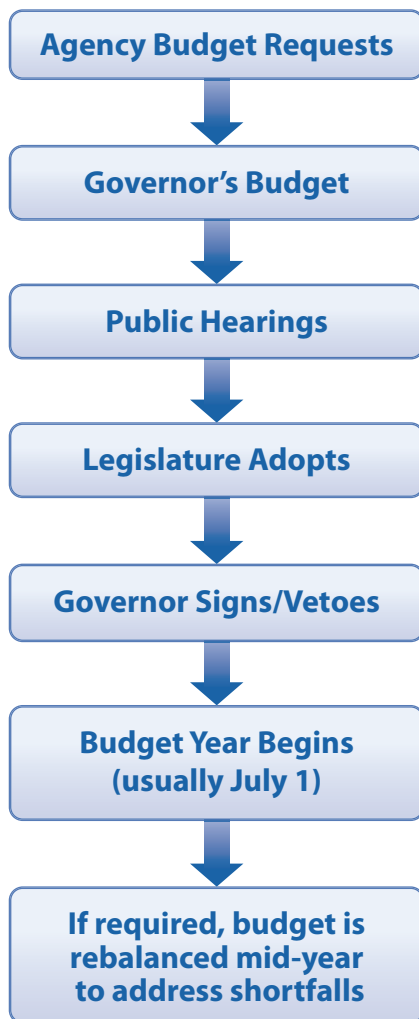


A Typical State Budget Timeline



Policy Basics is a series of brief background reports on issues related to budgets, taxes, and government assistance programs.

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January 28, 2010

States are facing an unprecedented budget crisis, as the recession has caused the greatest declines in state tax revenues on record. Below is some background on the fundamentals of state finances and the depth of the problems states face today.

The Budget Calendar

States are now in fiscal year 2010. In most states the fiscal year runs from July 1 to the following June 30. The exceptions are New York (whose fiscal year starts April 1), Texas (September 1), and Michigan and Alabama (October 1).

The public discussion of the budget typically starts when the governor issues his or her budget proposal by a date specified by the state's laws or constitution — generally in January or February.

While states vary in how much authority the legislature has to change the budget, it cannot take effect until the legislature approves it and the governor signs it. This is supposed to take place before the start of the fiscal year, though states sometimes miss the deadline and must pass temporary spending bills to keep the government running until the budget is enacted and/or temporarily shut down some functions. Some states write two-year or "biennial" budgets, but they often revise them midway through the two-year period.

Tax Revenues Fund Variety of Public Services

The largest, most important part of most states' budgets is the general fund, also known as the operating budget. In most states this is where most general tax revenue (like sales and income taxes) goes, and it pays for most of the state's spending on education, health care, public safety, human services, and other areas.

States' major source of revenue is state taxes, primarily personal and corporate income taxes and general sales taxes. Most states have both. Those with no personal income tax are: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. Those without a sales tax are: Alaska, Delaware, Montana, New Hampshire, and Oregon. Also, about a quarter of state funds come from the federal government, on average.

Over half of what states spend, on average, goes to two activities: education (K-12 and college) and health care. But states also fund a wide variety of other services, such as transportation, corrections, pensions and health benefits for public employees, care for the mentally ill and developmentally disabled, assistance to low-income families, economic development, environmental protection, state police, parks and recreation, and aid to local governments.

States Required to Balance Budgets

Unlike the federal government, every state except Vermont is required (by constitution or statute) to balance its budget. In other words, states generally cannot pay for ongoing expenditures using borrowed funds.

States can — and most states do — borrow for capital expenses, such as new roads and schools. They do this by selling bonds to investors, which states then repay over a set term (e.g., 20 years), with interest. Capital expenses are typically not considered part of the general fund, and public finance experts generally consider borrowing for capital expenses to be sound practice.

Each state's budget reflects an estimate of the amount of revenue the state will collect for the coming fiscal year. Depending on the state, this figure is set solely by the governor, by the governor and legislature jointly, by the legislature, or by an independent commission. If the estimate is short of what the state would need to fund ongoing services and meet existing obligations for the year, the state has a "budget shortfall" or "projected deficit." When this occurs, the budget must typically explain how the gap will be closed.

If, during the course of the fiscal year, revenues come in below what the state needs to fund services, the state has a "mid-year shortfall" or "mid-year deficit" for that year. Typically it must re-balance the budget through steps like using reserve funds, cutting spending, and increasing revenues. In some states the power to cut the budget mid-year rests with the governor, in others with the legislature.

Record Revenue Decline Causing Large Shortfalls

Going into fiscal year 2010, 48 states had to deal with budget shortfalls due to record drop-offs in state revenue brought on by the national recession. Since the 2010 fiscal year began, the budgets of more than three-quarters of the states have fallen out of balance as revenues have continued to fall short of expectations. These mid-year shortfalls total \$35 billion.

To balance their budgets, at least 43 states cut services over the past two years; 30 raised taxes (each of those states also cut services).

As states plan their fiscal year 2011 budgets, many already are projecting that revenues will be less than they need to maintain existing services. For fiscal years 2010 and 2011 combined, total shortfalls — the ones states have already closed and the ones they haven't — will be approximately \$350 billion.

These shortfalls overwhelmingly reflect falling revenues, resulting from the recession and the decline in economic activity. State spending as a whole was smaller as a share of the economy in fiscal year 2008 (before the recession started) than in fiscal year 2001 and has declined since then, particularly in fiscal year 2010. States also demonstrated fiscal prudence in building their largest budget reserves on record going into the recession, but they have now largely exhausted these reserves.

State budget shortfalls overwhelmingly reflect declining revenues, not excessive spending or mismanagement.