State of the States - Midyear 2014

State general fund spending is increasing, although it continues to lag behind historical averages, and revenue growth remains small in some states, according to a report the National Association of State Budget Officers released last week.

State executive budgets reveal that general fund spending is projected to increase by 3% in fiscal 2015, below the decades-long average of 5.5%. Fiscal 2015 revenues are projected to grow by 3.2%, a rate the report characterizes as "not overly robust." General fund spending is projected to reach $751 billion in fiscal 2015, up $21.4 billion over fiscal 2014. General fund tax revenues are estimated to reach $749 billion in fiscal 2015, $24 billion over the projected amount collected the previous fiscal year.

Increased revenue collections have boosted the short-term outlook for U.S. states, but the slow economic recovery and persistent high unemployment have many states concerned that the fiscal improvements may be temporary.

Nelson A. Rockefeller Institute of Government

States are set to increase spending at the slowest pace since the recession ended five years ago, reflecting wariness about the recovery. Even with many states projecting general fund surpluses, officials are hesitant to cut taxes, hire workers, or restore all cuts made after the 18-month recession ended in 2009. The growth of tax collections slowed this year, following a jump in 2013 after taxpayers sold stocks and collected bonus income early to avoid federal rate increases set to kick in that year. During the first four months of this year, income-tax collections slipped by 7.1 percent, or $8.4 billion, declining in 38 of the 41 states that impose a broad-based levy on wages, according to a report by the Nelson A. Rockefeller Institute of Government. New Jersey, Connecticut and Virginia are among states that were caught off guard by the magnitude of the drop. After deep budget cuts stemming from the recession, some states are hesitant to spend surpluses that emerged during the recovery. In California, for example, Governor Jerry Brown, a Democrat, is pressing lawmakers to pay off debt and bolster savings.

Fiscal Survey of the States

The Spring 2014 version of the Fiscal Survey of the States, released last week by the National Governors Association and the National Association of State Budget Officers shows slow growth, but increased stability for state budgets.

State budgets are expected to continue their trend of moderate growth in fiscal 2015 according to governors' spending proposals. Consistent year-over-year growth has helped states achieve relative budget stability, but progress remains slow for many states. With each passing year of slow improvement, more and more states are moving beyond recession induced declines and returning to spending and revenue growth. According to executive budgets, general fund spending is projected to increase by 3 percent in fiscal 2015. This

growth rate is less than the historical average, although inflation is also currently low. This means budget growth will likely outpace inflation in many states, presenting an opportunity to accelerate fiscal progress. Governors in most states have recommended additional spending for core services such as K-12 education. However, spending continues to be impacted by limited gains in revenue. Budgetary challenges also linger from a long recovery in the national economy, unemployment rates higher than policy makers want, and stagnant wages. As the economy continues along a trajectory of relatively slow growth, many states will continue to face difficult budgetary choices in fiscal 2015 and beyond.

Executive budgets in 42 states call for higher general fund spending levels in fiscal 2015 compared with fiscal 2014. However, additional spending is likely to be limited, with few budget dollars available to cover increasing demands in areas such as Medicaid and higher education. In addition, state spending for fiscal 2014 for the 50 states combined is still below the fiscal 2008 pre-recession peak after accounting for inflation. Aggregate spending levels would need to be at $761 billion, or 4.4 percent higher than the $729.1 billion estimated for fiscal 2014, to be equivalent with real 2008 spending levels.

Governors recommended that additional budget dollars most heavily target K-12 education and Medicaid in fiscal 2015. Executive budget proposals in 39 states recommend increasing general fund spending for K-12 education by $10.9 billion. Governors also recommended that additional funds be directed to Medicaid in 34 states and to higher education in 37 states, for net increases of $4.9 billion and $3.5 billion respectively. All areas of the budget received recommended spending increases in fiscal 2015 with the exception of public assistance, although much of the net decrease was due to a shift in spending from funds outside the general fund in California.

State budget gaps that arise during the fiscal year are primarily solved through a reduction in previously appropriated spending. Mid-year budget cuts have subsided compared with the years immediately following the recession when states had to make substantial cuts and take other actions, such as expend rainy day funds, to balance their budgets. Similar to fiscal 2012 and 2013, mid-year budget cuts have been minimal in fiscal 2014. At the time of data collection, February through April, eight states enacted net mid-year budget cuts totaling $1.0 billion in fiscal 2014. This compares with 11 states enacting $1.3 billion in net mid-year budget cuts in fiscal 2013, and eight states enacting $1.7 billion in net mid-year budget cuts in fiscal 2012. In contrast, 18 states enacted mid-year spending increases in fiscal 2014 totaling $2.3 billion. Additionally, six states enacted mid-year tax decreases, and one state enacted a mid-year tax increase resulting in a net revenue reduction of $184 million in fiscal 2014. Improved revenue collections and spending controls have significantly reduced the number of states needing to make budget cuts in fiscal 2014.

Aggregate general fund revenues are projected to modestly increase in fiscal 2015. Governors' recommended budgets show collections are projected to increase by 3.2 percent in fiscal 2015, a faster rate of growth than the estimated 1.2 percent gain in fiscal 2014. However, the growth rate is much slower than fiscal 2013, in which revenues increased by 7.1 percent. Substantial revenue increases in fiscal 2013 were attributable in large part to a one-time gain for states as high income taxpayers shifted capital gains, dividends and personal income to calendar year 2012 to avoid higher federal tax rates that were set to begin on

January 1, 2013. States planned for the revenue slowdown in fiscal 2014 accordingly, but collections may not meet expectations in some states. Revenue shortfalls in fiscal 2014 are more likely a consequence of unanticipated volatility tied to tax law changes that were part of the federal "fiscal cliff" and individual taxpayer behavior, rather than underlying changes in the economy.

Governors' budget proposals forecast total general fund tax revenues of $749.2 billion in fiscal 2015, compared to the estimated $725.6 billion collected in fiscal 2014. Total general fund revenues in fiscal 2013 reached $716.9 billion and surpassed the pre-recession highs of fiscal 2008 by $41.2 billion or 6.1 percent. Yet, aggregate revenues in fiscal 2014 are still 3.8 percent below fiscal 2008 levels after accounting for inflation. Fiscal 2014 revenues would have needed to reach $753 billion, rather than the estimated $725.6 billion, to be equivalent with inflation adjusted 2008 levels.

Executive budgets recommended reducing net taxes and fees by $2.5 billion in fiscal 2015, although most tax change proposals are modest. Eight governors proposed tax increases and 15 proposed tax decreases. Governors in 32 states either proposed no tax changes or changes resulting in less than $5 million. States with the largest proposed tax decreases include Florida, Minnesota, New York, and Ohio. States with governors proposing the largest tax increases include Delaware, Massachusetts, and New Jersey, which took efforts to close corporate tax loopholes. Governors have also proposed $440 million in new revenue measures in fiscal 2015. State legislatures enacted net tax cuts in fiscal 2014; however, fiscal 2015 is the first time since the onset of the recession that governors put forth recommendations to reduce rather than increase net taxes and fees. In fiscal 2014, states cut taxes and fees by $2.1 billion, after raising taxes and fees by $6.9 billion in fiscal 2013.

In fiscal 2013, total balances, which include ending balances and rainy day funds, reached $73.5 billion, or 10.6 percent of general fund expenditures. This marked an all-time high for states in terms of actual dollars, though not as a percent of expenditures. Budget reserves increased substantially in fiscal 2013 as one-time revenues attributable to the federal fiscal cliff resulted in collections higher than projections. This led to budget surpluses in many states and greater than anticipated ending balances by the close of fiscal 2013. However, total balances declined in fiscal 2014 as states utilized ending balances from fiscal 2013 to acclimate budgets to the slowdown in revenue collections. Total balances are estimated to be $63 billion or 8.6 percent of expenditures in fiscal 2014. And governors recommended decreasing total balance levels in fiscal 2015 to $55.4 billion or 7.4 percent of general fund expenditures. In addition, two states have a disproportionate share of states' budget reserves. The balance levels of Alaska and Texas are estimated to make up 37 percent of total state balance levels in fiscal 2014 and 37.7 percent in fiscal 2015. The remaining 48 states have balance levels that represent only 3.5 percent of general fund expenditures for fiscal 2014 and 3.0 percent for fiscal 2015.

For fiscal 2014, total Medicaid spending is estimated to grow by 13.0 percent with state funds increasing by 5.9 percent and federal funds increasing by 18.3 percent. Executive budgets for fiscal 2015 assume an increase in Medicaid spending of 7.6 percent in total funds with state funds increasing by 5.8 percent and federal funds increasing by 10.2 percent. The projected growth rates in fiscal 2014 and in fiscal 2015 reflect both the Affordable Care Act's Medicaid

expansion option that began on January 1, 2014, in addition to ongoing program spending. The rate of growth in federal funds exceeds the state fund growth rate since costs for those newly eligible for coverage are fully federally funded in calendar years 2014, 2015, and 2016, with federal financing phasing down to 90 percent by 2020.

Medicaid enrollment is estimated to increase by 6.9 percent in fiscal 2014. In governors' recommended budgets for fiscal 2015, Medicaid enrollment would rise by an additional 8.9 percent. This reflects both the impact from the Affordable Care Act including increased enrollment in states that have implemented the Medicaid expansion that began in January 1, 2014, as well as increased participation among those currently eligible in both states that did and did not implement the expansion.

State Public Pensions

While most public pension plans' funded ratios are stabilizing after multiple years of decline, they are doing so at lower levels, leaving states exposed to higher pension costs. While market gains and pension reforms may be helping some plans, pension challenges remain. Overall, actuarial liabilities rose without pause over the past five years.

The seemingly inexorable growth in actuarial liabilities during a period in which more than 40 states implemented numerous pension reforms underscores the difficulty of implementing benefit changes as wide-ranging as the reforms in Montana, New Mexico and Ohio. Funded ratios for Montana, New Mexico and Ohio's pensions have jumped significantly post-reform and included changes to the plan cost of living assets or shifting a portion of the contribution requirements from employers to employees.

Governments in general continue to contribute less to their pensions than the level calculated by their actuaries, the annual required contribution (ARC). Since the downturn, the ARC has risen significantly for most plans as they work to recoup past investment losses.

Numerous plans continue to calculate an ARC assuming a rolling, 30-year amortization of the unfunded liability. The repeated reamortization of the unfunded liability over a new, 30-year periods means that little meaningful progress is possible toward full funding, without investment gains exceeding the plan's investment return assumption.

Demographic profiles continue to weaken, with flat or declining government employment, rising retirements, and longer lifespans in retirement, trends that raise plan liabilities, pressure cash flows, and shift risk for plan performance to participating governments.

States' median debt burden totals 2.6% of personal income, while unfunded pensions attributable to the states total 3.3% of personal income. The range of state debt burdens is relatively narrow, from zero% to 9.2%. By contrast, the range of pension burdens is much broader, ranging from 0.2% to 19.3%.

Conclusion

State budgets are expected to continue their trend of moderate improvement in fiscal 2015, after several years of recovery in the national economy. Since the recession, states have transitioned to a sustained period of fiscal rebuilding. However, progress is slow and structural challenges remain. Spending challenges persist in areas such as health care and higher education, and governors' recommended budgets indicate that revenue growth may not be sufficient to meet all the competing demands for state resources. As states shift some of their focus from immediate budgetary pressures, long-term challenges are likely to persist in fiscal 2015 as revenue growth remains modest.