State Budgets in 2008 and 2009: Mired by the Ongoing National Recession and Sharp Revenue Declines, States are Forced to Make Difficult Budgetary Decisions

By Brian Sigritz

Fiscal conditions in the states began to decline in fiscal 2008. State spending and revenues grew at a lower rate than the prior year and balances were well-below their near record levels of fiscal 2007. While fiscal 2008 saw somewhat moderate declines, the fiscal situation in the states has deteriorated much more sharply in fiscal 2009. State spending is projected to be negative for the first time since 1983, balance levels are being reduced as states use reserves to address shortfalls, and recent data shows state revenues declining by 4 percent. As a result, states are likely to face a difficult budgetary environment in fiscal 2010 and beyond.

Introduction

After three straight years of strong revenue growth, near record-high balance levels and few budget cuts, state fiscal conditions began to deteriorate in fiscal 2008. Whereas fiscal 2007 saw general fund spending growth of 9.4 percent, the highest level since 1985, fiscal 2008 saw spending growth decline to 5.3 percent, below the historical average of 6.3 percent. Fiscal years 2005–2007 were marked by states using increased revenues and budget surpluses to bolster spending on programs that experienced significant budget cuts during the fiscal downturn of the early 2000s. This began to change in fiscal 2008 as some states, most notably those significantly impacted by the housing market collapse, saw a sharp decline in revenue, and other states adjusted their revenue forecasts downward in anticipation of the economic slowdown.

While fiscal 2008 marked a turning point for states, fiscal 2009 has seen states hampered by the ongoing national recession and rapidly declining revenues forcing them to make painful budget cuts, use rainy day funds, and examine tax and fee increases. Spending is projected to decline by 0.1 percent in fiscal 2009.[1] This would mark the first decline in actual dollars spent since 1983. The number of states making midyear budget cuts has also rapidly increased. As of December 2008, 22 states had made midyear cuts to their fiscal 2009 budget, compared to 13 states that made cuts in fiscal 2008 and three states that made cuts in fiscal 2007. More than two-thirds of states likely will have made cuts to their midyear budgets by the end of fiscal 2009. Furthermore, states are very concerned about fiscal 2010 and beyond, as it typically takes states several years to fully recover after a national recession ends. With the most recent economic data showing fourth-quarter 2008 Gross Domestic Product declining by 6.2 percent[2], and January unemployment rates reaching double-digits in several states[3], negative state fiscal conditions are likely to persist for several years.

The Current State Fiscal Condition

Revenues in Fiscal 2008

After several years of strong revenue collections, the rate of state revenue growth declined in fiscal 2008. Revenue collections from all sources[4] were higher than budgeted amounts in 25 states, were on target in five states, and were lower than anticipated in 20 states. By comparison, in fiscal 2007, 38 states exceeded projections, four states met projections, and only eight states had lower than projected revenue collections.[5] As recently as fiscal 2005 and fiscal 2006 all states either met or surpassed their budgeted estimates for revenue collections.

Combined revenue collections of sales, personal income and corporate income grew 2.2 percent in fiscal 2008 from fiscal 2007 levels. While still positive, the growth rate was considerably less than fiscal 2007 when collections grew 6 percent. Individually, sales tax collections grew 0.8 percent, personal income tax collections grew 4.8 percent, and corporate income tax collections declined 4.5 percent. In actual dollar terms, sales tax revenues increased by $1.6 billion and personal income tax revenues by $12.7 billion, while corporate income tax collections declined by $2.4 billion.[6]

Revenues in Fiscal 2009

While revenue growth was weak but positive for most states in fiscal 2008, revenue growth is now expected to turn negative for the majority of states in fiscal 2009. The latest information from the Nelson A. Rockefeller Institute of Government illustrates this point. According to preliminary figures from the second quarter of fiscal 2009, a majority of states that have reported data are experiencing a decline in both sales and personal income tax collections. Overall, states are experiencing a 4 percent decline in revenue.[7]

Economic conditions have declined much more sharply in fiscal 2009 than states expected. When states passed their fiscal 2009 budgets, they projected revenues from sales, personal income and corporate income taxes would be 2.9 percent higher than those collected in fiscal 2008. It should be noted that most states passed their fiscal 2009 budgets in the spring of 2008, well before the financial sector meltdown in the fall of 2008. As a result of the economic collapse, few states are meeting revenue projections. Through the first few months of fiscal 2009, only eight states have exceeded their revenue projections, 15 states are on target with their projections, and 25 states are below projections.[8] The number of states with revenue collections below projections is expected to grow considerably by end of fiscal 2009. The sharp decline in revenue has led to budget shortfalls in all regions of the country. As of December 2008, 31 states were experiencing a fiscal 2009 budget gap. Perhaps not surprisingly, this total is also expected to increase significantly by the time the fiscal year ends.

Tax and Fee Changes in Fiscal 2009

Overall, states enacted a net tax and fee increase of $1.5 billion in fiscal 2009. While collectively states enacted a net tax and fee increase, individually more states adopted net tax and fee decreases than increases, with 20 states adopting net decreases and 14 adopting net increases. Most states enacted tax and fee changes for fiscal 2009 in the spring of 2008, before the collapse of the financial sector. It is highly unlikely that states will enact net tax and fee decreases in fiscal 2010 due to declining state revenues and the continued weakening of the national economy. Instead, many states are more likely to consider measures such as increasing tobacco and motor fuel taxes as a partial solution to their current revenue shortfalls.

Corporate income taxes comprised the largest enacted revenue increase nationwide for fiscal 2009, totaling $1.36 billion. The largest enacted increase was in California, where the state suspended net operating loss credits and limited business credits, resulting in a revenue increase of $1.69 billion. The largest enacted decrease was in Ohio, where the state reduced the corporate franchise tax by 20 percent, which resulted in a decrease of $350 million. Along with the enacted increase in corporate income taxes, fees ($805.2 million), sales taxes ($676.8 million), cigarette/tobacco taxes ($270.6 million), motor fuel taxes ($67.7 million), and alcohol taxes ($7.5 million) also experienced net increases in fiscal 2009.

The largest enacted tax and fee decrease for fiscal 2009 was seen in other taxes, totaling $1.34 billion. Those taxes include personal property taxes, provider taxes, and levies on hotels and rental cars. Changes in Indiana's tax structure compromised the largest percentage of the overall decrease in other taxes as the state instituted a property tax reduction for local units, resulting in a decrease of $1.17 billion. In addition to reductions in other taxes, states also enacted a net decrease in personal income taxes ($321.7 million).[9]

State Spending in 2008

General funds serve as the primary source for financing a state's operations. General funds typically receive revenue from broad-based state taxes such as sales taxes and personal income taxes. In fiscal 2008, state general fund expenditures were $689.4 billion (preliminary actual), a 5.3 percent increase over fiscal 2007. That fiscal 2008 increase was slightly lower than the 31-year historical average of 6.3 percent. Fiscal 2008 marked the first year since fiscal 2003 that state general fund expenditures grew at a lower rate than the prior year. In fiscal 2007, general fund expenditures grew at 9.4 percent, the highest level since fiscal 1985. Spending growth slowed in fiscal 2008 as states began to be impacted by the economic slowdown. Several states most severely impacted by the housing market decline—such as Arizona, Florida and Nevada—enacted negative growth budgets. Overall, six states reported negative expenditure growth in fiscal 2008, 35 states reported growth that was positive but less than 10 percent, and nine states had growth rates of 10 percent or higher.[10] By comparison, 18 states reported general fund expenditure growth rates of 10 percent or higher for fiscal 2007.[11]

According to estimated fiscal 2008 numbers from the National Association of State Budget Officers' *State Expenditure Report*, general funds accounted for 44.3 percent of total state expenditures. Federal funds accounted for 27.1 percent of total expenditures, bonds accounted for 2.7 percent, and other state funds were 25.9 percent.[12] General fund spending has decreased substantially as a percentage of total state expenditures since NASBO first began compiling the *State Expenditure Report* in 1987. For example, in fiscal 1988 general fund spending accounted for 56.7 percent of total state expenditures, while in fiscal 2008 general fund spending decreased to 44.3 percent of total spending. This can partly be attributed to the increased use of bonds and other state funds, which includes money restricted by law for specific governmental functions or activities.

Elementary and secondary education remained the largest category of general fund expenditures in fiscal 2008, accounting for 34.5 percent of general fund expenditures. Medicaid represented 16.9 percent, and higher education accounted for 11.5 percent. Combined, Medicaid and education comprised nearly 63 percent of total state general fund spending. Other categories of general fund spending included corrections at 6.9 percent, public assistance at 1.8 percent, transportation at 0.8 percent, and all other spending[14] at 27.6 percent.

While elementary and secondary education remains by far the largest category of general fund expenditures, K–12 and Medicaid represent nearly the same level of total state expenditures. In fiscal 2008, elementary and secondary education is estimated to account for 20.9 percent of total state expenditures, with Medicaid close behind at 20.7 percent. Fiscal 2008 marks the first time since fiscal 2003 that elementary and secondary education represented a larger component of total state spending than Medicaid. Because Medicaid is a long-term health care program for low-income individuals, however, that spending is expected to increase sharply as more people feel the impact of the recession. Other categories of total state spending for fiscal 2008 include higher education at 10.3 percent, transportation at 8.1 percent, corrections at 3.4 percent, public assistance at 1.6 percent, and all other spending at 35.1 percent.[15]

State Spending in 2009

According to appropriated budgets, general fund expenditure growth is expected to decrease by 0.1 percent in fiscal 2009.[16] This will mark the first year since fiscal 1983 that nominal spending growth has been negative. Fiscal 2009's negative growth rate shows the rapid decline of state finances. As recently as fiscal 2007 states experienced spending growth of 9.4 percent, while fiscal 2008 saw growth at 5.3 percent. Not surprisingly, the number of states enacting negative growth budgets greatly increased in fiscal 2009. Eighteen states reported negative growth budgets, while another 23 states enacted budgets with either no spending growth or up to 4.9 percent.[17]

Additionally, the final figures for fiscal 2009 will likely show spending growth to be even less than -0.1 percent. In January 2009, the National Governors Association and NASBO asked states to submit estimated budget shortfall figures for fiscal 2009 and fiscal 2010 in order to gauge current fiscal conditions. The survey results determined that states face a cumulative $77 billion shortfall in fiscal 2009, and are potentially facing a $99 billion shortfall in fiscal 2010. These massive shortfall amounts will lead to even further spending reductions in fiscal 2009.

Budget Cuts

More states were forced to make midyear budget cuts in fiscal 2008 as the nation entered into a recession and state revenues began to decline. Thirteen states made midyear cuts in fiscal 2008, for a total $3.6 billion. By comparison, only three states made midyear budget cuts in fiscal 2007. The number of states cutting their budgets midyear has increased even more in fiscal 2009 as states' economic outlook continues to erode. As of December 2008, 22 states had made cuts to their enacted fiscal 2009 budgets for a total of $12.1 billion, and another five states are planning to do so.[18] More than two-thirds of states are expected to have to cut their budgets by the end of fiscal 2009. It should also be noted that even if the recession ends in fiscal 2010, many states will likely be forced to make midyear budget cuts for several years to come since states typically lag the economy as a whole in recovering from an economic downturn. Evidence of this can be seen in the fact that 37 states made midyear budget cuts in fiscal 2003, well after the 2001 recession ended.

Balances

Total balances include both ending balances as well as the amounts in states' budget stabilization funds; they reflect the funds states may use to respond to unforeseen circumstances after budget obligations have been met. Forty-eight states have either a budget stabilization fund or a rainy day fund, with about three-fifths of the states having limits on the size of these funds.[19]

Balances, like spending growth, declined in fiscal 2008 and are expected to decline even more in fiscal 2009. In fiscal 2008, balances were $50.8 billion or 7.4 percent of expenditures, considerably less than fiscal 2007 when balances were $65.9 billion, or 10.1 percent of expenditures. According to governors' enacted budgets, balances are projected to be 7.0 percent of expenditures, or $48.0 billion, in fiscal 2009. That amount, however, is likely to decline as a number of states have used rainy day funds and balances to partially address their current year budget shortfalls. Over the last 31 years, balances have averaged 5.7 percent of general fund expenditures.[20]

Looking Ahead

Negative fiscal conditions are expected to persist in the states for the remainder of fiscal 2009 and throughout fiscal 2010. Even if the national recession ended today, states will likely face several years of negative or low revenue growth. Typically, state tax revenues remain weak for several years after a recession. For example, it took state revenues at least five years to fully recover after the last two recessions.[21] Increased demands in areas such as health care and education, along with declining revenues, will continue to force states to use rainy day funds and balances, examine tax and fee increases, and make painful reductions in spending. Additionally, using history as a guide, a number of states will likely be forced to make midyear budget cuts in fiscal 2010, and perhaps in fiscal 2011. Thirty-seven states made midyear budget cuts in fiscal 2003, well after the 2001 recession ended. All these factors combined have led credit rating agencies to rate states' outlook as negative.[22]

While the immediate outlook for states may be negative, there are several factors that may help states weather the economic downturn. First, states did a good job building their rainy day funds and reserves during the preceding period of strong revenue growth. For example, in fiscal 2006 total balances reached $69.0 billion or 11.5 percent of expenditures, a record level. States may now tap these reserves to address their shortfalls. Second, states have been aggressive over the past five years in pursuing cost containment measures to help slow spending increases. One area where this has been readily evident is in Medicaid. According to the Kaiser Commission on Medicaid and the Uninsured, every state instituted cost-containment measures during this period. Finally, states will benefit from the passage of the American Recovery and Reinvestment Act, which will provide approximately $200 billion for states over the next couple of years in areas such as Medicaid, education and infrastructure. These federal funds will help states address current and ongoing budget shortfalls. That being said, the Recovery Act funds alone are unlikely to solve states' budget gaps. States will continue to have to make painful decisions to close budget deficits, and should begin to plan for the eventual end of the stimulus funding.

Notes

[1]National Association of State Budget Officers, The Fiscal Survey of States, (December 2008), 5.

[2]Bureau of Economic Analysis, *Gross Domestic Product: Fourth Quarter 2008*, (February 2009).

[3]Bureau of Labor Statistics, *January 2009 Regional and State Employment and Unemployment Summary*, (March 2009).

[4]"All Sources" includes revenues from sales, personal income, corporate income, gaming taxes, and all other taxes and fees.

[5]*The Fiscal Survey of States*, (December 2008), 15.

[6]*The Fiscal Survey of States*, (December 2008), 48–49.

[7]Nelson A. Rockefeller Institute of Government, State Revenue Report, (January 2009), 1.

[8]*The Fiscal Survey of States*, (December 2008), 18.

[9]*The Fiscal Survey of States*, (December 2008), 18–19.

[10]*The Fiscal Survey of States*, (December 2008), 7.

[11]*The Fiscal Survey of States*, (December 2007), 2.

[12]National Association of State Budget Officers, *2007 State Expenditure Report*, (Fall 2008), 6.

[13]National Association of State Budget Officers, *1988 State Expenditure Report*, 11.

[14]"All Other" spending in states includes the State Children's Health Insurance Program (SCHIP), institutional and community care for the mentally ill and developmentally disabled, public health programs, employer contributions to pensions and health benefits, economic development, environmental projects, state police, parks and recreation, housing, and general aid to local governments.

[15]*2007 State Expenditure Report*, (Fall 2008), 8.

[16]See note 1 above.

[17]See note 8 above.

[18]*The Fiscal Survey of States*, (December 2008), 1–4.

[19]National Association of State Budget Officers, *Budget Processes in the States*, (Summer 2008), 67–69.

[20]*The Fiscal Survey of States*, (December 2008), 24.

[21]Nelson A. Rockefeller Institute of Government, *Fiscal Features: What will Happen to State Budgets When the Money Runs Out?*, (February 2009), 2.

[22]Moody's Public Finance, *Outlook Remains Negative for U.S. States*, (February 2009), 1.

About the Author

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