
GUBERNATORIAL TRANSITIONS & **THE STATE BUDGET**



“STATE GOVERNMENT: IT’S ALL ABOUT THE BUDGET.”

*Fred Klass, former Chief Operating Officer,
California Department of Finance*



The state budget is the de facto statement of the Governor’s policies. Transitions to new leadership can mean shifting gears to different policy and budget priorities. This document provides an overview of four key issues of focus with the state budget.

1 TAKE IMMEDIATE CONTROL OF THE BUDGET

A top priority during transition should be understanding the budget. The state's budget is one of the most important overall documents that sets priorities and directs state policy. By directing where the state's money is spent, the budget is in effect the state's financial plan — and very importantly, the state's de facto strategic plan. Due to the budget's importance, Governors and their staffs should spend time immediately after the election understanding the fiscal situation in the state and the state's budget process.

A Key Tool. The budget is the primary tool a new Administration has available to emphasize the Governor's immediate priorities and to turn campaign ideas into action items. The budget allows the Governor's priorities to be placed at the top of the state's agenda through the allocation of resources. The first budget of a Governor is an opportunity to articulate and signal the most important goals and to set a path for consideration of a Governor's plans by the legislature.

Time is Critical. Since the time is short between the election and presentation of a budget recommendation

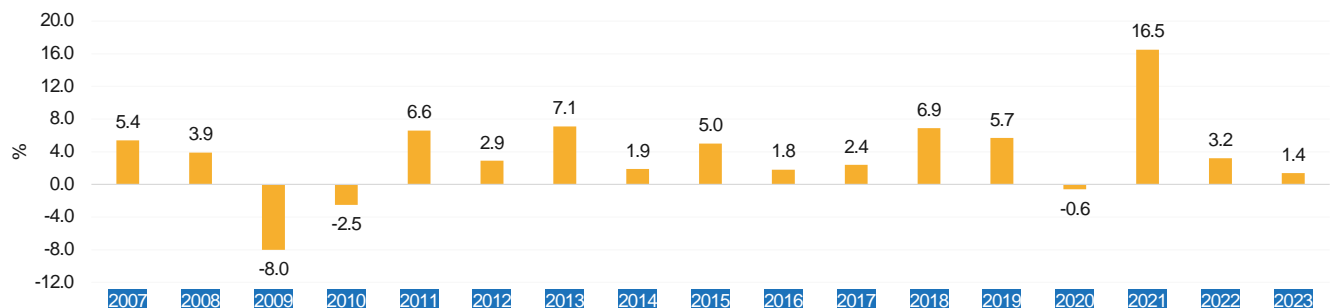
to the legislature, adequate time should be spent developing an overall budget strategy that is designed to meet the Governor's immediate policy goals. Some states provide a later deadline for a new Governor's budget recommendation. Most states provide for the Governor-Elect to have access to budget materials and briefings by existing budget office staff. A few states have the outgoing Governor submit a budget recommendation prior to the inauguration, then permit the new Governor to make an adjusted proposal.

Schedules and Deadlines. One of the first critical tasks necessary to deliver the Governor's budget recommendation is to develop a schedule of briefings, meetings and decision deadlines. Balancing the demands of setting up a new Administration must be recognized but the budget development calendar is usually fixed.

Develop Achievable Goals. The Governor and their staff should develop realistic goals of what they want to achieve in their first budget. These decisions are highly impacted by the state's fiscal environment.

Annual General Fund Revenue Percentage Changes

Fiscal 2007 - 2023



Note: Fiscal 2022 figure is estimated; fiscal 2023 figure is based on governors' recommended budgets.

Source: NASBO Fiscal Survey of States – Spring 2022

Early-Stage Considerations:

- ▶ **Arrange for the Governor-Elect's Involvement in Budget Briefings During the Transition Period**
- ▶ **Determine the Level of Personal Attention to Budget Decision-making**
- ▶ **Budget Briefings during the Transition Period.**
Early in the transition the Governor and key staff should be briefed on:

Current State Fiscal Situation - The state's current fiscal and economic situation.

Budget Process - Basics of the state's budget process—what are the major decision points and timelines?

Revenue and Spending Forecasts – A review of the revenue and spending forecasts of major expenditure areas for the next few years. This overview will inform the Governor about the availability of funding or actions necessary to yield available funds for priorities.

Major Areas of Budgetary Discretion Available to the Governor – An inventory of the decision points that provide funding options to the Governor.

Funding - A realistic appraisal of what is possible to accomplish in the first budget. What monies might be available for the incoming Administration's priorities?

Adjustments to Current Budget Allocations – What actions need to be or can be taken in the short-run with the current fiscal year's budget that may provide available funding for the Governor's priorities or set the fiscal direction of the new Administration?

2 CHOOSING THE BUDGET DIRECTOR AND UTILIZING BUDGET OFFICE STAFF

THE IMPORTANCE OF THE BUDGET DIRECTOR

Budget director choice is critical. One of the most critical decisions a new Governor will make is the selection of the budget director. The budget director is the person who should have the best understanding of how the budget is structured. The working relationship between the Governor and the budget director is very important. More than just a technician, the budget director plays an increasingly important role in communicating and promoting the Governor's policy goals and Administration management initiatives. The budget director must give the Governor objective and accurate advice to enable the Governor to make the best possible budget decisions.

The state's budget director and the budget office are responsible for converting the Governor's decisions into a full budget recommendation. They are also the lead agency in coordinating the execution of the entire state budget throughout each year. The budget director must give the Governor thoughtful, honest, accurate and apolitical information about the budget to enable the Governor to craft a realistic and responsive policy agenda. The Governor and Governor's staff should not expect the budget director to be the type that simply "tells them what they want to hear."

CHOOSING THE BUDGET DIRECTOR

Variety of skills necessary. Budget making primarily involves policy analysis, financial management and balancing various claims and choices. The budget director must have a firm understanding of the critical policy issues facing the state. The budget director must fully understand the state's fiscal and economic position, be aware of any expected changes in the coming months or years and understand the political climate and pressures that the Governor will face with respect to the new budget, especially with the legislature. The budget director must give the Governor objective and accurate fiscal data and information to enable the Governor to understand the tradeoffs and consequences of budget decisions.

Responsibilities. All of these responsibilities require the budget director position to be filled by someone skilled in a variety of areas. In general, the Governor should look for someone with most or all of the following attributes:

- ▶ **Experienced background** in public policy and financial management.
- ▶ **Credibility** necessary to promote the state's policy goals to agencies, legislators, the media and outside entities, such as bond rating agencies.
- ▶ Excellent **managerial skills** to handle issues that affect nearly every agency.
- ▶ **Capable communication skills** to transmit complex budget issues to state officials, legislators, the media and the public.
- ▶ **Political awareness** of state politics and the state's political history sufficient to help craft a strategy for budget adoption.
- ▶ **A solid understanding of state government** and programs to convey to the Governor the policy implications of various budget options.
- ▶ **The confidence to provide the Governor** and the Governor's staff recommendations and information about the fiscal situation.

“THE BUDGET OFFICER
SHOULD HAVE THE
COURAGE TO TELL THE
GOVERNOR THE TRUTH
ABOUT THE STATE
FINANCES.”

Dall Forsythe, author of Memos to the Governor



3 LEARNING THE BUDGET BASICS

THE GENERAL FUND AND OTHER FUNDS

State government's authority to spend comes through legislative appropriations, by way of different funds. The state's general fund is where most of the tax revenues are deposited and the source of the most important budget allocation decisions. Some states have a separate education fund with income or sales tax revenues dedicated to it. All but a few states also have a transportation fund comprised mostly of fuel tax revenues and vehicle license and registration fees that are devoted to roads, bridges and public transportation uses. In recent years, federal funds have made up an increasing share of all state budgets due to COVID-19 aid and other new and expanded programs. They now make up 41 percent of all state budgets, the highest share in the 35 years NASBO has collected data. Medicaid comprises 45 percent of those federal funds with the "all other" category having increased as a share in recent years due to COVID-19 aid.

THE LESS DISCRETIONARY PARTS OF THE BUDGET

During the campaign, a lot of budget numbers are discussed but often at the aggregate level. It is critical for the new Governor and staff to understand the basic parts of the budget.

What's difficult to cut - The budget officer and finance staff can play a critical role by helping to communicate the budget to the Governor and staff by breaking down the parts in detail. There are, for example, budget items that are difficult to change, at least in the short-term, and thus require a longer-term strategy to change.

These include:

- ▶ **Education:** Elementary and secondary education represents the largest portion of state general fund budgets. Many states have had state court decisions that affect the level of funding for schools and its equitable allocation. (50-state average is 36 percent of the state's General Fund)
- ▶ **Medicaid:** Medicaid, an entitlement program, includes a required state match. Under federal requirements governing Medicaid programs, there are certain restrictions in program changes, but cost containment strategies may be pursued. (50-state average is 18 percent of the state's General Fund)
- ▶ **Pension and retiree health benefits:** The state's contributions to employee retirement and health plans often represent contractual obligations and may require a longer-term strategy to adjust.
- ▶ **Corrections:** Corrections expenditures are borne nearly exclusively by state general funds. (50-state average is 6 percent of the state's General Fund)

BUILDING BLOCKS OF THE BUDGET

Understanding the basic building blocks of the budget, what parts are discretionary and what parts are less so, is critical to ensuring good budget decisions in the first few weeks. Despite these immediate realities, it is also important for the Governor to understand that, over time, it is possible to change even non-discretionary portions of the budget. In the short-term, Governors have the opportunity to use the discretionary parts of the budget to implement their own priorities through resource allocation and re-allocation. Governors and their new staffs should ensure they obtain information about long-term options to make changes to formulas and other non-discretionary parts of the budget.

REVENUE FORECASTS

Understand the economic and revenue situation. Right after the election, the Governor should be presented the current forecasts of the state's economy and revenue for the general fund and other key state funds. The Governor will want to be advised when financial forecasts are updated, and the risks to each forecast.

Assessing the revenue estimates and fiscal outlook. One of the first briefings during the transition period should be to assess the state's fiscal outlook for the next budget period or multiple years. The general fund revenue estimate dictates the primary budget constraint as most states require the Governor's budget proposal to adhere to a public revenue forecast of the general fund. Many states have a formal revenue estimating group that forecasts state revenues for the budget process, often in consensus with the legislative branch; others are prepared within the executive branch by the budget office or the revenue department. The budget office staff typically prepares a fiscal outlook incorporating revenue estimates and the expenditure side of the budget with multiple assumptions to model the amount of spending under current law and policies. These include funding requirements associated

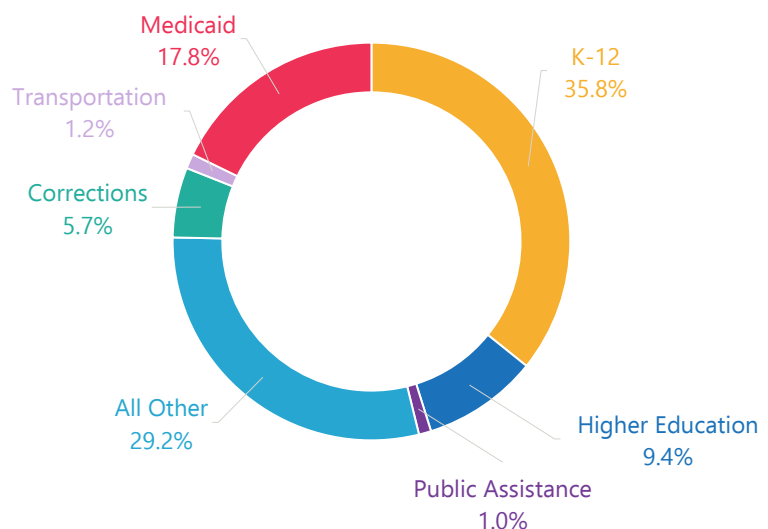
with elementary and secondary education, Medicaid, corrections, pensions, higher education, employee salary and benefits, and many other cost elements. These analyses are critical to understanding how a new Administration can identify how the Governor's principles and priorities fit within the current fiscal context. It is important for the Governor and key advisors to understand the underlying assumptions and the risks to these forecasts.

Recently state revenues have exceeded forecasts, resulting in one-time revenue surpluses. Given the uncertain economic environment, it is vital that the Governor understands what assumptions are made in forecasts, including regarding federal aid, when formulating budgets.

Debt affordability. The overall fiscal policies of the state also involve the ability to manage debt. Most states have some type of legal debt limit. A debt management policy takes into account debt service payments relative to the overall budget. More than half of states prepare debt affordability studies that inform the constraints on the amount of new debt that can be included in upcoming capital budgets. Budget office and finance staff keep these measures up-to-date and can provide historical

General Fund Expenditures by Function

Fiscal 2021



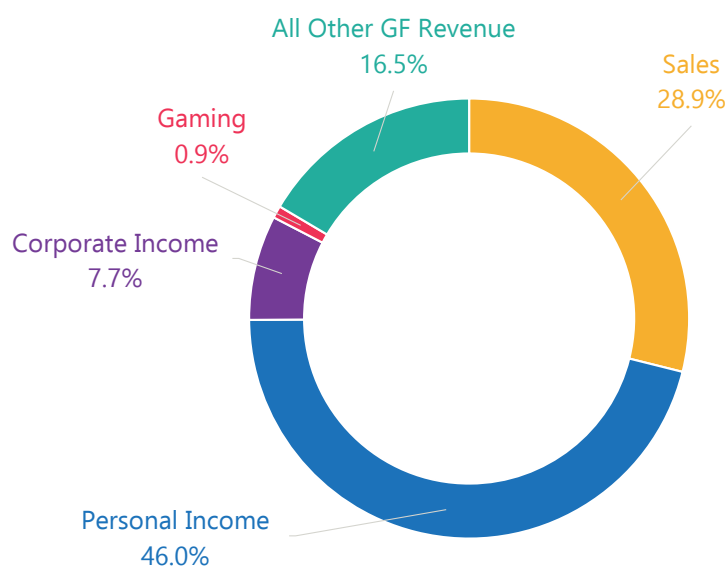
Source: NASBO State Expenditure Report

information on the amount and purposes of debt used in the past, which provides important context for the new Administration's views on transportation, education and economic development infrastructure investments.

Budget Reserves. All 50 states have a budget reserve or rainy day fund, a state's savings account. Rainy day funds are intended to provide partial bridge funding during revenue or budget shortfalls and may also serve as a source for emergency and natural disaster funding, though many states also have separate reserve funds designated for responding to emergencies and natural disasters. Rainy day funds are most commonly used by states facing a revenue shortfall to reduce the need for spending cuts and meet the requirement to end a fiscal year with a balanced budget. Since rainy day funds are a source of one-time money, their use for recurring spending requires consideration of the long-term fiscal outlook of the state and the policy priorities of the Governor. The rules for deposits to and withdrawals from the rainy day fund are based on statutory, budget bill or constitutional requirements. Rainy day funds are generally built up during stronger fiscal periods.

Recent balance trends and current fund policies demonstrate how states have taken actions to strengthen their reserves since the Great Recession such as by refining methods of deposit and tying target fund size to revenue volatility. After stronger than anticipated revenue growth in fiscal 2021 led to large surpluses and additional rainy day fund deposits in many states, rainy day fund balances saw their largest annual increase to date, reaching a new all-time high of \$124.5 billion. Increases were widespread across states, and the median balance as a share of general fund spending ended fiscal 2021 at 9.9 percent. The median balance is estimated to rise even higher in fiscal 2022 to 11.6 percent as a share of general fund spending. While reserve levels continue to vary by state, 45 states estimated rainy day fund balances representing at least 5 percent of their general fund expenditures in fiscal 2022 – including 28 states with balances exceeding 10 percent of spending. Adequate reserve balances enable a state to address unforeseen situations, limit mid-year budget cuts, and contribute to a state's bond rating.

General Fund Revenues by Source



Source: NASBO State Expenditure Report

UNDERSTANDING THE LONG-TERM BUDGET ENVIRONMENT

State fiscal conditions are affected heavily by the economic cycle. State governments receive more than 80 percent of their general fund revenues from taxes on income and consumption. Forty-one states have a broad-based personal income tax and forty-five states have a sales tax. States typically spend almost 3 out of every 4 general fund dollars on these four areas combined: elementary and secondary education, Medicaid, higher education, and corrections. Many are also experiencing spending pressures in transportation and pensions. The Governor will want to have a full understanding of the ongoing spending commitments and how to balance these commitments with policy initiatives.

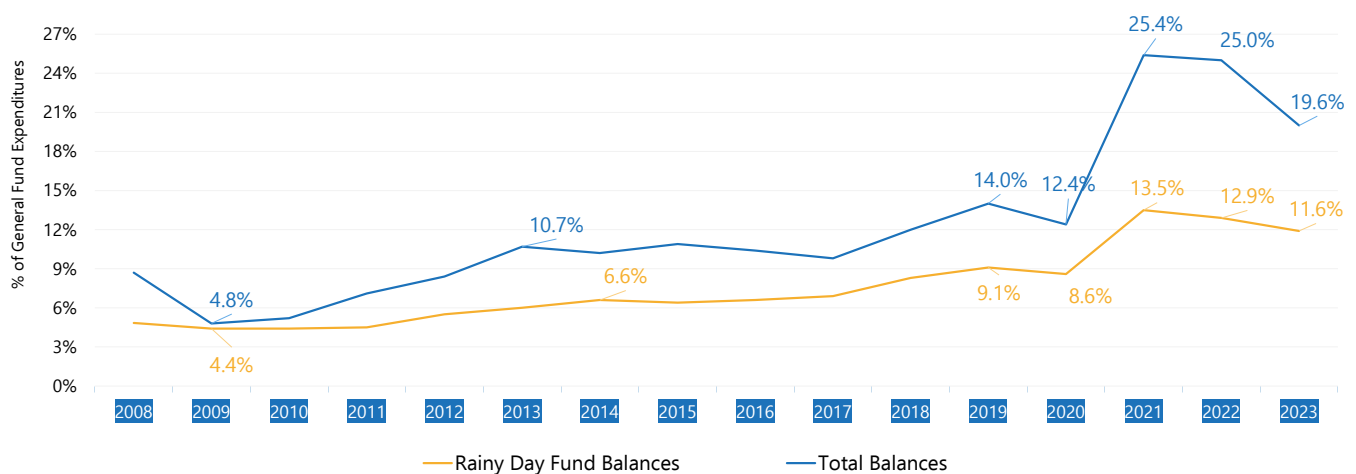
In addition to the economic cycles affecting state budgets, demographic changes also affect state budgets. More than 60 percent of spending in the Medicaid program is for the disabled (34 percent) and seniors over age 65 (21 percent).

Enrollment is the primary reason for Medicaid spending growth.

Even with prudent planning, the impact of economic cycles on the budget process makes it a challenging task. A new Governor needs to cautiously evaluate fiscal decisions during healthy economic times, such as in the current climate of one-time general fund surplus dollars and one-time federal aid, to ensure a structural balance to the state budget, and avoid more difficult impacts when the economy eventually softens or enters a recession. By doing so, they maintain the confidence in government's management of public resources. Budget issues are one of the most critical concerns for Governors, and understanding the budget situation as early as possible during the transition can be key to a Governor's success. Likewise, appointing officials in the finance and budget area with the appropriate experience and expertise is paramount.

State Rainy Day Funds and Total Balances

Fiscal 2008 - 2023



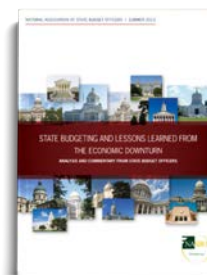
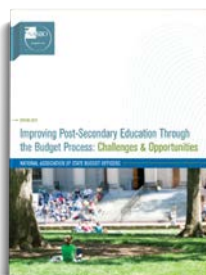
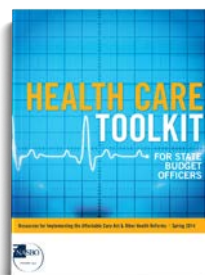
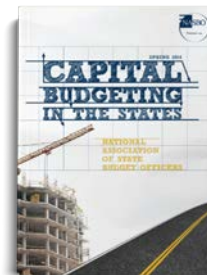
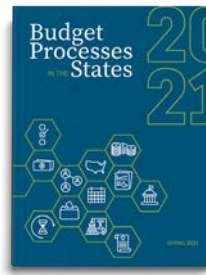
Source: NASBO Fiscal Survey of States



RESOURCES

KEY BUDGET REPORTS

All NASBO reports are available free for download.





ABOUT NASBO

The National Association of State Budget Officers (NASBO) has served as the professional membership organization for state budget and finance officers since 1945. NASBO collects and distributes data on state budgets and provides research and technical assistance to states. As the chief financial advisors to our nation's governors, NASBO members are active participants in the public policy discussions at the state level. The organization also provides policy development, education and training opportunities for members.

For more information about NASBO, please feel free to contact Shelby Kerns, Executive Director, at (202) 624-8804 or skerns@nasbo.org.





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