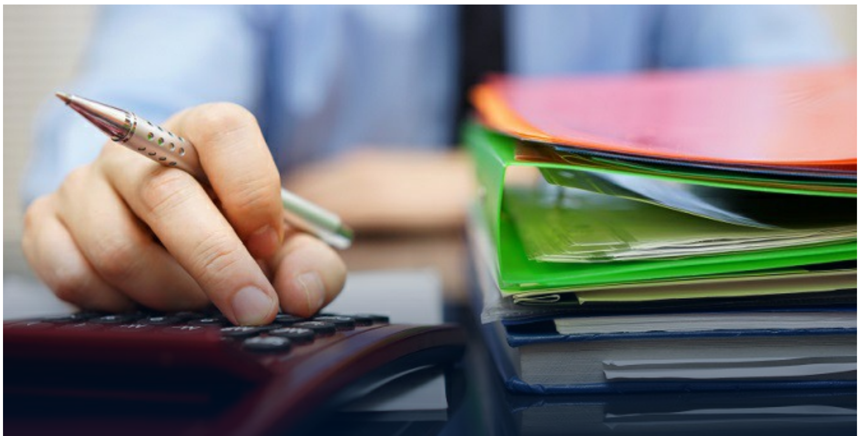

Report: Slowdowns in state spending lead to difficult choices

TAX AND BENEFITS CHALLENGES | DEC 27, 2016

In its most recent State Expenditure Report (Report), issued in November, the National Association of State Budget Officers' (NASBO) described slowing state spending rates in 2016, following the highest spending rate in a decade that occurred in fiscal year 2015. The Report, which analyzed data from actual fiscal years 2014 and 2015, and estimated data for fiscal year 2016, revealed that total state spending grew an average of 4 percent in fiscal 2016, down from the 10-year high of 6.9 percent in fiscal 2015. Declines in revenue growth were the main cause, including drops in personal income tax, sales tax, and corporate income tax revenues. Slower growth of federal fund collections due to a deceleration of Medicaid spending also contributed, as contrasted with the substantial increase in federal funding in 2015.

A summary provided data showing year-over-year percentage spending growth, by fund source, as follows:

Fund source	Fiscal year 2014	Fiscal year 2015	Fiscal year 2016
State funding sources	4.1%	5.5%	3.1%
Federal funding sources	3.4%	10.4%	5.8%
Total state expenditures	3.8%	6.9%	4.0%

Even so, the Report asserts, despite the slowdown of state spending, all program areas saw "at least a small increase in spending" between fiscal year 2014-15 and 2015-16. The data reflects the percentage changes in the major spending categories during these periods as follows:

Spending category	Fiscal year 2014-15	Fiscal year 2015-16
Elementary and secondary education	5.2%	2.6%
Higher education	5.0%	4.8%
Public assistance	-1.4%	2.0%
Medicaid	13.6%	6.9%
Corrections	3.0%	2.0%
Transportation	4.0%	6.3%
All other (includes the Children's Health Insurance Program, institutional and community care for the mentally ill and developmentally disabled, public health programs, some employer contributions to pensions and health benefits, economic development, environmental projects, state police, parks and recreation, housing, and general aid to local governments)	4.5%	0.9%
TOTAL:	**6.9%**	**4.0%**

In an article addressing the Report, the Hill pointed out that the modest growth that it addresses is sparking fears of recession beyond the few jurisdictions we considered earlier this month, Ohio, Florida, Illinois, all of which are in precarious fiscal situations.

The revenue shortfalls have caused 19 states to enact mid-year budget cuts, "more than in any year outside of a recession since 1990." The director of California's Department of Finance told the Hill that "[a] recession is coming sometime soon, but I think economists in all of the state offices would tell you that there's a really hard economic forecasting angle of predicting when that's going to happen." He noted that California, like others states, "has seen sales taxes consistently miss revenue targets in recent months, spurred by lower consumption."

In addition, Oregon's governor has taken steps to cover a $1.7 billion budget hole, and Massachusetts' governor has ordered nearly $100 million in spending cuts. Pennsylvania may see a structural deficit of as much as $2 billion, and Virginia legislators anticipate grappling with a $1.5 billion budget hole.

Overall, the Hill explained,

> States were forced to cut a total of $2.8 billion out of their budgets in the last fiscal year, and more states are likely to face cash flow crunches in upcoming legislative sessions. Seventeen states implemented cuts to their K-12 education programs, and [11] states cut public assistance programs.
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> Energy-producing states like Alaska, Louisiana, New Mexico, North Dakota, Oklahoma and Wyoming were particularly hard-hit, as falling

global commodity prices caused extraction tax revenues to tumble. Among the 12 states that saw revenues decline in 2016, nine are major energy producers.

TAX POLICY PREDICTIONS FOR 2017

Building on this reality, the Tax Foundation identified several patterns that have come to light in recent years:

- **Reduced Taxation of Capital:** There is an emerging consensus that these taxes impede economic growth and are ill-suited to the modern economy;
- **Lower Income Taxes but Higher Sales Taxes:** Since 2008, 15 states and the District of Columbia have adopted individual income tax cuts, and 15 states and the District of Columbia have reduced corporate income taxes. But over the past 18 months, several others, such as Kansas, Louisiana, and South Dakota, have raised sales tax rates;
- **The Erosion of Corporate Income Tax Bases:** This has reduced states' reliance on this revenue source and forced consideration of alternatives. For example, Ohio, Texas, and Nevada have all adapted a Gross Receipts Tax in recent years;
- **Fewer Estate and Inheritance Taxes:** Just 12 states and the District of Columbia still impose the estate tax, and only four have inheritance taxes. Only two states, Maryland and New Jersey, currently have both, but by January 2018, New Jersey's estate tax will be fully phase out;
- **Growing Utilization of Triggers and Phase-Ins:** The Tax Foundation opines that revenue triggers may become the default mechanism by which states implement tax reform.

As the Report states, most states' constitutions disallow incurring operating deficits. Accordingly, when revenues come in below estimates, lawmakers should make difficult spending choices. This has created many fights over conflicting priorities, just one more trend that is not likely to go away any time soon.

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