State Budgets in 2011 and 2012: Recovery Begins for States, but Fiscal Conditions Remain Below Pre-Recession Levels

By Brian Sigritz

Fiscal conditions began to improve for states in the 2011 fiscal year. State revenue collections grew by 6.4 percent and state general fund spending increased by 4 percent following two consecutive years of declines. Additionally, the number of states making midyear budget cuts dropped from 39 states in fiscal 2010 to 19 states in fiscal 2011. In the 2012 fiscal year, states are expected to continue their recent improvement with both state revenues and state spending projected to grow. Fiscal conditions, however, remain below pre-recession levels in many states even with the recent increases. States will have to continue to make difficult decisions in the 2013 fiscal year and beyond as they contend with increased spending demands, slowly recovering revenue collections, uncertainty regarding future federal funding and long-term liabilities including pensions and retiree health care costs.

Introduction

The 2011 fiscal year marked a turning point for state finances following two of the most challenging years for state budgets since the Great Depression. After a revenue decline of 8 percent in the 2009 fiscal year, and an additional 2.5 percent in the 2010 fiscal year, state revenues grew by 6.4 percent in 2011.[1] State spending also experienced a turnaround with general fund spending growing 4 percent in the 2011 fiscal year. This followed a 3.8 percent decline in general fund spending in 2009 and a 5.7 percent decline in 2010, which marked the first time in the 34 year history of the National Association of State Budget Officers' *Fiscal Survey of States* that general fund spending declined two years in a row.[2] While the 2010 fiscal year saw 45 states with general fund expenditures below 2009 levels, 38 states enacted a 2011 fiscal year budget with general fund spending levels above those of the 2010 fiscal year.[3] Perhaps not surprisingly, the number of states making midyear budget cuts also declined in 2011 with 19 states making midyear cuts, compared to 43 states in 2009 and 39 states in 2010.[4]

Both state revenues and state spending are projected to continue to grow in the 2012 fiscal year, although at slower rates than witnessed in 2011. According to governors' enacted budgets, state revenues are expected to increase 1.6 percent in 2012,[5] while general fund expenditures are expected to increase 2.9 percent.[6] Additionally, the vast majority of states have assumed at least moderate budget growth, with 43 states enacting a 2012 fiscal year budget with general fund spending levels above the 2011 fiscal year.[7]

Although fiscal conditions have improved, states still face a difficult budgetary environment. Revenues, spending and balances all remain well below pre-recession levels. Total state general fund revenues in 2012 are forecast to be nearly $21 billion, or 3.1 percent, below general fund revenue collections in fiscal 2008. Similarly, state general fund spending remains more than $20 billion, or 3.1 percent, below its 2008 fiscal year level. Total state balance levels have declined from a high of $69 billion in the 2006 fiscal year to $41.2 billion in the 2012 fiscal year. Furthermore, in 2012 states had to contend with a $43 billion dropoff in temporary federal aid provided through the *American Recovery and Reinvestment Act of 2009*.[8] All these factors, along with increased spending demands and uncertainty surrounding future federal funding levels, continue to present states with significant fiscal challenges.

The Current State Fiscal Condition

Revenues in Fiscal 2011

State revenues began a slow recovery in the 2011 fiscal year. After declining sharply by 8 percent in the 2009 fiscal year[9] and an additional 2.5 percent in the 2010 fiscal year, state revenues grew by 6.4 percent in 2011.[10] Sales, personal income and corporate income tax revenues all experienced gains in the 2011 fiscal year. Individually, sales tax collections grew by 4.8 percent, personal income tax collections rose by 9.7 percent and corporate income tax collections were 9.4 percent higher than 2010 fiscal year levels. In nominal dollars, sales tax revenues increased by $9.4 billion, personal income tax grew by $22.9 billion and corporate income tax collections rose by $3.7 billion.[11] Further indication of the improving revenue outlook can be seen in the fact that 2011 fiscal year revenue collections from all sources[12] were higher than projections in 32 states, on target in nine states and lower than budgeted amounts in only nine states. This contrasts sharply from the 2010 fiscal year, when revenues were lower than anticipated in 36 states, on target in another two states and higher than projections in only 12 states.[13]

Revenues in Fiscal 2012

Revenue collections are expected to continue to grow in the 2012 fiscal year, although likely at a slower rate than the 2011 fiscal year. State revenues are expected to increase 1.6 percent, or $10.4 billion, in the 2012 year, according to governors' enacted budgets.[14] The latest data from the Nelson A. Rockefeller Institute of Government indicates that state revenues are growing as forecasted. According to the Rockefeller Institute, state tax revenues grew by 6.1 percent in the first quarter of the 2012 fiscal year—third quarter of calendar year 2011—compared to the same quarter of the 2011 fiscal year. Additionally, preliminary figures for October and November 2011 show state revenues growing by 5.2 percent compared to the same time period in 2010.[15]

While encouraging, the revenue growth figures do not tell the entire story. For one, revenue growth has trended downward so far in 2012. First quarter growth rate of 6.1 percent in the 2012 fiscal year is considerably lower than the last quarter of the 2011 fiscal year, which saw 11.1 percent growth. Secondly, even if 2012 revenues grow at their projected level, state revenues will still be 3.1 percent below the 2008 fiscal year. In nominal dollars, revenues are projected to be $659.4 billion in 2012 compared to $680.2 billion in 2008, a decline of more than $20 billion. Revenue totals similar to the 2012 fiscal year haven't been seen since the 2007 fiscal year.[16]

Tax and Fee Changes in Fiscal 2012

In response to significant reductions in revenue, states enacted $23.9 billion in tax and fee increases in the 2010 fiscal year, marking the highest dollar amount attributable to tax and fee changes since NASBO's *Fiscal Survey of States* began tracking this data in 1979. In the 2011 fiscal year, states enacted an additional $6.2 billion in tax and fee increases. In the 2012 fiscal year, however, states enacted an aggregate decrease of $584.1 million in new taxes and fees. The decrease in net taxes and fees in 2012 is the first time since 2007 that states did not enact an increase.[17]

The largest enacted reduction in taxes and fees in the 2012 fiscal year came in corporate income taxes, declining by $1.3 billion. Of this, $1.1 billion is the result of the replacement of the Michigan Business Tax with a 6 percent corporate income tax. Overall, 13 states decreased corporate income taxes, while four states increased them. States also enacted a net decrease of $690.5 million in sales taxes in the 2012 fiscal year. Much of the change was due to the expiration of a temporary sales tax in North Carolina.

While states enacted an overall net reduction of nearly $600 million in taxes and fees, not all types of revenue experienced a decline. For example, personal income taxes experienced a net increase of $571 million, with much of this due to changes in Michigan and Connecticut. Other revenue sources that experienced a net increase include cigarette and tobacco taxes ($58.1 million), motor fuel taxes ($8.7 million), alcohol taxes ($97.1 million), other taxes ($557.1 million), and fees ($81.9 million).[18]

State Spending in 2011

Similar to what occurred with state revenue, state spending experienced a turnaround in the 2011 fiscal year. Spending from state funds—general funds and other state funds combined—grew for the first time since fiscal 2008. It should be noted though that the level of growth was significantly lower than the historical average. Additionally, federal funds to states continued to grow in the 2011 fiscal year. The federal funds growth rate, however, was much lower in 2011 than 2010 due to the winding down of American Recovery and Reinvestment Act, or Recovery Act, funds. This combination of modest growth in state funds and declining federal funds growth meant that state resources continued to be constrained in 2011.

Looking in greater detail at the 2011 fiscal year, general fund spending is estimated to be $636.3 billion, a 2.8 percent increase from 2010. General funds serve as the primary source for financing state operations. General funds typically receive their revenue from broad-based state taxes such as sales and personal income taxes.

The majority of program areas saw increased general fund spending in the 2011 fiscal year. Elementary and secondary education, higher education, Medicaid, corrections and transportation all experienced increased general fund spending, while public assistance and the "all other"[19] category saw relatively minor declines.[20] By far, the largest growth area in general fund spending was Medicaid, growing 13.5 percent. The large increase in state general fund Medicaid spending is attributable to a combination of factors, including increased enrollment, the winding down of temporary Medicaid funds provided through the Recovery Act, and maintenance of effort requirements included in the Recovery Act. Elementary and secondary education remained the largest category of general fund expenditures in 2011, accounting for 35 percent of general fund expenditures. Medicaid represented 17.4 percent and higher education accounted for 11.5 percent. Combined, Medicaid and education comprised 64 percent of total state general fund spending. Other categories of general fund spending included corrections at 7.4 percent, public assistance at 1.8 percent, transportation at 0.5 percent and all other spending at 26.5 percent.[21]

Federal funds to states increased by 4 percent in the 2011 fiscal year, much lower than the 2009 and 2010 fiscal years, which saw growth rates of 19.3 and 19.4 percent respectively. Federal fund spending grew from $552.7 billion in the 2010 fiscal year to an estimated $574.8 billion in the 2011 fiscal year.[22] All spending categories of federal funds, with the exception of corrections, experienced at least a modest increase in 2011. Medicaid accounted for the largest share of state spending from federal funds at 43.5 percent. Elementary and secondary education at 12.7 percent and transportation at 7.2 percent represented the next largest shares.[23]

Total state expenditures—general funds, federal funds, other state funds and bonds combined—grew by an estimated 4.1 percent in the 2011 fiscal year to $1.69 trillion.[24] Medicaid remained the largest component of total state spending in the 2011 fiscal year, representing 23.6 percent of total state expenditures. As recently as the 2008 fiscal year, elementary and secondary education represented a larger share of total state expenditures than Medicaid. In 2011, K–12 education represented 20.1 percent of total state expenditures. Other categories of total state expenditures include higher education at 10.1 percent, transportation at 7.6 percent, corrections at 3.1 percent, public assistance at 1.6 percent and all other spending at 33.9 percent.[25]

Finally, the passage of the Recovery Act in February 2009 produced a shift in the funding sources for state expenditures. Federal funds have grown from representing 26.3 percent of total state expenditures in the 2008 fiscal year to 34.1 percent in estimated expenditures in the 2011 fiscal year, while general funds have gone from representing 45.9 percent of total state spending in fiscal 2008 to 37.7 percent in fiscal 2011.[26] General funds, however, will likely make up a larger component of total state expenditures in the 2012 fiscal year as states deal with the rapid decline of Recovery Act funds.

State Spending in 2012

According to appropriated budgets, general fund expenditures are expected to increase by 2.9 percent in the 2012 fiscal year. General fund spending is estimated to be $666.6 billion in 2012, an $18.5 billion increase from the 2011 fiscal year.[27] Forty-three states enacted a 2012 fiscal year budget with general fund spending levels above 2011.[28] By comparison, as recently as fiscal 2010, 45 states enacted general fund budgets with lower levels of spending.[29] The 2012 fiscal year general fund spending is expected to remain well below pre-recession levels, even after assuming a 2.9 percent growth from the 2011 fiscal year. Specifically, general fund spending will remain $20 billion, or 3.1 percent, below its peak level in 2008. Furthermore, 29 states enacted a 2012 fiscal year budget with lower general fund spending than they had in the 2008 fiscal year.[30]

Budget Cuts

The number of states forced to make midyear budget cuts declined significantly in the 2011 fiscal year. While 43 states made midyear cuts totaling $31.3 billion in the 2009 fiscal year, and 39 states made midyear cuts totaling $18.3 billion in the 2010 fiscal year, only 19 states made midyear cuts totaling $7.4 billion in 2011. While the number of states forced to make midyear budget cuts was reduced in half from 2010 to 2011, states still made significant cuts. Education was one area that experienced widespread cuts, with 18 states making midyear cuts to higher education and 17 states making midyear cuts to K–12. Other program areas that were cut midyear include corrections (16 states), Medicaid (12 states), public assistance (11 states), and transportation (seven states).[31]

The number of states making midyear budget cuts has decreased even further so far in the 2012 fiscal year, with only two states reporting midyear cuts through December. The decrease in the number of states making midyear budget cuts is likely attributable to improved revenue collections and more accurate revenue projections. Through December, 15 states were exceeding revenue projections, while 22 states were on target, and only seven states were seeing revenues coming in lower than projections; not all states were able to provide preliminary 2012 fiscal year data.[32]

Balances

Total balances include both ending balances as well as the amounts in states' budget stabilization funds. Combined, these reserves reflect the funds states may use to respond to unforeseen circumstances after budget obligations have been met. Forty-eight states currently 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.[33]

Balances have fallen since the start of the recession as states have turned to them in response to declining revenue levels. In the 2012 fiscal year, balances are projected to be 6.2 percent of expenditures at $41.2 billion, considerably less than the 2008 fiscal year when balances were 8.6 percent of expenditures, or $59.1 billion. As recently as the 2006 fiscal year, balances were at record high levels of 11.5 percent of expenditures, $69 billion. The informal rule-of-thumb is that balances should be at least 5 percent of expenditures. While the 50-state average balance level of 6.2 percent for the 2012 fiscal year may seem like a significant cushion, two states—Alaska and Texas—represent nearly half of total balance levels. When those two states are removed, total balance levels drop to 3.7 percent of expenditures. Over the past 34 years, balances have averaged 5.8 percent of general fund expenditures.[34]

Looking Ahead

Even with the recent improvement in the national economy, states are likely to continue to face tight fiscal conditions for a number of years to come. While revenues have increased for most states, overall state revenues remain nearly $21 billion, or 3.1 percent, less than prerecession levels. Typically, state tax revenues lag movements in the national economy and can remain weak for several years after a recession ends. For example, it took state revenues at least five years to fully recover after the past two recessions.[35] Similar to state revenues, state general fund spending remains more than $20 billion, or 3.1 percent, less than the 2008 fiscal year. This is even after factoring in the 2012 fiscal year's projected 2.9 percent growth, the second consecutive year that general fund spending has increased. States also continue to face increased spending demands in areas such as Medicaid and public assistance due to the lingering impacts of the recent economic downturn and are being asked to maintain adequate funding levels in areas such as education.

Looking forward, states are concerned that general fund revenues will not have fully recovered enough to meet increased spending demands, as well as to replace the recently expired federal Recovery Act funds. States also face uncertainties regarding national economic growth, health care reform and future federal funding levels, and also must deal with long-term liabilities including pensions and retiree health care costs. All these factors combined mean that states are likely to face austere budgets for at least the next several years and will have to continue to reassess the roles and responsibilities of state government by making difficult decisions regarding funding levels and priorities.

Although conditions have improved and states will continue to meet their obligations, they face a challenging fiscal road ahead.

Notes

[1] National Association of State Budget Officers, *The Fiscal Survey of States*, (December 2011), 4–5.

[2] *The Fiscal Survey of States*, (December 2011), 2.

[3] *The Fiscal Survey of States*, (December 2011), 3.

[4] *The Fiscal Survey of States*, (December 2011), 8.

[5] The Fiscal Survey of States, (December 2011), 44.

[6] See note 2 above.

[7] See note 3 above.

[8] National Association of State Budget Officers, *Summary: Fall 2011 Fiscal Survey of States*, (November 2011), 1–4.

[9] *The Fiscal Survey of States*, (December 2010), 4.

[10] *The Fiscal Survey of States*, (December 2011), 4–5.

[11] *The Fiscal Survey of States*, (December 2011), 47.

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

[13] *The Fiscal Survey of States*, (December 2011), 45.

[14] *The Fiscal Survey of States*, (December 2011), 5-6

[15] Nelson A. Rockefeller Institute of Government, *State Revenue Report*, (January 2012), 1.

[16] *Summary: Fall 2011 Fiscal Survey of States*, (November 2011), 2.

[17] *The Fiscal Survey of States*, (December 2011), 50.

[18] *The Fiscal Survey of States*, (December 2011), 49, 53.

[19] "All Other" spending in states includes the Children's Health Insurance Program (CHIP), 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.

[20] National Association of State Budget Officers, *2010 State Expenditure Report,* (Fall 2011), 6.

[21] *2010 State Expenditure Report*, (Fall 2011), 9.

[22] *2010 State Expenditure Report*, (Fall 2011), 7.
[23] See note 21 above.
[24] See note 22 above.
[25] See note 21 above.
[26] See note 22 above.
[27] See note 14 above.
[28] See note 3 above.
[29] *The Fiscal Survey of States*, (December 2010), 3.
[30] *Summary: Fall 2011 Fiscal Survey of States*, (November 2011), 1.
[31] *The Fiscal Survey of States*, (December 2011), 10.
[32] See note 13 above.
[33] National Association of State Budget Officers, *Budget Processes in the States*, (Summer 2008), 67–69.
[34] *The Fiscal Survey of States*, (December 2011), 55–56.
[35] Nelson A. Rockefeller Institute of Government, *Fiscal Features: What Will Happen to State Budgets When the Money Runs Out?*, (February 2009), 2.

About the Author

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