RESEARCH

Economic Watch

United States

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Economic Analysis

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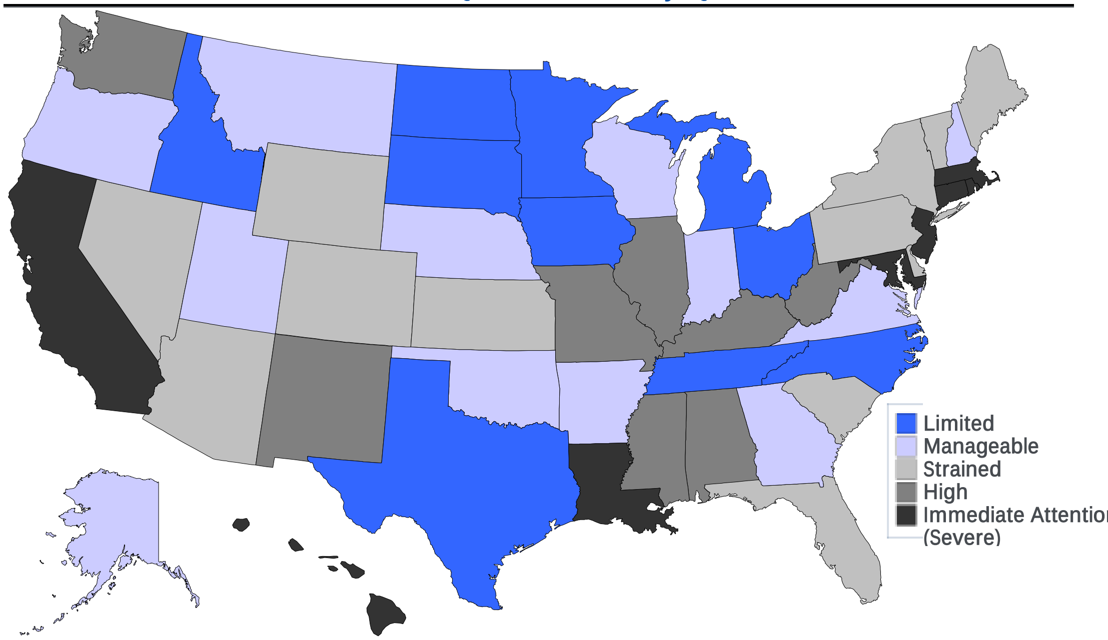
State Fiscal Stress Indexes

First Quarter 2012

- Although revenue collection has improved and states have made substantial cuts to trim deficits, pressures persist as federal funding declines
- The gap between the projected historical trend and realized revenue will close in approximately 20 states in 2012
- FY2012 revenue collections have trailed estimates in several states, most notably in California and New Jersey
- 10 states face mid-year budget shortfalls in 2012, and 19 states face budget gaps in FY2013. More cuts or higher taxes will be needed in a slow-growth environment.

Chart 1
State Fiscal Stress Indexes, First Quarter 2012, by Quintile



Source: BBVA Research

Our fiscal stress indicator is composed of two major components. First, a cyclical component combines three variables: the differences of state tax revenue and initial claims from their trends and the quarterly growth rate of the BBVA Compass state monthly activity index (a proxy for GDP). This cycle component reveals contemporaneous improvements in the state's fiscal situation. Second, a structural component compares any projected FY2012 & FY2013 budget shortfalls and the latest available data for the balance of the budget stabilization fund, interest payments as a share of expenses, the pension funding ratio, and the shortfall of government-wide total revenue and expenses. The cyclical and structural components are combined to form the final index. Source: BBVA Research

State Budgets Remain Under Pressure

Although the overall picture has improved during the previous year, less-than-stellar economic growth in 2011 and slowing growth in the labor market means that many state government budgets remain strained. During the past year, state governments experienced rising revenues as employment grew and sales taxes rose due to resilient personal spending. Indeed, personal consumption growth outpaced that of personal income during much of 2011. However, personal consumption has pulled back from its previously high pace, and job growth has slowed in 1Q12 as China's expansion has dipped and uncertainty about the European crisis envelops markets.

Many states made tough choices to balance their current fiscal year budgets, and thus only ten states now face a mid-year gap that will have to be closed. Nevertheless, states have seen actual revenue trail estimates, and thus the prospect of additional cuts to state budgets is high for FY 2013. For example, California's budget deficit heading into FY2013 has now swelled to more than $16 billion due to overly optimistic revenue forecasts from the governor's office. In New Jersey, Governor Chris Christie has announced that FY2012 revenue will trail estimates by more than $1.3 billion as it is growing too slowly. Louisiana will need additional cuts to close a nearly $200 million mid-year gap and an additional expected shortfall for 2013. Both in Louisiana and Missouri, legislators need to finalize an agreement to close projected budget gaps.

Some states with substantial budget issues have taken the necessary steps to devise a balanced budget for FY2013. Maryland has also been experiencing slow revenue growth and a "doomsday" budget was to take effect July 1 that would have cut over $500 million in expenses in FY2013. Instead, however, last week the legislature opted to raise income taxes on approximately 14% of taxpayers to avert the drastic cuts. Also last week, Connecticut also agreed to a balanced budget without raising taxes in part by trimming Medicaid benefits for low income residents. Yet, the state has substantial interest payment requirements on pre-existing debt and must find solutions to better fund its pension system. Massachusetts leaders are confident that they can close a nearly $1.4 billion projected gap without raising taxes; however, they are proposing to draw from the state's rainy day fund and even consider restoring some funding to previously cut programs.

Illinois continues to struggle despite raising state income taxes last year. Although revenue collections have jumped due to the substantially higher tax rate, the governor is proposing to cut $1.4 billion (down from a previous $2.7bn estimate) from the state's Medicaid program to keep it solvent. Furthermore, the state's pension funding ratio is the lowest in the nation – at just above 40%. The strained state budgets will continue to take their toll on local governments and municipalities in the coming fiscal year. For example, in Illinois, although state tax collections are higher, the legislature cut the share of transfers to local and municipalities from 10% to 6% of total collections last year. Projected decreases in federal transfers to states will also result in less money flowing to local municipalities.

On the plus side, revenues are improving, and this year we project that nearly 20 states will be back on track with their historical trend of revenue; yet, growth will be too slow to quickly restore the cuts states had to make in prior years. To ease the pain, however, states and municipalities are now starting to ramp up their debt issuance to take advantage of record low borrowing costs as treasury yields continue to fall and investors look to municipalities for stable returns. The rise in supply, however, means that the least credit-worthy states such as Illinois and California are being forced to offer higher yields to attract investors – a reflection of their precarious budget situation – yet the yield spread between low and top-rated issuers remains in check due to high demand.

Bottom Line. Although state governments have committed to balance their budgets (and many have already passed balanced FY2013 budgets), substantial challenges remain. Although low borrowing costs are aiding a modest expansion in debt over 2011, rising credit default swap rates in nearly all states that issue debt during the past two months suggest that investors are taking note of current pressures. Heading into the new fiscal year that begins July 1 in most states, residents should expect further cuts to state-run programs and perhaps higher taxes and fees to offset slowing revenue growth.

Table 1
Ranking of Individual States

Better

			Cyclical Components			5- Year Credit Default Swaps	
			Difference from Trend			* Not Available	
State	Fiscal Stress Rank	Structural Rank (Budget Comparison)	Initial Claims	Tax Rev.	3-Month Growth	Current Price (May 23)	1 Month % Change
	Higher rank denotes best position, ordered by lowest stress = 1						
ND	1	33	9	1	1	*	*
TN	2	2	3	8	24	*	*
SD	3	5	10	14	10	*	*
TX	4	7	28	10	3	81	-8.1
MN	5	15	32	4	8	96	8.8
NC	6	3	2	37	18	87	13.7
OH	7	6	12	19	17	138	7.8
IA	8	14	18	6	12	*	*
MI	9	9	1	5	32	147	-2.7
ID	10	23	35	30	2	*	*
NE	11	4	45	16	44	*	*
IN	12	17	21	25	7	*	*
OR	13	22	29	15	4	*	*
WI	14	8	27	13	39	94	0.85
AR	15	11	11	36	26	*	*
VA	16	10	17	39	22	*	*
AK	17	1	7	50	50	*	*
NH	18	30	49	9	5	*	*
UT	19	16	43	41	14	*	*
GA	20	19	41	27	30	*	*
MT	21	12	40	35	34	*	*
OK	22	29	33	12	20	*	*
NY	23	24	36	33	15	123	-1.09
SC	24	18	6	42	28	*	*
KS	25	27	38	18	29	*	*
NV	26	31	48	3	35	128	6.70
DE	27	25	14	21	40	58.6	0.01
PA	28	21	24	32	36	140	10.6
ME	29	26	26	23	45	*	*
AZ	30	20	47	43	27	*	*
CO	31	36	42	20	6	*	*
FL	32	28	50	38	25	119	10.8
VT	33	35	39	24	9	*	*
WY	34	13	30	49	16	*	*
WV	35	34	16	17	43	*	*
IL	36	46	20	2	33	237	12.1
WA	37	39	23	34	23	95	2.65
MS	38	37	5	28	49	*	*
AL	39	38	8	44	41	*	*
KY	40	43	4	26	19	*	*
NM	41	32	46	48	38	*	*
MO	42	40	22	29	42	*	*
MA	43	45	25	22	13	135	12.3
CT	44	48	31	11	21	142	6.6
MD	45	42	44	40	31	118	26.9
RI	46	47	13	7	47	126.4	9.2
NJ	47	41	19	46	37	156	5.6
HI	48	44	37	31	48	*	*
LA	49	49	15	47	46	*	*
CA	50	50	34	45	11	199.6	12.8

Worse

Source: BBVA Research