

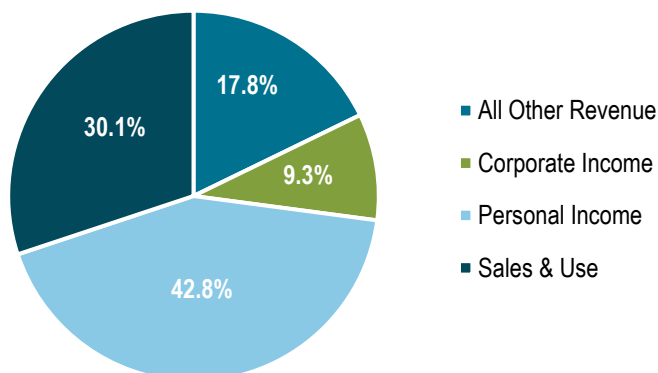
State of the States 2026: Strong Fiscal Footing Amid Tighter Conditions

States enter 2026 with record-high rainy day funds (RDFs), providing ample flexibility to navigate soft economic growth, cost pressures, and federal uncertainty. Many states anticipate decelerating revenue growth and have implemented spending cuts, suggesting that they are bracing for tighter fiscal conditions. But even if these pressures materialize, states have plenty of fiscal tools beyond their RDFs to manage their budgets: they can increase revenues, reduce expenses, and delay spending. With all these resources at their disposal, we expect most states to effectively manage financial challenges that may arise.

Revenue Expectations Are Slowing

To measure a state's financial condition, it's useful to track reserves and review revenue and expense trends within its main operating fund, known as the general fund. The latest edition of NASBO's Fiscal Survey of States* projects a median revenue growth rate of 0.3% for fiscal 2026. While small compared to post-pandemic trends, it also reflects the conservative measures that management teams employ in their budget process. For example, fiscal 2025 general fund revenue collections were 3.7% above target, with 34 states collecting above enacted estimates. One major reason for this slower expected revenue growth is a projected 5.2% decrease in corporate income taxes. But this source is also the smallest of the states' main tax revenue streams — with personal income and sales being the others — and notoriously difficult to predict as businesses can shift payment dates and often strategize to reduce taxation. In our view, the anticipated drop underscores the cautious tone when states set revenue expectations.

FIGURE 1
General Fund Revenue Sources (Fiscal 2026 Estimates)



Source: NASBO, Fiscal Survey of States Fall 2025 Fiscal Survey

*National Association of State Budget Officers Fall 2025 Fiscal Survey of States: <https://www.nasbo.org/reports-data/fiscal-survey-of-states>



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KEY POINTS:

Many US states expect to end their current fiscal years with record-high rainy day funds: Median balances are projected to reach 14.4% of expenditures — the second-highest level ever recorded.

Revenue and spending growth are slowing: States are projecting minimal revenue growth and muted spending increases, reflecting conservative budgeting and targeted cuts.

Federal pressures are intensifying: Federal policy uncertainty, tariff exposure, disaster-related funding gaps, and Medicaid present growing challenges.

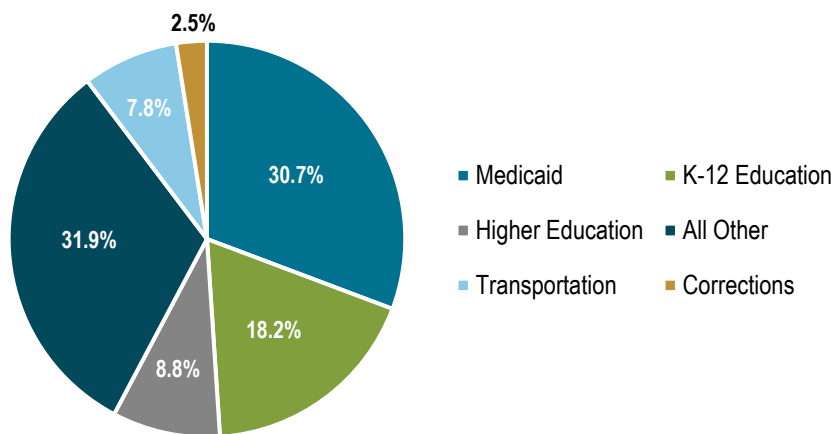
Most states are still well-positioned to manage challenges: 31 states expect rainy day fund increases in 2026, and strong reserve levels allow states to address temporary shortfalls — while structural gaps still require longer-term fixes.

General fund spending growth is also expected to step down in fiscal 2026 to a median 0.2% rate. The decline shows how states have effectively allocated pandemic aid and tax windfalls for one-time uses. The lower growth also incorporates an uptick in targeted cuts, hiring freezes, and vacant position elimination. While these measures suggest that some states are bracing for stricter budget environments, we consider them preferable to disruptive and reactionary mid-year cuts.

Federal Pressures Are Ramping Up

This spending trend comes at a time when federal policies could affect certain states. For example, tariffs may disproportionately harm economies with substantial trade and manufacturing while recent FEMA aid delays and denials suggest states more prone to natural disasters might increasingly rely on their own funds for relief. Medicaid, which comprises over 30% of budgets, is another pressure. This expense has climbed sharply over the last three years due to higher medical costs, elevated enrollment, and reduced pandemic-era federal assistance. While some states have revised their Medicaid programs to curb this growth, additional action will likely be needed given the recent reconciliation bill, which projects a 14% cut in federal Medicaid spending over the next 10 years. This mainly affects expansion states, though with most reductions starting in 2027 or later, budget officers have some time to address the funding gap. Even so, states may need to choose between lowering benefits or using their own resources to sustain them.

FIGURE 2
State Expenditures by Function (2025)

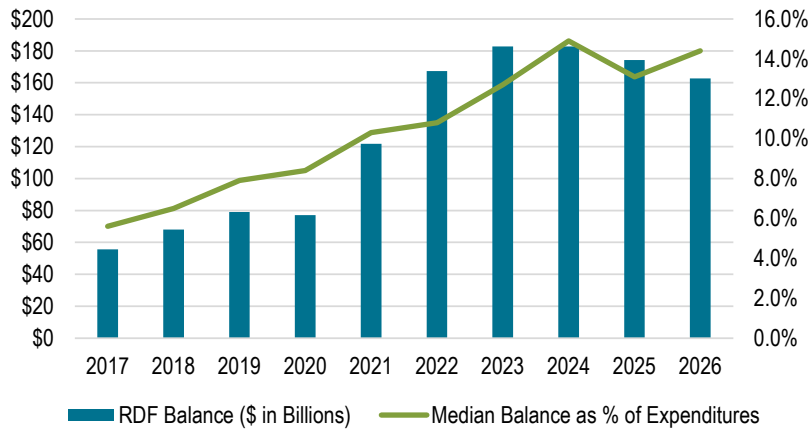


Source: NASBO, Fiscal Survey of States Fall 2025 Fiscal Survey

Fiscal Flexibility Remains Strong

Should these or other issues create fiscal challenges, we believe most states are well prepared. There are 31 states that project RDF increases for fiscal 2026, with the median balance rising modestly to 14.4% of expenditures. This amount is well above historical standards and the second highest ever recorded by NASBO. It's important to recognize the states' efforts to preserve these balances over the last few years, having exercised the fiscal discipline to amass these reserves without applying them to recurring operations.

FIGURE 3
States' Rainy Day Fund Balances Over Time



Source: NASBO, Fiscal Survey of States Fall 2025 Fiscal Survey

Finding the root cause of any budget gap is crucial. Shortfalls resulting from temporary factors, such as economic downturns or one-time expenses, can be addressed with RDF usage — after all, that’s the intended purpose of those funds. But structural problems require permanent revenue and/or expense solutions. Distinguishing the type of gap, if any, is a core part of our analysis when we evaluate the 34 states across our composite. We remain diligent in assessing each of our state exposures based on financial position, state policy actions, and other fundamental factors.

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