State Fiscal Conditions for FY 2006:
States Rebounding but Cautious

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Overview

The economic recovery begun in FY 2003 looks as if it will continue into FY 2006. Gross Domestic Product averaged 3.2 percent growth and employment grew by an average 1.65 percent throughout 2005. The Western States are doing considerably better than the rest of the nation due to substantial job growth led by Nevada with employment increases averaging 6.5 percent in 2005. Every state in the West exceeded the national average in job growth. State revenues grew across the nation with increases in all major taxes, continuing eight straight quarters of double-digit growth. State revenues exceeded expectations in all but six states in FY '05 with surpluses expended to restore funding to programs reduced during the economic downturn and to replenish rainy day funds. The economic picture is not entirely rosy; however, major increases in Medicaid and education funding have taken up much of the budget surpluses. Overall spending increased 6.5 percent for FY '05 – very near the average increase for the past 28 years, and is expected increase by 6.3 percent for FY '06.

Economic Indicators

Gross Domestic Product experienced sustained growth through FY 2004 and FY 2005. The growth of business activity is reflected in state budgets with very impressive increases in corporate and personal income tax revenues.

Percent Change in Real Gross Domestic Product
From previous quarter
Unemployment continues to fall across the country, down to 4.7 percent in January, 2006. The Western States report some of the lowest rates where unemployment rates are generally less than four percent. Hawaii reports the lowest unemployment rate in the nation at 2.4 percent while Alaska reports the highest rate of 6.7 percent.º

Reasons for Growth

State revenues have rebounded impressively since the economic downturn of FY ’01 and into FY ’02. The first quarter of FY ’06 recorded the fastest growth in state revenues since 1991. The reasons for growth in state revenues are due largely to economic growth which is borne out by the relationship between employment growth and state revenues in the fastest growing states. The West reports both the highest growth in state revenues and one of the fastest growing regions in terms of job growth.

State Revenue Changes
Year-to-Year Change in Total Tax Collections

Another reason for the growth of state revenues is the nature of the tax systems in high-growth states. States that rely on the income tax saw the strongest growth in revenues (these states also suffered because of the fluctuation in personal and corporate income taxes during the economic downturn). Some states are also adjusting their tax systems to reflect the changing economy. Sales taxes have been adjusted in some states to broaden the base and cover services. Similar measures are being contemplated to extend sales taxes to on-line and catalog purchases. Those states that depend on oil, such as Alaska and Wyoming in the West, have seen large increases in revenue due to the high price of oil. A number of states have
enacted tax law changes that have decreased total state revenues by an estimated $250 million in the first quarter of FY ’06. It is expected that several states will decrease tax rates as a result of significant surpluses in FY ’06. In the West, Idaho reduced taxes in FY ’05 while Washington increased taxes. Some of the more interesting tax law changes include:9

- Hurricane preparedness sales tax holiday in Florida
- Sales tax holiday for back-to-school purchases (New Mexico)
- Alternative energy consumption incentives (Idaho)
- Tax relief for military personnel (Arizona, Utah)
- Delay phasing an income tax cut (New Mexico)
- Commercial activities tax (Ohio)
- Corporate alternative minimum tax (Kentucky)
- Cigarette tax increases (Idaho, Washington)
- Penalty fee for running a red light (Florida)

**Outlook for 2006**

States are acting guardedly with budgets for FY ’06. Spending is expected to exceed revenue growth projections as state balances are expected to fall by the end of the fiscal year. Most states expect revenues to grow during the upcoming year by an average increase of 2.7 percent. Eight states (Alaska, Idaho, and Nevada in the West) expect revenues to decline, mostly due to the decline in oil prices, or changes in the tax structure.

**Medicaid.** State budgets for Medicaid are expected to increase by an average 7.2 percent compared to an increase of 14.8 percent in FY ’05. Medicaid costs are increasing because of both higher health care costs and utilization rates. A few states have reduced their budgets for Medicaid by reducing benefits.

**Education.** Spending on K-12 education is expected to grow nationally by 6 percent. Hawaii, Kansas and Maryland are making substantial efforts to improve funding for education (Hawaii will increase funding by 20.1 percent to pay for teacher salaries and benefits in addition to several new education programs in the state. Maryland has decided to improve education through a 5-year plan.

**Higher Education.** Higher education is expected to receive an average increase of 5.7 percent nationally. In the West, Hawaii and Nevada will budget more than a 10 percent increase to cover negotiated salaries and benefit increases.

**Corrections.** General fund expenditures for corrections is expected to increase by 3.8 percent over FY ’05. Montana and Hawaii have budgeted increases exceeding 10 percent growth over the previous year.

**Conclusion**

The economy and state revenues continue to improve since the economically troubling days of FY 2001 and FY 2002. FY 2005 was the year most states restored funding for programs
that had been cut in earlier years and replenished rainy day funds. FY 2006 appears to be the year states will move carefully to address needed expenditures in Medicaid and education without raising taxes. Continued growth in the West will keep revenues at high levels compared to other regions of the country, but increases in health care costs, public employee salaries, and in some cases tax reductions will consume expected surpluses.

References:

6 BEA
7 BLS
8 Nicholas, p.6.
9 NCSL, p. 5.
10 NCSL, p. 3.