THE VOLCKER ALLIANCE
Empowering and Inspiring Public Servants

APRIL 21, 2022

US State Budgets: Yesterday, Today, and Tomorrow

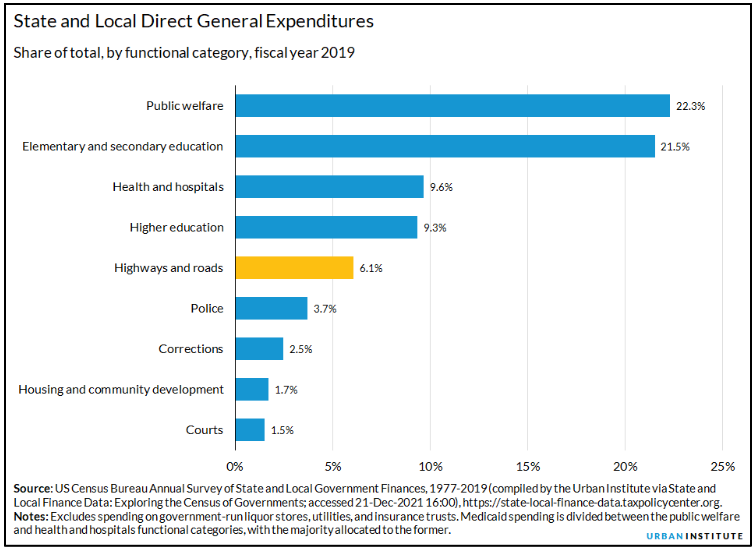
Prepared by: William Glasgall

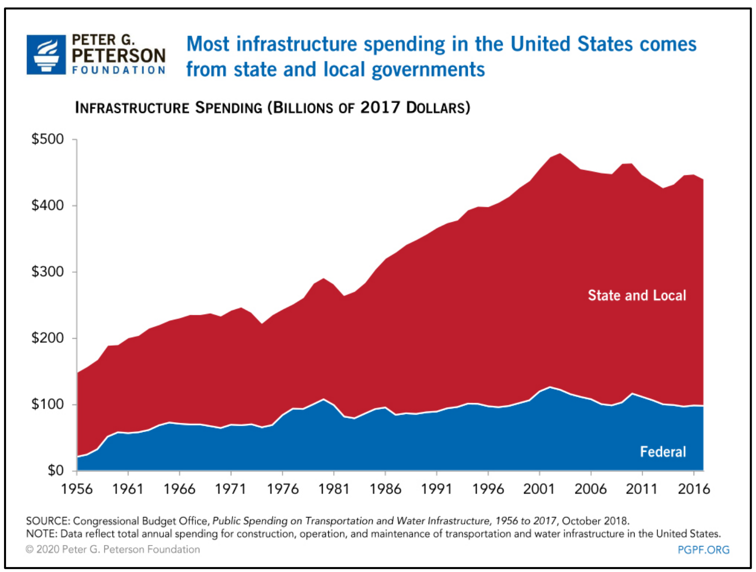
Truth and Integrity in Government Finance

- *TISB*: First 5-year review of state budget practices
- States graded in 5 areas: budget maneuvers, forecasting, reserves, legacy costs, transparency
- Which states were best-prepared for 2020 COVID-induced recession; implications for future performance
- NEW: *New York: State of Debt*
- COMING SOON: *The $195 Billion Challenge*

THE VOLCKER ALLIANCE
Empowering and Inspiring Public Servants

US State & Local Finances-at-a-Glance





- Federal government has very limited role in state & local budgeting practices
- 49 states require balanced budgets; no standard definition of "balanced," however. Almost all state & local governments use cash budgeting (major exception: NYC)
- States cannot file for bankruptcy; many stabilizers but full "bailouts" unlikely
- State & local govts spend ~$4 trillion/yr, employ 19.7 million workers
- Federal government sends states, localities ~$900 billion/yr in normal times
- Intergenerational liability transfers common (pensions, OPEB, debt, deferred maintenance)

- States & localities provide ~80% of government infrastructure investment
- Capital and some O&M is funded via general funds, motor fuel taxes, federal grants & loans, and bond sales in the $4 trillion muni market, largely exempt from US and many state taxes.
- Borrowing for ongoing expenditures relatively rare lately but can create crises (Detroit, IL, PR, etc.)

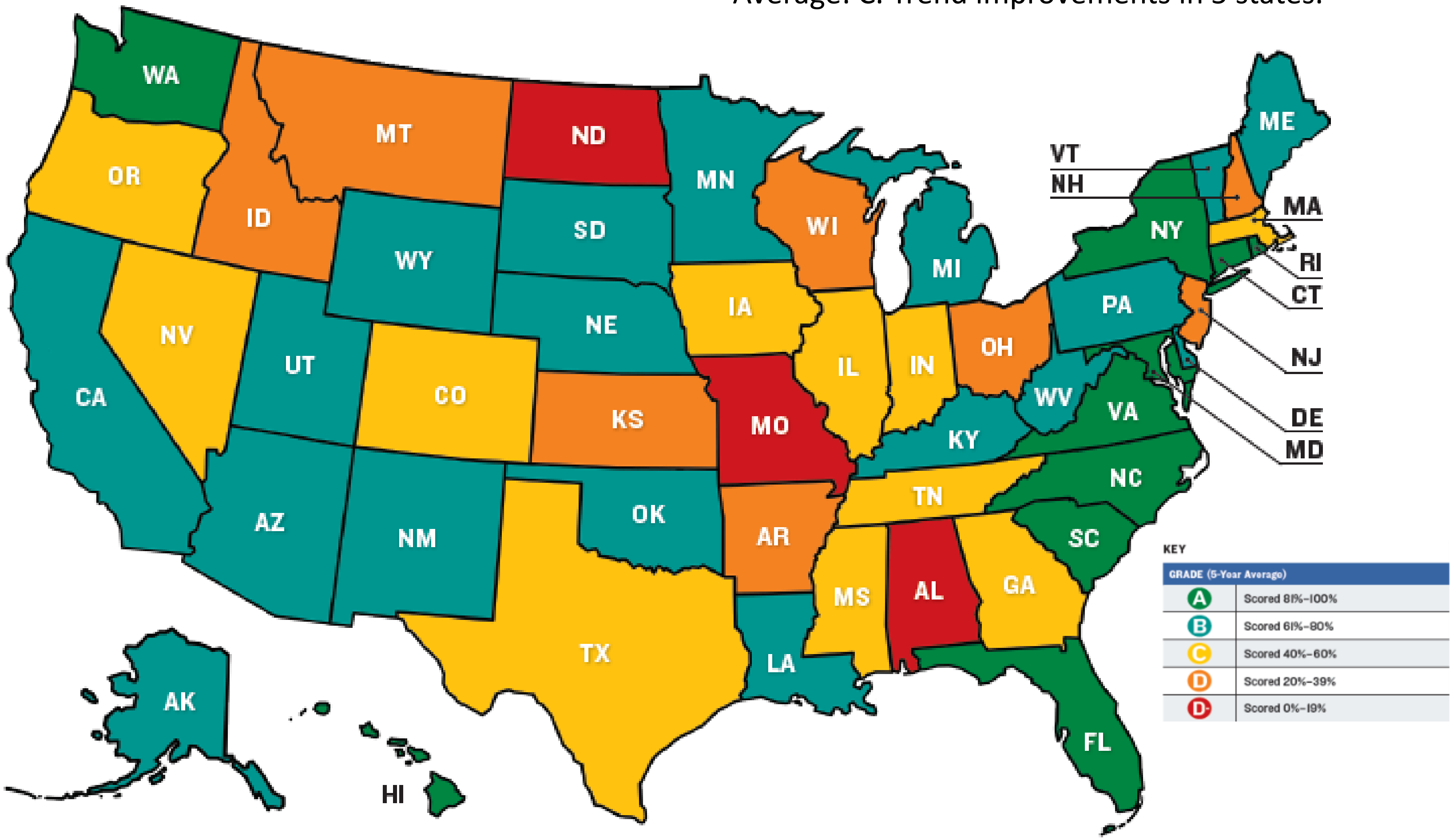
1. On the Eve of COVID-19: Boom Times

Budget Forecasting

Average grade, FY 2015-19

See "Improving Subnational Governments' Resilience," paragraph 51

Average: C. Trend improvements in 5 states.



THE VOLCKER ALLIANCE
Empowering and Inspiring Public Servants

Budget Forecasting Research Questions

BUDGET FORECASTING BASICS **When assessing a state's budget forecasting procedures, Volcker Alliance researchers considered these questions:**

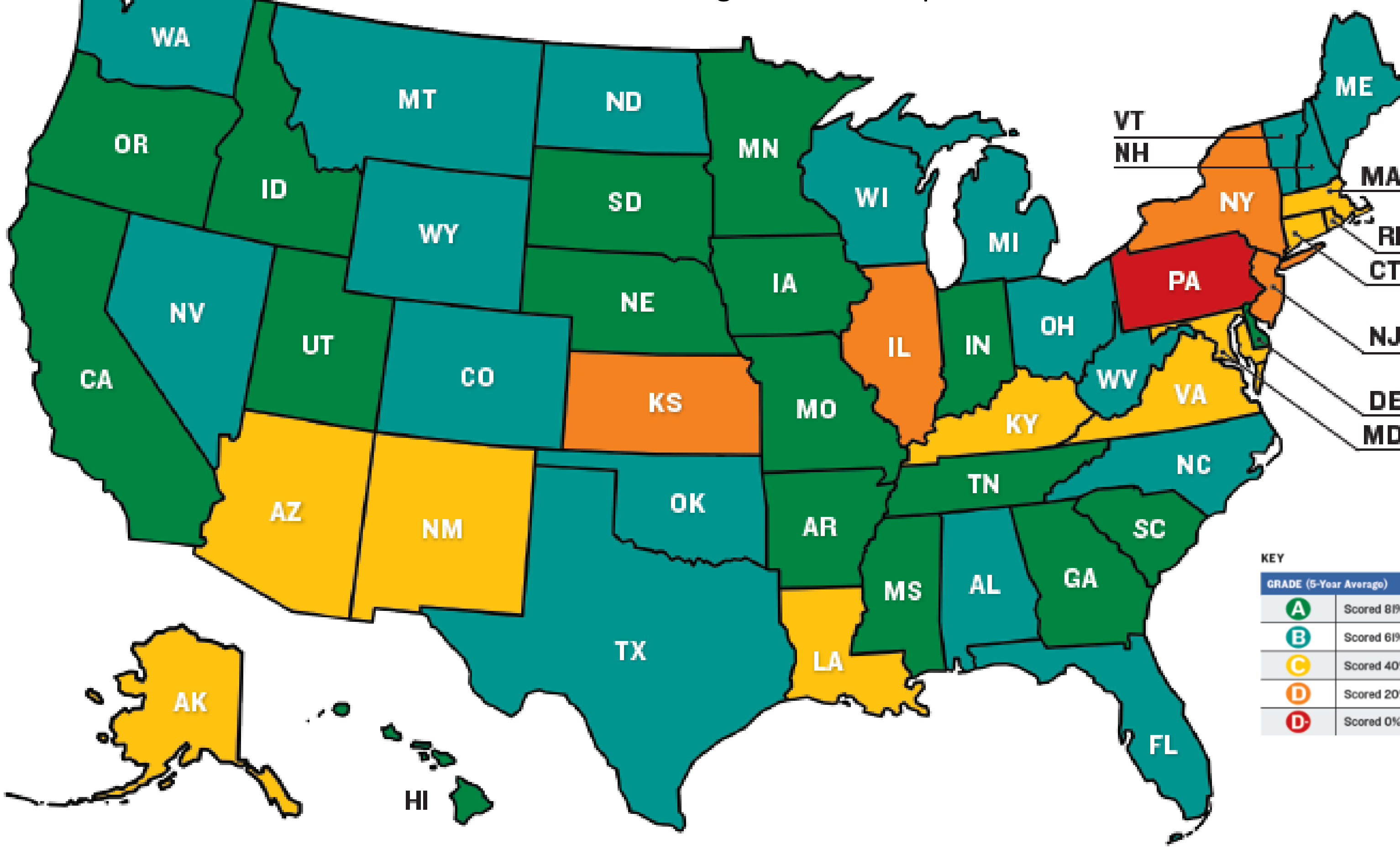
RESEARCH QUESTIONS	WHY IT'S IMPORTANT
Does the state utilize a consensus revenue estimate for the forthcoming fiscal year or biennium in budget and planning documents?	Consensus revenue estimates are a projection of revenues developed in agreement between the executive and legislative branches, sometimes with input from outside economists or business groups. While this method may not produce forecasts that are more accurate than ones produced solely by the governor's office, it reduces the risk of revenue forecasts being politically manipulated; focuses budgeting on a single, agreed-on revenue figure; and helps policymakers concentrate on spending decisions.
Does the state provide a reasonable, detailed rationale to support revenue growth projections at time of the initial budget?	To help determine the validity of revenue estimates, it is important for states to disclose the methodology used in calculating the figures. For example, without knowing that estimates in energy-producing states such as Wyoming largely depend on severance taxes, the reasoning behind the forecasts is lost.
Does the state utilize multiyear revenue forecasts for at least three full fiscal years in budget and planning documents?	Revenues come mainly from taxes, fees, federal aid, fines, legal settlements, and returns on investment. It is only through a multiyear forecast that a budget shows users how stable the state's revenues are. Such a forecast will indicate gaps that may appear when the current year's budget is based on temporary revenue sources. A multiyear forecast will also reveal the impact of changes in tax law.
Does the state utilize multiyear expenditure forecasts for at least three full fiscal years in budget and planning documents?	States should carefully examine possible contributors to expanding or declining expenditures in future years. A long-term estimate, for example, might consider evidence that a slowing economy could lead to increases in Medicaid caseloads and strain a state's fiscal stability. Such a scenario might suggest a need for spending cuts or tax increases to close future budget deficits.

Budget Maneuvers

Average grade, FY 2015-19

See "Improving Subnational Governments' Resilience," paragraph 45

Average: B. Trend improvements in 20 states



KEY

GRADE (5-Year Average)	
A	Scored 81%-100%
B	Scored 61%-80%
C	Scored 40%-60%
D	Scored 20%-39%
D-	Scored 0%-19%

THE VOLCKER ALLIANCE

Empowering and Inspiring Public Servants

Budget Maneuvers Research Questions

BUDGET MANEUVERS BASICS When assessing a state's budget maneuvers, Volcker Alliance researchers considered these questions:

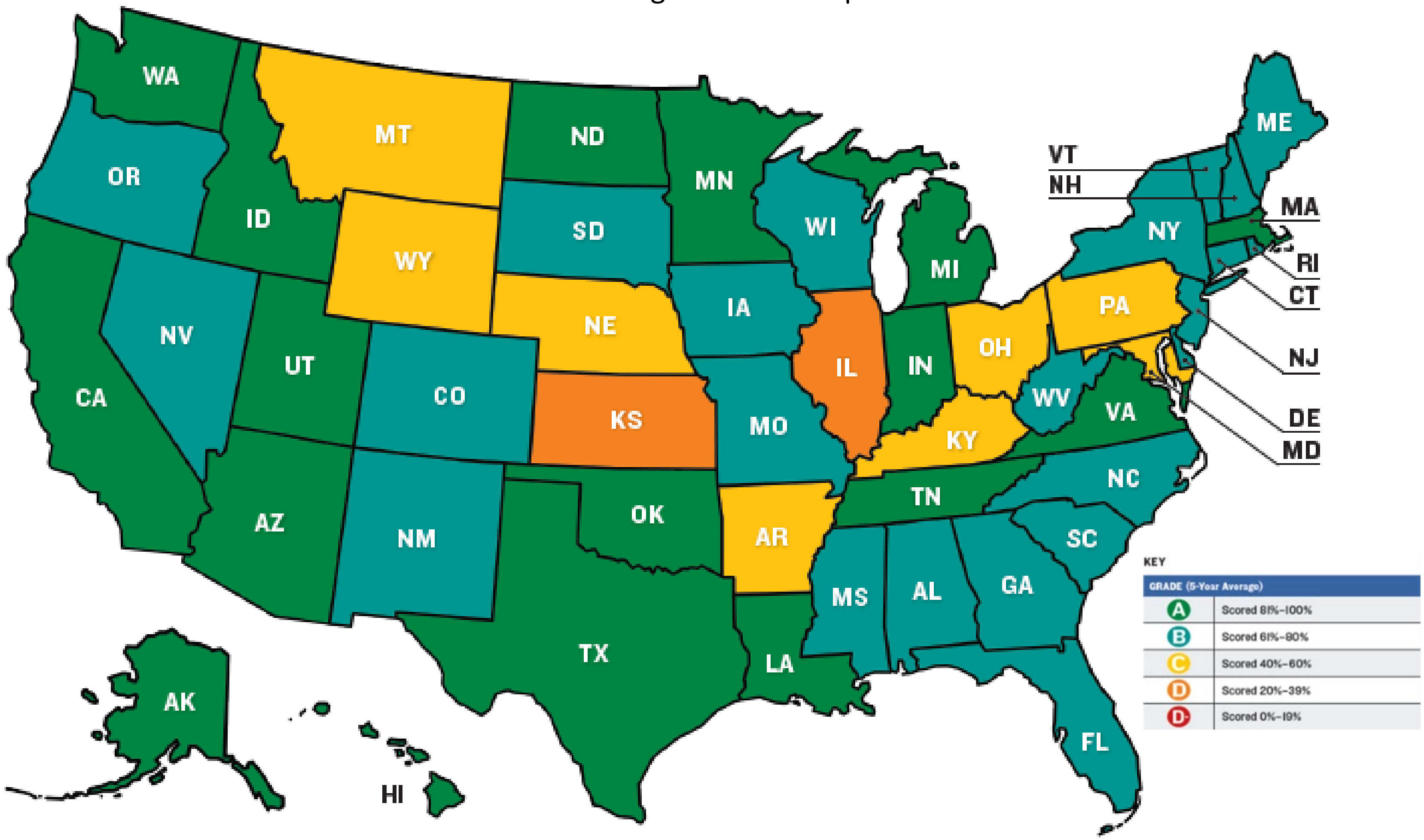
RESEARCH QUESTIONS	WHY IT'S IMPORTANT
Did the state successfully avoid deferring recurring expenditures, excluding those for capital projects, into future fiscal years from the current year?	The high costs of bridges, buildings, and other capital projects suggest that their expense should be spread over assets' useful life by financing them with long-term bonds. But putting off recurring operating expenditures to a future year will only shift them to future budgets, making budgets ever more difficult to balance.
Did the state successfully avoid temporarily shifting costs to counties, municipalities, school districts, or other governments or agencies, or avoid upstreaming cash from any such entity to the state if such shifting or upstreaming is not part of a regular agreement or process? **Did the state successfully avoid utilizing one-time transfers into the general fund from special funds to pay for recurring expenditures?** **Did the state successfully avoid drawing down the rainy day or other budget stabilization reserve funds to pay for recurring expenditures?** **Did the state successfully avoid drawing down the general fund reserve on a budgetary basis to pay for recurring expenditures?**	Temporarily shifting costs from the general fund to other governments or agencies balances the budget but still leaves taxpayers footing the bill. One-time transfers into the general fund from special funds may be impossible to sustain, especially if the special funds are drained.
Did the state successfully avoid utilizing the proceeds of borrowing to pay for recurring expenditures? Are such proceeds counted as revenue for balancing the budget? **Did the state successfully avoid utilizing scoop-and-toss refinancing to raise funds for any current expenditures, including debt service?** **Did the state successfully avoid diverting bond premiums (or other up-front cash flows generated during sales of bonds or other financial transactions) into the general fund or other general revenue account?** **Did the state successfully avoid utilizing pension bond proceeds to make the annual required or actuarially determined contribution to any pension?**	States should avoid using bond premiums, a form of borrowed money, for the general fund or using bonds to make pension payments. Other practices, hazardous for the same reasons, include using up-front funds derived from refinancings to balance current budgets or pushing debt costs into the future to free up revenues to pay current bills.
Did the state successfully avoid utilizing proceeds from material, nonrecurring asset sales (excluding routine disposals of surplus or outdated property) to fund recurring expenditures? **Did the state successfully avoid utilizing up-front proceeds or deferral of up-front costs on financial transactions to fund recurring expenditures?** **Did the state successfully avoid accelerating tax or other revenues from a future year into the current fiscal year to fund recurring expenditures?**	While assets can be sold to pay for recurring expenditures, there is no assurance that other assets will be available for such spending in future years. For example, government buildings that are sold may have to be leased back at taxpayer expense, or tolls may be raised if roads are sold through privatization. Paying for ongoing costs by accelerating revenues or using similar techniques can stress future budgets.

THE VOLCKER ALLIANCE
Empowering and Inspiring Public Servants

Reserve Funds

Average grade, FY 2015-19

Average: B. Trend improvements in 5 states.



THE VOLCKER ALLIANCE

Empowering and Inspiring Public Servants

Reserve Funds Research Questions

RAINY DAY FUND BASICS When assessing a state's rainy day funds and budgetary reserves, Volcker Alliance researchers considered these questions:

RESEARCH QUESTIONS	WHY IT'S IMPORTANT
Were state reserve funds greater than $0 on the first day of the fiscal year?	Particularly in economic downturns, raising taxes or cutting programs can be politically and economically perilous. One alternative is to fill the gap temporarily with money retained in a general fund balance or rainy day fund. Doing so might allow a state to avoid even less sustainable one-time solutions.
Does the state have a policy (set by constitution, referendum, statute, or other formal rule) for the use of rainy day funds?	Without a clear policy governing the use of reserves, they can turn into slush funds to be spent at legislators' whim. States should have policies governing when and how reserves can be tapped for natural disasters and when the economy slumps, tax revenues drop, and rising unemployment creates higher demand for state services.
Does the state have a policy (set by constitution, referendum, statute, or other formal rule) for the replenishment of rainy day funds?	If rainy day funds are used to help deal with emergencies, unexpected expenses, or revenue shortfalls, states need to follow guidelines to ensure that the cash is replaced. Without replenishment policies, states risk facing the next economic downturn with minimal financial cushion to help sustain operations.
Is the state's targeted rainy day fund balance specifically tied to the historical trend of revenue volatility? **Are deposits into the state's rainy day fund specifically tied to the historical trend of revenue volatility?**	States with less volatile revenues can sensibly establish smaller reserves than those in which revenue fluctuations are more frequent and more dramatic.

THE VOLCKER ALLIANCE

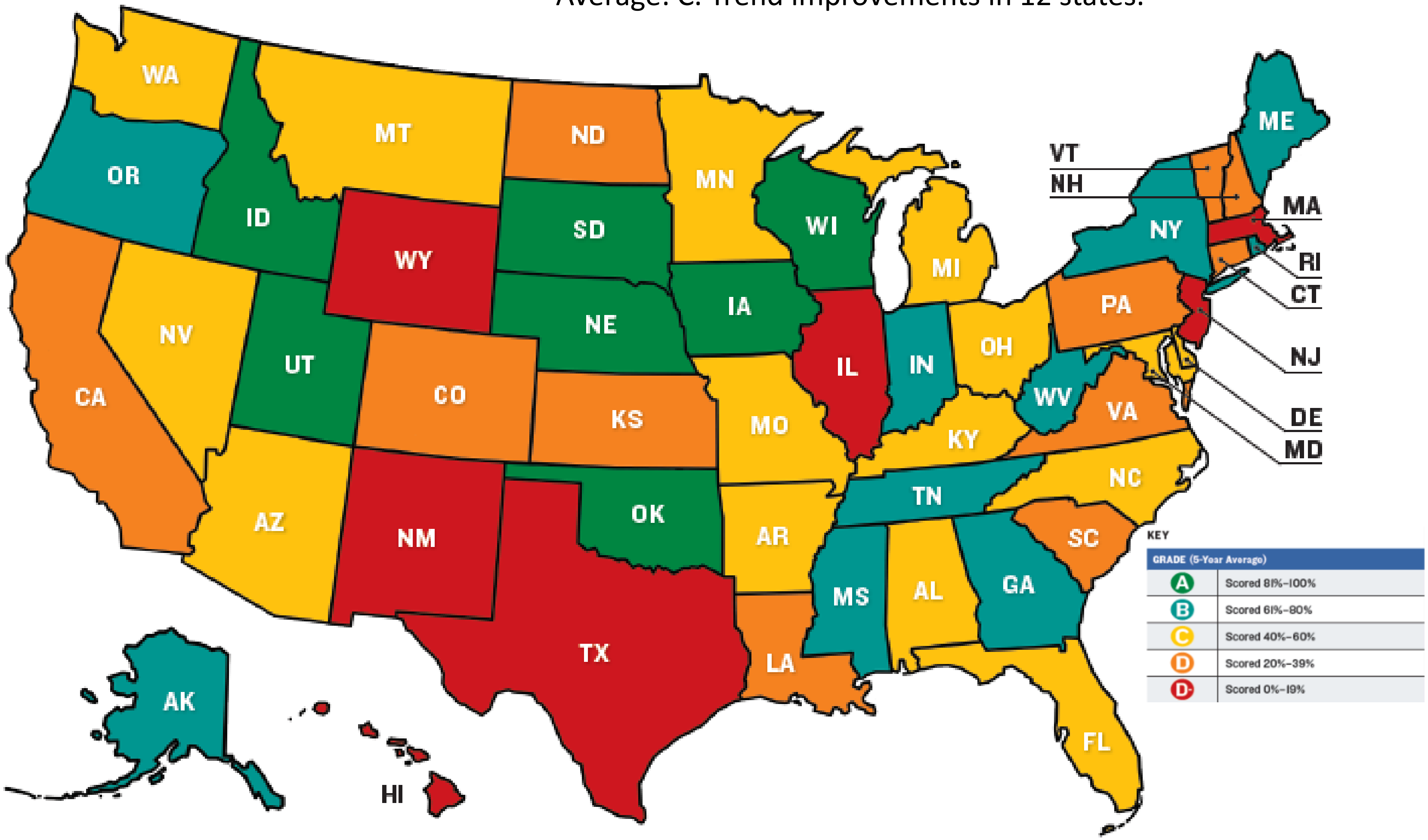
Empowering and Inspiring Public Servants

Legacy Costs

Average grade, FY 2015-19

See "Improving Subnational Governments' Resilience," paragraph 50

Average: C. Trend improvements in 12 states.



Legacy Costs Research Questions

LEGACY COST BASICS When assessing a state's legacy costs, Volcker Alliance researchers considered these questions:

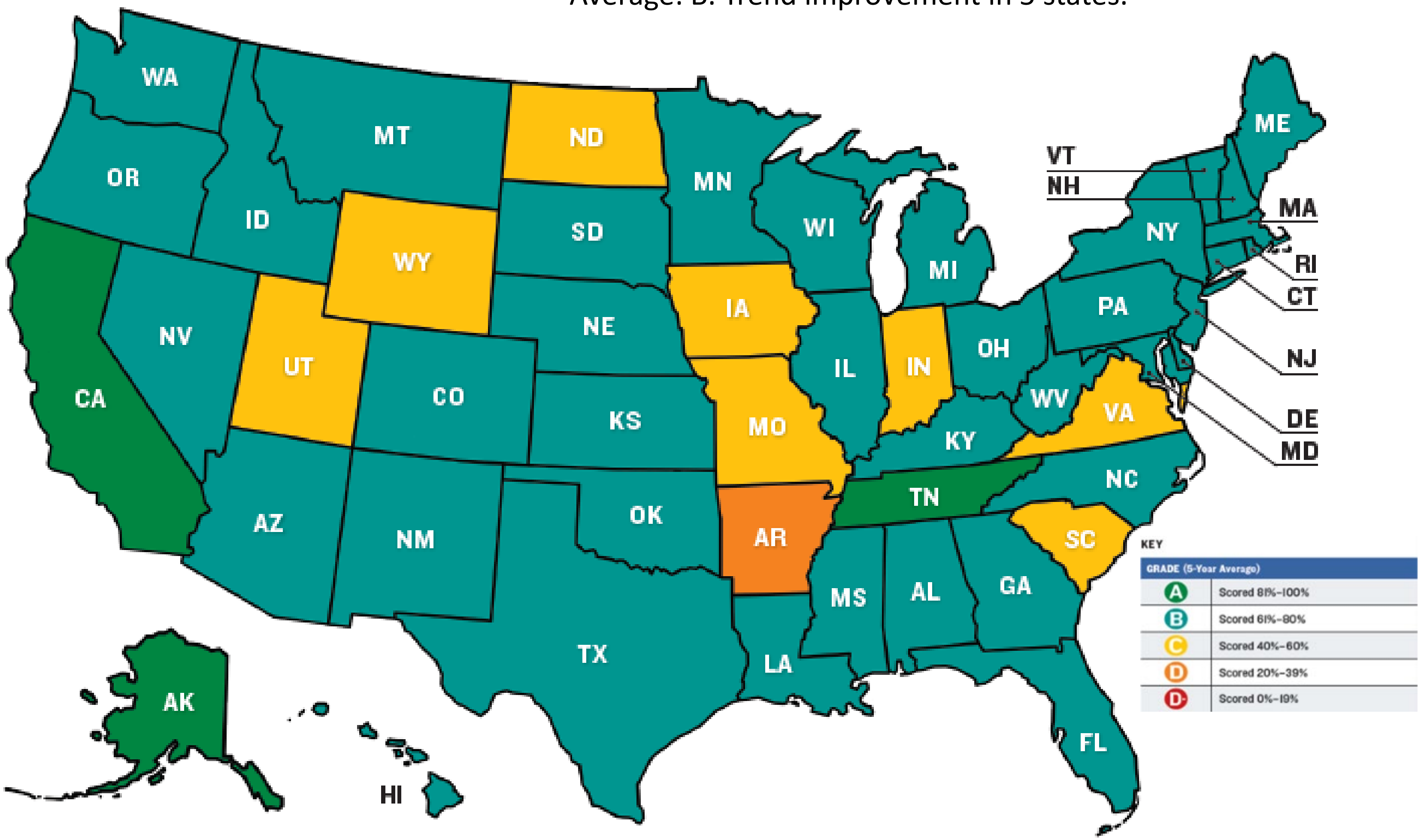
RESEARCH QUESTIONS	WHY IT'S IMPORTANT
Was the contribution to public employee pension funds effectively 100 percent of the actuarially required or determined (ARC or ADC) amount?	State pension actuaries determine how much each government employer needs to set aside every year to ensure that sufficient assets are available to cover future pension benefits. If a state deposits less than the amount actuaries recommend, future government contributions are likely to rise, limiting states' capacity to pay for essential services.
Was the contribution to public employee other postemployment benefits (OPEB) effectively 100 percent of the ARC or ADC amount?	States have over $600 billion in unfunded OPEB retirement liabilities. These largely stem from promised health care benefits for retired public workers. While states are required to report OPEB liabilities, most pay for retiree health costs, when coverage is offered, on a pay-as-you-go basis. The result is that unfunded liabilities will grow along with the ranks of retired workers.
Was the state's pension funded ratio above 90 percent (for full credit) or above 70 percent (for half credit)?	Even though states may be making the ARC or ADC for pensions, many still have large unfunded liabilities built up from past years. A large accrued debt necessitates spending more on amortization each year.

THE VOLCKER ALLIANCE
Empowering and Inspiring Public Servants

Budget Transparency

Average grade, FY 2015-19

Average: B. Trend improvement in 5 states.



THE VOLCKER ALLIANCE

Empowering and Inspiring Public Servants

Budget Transparency Research Questions

BUDGET TRANSPARENCY BASICS When assessing a state's transparency, Volcker Alliance researchers considered these questions:

RESEARCH QUESTIONS	WHY IT'S IMPORTANT
Does the state have a consolidated website or set of related sites that provide budget and supplemental data?	Complete and useful information about a state's budget and budgetary processes is critical for policymakers, policy advocates, and citizens. Much of this information is now available on government websites.
Does the state provide tables listing outstanding debt and debt service costs, as well as provide information on any legal debt limits?	Clear disclosure of the amount of a state's debt is essential to understanding its fiscal health and the burden that borrowing may place on the budget. Excessive debt levels increase principal and interest payments, may lead to lower credit ratings, and squeeze the government's ability to spend on education, infrastructure, or other needs.
Is the estimated cost of the deferred infrastructure maintenance liability for all the state's capital assets disclosed in budget and planning documents?	Most states fail to disclose the estimated cost of deferred infrastructure maintenance. This is a liability like underfunded pension costs. While many governors have acknowledged the importance of spending more on infrastructure, it is difficult to persuade taxpayers and legislators that this is a critical issue as long as basic cost data are not included in budgetary or related documents.
Does the state provide an annual or biennial tax expenditure budget (or similar description) of the cost of any tax exemptions, credits, and abatements?	Many states use tax exemptions, credits, and abatements to attract or retain economic development and jobs; harmonize state and federal tax codes; or lower the cost of food, clothing, or other basic consumer goods. A dearth of data on such expenditures makes it difficult for policymakers to consider their benefits versus their costs.

THE VOLCKER ALLIANCE

Empowering and Inspiring Public Servants

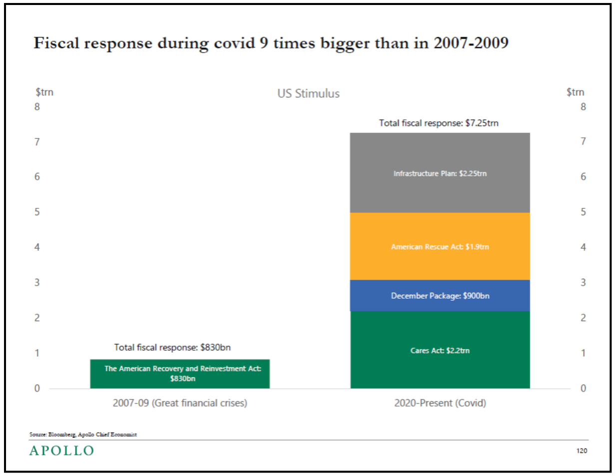
2. From Boom to Bust to Boom: What Comes Next?

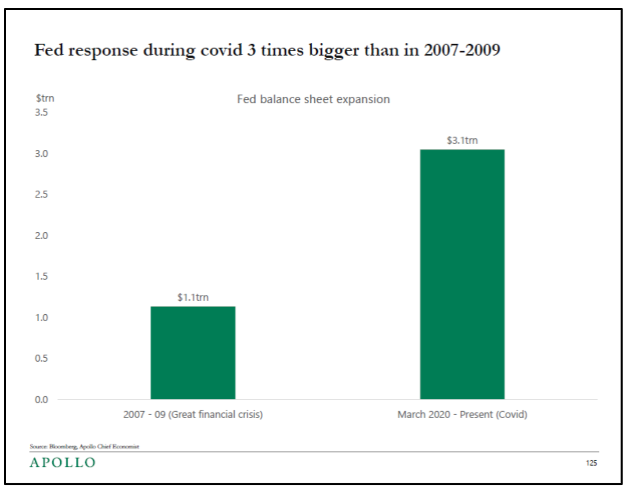
Initial State Fiscal Responses to COVID-19 Gaps…

- To maintain budgetary balance, ~27 states tapped rainy day funds, general fund balances, or both. Alaska faced $900mm deficit in FY21, $2b gap in FY22 and used Permanent Fund drawdowns to balance budget.
- Most states refrained from major tax increases. Exceptions: NY enacted new millionaire taxes ($4b/yr); NJ millionaire tax ($0.4b); CA suspended net operating loss deductions and limits on business taxes and raised managed care taxes ($8.7b). PA governor proposed 46% rise in PIT rate to 4.49%, offset by low-income credit, corporate rate cut ($6.3b) Numerous states raised tobacco, vaping, motor fuel taxes.
- Some states with low Budget Maneuvers grades used debt to cover shortfalls: IL, and NY MTA borrowed from the Federal Reserve Municipal Liquidity Facility ($3.2b/$3.4b); NJ borrowed $4 billion in muni market; at least 18 states and USVI borrowed $52 billion from US Treasury to bail out unemployment trust funds

…Followed by Federal COVID-19 Relief Legislation…

Unprecedented stimulus: >33% of GDP





- $1.9T American Rescue Plan Act provided $350B Coronavirus State & Local Fiscal Recovery Funds
- States, DC got $195.3 billion of total
- Common uses for SLFRF: water, sewer,
- broadband infrastructure; repayment of state unemployment trust fund
- loans; premium pay
- These align with Volcker Alliance principle: Avoid using one-time revenues to finance recurring costs!
- BUT… some states may be using
- SLFRF for recurring expenditures, including California, Illinois, Pennsylvania. They risk a “fiscal cliff” when ARPA cash runs out by Dec. 2026

THE VOLCKER ALLIANCE
Empowering and Inspiring Public Servants

…Leaving States Flush with Cash. Will it Last?

- FY 2022 personal income, sales, other tax revenues beating initial estimates in at least half of states. Example: NY State tax collections for fiscal year ending April 1 were $121.1 billion — $30 billion above projections a year ago. Capital gains, sales taxes major drivers
- Strong corporate income tax revenues
- Sharp rebound in severance tax collections as oil, gas prices recover
- 'Sin' tax revenues – lotteries, online gaming, cannabis, liquor – booming as personal income remains robust, markets expand
- 'Rainy Day Fund' balances reached record $113B, ~9.4% of general fund spending
- States adopted at least $2.9B in tax cuts in FY 2021; three states enacted personal income tax reductions in 2022; five more are considering them. At least four states suspended gas taxes temporarily. Local property tax rebates also spreading
- *"Over the long-term, there is less certainty about the strength of state fiscal conditions. The one-time nature of federal funds potentially sets states up to face a fiscal cliff as federal funding runs out, but projects and programs funded with federal aid continue."* – National Conference of State Legislatures, "FY 2022 State Budget Update"

Contact Information

William Glasgall
Senior Director, Public Finance

wglasgall@volckeralliance.org
+1-973-715-8665
@Wglasgall

For more information, visit www.volckeralliance.org
Follow us @VolckerAlliance

THE VOLCKER ALLIANCE
Empowering and Inspiring Public Servants