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April 20, 2006

HOW STRONG ARE STATE BUDGETS?

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A new report from the National Conference of State Legislatures finds some improvement in state budget conditions for the current fiscal year (FY 2007), which in most states ends June 30, 2007, and for the upcoming fiscal year.[1]

KEY FINDINGS

- State fiscal conditions appear solid right now, resulting from strong revenue collections of the last several years.
- But the most recent data suggest fiscal conditions are starting to get weaker.
- States spend their money primarily on education, health care, and transportation. Weakening revenue streams could make it harder for states to finance those services in the future.

But the improvements that have occurred since budgets' enactment last spring have been, at best, modest in most states. Among the 38 states that recently have revised their revenue forecasts for the current fiscal year, for instance, the median state revised its forecast upwards by less than 1 percent, and some of that increase is due to conservative forecasting at the time the budget was enacted.

The data in the NCSL report show that the apparent strength of state budgets right now largely reflects the availability of one-time funds that have been carried over from the last few years or that have resulted from better-than-expected revenues in the current fiscal year.

An example is Texas. The NCSL report identifies Texas as having $6.9 billion in "unexpected revenue." But most of these funds are not higher-than-projected revenues; instead, legislators chose to leave significant amounts of state revenue unspent in previous years to help finance local property tax cuts that are taking effect this year. In no meaningful sense does Texas have a surplus of the magnitude that the NCSL report might appear to suggest. Another example is Oregon, where NCSL notes that the "unexpected revenue" mostly represents funds realized over the last two years that are already committed to constitutionally required tax refunds and to a rainy day fund.

In other words, what makes state budgets appear "strong" right now seems in significant part to be due to the uptick in state revenue collections that occurred in 2004, 2005 and 2006 as states emerged from the last recession.

[1] National Conference of State Legislatures, *State Budget Update: March 2007*, released April 19, 2007.

Rather than making budgetary decisions based on past years' revenue strength, good public finance practice suggests that states would structure budget decisions based on prospects for future years. Although the NCSL report mostly addresses fiscal conditions in fiscal 2007 and is silent on prospects for state finances beyond fiscal year 2008, other evidence suggests problems may be brewing.

- The rate of revenue growth is slowing. According to the most recent report from the Rockefeller Institute, the growth of state tax collections for the October-December quarter – halfway through the FY2007 fiscal year – was the weakest since 2003. Tax collections were just 1.5 percent higher than in the same period of the previous year, after adjusting for legislated changes and inflation. The NCSL report and other sources indicate that sales tax revenue, in particular, is slowing; one Wall Street analysis indicates that only one in six states met their sales tax projections for the month of March.[2] Property tax revenue appears also to have peaked in many places. While property taxes are primarily a local government revenue source, weak local revenues may have implications for state aid to localities.

- Many states have spent their one-time carryovers from past years on multi-year tax cuts that will weaken revenues for years to come. Last year, 10 states enacted tax cuts that had most of their fiscal impacts in the "out-years."[3] Additional states such as Missouri appear to be considering similar actions this year.

- States face a number of long-term structural problems. Although the problems vary from state to state, they commonly include antiquated sales tax systems, corporate income tax structures that are increasingly riddled with loopholes, underfunded state pension plans, and other concerns.[4]

- Should the nation enter a recession, state Rainy Day Funds are likely to prove inadequate. Most states' Rainy Day Funds are well below the level of 15 percent or more the Government Finance Officers Association suggests is prudent and that CBPP research suggests would be needed for a state to weather a recession.[5]

In short, there is little reason to feel confident — and substantial reason to be concerned — about many states' budgetary conditions over the next few years. This is a problem because most of the tasks that state governments undertake, such as educating their young people, building roads, supporting the health care system, and so on, require sustained funding commitment over multiple years in order to meet their objectives. Moreover, these tasks will be at least as important in the future as they are today, and therefore will continue to require adequate funding levels. It is welcome news that state budgets in the current fiscal year are on relatively solid ground. Given the significant challenges that lie ahead, however, it is difficult to be sanguine about future trends.

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[2] *The Liscio Report*, April 13, 2007.
[3] Nicholas Johnson and Sarah Farkas, *Tax Cuts on Layaway: The Short– and Long-term Fiscal Implications of 2006 State Tax Actions*, Center on Budget and Policy Priorities, October 2006.
[4] Iris J. Lav, Elizabeth McNichol and Robert Zahradnik, *Faulty Foundations: State Structural Budget Problems and How to Fix Them*, Center on Budget and Policy Priorities, May 2005.
[5] Elizabeth McNichol and Brian Filipowich, *Rainy Day Funds: Opportunities for Reform*, Center on Budget and Policy Priorities, April 2007.