

# State Budget Basics During an Economic Downturn

May 6, 2020

The COVID-19 pandemic is placing significant stress on state budgets while also drastically reducing revenue sources that fund critical services to citizens. This blog outlines where states get their money from, what they spend this money on and the decisions that must be made during an economic downturn when there is not enough revenue to cover expenses.

## State Revenues: Where Does the Money Come From?

States collect revenue from a variety of sources, mostly in the form of taxes and fees. States use these revenues to pay for critical services that people depend on, including schools, roads, health care, state police and prisons, state parks, and economic development, just to name a few. State general fund revenue is the largest source of state spending. States have the most control over this portion of their budget when adjustments need to be made because there is not enough revenue coming in to cover planned spending.

### Where does the money come from?

## General Fund Revenue Sources

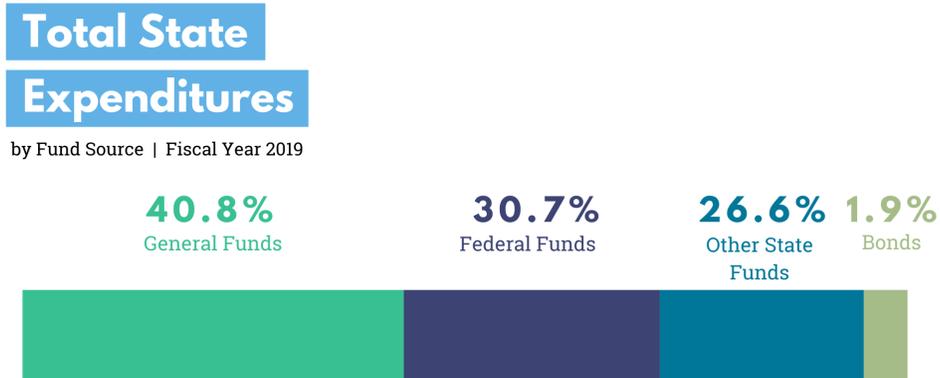
Fiscal Year 2019



\*All other general fund revenue may include cigarette and tobacco taxes, alcoholic beverage taxes, licenses and fees for permits, and charges for state-provided services, for example.

# State Expenditures: Where Does the Money Go?

A state's general fund is typically the largest fund for financing state operations, including core services such as education, health care, and public safety. States also spend money from federal funds, other state funds (which may include motor fuel taxes, user fees, gaming revenues, and other dedicated revenues) and bonds for capital projects.



State governments seek to stretch every dollar available to provide services for citizens. The graphic below broadly highlights what states spend money on. During an economic downturn when states must make significant cuts to balance their budgets, they often have to look to the largest pots of money.

## Where does the money go?

### General Fund Expenditures

by Function | Fiscal Year 2019



- **K-12 Education** – As a group, state governments cover 47 percent of total K-12 education costs. Property taxes and other revenues from local governments make up 45 percent of school funding and 8 percent comes from the federal government.<sup>[1]</sup>
- **Medicaid** - Provides health care to low-income individuals and families, including the elderly and disabled. In an economic downturn, Medicaid enrollment and costs increase, even while state general fund revenues decline. During a public health crisis, cuts to Medicaid may be unwise or unfeasible.
- **Higher education** - State general fund support makes up 39 percent of total state expenditures for higher education, while other state funds, which includes tuition and fees, makes up 49 percent.
- **Corrections** - Includes state prison systems, probation and parole, and juvenile justice. Among the major areas of state government spending, corrections is the most heavily reliant upon general fund dollars.
- **Public Assistance** - Includes spending on the Temporary Assistance for Needy Families (TANF) program and other cash assistance to low-income families and disabled citizens.
- **Transportation** – Rather than general funds, most states primarily rely on dedicated funds, such as gas taxes and license/registration fees, to pay for roads, bridges, and other transportation projects. States spend 8 percent of their total budgets (from all fund sources) on transportation.
- **All Other** – Includes a broad range of programs, like the Children’s Health Insurance Program (CHIP), public health and behavioral health, child welfare and family services, economic development, state police, parks and recreation, housing, and other areas.

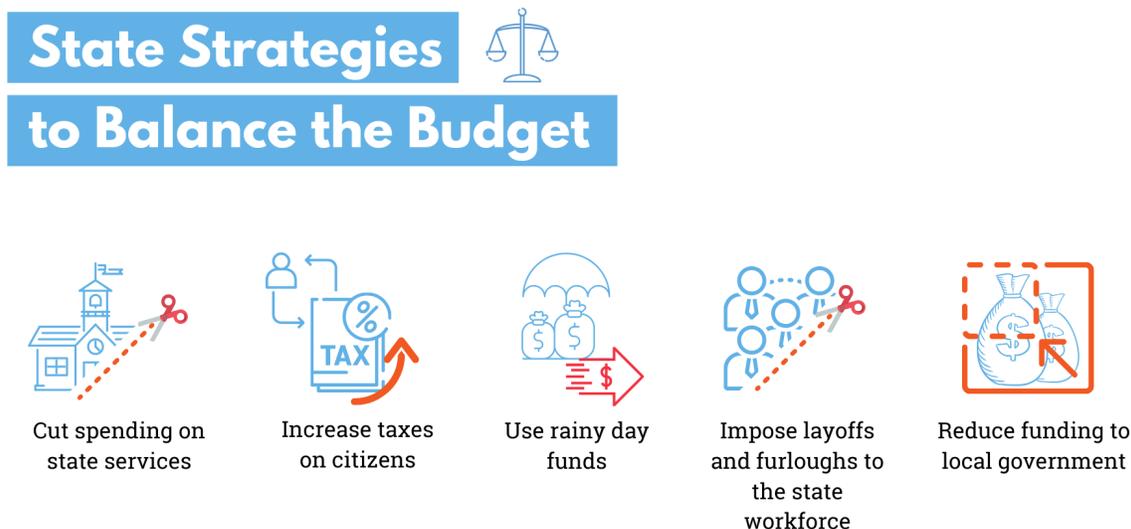
## Rainy Day Funds: Planning for Economic Downturns and More

Similar to families who put money into a savings account for unexpected expenses like car repairs, for example, states also put money into reserve or “rainy day” funds to mitigate disruptions to state services during an economic downturn and other

unanticipated events, like natural disasters. Since the last downturn in fiscal 2010, the average state's rainy day fund balance as a share of general fund spending has grown from 1.6 percent to 7.6 percent in fiscal 2019.

## Decisions to Balance the Budget

Unlike the federal government, states are required by law to balance their budgets. This means that states must have enough revenue to cover expenses. When revenues come in below a state's budget projections for a fiscal year (what is known as a "revenue shortfall"), states must take actions to close this shortfall and bring the budget into balance. These strategies can include:



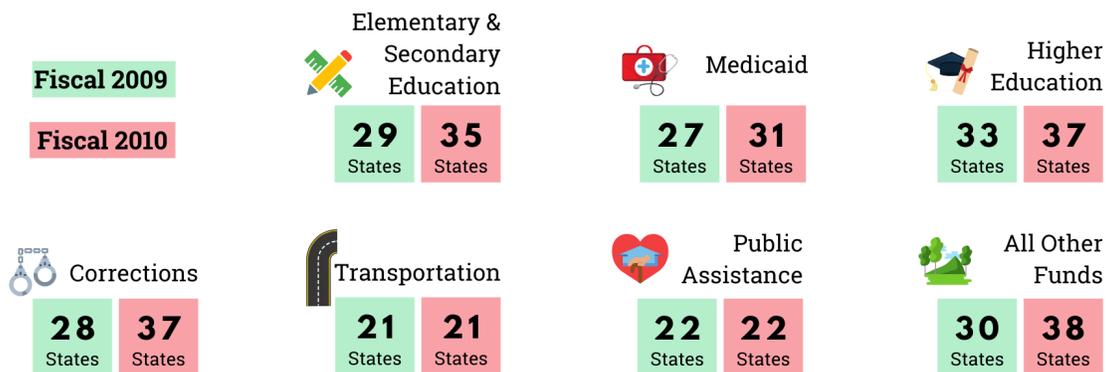
The later in the fiscal year that the shortfall occurs, the less time and flexibility states have to fix it.<sup>[iii]</sup> When states develop a budget for the next fiscal year, projecting less revenue means states have to take similar actions but they have more time to make adjustments.

## Lessons from the Great Recession

In the last economic downturn, state revenue declined 10 percent over two years (fiscal years 2009 and 2010). Even with federal aid to states and use of their reserve funds, states still made significant budget cuts. In fiscal 2010 alone, 26 states made across-the-board budget cuts to all programs and 33 states made targeted cuts to close budget gaps. Overall, general fund spending declined 9 percent over two years (FY2009 and

FY2010). Given that state spending represents roughly 10 percent of the nation’s annual gross domestic product, substantial cuts to services and the state/local workforce can harm citizens and dampen a national economic recovery.

## Mid-Year Budget Cuts by Program Area



*If you have any questions, please contact Kathryn White at [kwhite@nasbo.org](mailto:kwhite@nasbo.org).*

<sup>[i]</sup> U.S. Census Bureau data on public education finances.

<sup>[ii]</sup> Forty-five states will end their fiscal year on June 30. New York State ended its fiscal year on March 31; Texas ends its fiscal year on August 30; and Alabama and Michigan end their fiscal year on September 30. New Jersey is extending its fiscal year until September 30 temporarily in response to the COVID-19 crisis.