States are slowly recovering from an unprecedented budget crisis that resulted from the recent recession and the greatest decline in state tax revenues on record. Below is some background on the fundamentals of state finances and the depth of the problems that states face today.

The Budget Calendar

States are now in fiscal year 2013. For 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 Alabama, the District of Columbia, and Michigan (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, sometimes 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, and in others it rests with the legislature.

States Face Historic Challenges

Without adequate revenues, states and localities cannot continue providing public services like education and health care that lay the groundwork for a prosperous future. Today, states face a number of disturbing problems that make their revenue systems weak and vulnerable:

- State revenues remain deeply damaged by the recent recession, which was the worst downturn for states in 70 years. While revenues have improved recently, funding levels remain far below pre-recession levels and reserve funds need replenishing, making it very hard for states to strengthen key services.

- State tax systems are ill-equipped to raise revenue in a 21st century economy. For instance, the rise of e-commerce is weakening state sales taxes because it often goes untaxed. And many states still maintain income tax systems with flat or nearly flat rates, leaving them relatively less able to produce revenue for public services in a time of very high income inequality.

- The federal government, which provides about one-quarter of state revenues, is poised to make deep spending cuts. As a result of cuts implemented in 2011, federal funding for schools and other non-entitlement grants to states are on track to reach their lowest levels in four decades, measured as a share of the economy.

- Some state policymakers are pushing for large tax cuts that would further undermine state revenues, with potentially dramatic consequences for public services.

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