An Assessment of Southeastern State Fiscal Health

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Introduction

The state budget situation usually goes along with the economic boom and bust cycle. The economic bubble causes the major tax revenue for state governments—personal income tax, sales tax and property tax to increase. In other words, it causes the finance of the state and local sector to grow faster than the long-term sustainable rate. This makes the politically favorable action, such as tax cuts, possible and easy to implement for the state governments. On the expenditure side, economic booms allow states to expand spending on programs like K-12, higher education, correction, Medicaid, and welfare. When the business cycle steps into an economic bust, state governments had to go through painful spending cut and tax increase. This pro-cyclical fiscal policy makes state government vulnerable during the economic recessions. Fiscal health has long been a focus of the study of the state governments finance. It is argued that besides cyclical deficit, most of the states also have the problem of structural deficits. The study of the Wisconsin's budget deficit indicated that it is among the states experiencing a severe crisis. The reason for this severity is that Wisconsin hadn't achieved budget structural balance in 1990(Conant, 2003). On the contrary, another study of Georgia's budget during recession period concluded that Georgia is able to successfully deal with the budget shortfall since it had achieved structural balance in the1990s(Lauth, 2003).

The Government Finance Officer Association (GFOA) advocated for achieving a structurally balanced budget as one of the best practices. It recommends, "that governments adopt rigorous policies, for all operating funds, aimed at achieving and maintaining a structurally balanced budget. The policy should include parameters for achieving and maintaining a structural balance where recurring revenues are equal to recurring expenditures in the adopted budget."

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The Truth and Integrity in Government Finance Project sponsored by the Volcker Alliance aims at examining the budget process of the state governments concerning revenue forecasting, one-time actions to balance the budget, pension/OPEB funding, rainy day funds and disclosure practice. Under each category are there several specific questions that need to be examined based on the thorough examination of the budget documents, bond official statements, CAFR, news release, and various reports. If necessary, researchers will conduct an interview with officials either from the executive branch or the legislature branch to confirm or clarify. Using the preliminary responses to the section of one-time actions and rainy-day funds, this paper intends to assess the fiscal health of the 15 southeastern states in the context of structural budget balance.

This paper proceeds in four sections. Following the introduction, the paper reviews the concept and definition of the structural deficit. The third section presents the descriptive analysis of the preliminary responses to the Volcker project questions among 15 southeastern States. The last section concludes with an overall assessment and suggestions.

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Structural Balance—Concept and Definition

The structural deficit is not a new problem for the States. In the early 1990s, this problem emerged among states and raised the attention of scholars and practitioners at that time; however, the economic booming in mid-1990s increases the states' revenue collection, which disguised the problem of the structural deficit. Even in the late 90s, when states have a relatively large surplus, there were warnings of structural deficits among states. (State Policy Reports,1998).As the economy goes down, this problem emerges again and together with cyclical deficit worsens the states' budget situation. Structural balance is one of the five criteria used by 2005 Government Performance Project to evaluate the state government

performance. It is stated as “The state’s financial management activities support a structural balance between ongoing revenue and expenditure”(GPP, 2005). And the evaluation results reveal that this is the area in which States have the worst performance regarding to budget structural balance with average grading score of 1.84, the lowest among the five criteria of the financial management section.

Budget structural balance, as an indicator of a government’s fiscal position, is not only discussed among the state governments in the U.S. It is has been an issue to be studied at the countries’ level. Particularly, IMF publishes annually their estimated budget structural balance of OECD countries. And Congressional Budget Office of the United States termed structural deficit as the standardized-employment deficit. Since State governments in the U.S. have some unique characteristics concerning budget and they have some budgetary rules like Balanced Budget Rules(BBR) and Tax and Expenditure Limitation(TEL), the concept of budget structural balance has somewhat different meanings.

There is no universally agreed definition of the structural deficit. Generally speaking, the difference between the government revenue and expenditure outlay is the actual budget balance. If the revenue is greater than the expenditure outlay, there occurs a budget surplus; otherwise, there is a budget deficit. It is known that both the revenue and expenditure of a government fluctuated with the business cycle. When the economy is booming, the revenue collection is expanding; and when the economic is going bust, the unemployment insurance benefit will increase, however these changes of the budget balance, which are referred to as the cyclical effect of the budget, can be offset within a business cycle. Therefore, it has a temporary effect on the budget. On the other hand, permanent factors affecting the budget

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balance are usually referred to as the structure effect to the budget balance. According to a working paper by International Monetary Fund (IMF):

> "Permanent elements refer to the enduring components of expenditures and revenues, that can generally be expected to be observed under normal circumstances, by which is usually mean an absence of external shocks and when the economy is operating at a maximum level consistent of capacity utilization with low and stable inflation" (Hagemann, 1999)

Both temporary and permanent factors will influence the actual budget balance. It is simple and useful to consider that there are two parts of the actual budget balance—cyclical balance and structural balance. In fact, the concept of the structural budget balance is to decompose the actual budget balance and remove the cyclical effect. It is often regarded as a fiscal indicator to guide fiscal policies. **"**The Structural balance indicates what the financial position of general government would be if the utilization of the production factors were at a "normal" level. In other words, it represents the difference between revenue and expenditure in a notional cyclically normal situation"(Boije, 2004). Structural deficit as one aspect of the structural balance is stated as "A structural budget deficit is then that excess of public spending over revenues which would persist if the economy were to grow steadily at its highest sustainable employment rate, i.e. at the same rate as potential output"(Muller & Price, 1984).

The Congressional Budget Office in the United States also estimates the budget structural balance, which is termed as "standardized-employment deficit" (The Economic and Budget Outlook: Fiscal Years 1997-2006. May 1996) and it is defined as "the level of the federal budget deficit that would occur under current law if the economy was operating at potential GDP. It provides a measure of underlying fiscal policy by removing the influence of cyclical factors from the budget deficit". Besides adjusting for the effect of the business cycle to the budget, CBO also corrected for inflation and interest payment. The argument for

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removing the interest payment cannot be directly controlled by the legislatures. After adjusting these, it is called primary structural budget deficit, which is regarded as a better fiscal indicator for the change of fiscal policy. At the federal level, the issue of the structural balance emerged in the 1980s because of the accumulated federal debt outstanding.

State governments in the United State also began to pay attention to the structural budget deficit as they had experienced the fiscal crises. To better understand the budget structural balance, it is necessary to start with the difference between the budget at the federal level and state level. The key difference concerning the structural budget balance is that state governments have a separate capital budget and federal doesn't have. Integrating capital budget with operating budget makes federal structural deficit more severe. However, at the state level, the tax-exempt municipal bond market encourages state government to fund their capital projects by issuing bonds. Instead of the actual outlay of the capital projects, only the payment of debt service is on the state annual operating budget. Therefore, the budget structural balance (surplus or deficit) of the state government is referring to their operating budget. Several studies indicated that states are having the problem of structural deficit or structural imbalance(Brown & Reading, 2005; Conant, 2003; Watkins & Smith, 2003). However there is not a clear and systematic definition of the structural balance or structural deficit for the state government. A structurally balanced budget is usually described as a government's ongoing revenue matches with ongoing expenditure, or recurring revenue matches recurring expenditures. The deficit is usually an issue that attracts more concerns. Logically, the structural deficit is described as the ongoing/recurring revenues cannot keep pace with ongoing expenditure/recurring expenditure (Conant, 2003; Khan & Hildreth, 2003).

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In other words, the growth of the revenue cannot keep pace with the growth of expenditures (Proctor, 1994).

In a conference paper, Gates and Thompson(Gates & Thompson, 2005) indicated that since state governments have balanced budget rules, which require state to financially balance budget by the end of the fiscal year, the definition of the structural deficit for the federal government does not fit in the states' situation, and they provides a definition for budget structural balance—" Structural balance is sufficient revenue to meet a state's obligations over the course of the business cycle; under a structural deficit, revenue would be insufficient"(Gates & Thompson, 2005).

Another study of the state budget structural balance by the Center on Budget and Policy Priorities(Lav, McNichol, & Zahradnik, 2005) has a somewhat narrower concept of the structural deficit. In their study, they differentiated structural deficit problem from revenue adequacy problem. Their concept of structural balance does not include some discretionary fiscal policies that cause the deficit, for instance, using windfall revenue to enact permanent tax cuts, initialize new program, or the cost of funding federal government mandates. Their narrower concept of structural balance focuses on the growth rate of the revenue and expenditure and time span of the deficit. Previous mentioned concept or definition of the structural balance imply that structural imbalance/deficit is an indicator of the change of discretionary fiscal policy. The purpose of obtaining the structural balance is to remove the cyclical components caused by business cycle from the budget and to guide the discretionary fiscal policy. Compared to other studies of the structural balance, their definition is narrower; however this study identified potential causes for the structural imbalance among state governments.

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Even though the wording of the concept of the budget structural balance among state governments is different, the core purpose of identifying these unobserved components of the budget balance is roughly the same. The major concern is whether the state government's ability to generate revenue in a long run can meet the public obligation; whether states' tax and spending policy can achieve fiscal sustainability. At state with potential budget structural imbalance problem, unless it is solved, it can concentrate on dealing with the cyclical components of the budget. The state budget deficit crises occurred the past three decades show the fact that structural deficit is hidden by the good economy and emerge at the same times as the cyclical deficit due to the slowdown of the economy and as a consequence worsen the fiscal crises.

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Preliminary analysis

The need for a mid-year budget adjustment serves as a good indicator of fiscal stress. Most states are required to adopt a balanced budget based on the revenue estimates. If the revenue estimates are too optimistic or the revenue shortfall is greater than anticipated, states governments have to take actions prevent from carrying the deficit into the next fiscal year. Question 5 intends to examine the need for a meaningful mid-year adjustment from FY 2015 to FY 2017. According to the responses, six out of the 15 southeastern states needed mid-year adjustment in FY 2015, which are Virginia, Maryland, West Virginia, Arkansas, Louisiana, Oklahoma, and Tennessee. The number of states that needed mid-year adjustment increases to eight in FY 2016. Virginia, West Virginia, Louisiana, Oklahoma, and Tennessee continued to need the adjustment, but not Maryland and Arkansas. North Carolina and Mississippi emerged to need mid-year adjustment in FY 2016, which continued doing so in FY 2017. West Virginia is the only state that needs mid-year adjustment in all the three fiscal years. West

Virginia has experienced consecutive budget gaps since FY 2014. On top of the cut of the base budget, The Governor in West Virginia needs to issue executive order to balance the budget with additional spending cuts.

Some mid-year adjustment intended to fill the budget gap ended with a surplus at the end of the fiscal year. For example, Maryland identified a budget deficit that is about 3 percent of the general fund at the mid-point of the fiscal year 2015. Most of the states' mid-year adjustment calculation is based on the revenue deficiency. Not only did Maryland conduct the revenue deficiency estimation but also the expenditure deficiency. Combining both the deficiency from both the revenue and expenditure side, Maryland's Governor Larry Hogan proposed deficiency appropriations. However, the revenue growth caught up with the original estimation, therefore the FY 2015 ended with a surplus of $214 million. The weak economy in the energy sector is apparently a key factor for the budget gap, the deep tax cuts since the Great Recession exacerbated the fiscal problem (O'Leary & Boettner, 2016).

Corresponding to the GFOA definition of the structural balance—"recurring revenues revenue are equal to recurring expenditures in the adopted budget", the Volcker project has a section of questions that examine a state has used any one-time action to cover the recurring expenditure. The one-time actions include using cash from bonds proceeds, premium or generated from refinancing process, deferring expenditure to the future fiscal year, asset sales, special transfers, and shifts costs to other entities. Table 1 summarizes the responses of the one-time actions questions.

Table 1 One-Time Actions FY 2015-FY 2017

One-time Actions	FY 2015	FY 2016	FY 2017
Did the state use borrowing proceeds to pay for recurring expenditures?	5	5	4

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Did the state use "scoop and toss" refinancing to raise funds for current expenditures and lengthen maturities?	0	1	1
Did the state use bond premiums or other upfront cash flows upon refinancing to pay for recurring expenditures?	4	4	4
Did the state use upfront proceeds or deferral of upfront costs on other financial transactions to pay for recurring expenditures?	3	3	3
Did the state use pension bond proceeds to make the annual required or actuarially determined contribution to any pension?	0	0	0
Did the state defer expenditures into future fiscal year(s) from the current year?	4	3	2
Did the state use proceeds from asset sales to fund current expenditures?	5	4	4
Did the state use transfers into the general fund from special funds to pay for current expenditures?	10	11	7
Did the state temporarily shift costs to other governments or agencies or upstream cash from any such entity to the state that is not part of a regular agreement/process?	3	3	3
Did the state utilize any other one-time actions to balance the budget or cover recurring expenditures?	3	3	3

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The most frequently used one-time action by the southeastern states is the transfer from the special fund to the general fund. Two-thirds of the states used this strategy to pay for recurring expenditure in FY 2015 and FY 2016. The information for FY 2017 is not complete yet. However, the number of states that used this strategy has reached seven by the end of October 2016. The states that transferred from the special fund to the general fund consecutively include Alabama, Florida, West Virginia, Maryland, North Carolina, and Arkansas.

According to a report "Putting the Trust Back in Trust Funds" by the Florida Tax Watch, Florida legislature often transferred from trust fund to general fund to balance the budget. The

trend of the fund sweep is declining. "The 2013 Legislature transferred $385.5 million from trust funds to general revenue to help balance the budget. The 2012 Legislature swept $542.1 million. More than $3.4 billion has been swept since 2008. "(Tax Watch, 2014 P.4) The largest operating fund in Alabama is Education Trust Fund instead of the State General Fund. The general fund appropriation was $1.8 billion and the Education Trust Fund is $5.9 billion. According to a report--"General Fund Sputters Along" by the Public Affairs Research Council of Alabama (PARCA), the FY 2015 general fund includes a one-time transfer of $105 million from a business tax escrow account and $146 million in borrowing from the Alabama Trust Fund (PARCA, 2015). Alabama transferred $ 80 million from the education trust fund to the general fund in FY 2016. Governor Bentley proposed moving $181 million from Education Trust Fund to General Fund for FY 2017 budget and using budget stabilization fund to replace it in FY 2017 (Carson, 2016).

Arkansas, Louisiana, and Oklahoma are identified as the states that deployed most types of one-time actions to pay for the recurring expenditures. These three states used bonds proceed, bond premium, and asset sales proceed consecutively from FY 2015 to FY 2017. Louisiana adopted “scoop and toss” practice to lengthen the maturity in FY 2016 and FY 2017.

Besides recurring revenues and recurring expenditures, the GFOA best practice also identifies budget reserve as one of the key term related to the structural balance. Even though the rainy-day funds are supposed to deal with the cyclical deficit problem, however, it is not easy to differentiate these types of deficit. What usually happened is that the structural budget imbalance is hidden during the boom years, and the state budget crisis gets exacerbated when the cyclical problem occurs during bust years. This is partly due to the elasticity of the

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revenue structure. With a high elastic tax structure, the revenue growth during the boom years is faster than the economic growth. Therefore the surplus generated during the good years may cover the potential structural problem underneath. The pro-cyclical fiscal policy may make it even worse, for states may enact permanent tax cuts or expanding spending. Since State governments started to adopt rainy day fund (budget stabilization fund) in the early 1980s, there has been the discussion on the optimum balance for the rainy-day funds. The initial proposal is the Wall Street rule of thumb for private sectors—5 percent of the general fund revenue. However, the recent budget crises were more severe than anticipated. As a result, 5% percent rule seems not appropriate for the governments' situation. Raising the rainy-day fund balance also involves political risk, for citizens may consider it as a waste of tax dollars if a large amount of idle money is set aside. The recent Pew Center report on rainy day deposit advocated for linking the rainy-day fund balance to the revenue volatility. The Volcker project also has a question examining whether the rainy fund balance or contribution tied to the revenue volatility. Virginia is the only southeastern state that is among the 12 states that link the rainy day balance to the revenue volatility at various degrees identified by the Pew Center study.

Moreover, the Volcker project also examines the replenishment policy and use policy of the rainy day fund. Even though most of the southeastern states have some replenishment plan, there are only three states specify the time limit for replenishing the rainy day fund, namely Alabama, Florida, and South Carolina. Alabama has two rainy day accounts located in the Education Trust Fund and the General Fund. The time limit for replenishment is respectively six years and ten years after the withdraw. Florida is currently in the process of replenishing its rainy fund. Over one billion dollars were used in the FY 2009. According to

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the replenishment plan, five equal repayments started in FY 2012 and ended in FY 2016. South Carolina has two budget stabilization funds—the general reserve fund and the Capital Reserve fund. The General reserve fund needs to be used after depleting the Capital Reserve Fund and be repaid within five years Six southeastern states specify the minimum balance for rainy fund ranging from 5% to 8% of the general fund. Tennessee requires the minimum balance to be 10% of the estimated tax growth. There are also six southeastern states that specify the maximum balance of the rainy day fund ranging from 5% to 15% of the general fund revenue or appropriation. Virginia limits its rainy fund balance to 15% of the average income and sales taxes from the previous three fiscal years, which reflects the tie to the revenue volatility.

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Table 2 Policy of the use of Rainy Day Fund

Approval Authority / Purpose	Executive	Appropriation	Supermajority approval
Offsetting budget deficit	AL, FL,MS	GA, NC	DE, LA
Cash shortfall/temporary transfer	FL,MD, MS	MD	
Revenue shortfall/revenue reduction	FL ,TN	KY, NC, OK, SC,VA,MD	LA
Other emergency	FL, MS	NC	AL, OK

Table 2 shows how the southeastern states regulate the use of rainy day funds. Most of the rainy day funds are used for offsetting budget deficit or filling the revenue shortfall. However, some states also use rainy day funds for the cash shortfall and other emergencies than the economic downturn. Florida, Maryland, and Mississippi allow the governor or the treasurer to

deploy rainy day fund for cash flow needs under specific circumstance, as long as it is repaid within the fiscal year. It usually needs legislative approval to deploy the rainy day fund in the appropriation bill to offset the budget deficit or deal with the revenue shortfall. Some states even require supermajority approval to deploy the rainy day fund. For instance, Delaware requires 3/5 votes to appropriate rainy day funds and Louisiana needs 2/3 votes.

Furthermore, we trace the rainy day fund balance back to 1988 and show a trend of the rainy day fund balance as a percentage of the general fund revenue with the access to the fiscal surveys provided by the NASBO. Figure 1 depicts each southeastern state's rainy day fund balance compared to the national average level and the southeastern average level from FY 1988 to FY 2015. The southeastern states' average rainy day balance level is close to the national level. Most of the state peaked the balance level around 2007 or 2008 before the Great Recession started to affect the state budget, except for Florida, which had the highest balance in FY 2000. West Virginia reached a new peak after the Great Recession in FY 2014 with the balance over 20 percent of the GF revenue. It started to drop as the budget situations started to deteriorate in FY 2014. Both Georgia and Mississippi almost restore the pre-recession level after a deep drop during the recession. South Carolina returned to its peak in FY 2011, but it dropped again in the following fiscal year. Delaware kept a steady balance in the rainy day fund over the decades, which are around 5%. Five states have remained lower than the national average through the years after the Great Recession namely, Alabama, Florida, Kentucky, Virginia, and North Carolina.

Assessment and Discussion

It has been almost a decade since the Great Recession. Are State governments prepared for the next budget crisis? Although the in-depth analysis is needed for assessing the

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fiscal health of the southeastern states, the preliminary descriptive analysis has already revealed some concerns. Arkansas, Louisiana, and Oklahoma may have a structural problem in their budget, for they used various one-time actions to pay for the recurring expenditure. West Virginia and Mississippi are currently facing budget challenges, for both states needed to enact deep budget cut consecutively. Despite the high level of rainy day fund, West Virginia needs to take other one-time action to balance the budget. Mississippi's budget problem seems to be related to their optimistic revenue forecasting. The relatively low level of rainy day fund in North Carolina, Kentucky and Virginia may raise a red flag.

More importantly, the preliminary overview of the one-time action in the budget process and the rainy day fund policy and balance among 15 southeastern states may raise some thought-provoking questions. Scholars in public budgeting and finance have been seeking for the optimal level or rainy day fund since its adoption in the early 1980s. There may not be a one size fit all solution. Tying the rainy day balance to the revenue volatility may well serve the purpose of the rainy day fund, which is designed to save during boom years and spend in the bust years. This recommendation is based on the assumption that the revenue structure is elastic. In other words, the revenue structure keeps up with the economic change. It again raises the question whether the state revenue structure is obsolete. According to a Forbes report, Wal-mart is still the largest retailer, but Amazon is catching up. "Traditional retailers have been given a run for their money amid a decline in mall traffic and growing consumer preference for shopping online and at discount and fast fashion stores"(Gensler, 2016). The emergence of the sharing economy also challenges the current tax system. When we try to assess the fiscal health of a state government, we may need to move a

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step further to evaluate whether its tax system is aligned with its economic structure and resilient to it economic changes.

Most of the previous studies on state and local fiscal crises focus on the causes of the fiscal crisis and responses to the crisis. It is equally important to examine the fiscal surplus during the boom years. Whether states learned from previous crises and conducted appropriate fiscal policies to cope with the economic fluctuation or states did not learn at all and their actions make the situation even worse.

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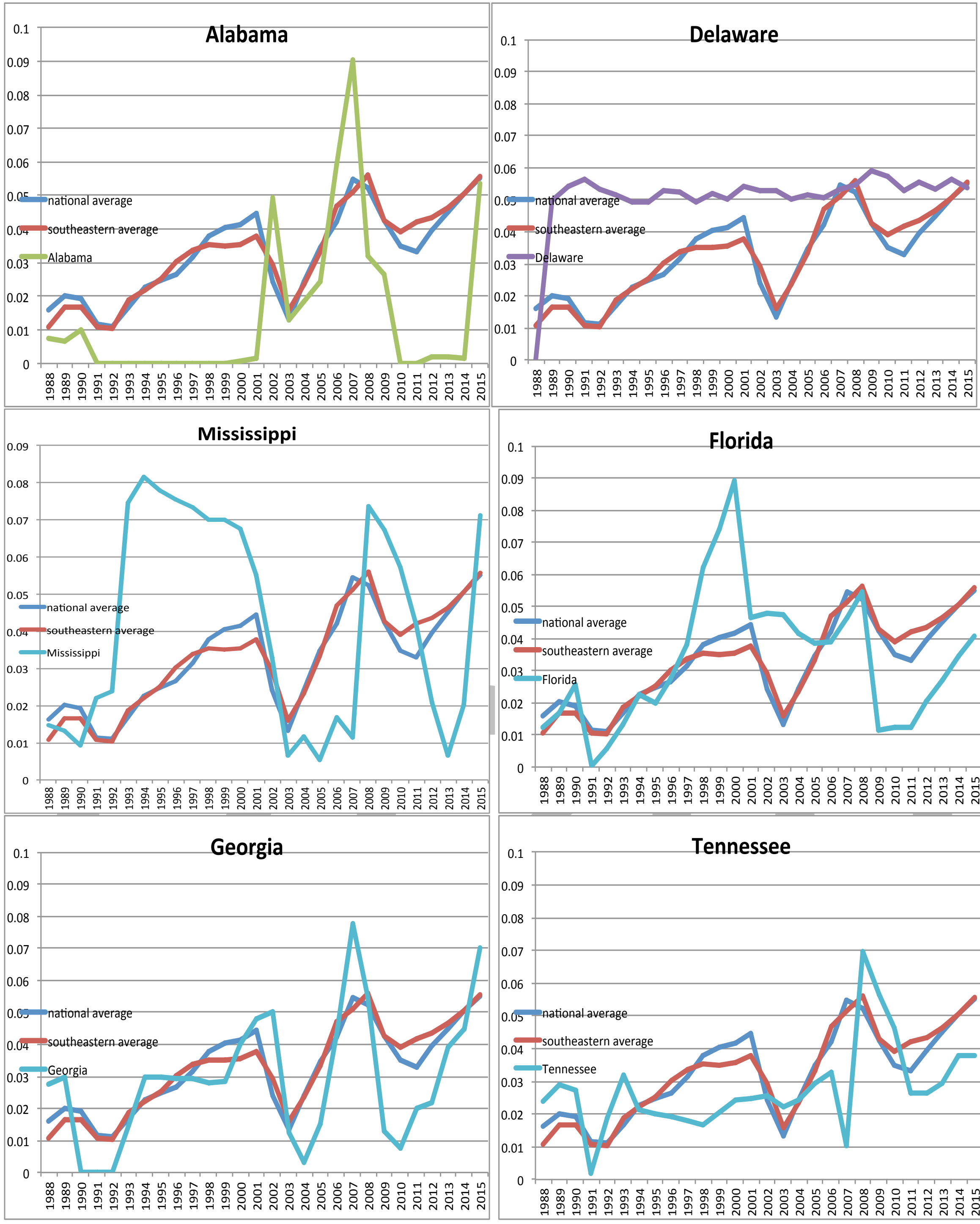
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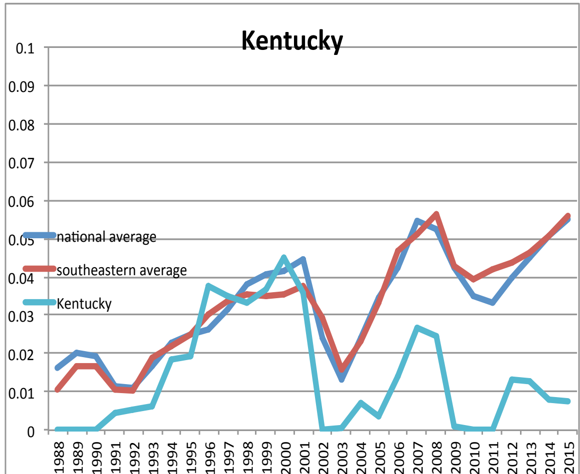
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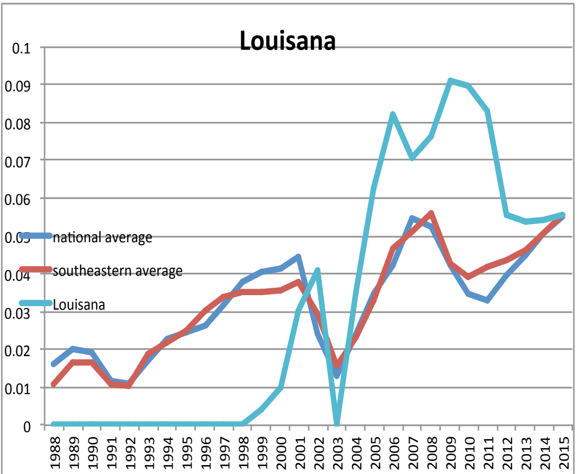
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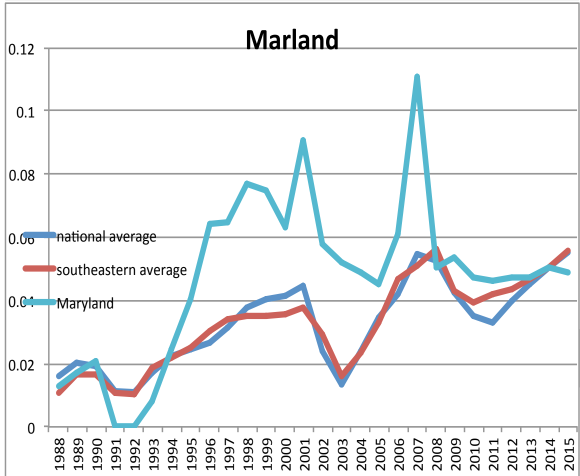
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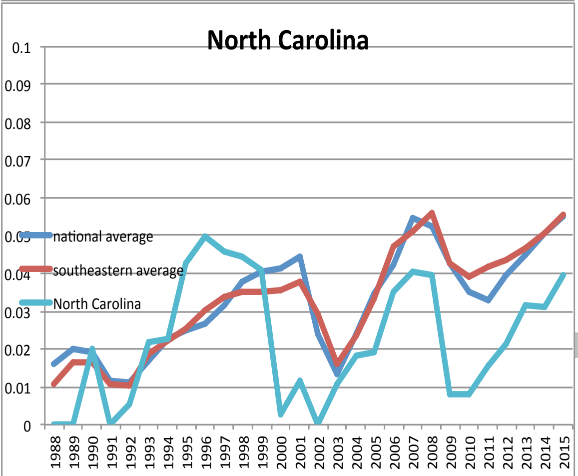
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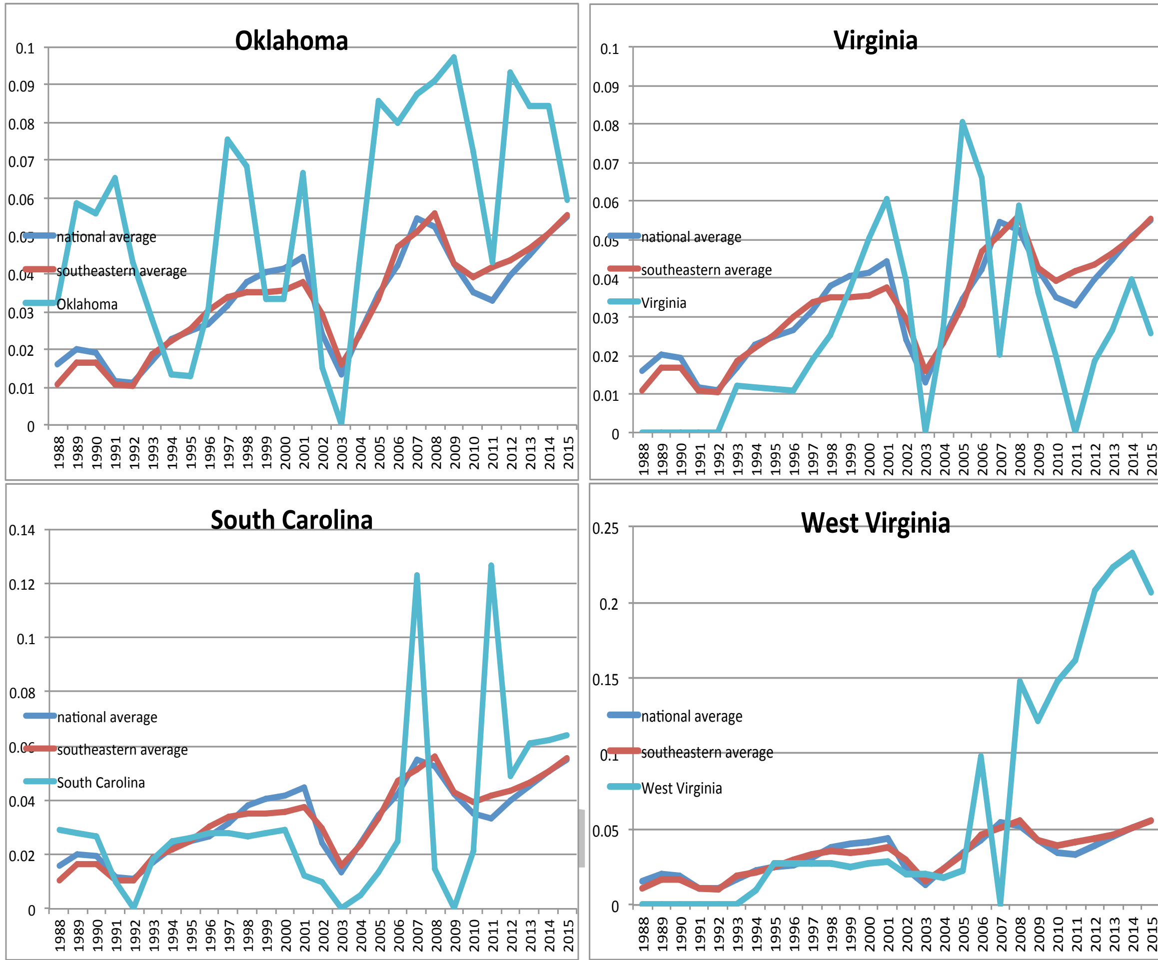

Figure 1 Southeastern States' Rainy Day Fund Balance

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