

SUMMARY: SPRING 2018 FISCAL SURVEY OF STATES

June 14, 2018

State Fiscal Conditions Show Signs of Improvement Heading into Fiscal 2019

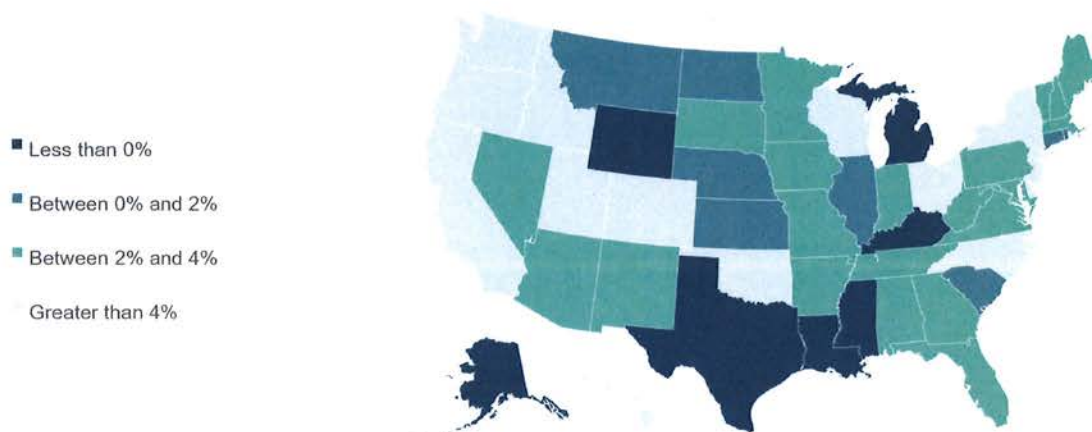
Fiscal 2019 will mark the ninth consecutive year of modest state spending and revenue growth, according to governors' budget proposals, as well as enacted budgets for some biennial budget states¹. Compared to this time last year, state fiscal conditions show signs of improvement and greater stability. General fund revenue collections have been on the upswing in fiscal 2018, giving governors more flexibility in their spending plans for fiscal 2019 compared to this time last year. The vast majority of states are meeting or exceeding their original revenue projections for fiscal 2018, following two straight years where at least half of states missed their targets. As a result, far fewer states have had to make mid-year spending reductions in fiscal 2018 compared to the

last couple of years. States also continue to prioritize their rainy day funds, with most states recommending increases in their reserve balances in fiscal 2019. While conditions have improved overall, states continue to face long-term budget challenges as spending demands for fixed costs such as pension contributions and health care are expected to grow faster than revenues over the long term. States are also assessing the impacts of the new federal tax law on their revenues, and it remains uncertain how much of the revenue acceleration states are seeing in fiscal 2018 will continue into fiscal 2019 and beyond.

Governors' Budgets for Fiscal 2019 Recommend Moderate Spending Growth

State general fund budgets are expected to increase 3.2 percent in fiscal 2019 (without adjusting for inflation),

Figure 1. General Fund Spending Percentage Change in Fiscal 2019 Proposed Budgets*



* Compared to fiscal 2018 estimated spending levels



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totaling \$861.8 billion, according to governors' recommended budgets, in line with the average annual growth rate proposed by governors since the Great Recession. This represents an improvement over this time last year, when states were dealing with the impacts of lackluster revenue growth for multiple years, causing governors to propose extremely cautious budgets with a total general fund spending increase of just 1.0 percent for fiscal 2018. Overall, 42 states plan for general fund spending increases in fiscal 2019, including 35 states with planned increases of 2 percent or more. (See **Figure 1.**) By comparison, this time last year, governors' spending plans for fiscal 2018 called for increases in just 35 states, and only 24 states were expecting growth of more than 2 percent.

Governors' recommended spending changes by program area for fiscal 2019 reflect an improved fiscal environment relative to last year. For the upcoming fiscal year, governors called for general fund spending increases across all program areas totaling \$26.5 billion (compared to enacted fiscal 2018 appropriation levels). While a modest increase, this figure represents a return to relative stability when compared to this time last year, when governors called for general fund spending increases of just \$8.7 billion across all programs. (See **Figure 2.**) K-12 education would once again receive the largest spending boost, not surprising given that it is the largest category of state general fund spending. Medicaid, the second largest component of state

general fund spending, would also see a sizeable bump in general fund spending. All other program areas would also see spending increases in fiscal 2019. General fund spending changes are sometimes partially or fully offset by spending changes in other state funds, which are not captured in this survey.

States Make Minimal Mid-Year Budget Cuts in Fiscal 2018, Far Fewer than Last Year

Improved revenue conditions in states this fiscal year led to significantly fewer states making mid-year budget reductions compared to the last couple of years. Nine states reported making net mid-year budget cuts totaling \$830 million in fiscal 2018, compared to this time last year, when 23 states reported mid-year cuts totaling \$4.9 billion in fiscal 2017 – which was later reduced to 22 states making \$3.5 billion in cuts when states reported on final fiscal 2017 spending changes in NASBO's *Fall 2017 Fiscal Survey of States* (See **Figure 3.**) Overall, 19 states increased their fiscal 2018 budgets in the mid-year, resulting in a net spending increase of \$1.6 billion across all program areas, compared to original enacted budgets.

Overall, estimated general fund spending in fiscal 2018 increased 3.4 percent – higher than what was originally recommended and what states enacted, due to

Figure 2. Recommended General Fund Spending Changes By Program Area | in Billions

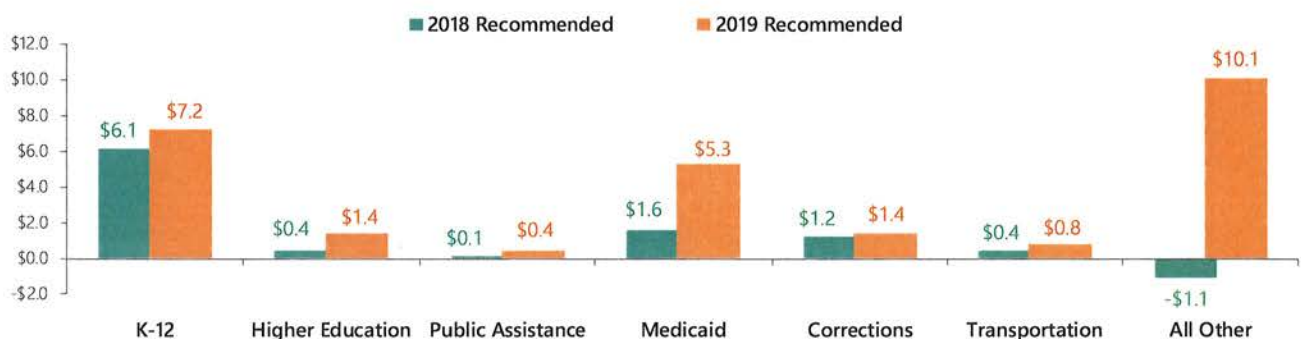
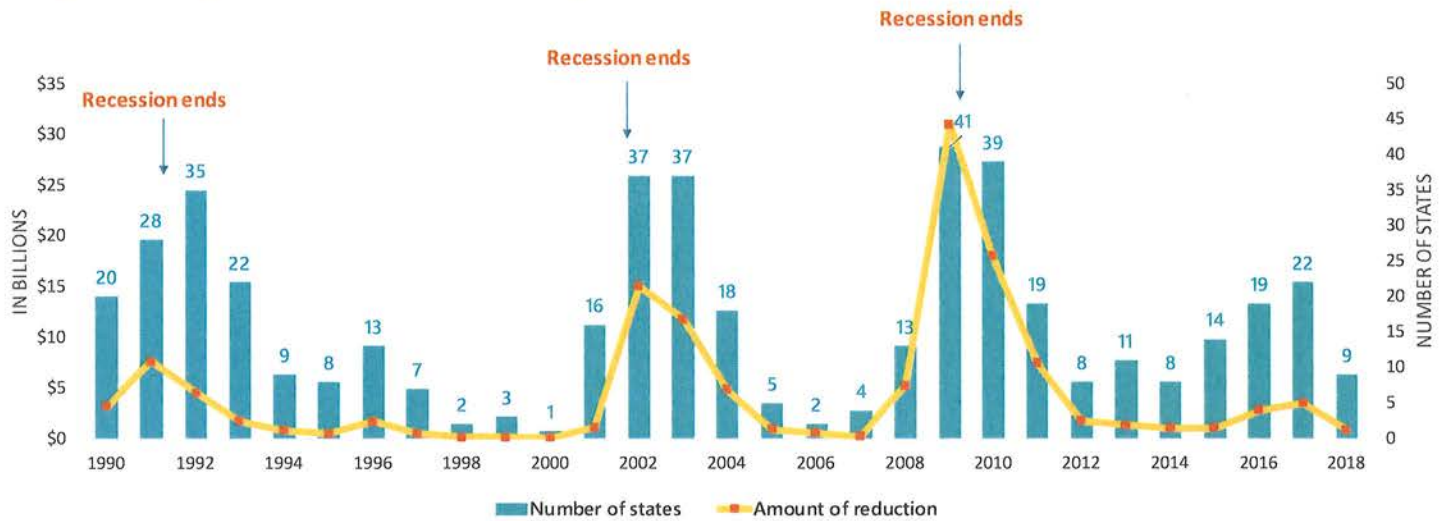


Figure 3. Budget Cuts Made After the Budget Passed



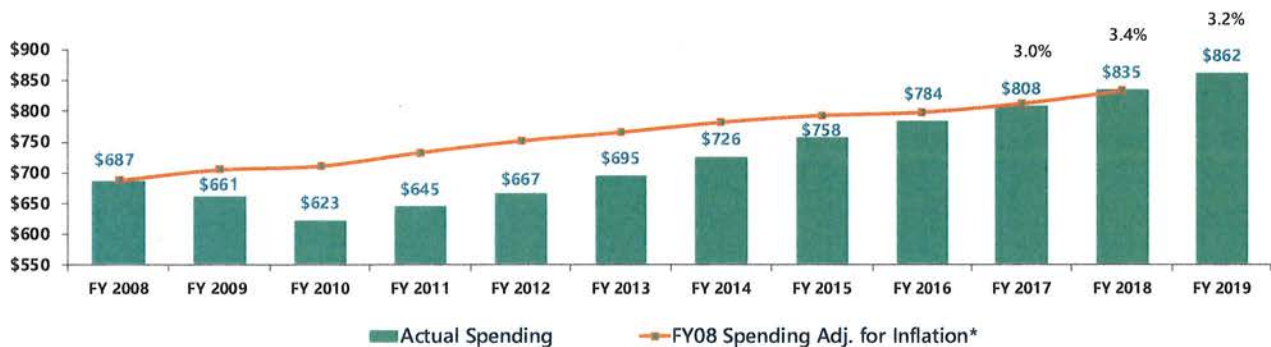
a combination of mid-year spending increases in fiscal 2018 and actual spending coming in lower than previously estimated for fiscal 2017. In the aggregate, estimated general fund spending in fiscal 2018 is slightly above the inflation-adjusted spending 50-state total in fiscal 2008, the pre-Great Recession peak one decade ago.² (See Figure 4.) Budget situations continue to vary by state. Twenty-seven states report general fund spending levels in fiscal 2018 that are lower than their fiscal 2008 levels, after adjusting for inflation – including 11 states with spending levels more than 10 percent below their pre-recession peak levels. At

the same time, nine states have inflation-adjusted general fund spending amounts more than 10 percent above their fiscal 2008 levels.

Revenue Growth Accelerates in Fiscal 2018 After Two Years of Weakness

Most states have seen improved revenue conditions in fiscal 2018 following the slowdown experienced in tax collections in fiscal 2016 and fiscal 2017. Total state general

Figure 4. General Fund Spending, Fiscal 2008 to Fiscal 2019 | in Billions



Fiscal 2018 figure is estimated and fiscal 2019 is based on governors' proposed budgets.
 *Aggregate spending level needed to total at least \$832 billion in fiscal 2018 to be equivalent with or exceed real 2008 spending level.
 Percentages shown represent annual general fund spending growth.

Figure 5. General Fund Revenue, Fiscal 2008 to Fiscal 2019 | in Billions



Fiscal 2018 figure is estimated and fiscal 2019 is based on governors' proposed budgets. Percentages shown represent annual general fund revenue growth.

fund revenues grew an estimated 4.9 percent in fiscal 2018, after growing 2.3 percent in fiscal 2017. (See **Figure 5**.) This improvement reflects continued job growth, a stronger performance of the stock market in calendar year 2017, and a modest recovery in some energy-producing states following steep oil and gas price declines. Fiscal 2018 revenues in a few states were also bolstered by enacted tax increases. The federal tax changes under the *Tax Cuts and Jobs Act* (TCJA) have implications for state revenue collections as well, and states are still working to better understand the new federal law's effects on their revenues – see further discussion below. Note that the total estimated revenue growth rate is driven in part by faster growth in several large states – in fact, five out of the six most populated states in the country reported estimated general fund revenue growth above 6

percent for fiscal 2018. The median revenue growth rate for fiscal 2018 is much lower, at 2.7 percent, with a majority of states estimating revenue growth below 3 percent.

At the time of data collection for this survey, 39 states were meeting or exceeding their original budgeted revenue projections – with 24 states coming in higher and 15 states on target. (See **Figure 6**.) Based on updated general fund revenue information from states, the number of states exceeding their budget targets seems likely to rise further before the end of the fiscal year, which is June 30 for 46 out of the 50 states. General fund sales and personal income tax collections were both significantly exceeding original budget targets in the aggregate for fiscal 2018, by 2.1 percent and 0.9 percent, respectively. Among the states

Figure 6. General Fund Revenue Collections Compared to Budget Projections | by Fiscal Year



that have revised their fiscal 2018 revenue estimates since releasing their governors' recommendations for fiscal 2019, the vast majority made upward revisions for the current fiscal year. Compared to fiscal 2017 levels, sales and use tax collections are estimated to grow 3.6 percent (median rate of 3.7 percent), personal income tax collections by 7.0 percent (median of 4.8 percent), and corporate income tax collections by 3.2 percent (median of 2.8 percent) in fiscal 2018.

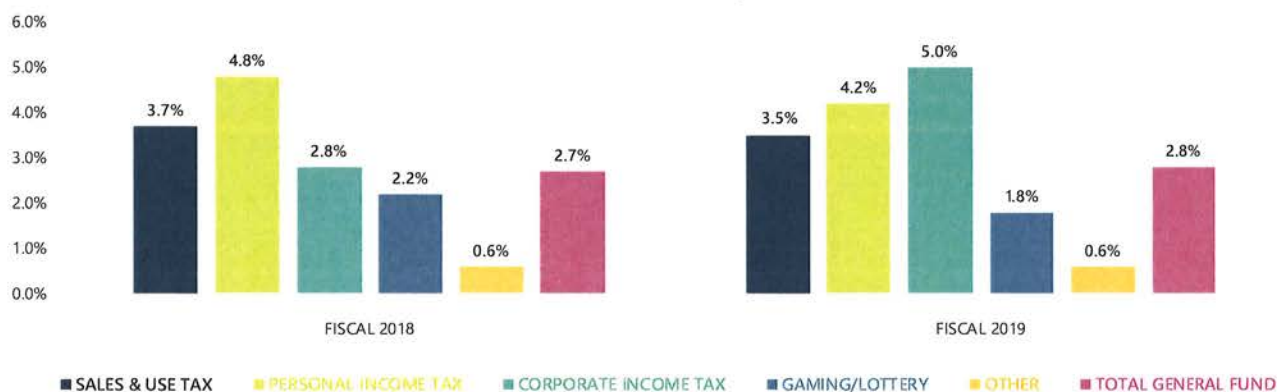
Modest Revenue Growth Expected in Fiscal 2019 Budgets, But Uncertainty Surrounds Forecasts

According to governors' budgets for fiscal 2019, states predict that general fund revenue collections will increase modestly, with total revenues growing 2.1 percent and 40 states forecasting positive revenue growth. The median growth rate for fiscal 2019 is higher, at 2.8 percent. Similar to the spending side, 27 states forecast revenues to increase between 2 and 5 percent compared to estimated fiscal 2018 budgets, with seven states forecasting growth above 5 percent, six states predicting growth between 0 and 2 percent, and the remaining 10 states forecasting revenue declines. Sales and use tax collections (roughly 31 percent of total general fund revenues) are forecasted to grow by a median rate of 3.5 percent in fiscal 2019 (total growth of

2.3 percent). Personal income taxes (about 45 percent of general fund revenues) are projected to grow at a median rate of 4.2 percent (total growth of 2.9 percent). Corporate income taxes, the third largest component of general fund revenues at about 6 percent, are estimated to grow at a 5.0 percent median rate in fiscal 2019 (total growth of 8.4 percent). Large fluctuations in revenue collections in some states can skew 50-state total growth rates, while a median growth rate – the “middle” percentile when states' revenue growth rates are ranked lowest to highest – tends to be more representative of the “average” state. While total general fund revenue growth is expected to slow in fiscal 2019 relative to fiscal 2018, the median growth rates for the two years are nearly identical, and both fairly modest. (See **Figure 7.**)

Significant uncertainty surrounds these revenue forecasts, however, as states continue to analyze and predict the effects of federal tax changes under *Tax Cuts and Jobs Act* (TCJA) – including both the impacts related to how a state conforms with the federal code as well as behavioral responses by taxpayers to shift the timing of income. Most governors' budgets came out before states were able to incorporate the effects of the TCJA into their revenue forecasts. The federal tax changes have already affected state revenue collections for the current fiscal year – states saw a significant uptick in their December personal income tax collections,

Figure 7. Median Percentage Change in General Fund Revenue Collections | by Revenue Source



believed to be largely driven by high-income taxpayers making advance payments to take advantage of expiring tax breaks. While some expected April tax collections to be lower as a result, preliminary data available indicate that states saw strong growth in their collections in April too. States are still working to untangle and better understand these trends and the impacts of the federal tax law on their revenues, and it remains to be seen how much of the revenue increase this fiscal year will carry into fiscal 2019 and subsequent years. States are also awaiting a decision on the U.S. Supreme Court case, *South Dakota v. Wayfair et al.*, regarding the legality of states compelling remote/online retailers to collect sales taxes on remote purchases.

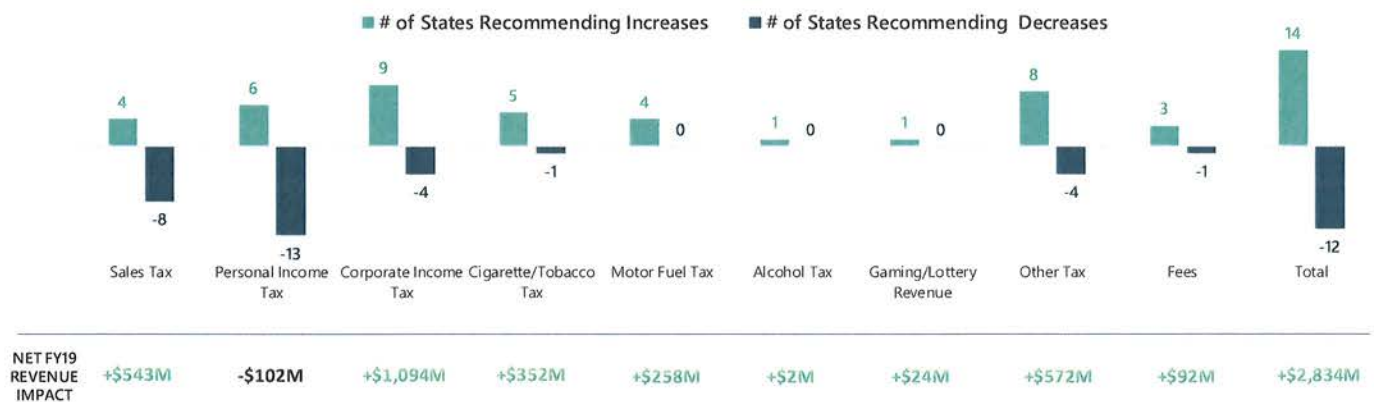
Governors Propose Mostly Modest Tax Changes for Fiscal 2019, Some in Response to New Federal Tax Law

Fiscal 2019 revenue projections in this survey incorporate the mostly modest tax proposals included in governors' recommended budgets. Governors in 14 states recommended net increases in taxes and fees in fiscal 2019, while 12 states recommended decreases, resulting in a net increase of \$2.8 billion, including general fund and other state fund revenues. (See **Figure 8**.) The revenue proposals with the largest dollar impact include packages

of tax increases recommended by the governors of New Jersey and Oklahoma. Additionally, 16 states provided information on revenue measures, which would result in a net revenue increase of \$3.0 billion. Most of this impact comes from the proposed drawdown from Alaska's Permanent Fund account, along with a recommendation to move New Jersey's energy sales tax revenues on budget. These measures usually enhance general fund revenue but do not affect taxpayer liability.

Some of the personal and corporate income tax changes proposed during 2018 legislative sessions were prompted by or in direct response to the new federal tax law passed in December 2017. States have reacted to the *Tax Cuts and Jobs Act* in a variety of ways, depending on how their tax code conforms to federal law, political priorities, and other factors. Governors' revenue proposals responding to federal tax changes included actions to cut state tax rates, decouple from the federal tax code to prevent state revenue increases (or decreases), expand family tax credits, create options for taxpayers to mitigate the impact of the cap on state and local tax deductibility, and other provisions. Due to the deadlines for submitting proposed budgets, governors in many states made or endorsed later recommendations in reaction to the federal tax law changes.

Figure 8. Summary of Recommended State Revenue Changes for Fiscal 2019 | by Revenue Source



Most States Continue to Strengthen Rainy Day Funds, With 28 States Calling for Increases in Fiscal 2019

Rainy day fund balances – budget stabilization funds and/or reserve accounts set aside to respond to unforeseen circumstances – are a crucial tool that states rely on during fiscal downturns and to address shortfalls. States have made building up their reserves a priority in the years following the Great Recession, when rainy day fund balances fell to \$21.0 billion in fiscal 2010 (or just \$10.7 billion when excluding Alaska). Significant progress has been made since then – from fiscal 2011 to fiscal 2018, the median rainy day fund balance grew from 1.9 percent as a share of general fund expenditures to 5.8 percent, surpassing the pre-recession peak of 4.9 percent. The median balance is projected to rise to 6.2 percent in fiscal 2019, as governors continued to prioritize rainy day funds in their budgets, with 28 states recommending increases in their rainy day fund balances and only three states projecting declines. (See **Figure 9**.)

Rainy day fund levels, as a share of expenditures, vary across states. This variation is related to differing fiscal conditions, rainy day fund structures, policy decisions, revenue volatility levels and other factors. Three states – Georgia, Oklahoma and Wisconsin – were not able to

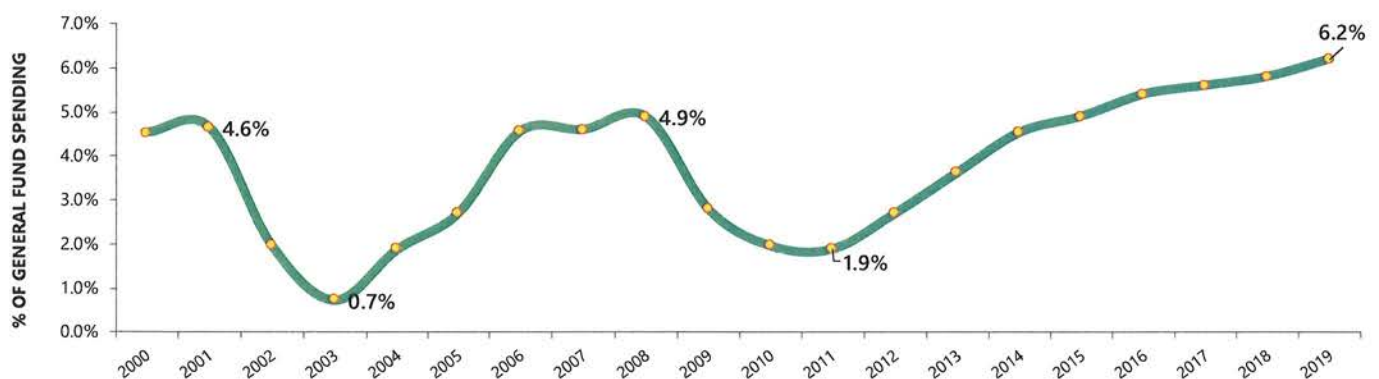
report on their rainy day fund balance levels for fiscal 2018 and/or fiscal 2019. Excluding these three states, rainy day fund balances are expected to total \$52.0 billion in fiscal 2017, \$53.6 billion in fiscal 2018, and \$58.1 billion in fiscal 2019.

Total balances include both general fund ending balances and the amounts in states' rainy day funds. Total balances reflect the surplus funds and reserves that states may use to respond to unforeseen circumstances and to help smooth revenue volatility, though in some states, part of the ending balance may already be reserved for expenditure in a subsequent year. Total balances are estimated at \$78.0 billion in fiscal 2018 (excluding Oklahoma), little changed from fiscal 2017, and they are projected to dip somewhat to \$74.6 billion in fiscal 2019 (excluding Oklahoma and Wisconsin).

States Expect Medicaid Spending Growth to Slow in Fiscal 2019

NASBO's spring edition of the *Fiscal Survey of States* also contains a special section on the Medicaid outlook for states. The median growth rate for Medicaid spending from all fund sources is estimated at 5.2 percent for fiscal 2018. Looking just at spending from state fund sources, the median growth rate is 4.5 percent, while spending from federal funds has an estimated median growth rate of 5.9

Figure 9. Median Rainy Day Fund Balance Over Time



percent for fiscal 2018. Looking ahead, Medicaid spending growth is forecasted to slow considerably in fiscal 2019, based on governors' budgets. The median growth rate for total Medicaid spending is projected at 1.9 percent for the upcoming fiscal year. State fund spending is projected to grow by 1.5 percent (median), while federal fund spending is expected to increase by a median of 2.3 percent. (See **Figure 10.**) Given large swings in some states that can substantially influence total Medicaid spending growth rates, examining the median percentage change often better reflects underlying trends, though timing issues can still skew the data.

While Medicaid spending growth shows signs of slowing in the short term, the long-term growth projections for the program are expected to be closer to historical growth levels, about 5.5 percent per year, according to the Congressional Budget Office (CBO). The Medicaid program continues to pose long-term spending pressures for states as they monitor the impacts on their budgets of rising prescription drug costs, the growing elderly and disabled population, changes in federal laws and regulations, and costs associated with the opioid epidemic. States reported on continued cost containment and delivery service reform efforts, with states passing or considering policies to cut drug costs, enhance program integrity, and expand managed care. At the same time, with budget conditions fairly stable in most states, a

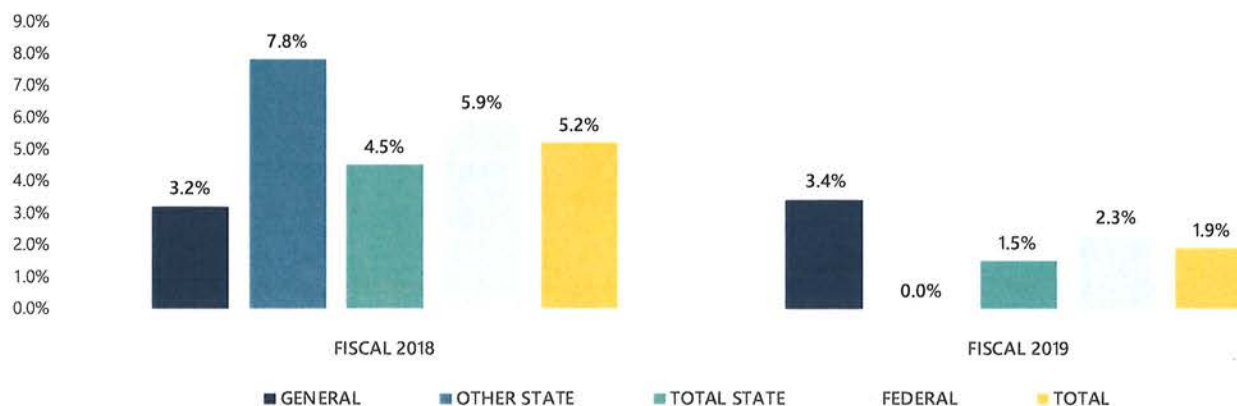
number of states reported increasing provider payments and expanding Medicaid benefits, while fewer states reported restricting payments or benefits.

States that expanded Medicaid also reported on their expenditures for the new adult eligibility group (including both “newly eligible” and “not newly eligible”) by fund source. As states have begun to pick up a larger share of the cost, Medicaid expansion spending from state funds is estimated to increase \$3.6 billion in fiscal 2018. Most states are planning for increases in state fund spending on Medicaid expansion in fiscal 2019 as well, though 50-state total spending from state funds is projected to decrease.

Outlook: Improved Fiscal Conditions in States, but Long-Term Challenges Remain

Overall, state fiscal conditions show signs of improvement compared to this time last year by a number of measures. General fund revenue growth accelerated in fiscal 2018, the vast majority of states are seeing tax collections come in on target or above budget projections, and relatively few states have had to make mid-year budget cuts in fiscal 2018. In this more stable environment, most governors recommended modest general fund spending increases in their budget proposals for fiscal 2019. Last spring, states were also facing

Figure 10. Median Percentage Change In Medicaid Spending | by Fund Source



tremendous federal uncertainty regarding future federal funding levels, health care and Medicaid financing, and the prospects for tax reform. Much of this uncertainty has been eliminated or significantly reduced – at least for the time being – after Congress reached agreement on a two-year spending framework, made no changes to Medicaid’s federal/state sharing arrangement, and enacted the largest set of changes to the federal tax code in more than 30 years. States are now trying to untangle the complicated effects

of the recent federal tax changes on their revenues, and it remains to be seen how much of the revenue uptick states are experiencing in fiscal 2018 will continue into fiscal 2019 and beyond. While budget conditions vary by state, all states to some extent are facing long-term spending pressures in areas ranging from health care and pensions to adequately funding K-12 education and infrastructure. States are also working to prepare for the next downturn by strengthening their reserve funds.

¹Most biennial budget states enacted two-year budgets during 2017 legislative sessions covering fiscal 2018 and fiscal 2019. Among these states, most reported on fiscal 2019 in this survey based on their enacted biennial budgets, some with enacted revisions.

²The state and local government implicit price deflator cited by the Bureau of Economic Analysis National Income and Product Account Tables, Table 3.9.4., Line 33 (last updated on April 27, 2018), is used for inflation adjustments. Quarterly averages are used to calculate fiscal year inflation rates.

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