NORTHERN TRUST
ASSET MANAGEMENT

STATE BUDGETS IN 2019

NINE YEARS INTO ECONOMIC EXPANSION, NEAR-TERM BUDGET OUTLOOKS HAVE IMPROVED; LONG-TERM BUDGETARY CHALLENGES REMAIN

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Budgets in fiscal year 2019 are largely stable – projecting moderate revenue growth supported by improved economic data, federal tax policy changes, and potential for greater collection of sales taxes. Much of the revenue growth will be utilized for education, Medicaid, and pension funding. Use of reserves, operational borrowing, and temporary tax increases to fill budget gaps is down this year over last and projected reserves are largely stable to slightly positive over last year. As of July 1, only Massachusetts and South Carolina have yet to formally pass a budget, down from 11 states at this time last year.

Resiliency across the states remains largely weak to moderate as states struggle to build rainy day funds in the midst of spending pressures and rising fixed costs. States continue to face long term spending pressures in pension, Medicaid, education and infrastructure spending.

Revenue: As per the National Association of Budget Officers Annual Survey, states are expecting personal income and sales tax collections to rise by a median 4.2% and 3.5%, respectively.

Personal income taxes should experience growth derived from continued employment gains, healthy dividends and realized capital gains, as well as potential emerging wage growth.

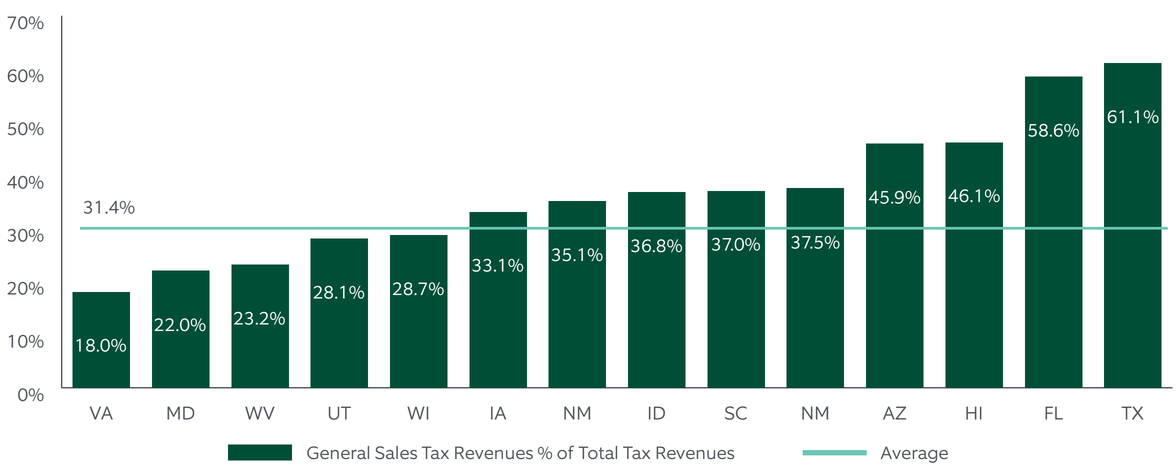
Sales tax collections are likely to benefit both from greater after-tax income from the federal tax reform (though limits on **state and local tax deductions** will mute the overall positive impact for high tax states) and the **Supreme Court ruling on internet tax collections**. The decades old Supreme Court ruling prevented states from collecting any sales tax from retail purchases made over the internet or other e-commerce establishment unless the seller has a physical presence in their state. Now, overruled in June 2018, the

Fiscal 2018 Projected Budget Results Improved over 2017
(# of states)

	FY2018	FY2017
Projected surplus based on original budget	24	13
Midyear budget reductions	9	22
Deficit projected	11	33

SOURCE: NASBO Fiscal Survey of States – 2018 (2017) collection of online sales tax is positive for the states and local governments in an e-commerce era. The magnitude of the benefit depends on each entity's reliance on sales tax revenues and the extent to which online sales taxes are already being collected. Prior to the ruling, 31 states passed "kill quill" laws to force at least partial collection. At state government level, in five states, sales tax revenues account for more than 50% of total revenues, of which Texas and Florida are the two states that will benefit from expanding their online sales tax collection under the ruling.

SALES TAX REVENUE DEPENDENT STATES LIKELY TO BENEFIT MOST FROM ELIMINATION OF PHYSICAL PRESENCE RULE (currently without "Kill Quill" rule)



SOURCE: US Census, Tax Foundation, Northern Trust

Energy producing states such as Alaska and Louisiana show signs of modest recovery with the rebound in oil prices. However, economic concentration in oil and gas continues to pose additional problems for these states, where both the local tax base and state revenue are volatile and tied to commodity prices and severance taxes.

Spending: Spending pressures vary widely across states. **Pension burdens** continue to stress state finances as historical underfunding and weaker than expected market performance in pension plans continue to push liabilities higher. The median return for public pension funds for the fiscal year ended June 30, 2017 was 12.4%, which followed a lackluster median investment return of 0.54% in fiscal 2016. As a result, combined state pension liabilities are still projected to grow by 21%[1] by 2018. Overall, returns lag the long-term forecast, funding is largely inadequate, and budgets remain highly vulnerable to sustained market swings in large pension plans.

Fiscal 2019 (18) number of states proposing cuts to:

K-12 Education	7	(11)
Higher Education	10	(19)
Public Assistance	10	(15)
Medicaid	10	(14)
Corrections	6	(16)
Transportation	7	(13)
Other	6	(18)

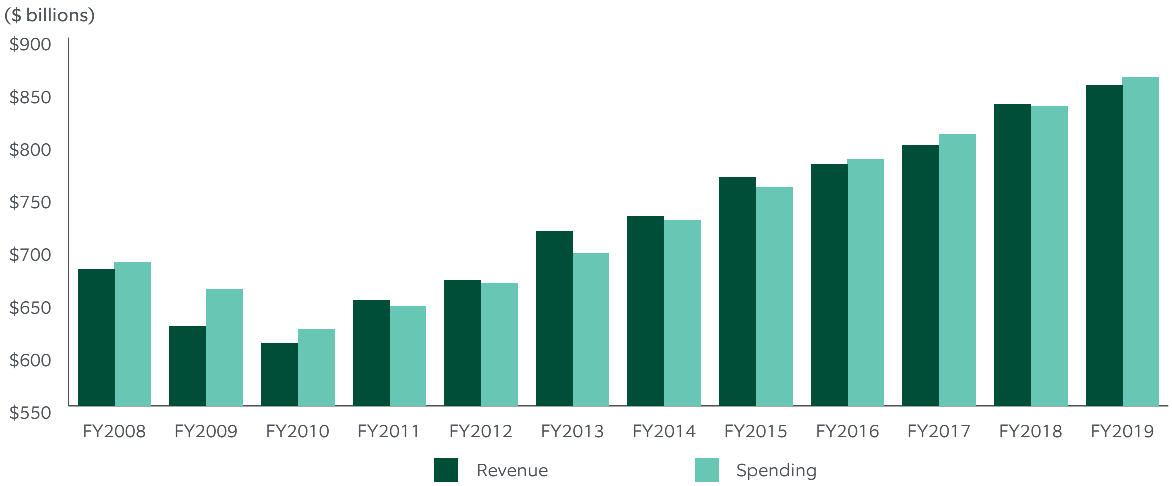
SOURCE: NASBO Fiscal Survey of States – 2018 (2017)

[1] *Moderate Adjusted Net Pension Liability Growth in 2016 Precedes Spike in 2017* – Moody's Investor Service, September 2017

Rising **Medicaid** costs continue to be a significant concern for states. As the second largest component of state general fund expenditures, even moderate cuts in federal support pose a material threat. Across the states, total Medicaid costs are estimated to increase by 5.2% in 2018 and 1.9% in 2019[2]. Long-term cost growth, according to the Congressional Budget Office (CBO), is projected at 5.5% annually.

AGGREGATE 2019 SPENDING WILL OUTPACE BUDGETED REVENUES

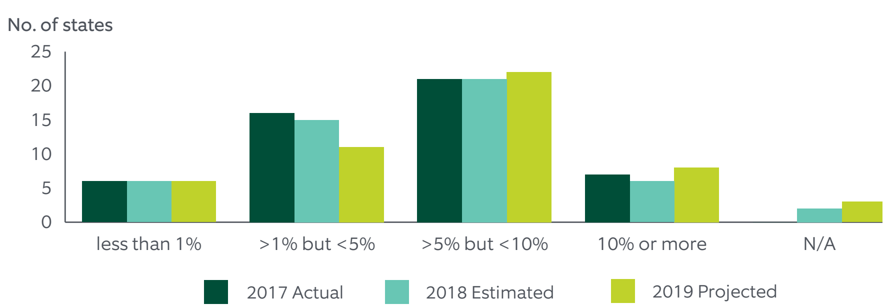
$7 billion gap is driven by near $3 billion gap in Alaska and several smaller state adjustments and transfers



SOURCE: National Association of State Budget Officers Fiscal Survey of States 2018 (2017)

Rainy day fund balances that are critical to states during an economic downturn or budget shortfall are projected to improve in several states. States have been building their reserves since fiscal 2011 to fiscal 2018 while median rainy day fund balance as a share of general fund expenditures grew from 1.9% to 5.8%, surpassing the pre-recession peak of 4.9%. The median balance is projected to rise to 6.2% in fiscal 2019 as 28 states are projecting their rainy day fund balances to grow, while only three states are projecting a decline. However, despite the growth in rainy day funds, several states will still struggle in case of a moderate downturn.

RAINY DAY FUNDS LARGELY STABLE AS % OF EXPENDITURES



SOURCE: NASBO Fiscal Survey of States

[2] *The Fiscal Survey of States – Spring 2018*. National Association of State Budget Officers

State	2019 Budget Outlook (may not match credit outlook)	Recession Resiliency (ability to manage moderate downturn in 12-18 months)
Alaska	**Negative:** Alaska relied on a $2.1 billion draw from reserves to fix the budget deficit in fiscal 2018. The 2019 budget relies on a withdrawal of $1.7 billion from Permanent Fund earnings and another $700 million from reserves to plug the deficit. Although oil prices have rallied, it is still insufficient to plug the massive budget holes for this oil dependent state.	**Healthy:** In the short-term, resiliency is healthy, with 2018 year end reserves at about 2.5 times the budget and another $47 billion in its Permanent Fund that can be used with a constitutional amendment. However, resiliency will weaken if dependence on reserves to plug budget gaps continues at this rate.
Arizona	**Stable:** Arizona is expected to end fiscal 2018 in line with budget. The balanced budget for 2019 prioritizes education. The budget calls for a moderate 3.2% revenue growth and 3% spending growth.	**Weak:** Arizona is prone to higher revenue volatility, as seen during the recession. While the economy continues to improve and fixed costs are manageable, narrow reserves limit the state's ability to absorb economic swings.
California	**Stable:** California concluded 2018 slightly below the revised projections for the year, but still well above the original budget with growth in reserves. Fiscal 2019 budget is near balanced, continues to grow funding for education and social programs and funds the CalPERs annual pension requirement but significantly underfunds CalSTERs. Total revenue is projected to grow at 4% in 2019 driven by personal income tax revenue growth.	**Moderate:** While fixed costs are moderate compared to peers, pension funding is well below pre-recession. Progressive tax rates and dependence on capital gains creates a high level of volatility in revenues, and medical costs will continue to pressure expenditures. While still moderate compared to the potential for revenue swings, reserves of 13% are favorably keeping pace with budget growth and are significantly higher than they were pre-recession.
Colorado	**Stable:** Colorado expects to outperform 2018 revenue projections. State projects strong revenue growth of 5% in 2019 based on strong economic outlook and recovery in oil prices. The 2019 budget is close to balanced, but held back by underfunding of pension contributions.	**Moderate:** Reserves of 11.7% vs. policy of 6.5% provide moderate hedge against downturn given the elevated revenue volatility. Revenue flexibility is constrained by taxpayer bill of rights (TABOR) restrictions that prohibit tax increases and require the rebate of tax revenue above a certain threshold. Pensions are underfunded but low fixed costs and healthy economic growth support moderate rating.
Connecticut	**Stable:** Connecticut anticipates a 3.5% deficit for fiscal 2018. The fiscal 2019 budget is structurally balanced with 2% revenue growth and includes a full pension payment.	**Very Weak:** Reserves of 3.7% are at their highest level since the recession but are insufficient to hedge the volatility of the revenue structure. High fixed cost burden of 30% of general fund spending coupled with large unfunded pension liability and lagging economy will present severe challenges to the state's budget should a downturn occur.
Florida	**Stable:** Fiscal 2018 performance was in line with revised budget expectations. Fiscal 2019 budget is structurally balanced with anticipated revenue growth of 3.6% and full pension contributions. Sales tax revenue that comprises 78% of tax revenue has grown 43% after declining 18% during the downturn.	**Moderate:** Reserves have improved after the downturn and the current 7.8% combined rainy day fund and general fund balance provides a moderate cushion for the above-average volatility exhibited in the sales tax base. Fixed costs and pension liabilities are manageable.

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Hawaii	**Negative:** Hawaii's revenues underperformed in fiscal 2018 by 3.3% along with a modest reserve draw. In 2019, Hawaii expects 4.5% revenue growth but relies on another reserve draw. While reserve draws are moderate, Hawaii's use of reserves during economic expansion signals structural imbalance and is expected to continue till 2022. Budget plans to fund only 78% of annual pension requirement.	**Moderate:** Hawaii's highly progressive income tax, expenditure growth outpacing revenue growth, and very high fixed cost burden (given high debt, unfunded pension and OPEB liability) make it more vulnerable in downturns. The projected combined reserve of 14.6% at the close of 2019 is among the highest of the states, but provides only a moderate cushion to hedge elevated downturn risk.
Illinois	**Negative:** Illinois has not presented a balanced budget since 2001. The 2019 budget is out of balance by as much as $1.5 billion, relying on non-recurring revenue such as asset sales and investment earnings. The backlog of bills stands at $7.04 billion despite issuance of $6 billion of bonds to pay it down. Fixed costs are expected to reach 30% of revenues and the aggregate funding ratio of the state's five pensions was just 40 percent.	**Very Weak:** Illinois has no formal rainy day fund and does not use a consensus revenue estimate, resulting in annual budget miscalculations. Illinois has chosen to use short-term fixes such as bond refinancing to buttress spending and one-off loans to fulfill the recurring obligations of public worker pensions and health care benefits. The significantly high legacy costs affects core government programs such as education, public safety and social services.
Kansas	**Stable:** Following two years of budget gaps, tax rate hikes helped the state to balance the budget. 2018 projected revenues are 2% over budget estimates. 2019 is structurally balanced and anticipates 3.4% revenue growth. Budget includes full actuarial pension payment that is still below tread water contributions.	**Weak:** Although reserves are 6% of budget, reserve position is challenged by moderate revenue volatility, stagnant economy, rising fixed cost due to underfunding of pension and political uncertainty.
Kentucky	**Stable:** Kentucky has a persistent structural imbalance, but the gap has narrowed substantially to less than 1% due to tax law changes that broadened bases while lowering tax rates. Pension reforms fully fund required contributions while putting the state on target to reach a pension funding ratio of 70% in 30 years, up from 32% for all systems. The adjustments place new state employees in a hybrid retirement plan.	**Weak:** Historically weak reserves and high fixed costs remain areas of concern. Kentucky underperforms the nation in key indices such as population growth, personal income and housing values. The eastern portion of the state is particularly vulnerable to poverty and the adverse effect of EPA regulations impacting the coal industry. On a positive note, the improved revenue structure should reduce the pattern of mid-year expenditure reductions.
Louisiana	**Stable:** Revenue collections for 2018 outperformed the budget as economic trends improved along with the rebound in oil prices. A temporary sales tax increase was set to expire in July leading to a fiscal cliff of over $1 billion for the 2019 budget, but due to a revenue boost from the enactment of the federal tax reform and a reinstatement of a portion of the sales tax increase for the next seven years, the 2019 budget is balanced with minimal spending cuts.	**Weak:** Budget flexibility is limited as more than half of the state's general revenue is obligated due to constitutional provisions which have historically led to budget cuts being focused on health care and higher education. Reserves of 3% limit resiliency in downturn as volatility is elevated due to reliance on sales tax and exposure to the energy industry. Fixed costs are 10% and slightly above peers.

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Maryland	**Stable:** Maryland expects to report a small operating surplus for 2018. Fiscal 2019 budget is structurally balanced, expects 2% revenue growth and full pension contributions. Revenues have historically been less volatile but expenditures are expected to keep pace.	**Moderate:** Projected reserves are expected to be 5.6% of budget. Fixed costs are higher than peers but are manageable and amortize quickly. Large government presence makes the state vulnerable to cuts in the federal budget.
Massachusetts	**Negative:** Tax collections for 2018 are running well ahead of revenue consensus and this represents the best revenue growth since 2011. The proposed 2019 budget is structurally unbalanced and anticipates 3.5% growth. As of this report, Massachusetts has not passed a budget for 2019 and there is no provision for a full pension payment.	**Weak:** Massachusetts anticipates reserves of 5% of spending but is not well positioned to deal with an economic downturn due to elevated volatility of revenues and high fixed cost burden. Reserves have declined in each of the last five years despite economic expansion and annual pension contributions remain inadequate to stem liability and cost growth.
Minnesota	**Stable:** 2018 projected revenues are closely tracking budget estimates. The 2017-19 biennium budget is structurally balanced and projects a 4.9% revenue growth in 2019. Recently enacted pension reforms will improve the pension profile, but contributions below tread water level still persist.	**Moderate:** Minnesota has moderately high volatility, given its dependence on a progressive income tax rate. Fixed costs, at 6%, are expected to increase modestly due to pension reform. Reserves of 11% provide a moderate financial cushion.
New Jersey	**Negative:** New Jersey anticipates a revenue shortfall of 4% in 2018. The budget anticipates 1.4% revenue growth and plans to fund only 60% of the annual pension payment. Budget imbalance continues to be driven by severe pension underfunding.	**Very Weak:** Liquidity is a concern for New Jersey with reserves at just 2%. After a series of chronic budget deficits and lagging economy, reserves have been depleted. The state's volatility is above average and debt is high. It severely underfunds the pension, resulting in rapid liability growth.
New York	**Stable:** New York anticipates a small operating surplus for fiscal 2018. Fiscal 2019 budget is structurally balanced and holds spending growth at 2% as has been the case for the past several years. Budget includes full funding of its annual pension contribution. Federal tax reform and changes to the Medicaid Disproportional Share Hospital program may challenge the state.	**Moderate:** New York has been historically resilient. Fiscal 2018 reserves are expected to be 5.7% of budget. The progressive income tax dominates the state's revenues. Revenue volatility is above average and fixed costs are moderate with high debt and a well-funded pension.
North Carolina	**Stable:** North Carolina projects a modest surplus in 2018. For 2019, the budget is structurally balanced and anticipates modest revenue growth of 2.3%. Budget includes full pension payment.	**Healthy:** Budget reserves at over 18% of spending provide healthy cushion to support a moderate downturn. Fixed costs are low given manageable debt and well-funded pensions.
Oklahoma	**Stable:** Oklahoma managed to outperform its 2018 budget deficit through new revenues, targeted cuts and use of reserves. The 2019 budget is structurally balanced and projects a strong 8% revenue growth mostly driven by tax increases on cigarettes, motor fuel and oil and gas production. Budget includes full pension payment.	**Weak:** Exposure to the energy industry creates elevated volatility. Debt levels are low and overall fixed cost burden is modest compared to peers. Inability to grow reserves above the current 1% limits flexibility in an economic downturn.

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Oregon	**Stable:** 2018 performance is slightly below projections, reflecting a downward revision to corporate income tax even as personal income tax continues to show growth. The 2017-19 biennium budget is balanced based on strong projected personal income tax revenue growth and includes a full pension contribution.	**Healthy:** Oregon's progressive income tax revenue structure demonstrates somewhat elevated volatility. A moderate fixed cost burden and combined budget reserve of over 15% provides a relatively healthy cushion to absorb short-term shock.
Pennsylvania	**Stable:** Revenues are projected to meet expectations for the 2018 budget, but with reliance on $1.7 billion of borrowing. Favorably, the state economy outperformed in 2018 following several years of economic underperformance. Fiscal 2019 budget is near balanced, projects 3% revenue growth and funds pensions somewhat below tread water levels.	**Weak:** Fiscal 2018 projected reserves are negative and state is ill-equipped to handle a moderate downturn. Volatility is relatively low, but fixed costs at 16% of revenue are elevated with poorly funded pensions and moderate debt. Low resiliency is driven by a lagging economy, aging demographic, negative reserves, and reliance on interfund borrowing eight years into an economic expansion.
Texas	**Stable:** Texas anticipates ending 2018 with revenues exceeding conservative projections of 5.5% due to the energy turnaround and robust economic growth. 2019 budget is near balanced and projects a 3.8% revenue growth. The state continues to underfund the pension, causing liabilities to grow.	**Healthy:** Conservative budget estimates and strong reserves nearing 19% will provide a solid cushion for moderate sales tax volatility and to cover some costs associated with Hurricane Harvey recovery and cleanup efforts. Fixed costs are manageable, though pensions need additional funding. While somewhat concentrated in oil and gas, the economy has become more diversified.
Washington	**Stable:** Fiscal 2018 revenues were a healthy 7.2% above budgeted estimates. Fiscal 2019 budget is near balanced along with a strong 5.7% revenue growth projection. The budget includes a full pension payment and uses reserves to plug the deficit. The budget includes significant investments into education.	**Healthy:** Healthy reserves of 13.7% provide a good cushion to support below-average volatility in the sales tax and export based revenue structure and rising K-12 education expenditures. Fixed costs are manageable, incorporating a high debt load and well-funded pensions. We note elevated exposure to international trade agreements.
Wisconsin	**Stable:** Wisconsin's 2018 revenue estimates are closely tracking the budget. The 2019 budget is near balanced and projects a 2.7% organic revenue growth assumption. Budget includes full annual pension payment.	**Moderate:** Wisconsin continues to carry a negative 9% generally accepted accounting principles (GAAP) balance, which it has struggled to close since the recession. Actual cash reserves have improved to 4.8% of the budget. While reserves are low, the state has below average revenue volatility and low fixed cost burden, comprised of moderate debt and a fully funded pension system that by design reduces risk to the state.

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