017), is used for inflation adjustments. Quarterly averages are used to calculate fiscal year inflation rates.

4 For more details on states’ budget stabilization or rainy day funds, see NASBO’s *Budget Processes in the States* report (2015), Table 14.

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If you would like additional information, please contact Kathryn Vesey White ([kwhite@nasbo.org](mailto:kwhite@nasbo.org) or 202-624-5949).